Bank Loans

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All Bank Loans Are Not Created Equal – Considerations for Investors

As a Corporate Bond Manager we often receive inquiries regarding our thoughts on the Bank Loan Market especially in the current interest rate environment where the 10-year US Treasury Bond yield has increased 1% over the last 9 months. We believe that the asset class may warrant a place in an investor's asset allocation and complement other credit sectors such as Investment Grade Corporates and High Yield but we suggest exercising caution, as all loans are not created equal.

Investors are attracted to Bank Loans for portfolio diversification as well as for:

1. **Floating Rate Coupon –** structured as a spread plus the rate of LIBOR, generally 3-month, thus providing an income stream that adjusts with changing rates and dampening duration risk.
2. **Seniority –** loans are typically at the top of the capital structure having priority status over other investors and historically have exhibited higher recovery rates (65.16% vs. 44.47%) than High Yield bonds in a bankruptcy restructuring.
3. **Security –** loans are often secured by hard assets such as property, plant, and equipment on a first lien basis.
4. **Covenants –** require the borrower to fulfill certain financial conditions as well as prohibit various activities and transactions.

The Financial Crisis of 2007-2008 ushered in a low or near zero interest rate environment that has impacted the structure of post 2008 issued bank loans. In the aftermath of the market collapse, demand for loans as well as the rate being paid on LIBOR, eroded significantly. In order to offer a minimum yield to investors, issuers began to include LIBOR floors on newly originated loans. The floor effectively provides for a minimum yield in a declining rate environment, generally ranging from 1% – 2.5%. For example, if a loan is offered at LIBOR + 250 basis point coupon with a 100 basis point LIBOR floor, then when 3-month LIBOR is at .25%, the yield would be 3.50% (coupon + the greater of LIBOR or the floor). Conversely, the investor will not see his income stream rise until 3-month LIBOR is above the floor. In this example the investor has duration risk from the current rate of .25% to the floor of 1%, as the income stream does not change thus a straight bond is effectively created. The floating rate coupon only provides relief from interest rate risk if the investor is swapping pricing off Treasuries, as in the case with bonds, with LIBOR since Treasuries are highly correlated to the Fed Funds rate (Chart 1) that is established or set by the Federal Reserve. It is plausible that monetary policy does not materially change over the term of the loan, leaving the investor with an equivalent duration of a low coupon fixed rate high yield bond.

Chart 1.

[1] *Source: Credit Suisse for the period of 1995-2012*

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In the current market environment for loans, interest rate risk (LIBOR yield) is the lesser portion of the total return, and the floating rate feature does not reduce the impact of a change in credit quality. To further illustrate this point (Table 1), the following are the characteristics of a loan issued by Heinz earlier this year in conjunction with their leveraged buyout by Berkshire Hathaway and 3G Capital. As depicted, and contrary to common views, the Heinz loan does carry duration risk due to the LIBOR floor and imbedded call protection as the cash flow stream has been altered. If credit spreads widen resulting from a change in credit quality of the company or in market sentiment as a whole, the price would be expected to decline in value approximated by the percentage move in the spread multiplied by the duration measure. The Heinz example demonstrates that the investor has investment risk from two sources: (1) from the current rate of LIBOR to the floor resulting in duration risk, and (2) from the potential change in credit quality or spread risk.

Table 1.

Issuer	HJ Heinz Co.	Equinix Inc.
Security	Term B-2 Loan	Senior Note
Size	$6.5B	$750MM
Index + Margin	LIBOR +250bps	
LIBOR Floor	100bps	
Maturity	6/5/2020	7/15/2021
Call Protection	Yes	Yes until 7/15/2016
Credit Quality	Ba2	Ba3
Leverage	4.5x	4.6x
Fixed Equivalent		
Coupon	4.50%	7.00%
Duration	2.05	2.49
Yield to Worst	3.50%	5.62%

Source: Bloomberg 10/17/2013

Investors have also been attracted to loans as they have historically come with robust covenant packages, such as maximum debt to net worth and minimum interest coverage, intended to prohibit the issuer from engaging in transactions or activities that would be detrimental to the value of the loan. As demand for yield has been high in this zero interest rate world, these protective covenants have been stripped from the large majority of the loans issued over the past two years (Table 2) and are at higher levels than the apex of the LBO boom in 2007. It is important to note that the loan market is roughly $625bn and new issue volumes indicate that the bulk of outstanding loans have been issued in the last three years. In the search for yield, investors have been willing to accept materially weaker credit quality.

