

Leveraged Finance:

The U.S. Leveraged Loan Market Approaches Record Defaults, But Still Attracts Investors

Leveraged Loan & Recovery:

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The U.S. Leveraged Loan Market Approaches Record Defaults, But Still Attracts Investors

The king is dead! Long live the king! So went the shout in medieval times when one monarch passed away and a new one took the throne. The same could be said these days for the U.S. leveraged loan market, which had been on all but life support since the height of the credit crunch last fall, but now seems to be springing back to life, albeit in a more limited form than before. Although loan default rates seem likely to continue rising in the immediate future, recoveries will probably be lower than in past late-stage recessions, and some loan asset categories may lose their luster altogether. Still, there will be investors looking to loans as part of their investment portfolios and companies that need to borrow as part of doing business. In addition, some new developments, such as loan credit default swaps, as well as potential new regulation of the broader swaps market, could also add robustness to a now-battered market. The loan market won't be the same, but it will continue.

That was the consensus of four financial executives at the 15th Annual Thomson Reuters LPC Loan Conference held in New York on Sept. 17, who sat on a conference panel to answer the question: "After more than two years, how are loans holding up?" Standard & Poor's Managing Director William Chew moderated, and the panelists included Mark A. Campellone, managing director and portfolio manager at New York Life Investment Management LLC; Jonathan Insull, managing director at Trust Company of the West; Linda Pace, managing director and leveraged loan portfolio manager at The Carlyle Group; and Scott H. Page, vice-president and senior market analyst at Eaton Vance.

Loan Defaults To Keep Rising

The bad news first: Most of the panelists believed that the default rate of loans will continue to rise over the next year. Standard & Poor's view of speculative-grade loan defaults is that they will be higher than in any previous downturn, cresting at 13.9% a year from now. Mr. Page agreed with that figure, while Mr. Insull foresaw a less daunting rate of default a year from now, perhaps in the high-single digits after peaking in the low teens sometime earlier. Some of the pressure on default rates could be easing a bit, added Mr. Campellone, as credit markets have become more amenable to refinancing in recent months. He sees a default rate of 10% over the next 12 months.

Although no one can say for sure what the default rate will be in the future, there was little disagreement about the cause of the increase in bad loans. The lack of liquidity is a prime culprit, along with the reality that the business model of many borrowers has proven inadequate to meet the challenges of the recession.

"It's important how much liquidity a company has on its balance sheet," said Ms. Pace. "Can they make it through to the other side or not? They can only cut costs but so much."

Some borrowers have also seen fundamental changes in how they operate their businesses. That has been notably true of companies participating in industries such as the media sector, where traditional practices have been disrupted by digital technology. "There have been technological changes that were more than anticipated," said Mr. Insull.

"With the economy only slowly on the rebound, according to most economists, there could still be a lot of work for

borrowers to do to maintain their soundness," said Mr. Chew.

The partial restructurings many issuers have undergone may simply not be enough to carry them through the recession unscathed.

"Are we creating a scenario where we'll see companies having to deal with their capital structures in two or three years because they haven't done it yet?" asked Mr. Campellone.

Ms. Pace agreed that in restructuring their debt, certain companies have taken only "a band-aid approach that still leaves them overleveraged." She believed that this has been the case for some broadcasters, among other companies.

According to Mr. Chew, Standard & Poor's estimates that recoveries across all debt classes will be lower than in previous contractions. Ms. Pace noted that while she expects 50% recovery on first-lien debt and 10% to 20% on lower-rated debt, there is upside potential for investors who are getting substantial equity positions in restructured companies.

Protecting The Investment

Of course one of the best ways to avoid holding bad paper is to insure against it through the use of CDSs (credit default swaps) and LCDs (loan credit default swaps)--instruments that investors or lenders can use to protect against defaults on the debt they hold. But these instruments can, in some cases, be a disincentive for lenders to work out or restructure loans that are in danger of default. Mr. Insull said that he had seen some evidence of such behavior in the market. That could change, however, if proposed regulation of the swaps markets comes about.

"It will make trading more transparent," said Mr. Page, "and increase liquidity if unlimited leverage is not allowed."

"Still, the newer default protection instruments like LCDs--which are default swaps specifically for loans rather than bonds--and default indices could entice investors into the loan market," said Mr. Campellone.

Mr. Insull agreed. "A lot of institutional investors will be willing to explore them."

CLOs Face An Uncertain Future

While the loan market is not going to disappear anytime soon, the market for CLOs (collateralized loan obligations) has already shrunk dramatically. Will these loan packages ever again be a major asset class for investors to consider? Here the panelists had divergent views.

"I think that they will come back, but will be thought of more as a financing tool than an asset class," said Mr. Insull. "And they'll be simpler as well."

"These products would also benefit from additional rating transparency," added Mr. Campellone. (We note that in late-September 2009, Standard & Poor's released a series of criteria updates on various types of collateralized debt obligations.)

Ms. Pace, however, seemed to believe that investors' recent experience with these debt instruments will keep them away. "I'm more pessimistic about CLOs returning, but I do think you need some form of securitization to finance

Corporate America."

But whether investors will go for them as they have in the past is a question that cannot yet be answered. Nonetheless, the bank loan asset class, in general, will continue to hold investor interest.

"You'll see an interest in floating-rate issues," said Mr. Page. "There aren't many floating-rate asset classes out there."

Writer: Robert McNatt

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