PORTFOLIO STRATEGY

FIXED INCOME & CREDIT

KEY POINTS

- Lending standards have become weaker across credit markets
- The ratio of stressed credit has risen in the US and Europe
- In a downturn, recovery rates may be below historical levels
- Investors may see a dispersion between returns from credit portfolios

Credit at a crossroads

LENDING STANDARDS

CARLO SVALUTO MOREOLO

How will weak lending standards hurt credit investors in a global slowdown?

"There has been a general dilution of legal protections in the high-yield market"

Rhys Davies

After over a decade of spectacular growth, credit markets may be facing one of their most difficult years since the 2008 global financial crisis. Issuance of high-yield bonds, leveraged loans and private debt could grind to a halt, amid fears around the economic impact of the COVID-19 pandemic and pressure on the oil price.

In early March, liquidity in the credit markets was drying up as markets panicked at the spread of COVID-19 in Europe. The real test for illiquid credit portfolios will be a global economic slowdown.

Interest rates were already at historically low levels and central banks have reacted to market turbulence by reducing them further. Governments are planning stimulus packages. However, strong demand for the illiquid credit by yield-starved investors in recent years has caused a decline in lending standards. Loan terms strongly favour borrowers, leaving lenders exposed to potential losses on bad credits if economic growth decelerates.

"There has been a general dilution of legal protections in the high-yield market, partly driven by an insatiable demand for yield. Investors have been prepared to accept weaker covenants," says Rhys Davies, senior portfolio managers at Invesco. This is not new, but it has intensified and evolved, to the extent that companies present inflated earnings to investors.

"Investors accept adjustments to EBITDA [earnings before interest, taxes, depreciation and amortisation], which forms an important part of ratios that are tested by legal covenants," he says.

According to Davies, there have been cases where investors are presented with deals with adjusted EBITDA levels 50% higher than the reality. That means leverage is higher than implied by the deal's terms. This is not uncommon, and forces managers to take a view on whether borrowers are capable of managing higher leverage multiples.

"We have to be cognisant of these dynamics and make sure we build our own view on such deals. Our general approach is to remain cautious and be very aware of valuations. We strive to understand the credit risk to the company that we invest in and make sure that the yield that the bonds offer compensates appropriately," he says.

The loosening of covenants in the high-yield market is mirrored by even deeper changes in the leveraged-loan market, points out Davies. Immediately after the 2008 crisis, leveraged-loan investors could count on regular testing of an issuer's financial strength. Today, there are typically few covenants. Cov-lite deals have become the market norm.

It would be wrong to assume that managers have let borrowers take full advantage of their relative power. Jens Vanbrabant, head of high-yield at Wells Fargo Asset Management, points out that managers have occasionally pushed back. He says: "There have been cases of stressed high-yield bond issuers moving their intellectual property into subsidiaries to store value away. Some issuers have tried to take advantage of indebtedness covenants, which limit the amount of additional debt they can issue during the life of the loan. Investors have pushed back on such egregious behaviour."

Besides, the ample liquidity available in the leveraged loan market, at least until COVID-19 spooked investors, seems to have offset the impact of looser credit standards. Ranbir Lakhpuri, senior portfolio manager for secured finance at Insight Investment, says: "In the broadly syndicated loan markets, flows have been two ways. Investors can trade out of loans that underperform.

"Yes, covenant packages are weaker, but this is mitigated but still reasonable equity levels and much better liquidity than a decade ago, because there are far more long-term investors in the market.

"We have also a level of credit discipline in the market, where investors have stepped away from transactions because they were unhappy with the fundamentals of the business."

He adds: "We are far more cautious in the direct lending space, because as investors we do not benefit from the ability of trading out of deals." Instead, Insight is focusing on trade finance, a less competitive area where loan terms and yields are still attractive. Investing in this area, in his view, requires specialist knowledge.

A pact with the devil?

For direct-lending investors, a loosening of lending standards is a serious problem. So far, it is not clear how the trend has affected the traditionally more opaque area of private debt.

Patrick Marshall, head of private debt and collateralised loan obligations [CLOs] at Federated Hermes, says: "We've not quite seen cov-lite yet in mid-market direct lending, but we have seen I would call cov-loose.

