Tortoise QuickTake
Credit Podcast

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Welcome to the Tortoise QuickTake podcast. Thank you for joining us. Today, senior members of Tortoise provide a timely update on trending topics in the market.

Welcome to this week's Tortoise credit podcast. I'm John Heitkemper, portfolio manager for high yield bonds and leveraged loans at Tortoise.

We're nearing our one year anniversary for the new Tortoise office in downtown L.A., and if you had a time lapse camera in the office since the opening, one trend you might notice is the sprouting of facial hair on several of the men, myself included. I'm not sure whether we've just become too lazy to shave or it's a desperate attempt to look like the millennials on the WeWork floors below us. If it's the latter, we have a little problem: namely, more than a few gray whiskers that reveal our true generational identities.

On the topic of gray hair, the current credit cycle is also beginning to show its age. My colleague, Greg Haendel, spoke last week about increased leverage among investment grade companies, particularly BBBs. In the leveraged finance arena, we're also seeing warning signs, maybe most notably in the bank loan – or leveraged loan – market.

Like BBBs within the investment grade market, the bank loan market has seen tremendous growth in recent years, taking share from high yield bonds in the Lev Fin space. In fact, according to one of the most followed leveraged loan benchmarks, the S&P/LSTA Index, the loan market just topped $1 trillion outstanding, doubling in size from 2010. Several factors have driven the growth over the past few years. The CLO market, which accounts for approximately two-thirds of loan demand, has experienced robust new issue volumes, as securitized investors have sought higher-yielding products.

Additionally, with Treasury rates moving up in conjunction with the Federal Reserve's hiking process, retail investors have sought floating rate exposure, including bank loans, which are indexed to Libor. Since the beginning of 2016, retail leveraged loan funds have seen inflows of nearly $29 billion, which combined with nearly $250 billion of new CLO formation, creates a very strong demand backdrop. And to put those figures in perspective, during that same period, the high yield market has lost nearly $30 billion in retail outflows, with the total high yield market remaining essentially flat over the past two years.

Against the strong demand backdrop for loans, below investment grade issuers, having the choice whether to raise debt in the loan or high yield market, naturally flocked to the loan market. Since 2010, not only have outstanding loans doubled, but the number of companies issuing in the market jumped 50% to over 1,000. Given this rapid expansion, and the extended length of the current cycle, we think it's advisable to look for pockets of trouble, or potential signs of "irrational exuberance," if you will. Here are a few points of concern that we're focused on in the loan market.

First, it's not necessarily the growth or absolute size of the loan market, per se, that should warrant caution, but the composition. With the increase in the number of issuers, the loan market is seeing a higher percentage of "loan only" deals, so called because the issuer's capital structure does not have corresponding unsecured high yield debt. Loans are typically secured by the company's assets, one of the strong selling points of the loan asset class. In default situations, high yield bonds normally absorb the first credit losses, which results in loans historically enjoying higher recovery rates than high yield bonds, with loan-only structures, this cushion is missing. When the credit cycle does turn, we would anticipate loan-only structures to experience lower recovery rates than historical data might suggest.

A second worrying trend is an increase in starting leverage in recent loan transactions. While we haven't seen a return of the massive, highly-leveraged LBOs of the pre-crisis era, there's been a slow creep of late. According to Fitch, starting leverage for 2018 LBOs is 6.4x debt-to-EBITDA, up from 6.2x last year and 5.9x in 2016. Anecdotally, we're seeing more deals with leverage north of 7x, and on top of this, we're noticing that many issuers and underwriters are utilizing aggressive add-backs to boost EBITDA, thereby understating leverage. This is particularly a concern at the end of a cycle when the company many not have the chance to grow EBITDA before an economic downturn hits, potentially leaving the company with an unmanageable debt burden.

Lastly, several years of strong loan demand have given issuers, and their bankers, the upper hand when it comes to negotiating terms. Financial covenants, which require companies to operate within certain leverage and interest coverage constraints, are rare now, with most issuers able to print so-called "cov-lite" loans. In prior cycles, when an issuer bumped up against its financial covenants, lenders were often able to force the company to conserve cash and increase the rate on the loan; cov-lite loans, by contrast, lack these protections and in effect act more like a floating rate bond. Additionally, other structural safeguards traditionally enjoyed by bank loan lenders have also weakened, including requirements to use asset sale proceeds and excess free cash flow to repay debt. Again, these trends suggest that loans could fare worse on the recovery front than they have in past cycles.

Despite the concerns that we've highlighted, there are still compelling reasons to own the asset class. For one, loans offer shelter in a rising-rate environment and look particularly compelling versus BB-rated high yield, which tends to be the most rate-sensitive segment of the Lev Fin market. Secondly, with loan and high yield bonds offering nearly identical yields now, we think it makes sense to move up to the secured portion of the cap structure. But as you can probably guess, we're cautious on loan-only issuers and aggressively leveraged balance sheets, eager to avoid more gray hair when the credit cycle eventually turns.

Thanks for listening and please tune in for future Tortoise credit podcasts.

Thank you for joining us. And stay tuned for our next cast. Have topics you want covered or other feedback to share? Write us at info@tortoiseadvisors.com.

The S&P/LSTA Leveraged Loan Total Return Index is a market value-weighted index designed to measure the performance of the U.S. leveraged loan market based upon market weightings, spreads and interest payments.