Table 2.

Leveraged Loan New Issue Volumes, Face Values (US$mn equivalents)
Global issuers with loans issued in US$
1997- Sep 30, 2013

Global		Ratings							
Annual	Total	BB	B	CCC	NR	TLb	2nd Lien	Cov Lite	% of Cov Lite
1997	28,284	4,283	5,215		18,786	27,926	295		
1998	56,726	12,740	12,170	0	31,816	55,861	865		
1999	59,800	26,351	15,326		18,124	58,977	374		
2000	43,548	19,456	13,499	0	10,594	39,868	140		
2001	34,106	18,608	9,886		5,612	33,573	65		
2002	57,702	37,618	12,321	4	7,759	50,714	630		
2003	89,637	41,719	35,818	1,262	10,839	77,760	3,076		
2004	153,997	46,732	80,227	2,278	24,761	133,547	12,122	65	0.04%
2005	183,789	45,362	93,450	3,196	41,780	161,802	16,606	3,865	2.10%
2006	324,424	102,610	151,201	9,154	61,460	289,406	29,724	27,460	8.46%
2007	388,802	121,696	173,587	19,490	74,029	354,616	30,151	115,175	29.62%
2008	72,362	31,856	20,561	428	19,518	68,326	2,986	2,545	3.52%
2009	38,277	15,789	10,164	700	11,624	35,097	1,530	2,745	7.17%
2010	157,954	71,463	61,182	1,620	23,689	149,694	4,933	8,007	5.07%
2011	231,846	94,253	117,819	3,206	16,568	223,024	7,026	59,101	25.49%
2012	295,317	105,009	161,923	13,156	15,230	268,796	17,156	97,546	33.03%
2013	366,820	121,772	211,703	14,939	18,407	342,251	22,005	218,847	59.66%

Source: BofA Merrill Lynch Global Research

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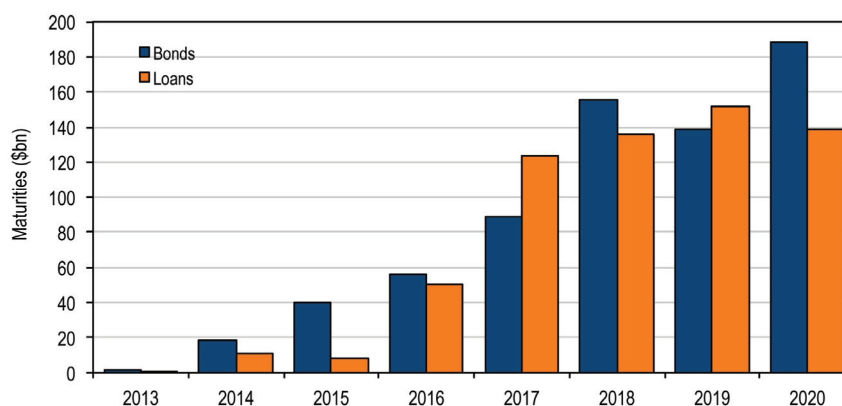
As the changes in loan structure and covenant protection have been addressed, the security and seniority features are attractive benefits. Also, included in Table 1 are the characteristics of a high yield bond issued by Equinix. This security was selected as it has a similar maturity, duration, credit quality, and leverage profile as the Heinz loan. The difference is that the Equinix bond is not secured and is junior in the capital structure. Note that on a yield to worst basis the bond pays 2.12% more in yield than the loan. Is security and seniority worth the give up in yield? The answer depends on where you are in the credit cycle, as secured collateral and seniority has much more value when defaults are increasing or running at a rate higher than historical average. Defaults across the credit markets have been well below historical averages since 2010 . The demand for yield has allowed issuers the ability to refinance their existing debt (stretch out their maturity profile) and obtain a lower cost of financing. Refinancing has bought issuers time, both in the high yield and loan markets (Chart 2), in terms of not having a large liquidity event, such as repayment of principal, and this should contribute to a continuing lower default environment.

Chart 2.



Source: BofA Merrill Lynch Global Research

Summary & Conclusion

We believe bank loans may merit a place and have a purpose from an asset allocation perspective; however, changes in loan structure and stripping of covenants have altered the cash flow investors receive in addition to impacting the expected return outcome. Once thought of as a fixed income investment that has a built in hedge against rising interest rates, many bank loans have become low coupon high yield bonds. Investors should now be able to see that all bank loans are not created equally.

[2]Fitch U.S. High Yield Default Insight, October 2, 2013

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