"Lenders are putting in place covenants that either have such high headroom that they are meaningless or that do not get more conservative along the life of the loan.

"Covenants flatline throughout the life of the loan, instead of getting stricter and stricter every quarter, thus incentivising the borrower to improve its EBITDA and reduce leverage, in order to be in a good place to repay the loan.

> **"Even before the markets reacted to the spread of COVID-19, there was a lot of competition around pricing in the market"**
>
> Barry Fowler

"In general, we see certain lenders setting covenants that do not have teeth. That allows fund managers to tell investors that they do not do cov-lite deals, while, in fact, they are giving their borrowers the flexibility they need, in order for them to pay the higher yields that managers need. It's a pact with the devil," says Marshall.

EBITDA adjustments are also more common in the direct lending market, particularly among uni-tranche lenders, according to Marshall. Some 30% to 40% of mid-market deals include earnings adjustments.

These trends are linked, he says, to the rising valuations of private equity assets. Private equity firms are forcing more risk on lenders in order to achieve the returns they have promised. "Large-cap private equity firms that have not been able to deploy the capital they have raised are now forced to look at mid-market deals and pushing for large-cap loan protection on mid-market companies," Marshall says.

It is difficult, however, to establish how widespread this phenomenon is across private debt. Barry Fowler, managing director for alternative income at Aviva Investors, says: "In the real estate debt space, we do hear that some sponsors are increasingly demanding transactions to be done on a covenant-lite basis, but we still see a sufficient volume of transactions with covenant protection, which allows us to write enough good-quality business."

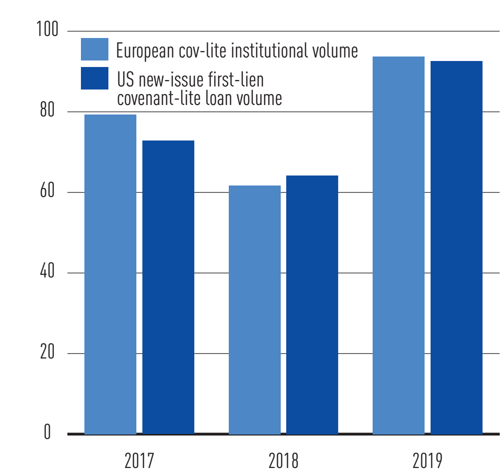
When it comes to private corporate debt, it depends on transactions, adds Fowler. "We have quite a substantial book of private placements in the investment-grade space, and we still see financial covenants in those trades. That is one of the attractions of investing in that segment. Similarly, in terms of leveraged loans, we are still able to invest in single-B issuers and get tests of leverage, cashflow and interest cover."

However, he points out that higher competition for assets has made it harder to find opportunities and has affected loan pricing levels. "Even before the markets reacted to the spread of COVID-19, there was a lot of competition around pricing in the market. We are unwilling to push on the leverage size, and we will not compromise on covenants. Pricing is the only lever we can pull," he says.

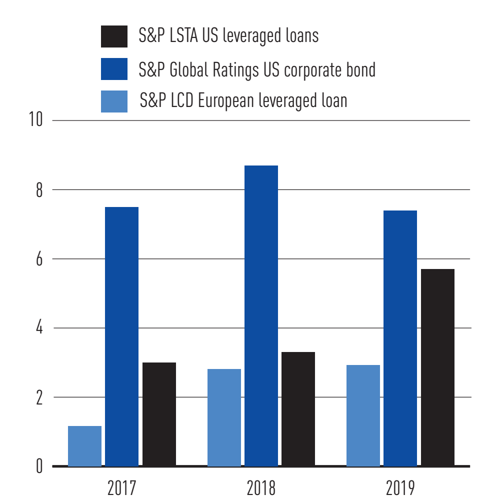
The prevalence of soft loan covenants is bound to affect default and recovery rates as the credit cycle unwinds. "I think the average recovery rate for high-yield bonds will be anywhere between 55% to 60% in the next default cycle. We are looking at a drop of 10 to 15 percentage points in the average recovery rate as a result of the increased flexibility that borrowers have to manipulate, so to speak, covenant packages,", says Vanbrabant.

Lower recovery rates are likely as softer covenants mean issuers will survive for longer before they default. It is hard to say whether this will be a generalised phenomenon spanning

1. Cov-lite issuance dominates Europe and the US
2017-19, three-month rolling average



2. Share of distressed assets has grown
2017-19, % distressed ratio



Source for both: S&P Global Ratings

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across the credit spectrum.

There is evidence, however, that a growing share of credit issuers are already suffering. Galia Velimukhametova, senior investment manager for distressed debt at Pictet Asset Management, says: "Over the last three years, we have seen a constant increase in the ratio of stressed high-yield bonds and leveraged loans as a share of the total, both in the US and Europe, despite the relatively benign economic environment.

"In February, the stressed ratio for high-yield bonds was 11% in the US and around 7% in Europe. It was less than 3% in Europe at the beginning of 2018.

"This is due to exuberance in the credit market, which has seen issuance grow quite dramatically, driven by an unstoppable demand for yield. A lot of companies that were quite weak in terms of credit quality managed to issue paper, and should have never been allowed to issue as much debt as they did. A few years later, the market has come to realise they cannot outgrow their balance sheet. Another reason for the rise in the stressed ratio is the relatively disappointing economic growth in Europe."

Credit investors can go into the next default cycle with the reassurance that, on average, corporates bear historically lower debt-servicing costs. However, if lending standards have been too weak, it may already be too late to protect portfolios from losses. In that case, diversification becomes essential. "We are very big proponents of broad diversification", says John Redding, portfolio manager at Eaton Vance, who specialises in leveraged loans. "We have 500 issuers in our portfolio. Although we do not underweight or overweight sectors as a matter of principle, we will favour more defensive businesses, particularly at this stage.

"This is an income asset class. You earn reasonable income during the life of the loan, but it is really about protecting your upside. Whatever the terms of the loan are, the biggest determinant of how much of your money you are going to get back is the stability of the cashflows of the underlying businesses."

A key repercussion of the weakening of lending standards is higher return dispersion among managers. This is clear from the perspective of Paolo Malaguti, founder and CEO at Credit Vision. Malaguti's firm collects thousands of data points relating to corporate credits. He says his data highlights important differences in how fund managers run credit due diligence, and that established managers that buy large amounts of debt are not necessarily more disciplined with credit assessments. It also suggests that specialist managers might be able to offer an investment strategy more closely aligned to the needs of their investors than more established managers.

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Laura Carpi, managing partner at 3 Peak Consulting, makes a similar case. She warns investors not to be swayed by the size of a private debt manager or its brand strength.

Carpi says: "In the direct lending space, it is key for managers to have experienced teams that have lived through a crisis. This is not the case for many large multi-strategy managers that have set up private debt teams in recent years. These managers often compete with banks for assets, and can stumble into lower-quality credits that banks have rejected."

Returns are at risk for investors that have partnered with private debt managers that have weak origination capabilities, she argues. "For that reason, it pays to add an exposure to more diversified instruments, such as CLOs, that carry low idiosyncratic risk."

High-yield worries grow

HIGH YIELD

JOSEPH MARIATHASAN

Global high yield and loans still offer attractive returns but the worry is about the stage we are in the credit cycle

KEY POINTS

- A crash and a reversal and a crash – where to now?
- Pressure on shale producers is continuing
- The fallout from coronavirus still represents a strong risk to investors

The global high-yield and loan markets have been the most obvious segment of the global debt markets with potential to generate attractive yields when over 30% of investment-grade debt in the world can only offer investors negative yields.

After a calamitous year in 2018, last year saw a bounce back in all asset markets including high-yield and loans. But the crash induced by coronavirus and the oil price shock has taken the world by surprise. The spread of US high-yield over Treasuries widened to well over 600bps in March this year from under 400bps at the end of February and for much of the preceding three years or so. Likewise, the cost of credit default swap (CDS) protection on US high-yield increased from under 300bps in late 2019 and early 2020, to almost 700bps in mid-March.

Grappling with the longer-term implications, means seeing beyond short-term volatility driven by market panic.

The European and US markets have very different sector compositions, with energy accounting for more than 10% of the US high-yield market and with barely a presence in Europe. That accounts for a great deal of the dispersion in results