SPECIAL TOPICS

Leveraged Loans and High Yield Bonds

There is a wide investor perception that a leveraged loan (LL) is the more attractive alternative to a high-yield bond (HYB) as being safer and possibly also higher yielding. As this perception basically violates the principle of higher risk – higher return, it seems worth-while taking a closer look, also from the perspective of an issuer:

To start with, both, LLs and HYBs are funding tools for corporates with less than stellar, so-called non-investment grade credit ratings (Moody´s Ba1 or S&P BB+ or lower). Whilst a HYB is a security which can easily be traded, a LL is a contract between a lender and a borrower with each one being different and unique. Further and in general, LLs are secured and equipped with floating interest payments, whilst HYBs are usually unsecured and issued with fixed interest features. Hence, LLs seem therefore better suited for investors in an environment with increasing interest rates.

The investment risk assumed with LLs is compensated in that these loans earn an interest on top of a benchmark rate (mostly LIBOR) which increases as the loan gets riskier. In the case of a corporate default, LLs, which are secured by physical assets, are paid off prior to (unsecured) HYBs, which historically have widely been used to fund LBOs. - Therefore, historically, LLs have always had higher recovery rates.

Whilst usually issued with fixed interest rates, HYBs can also be equipped with floating features (either physical or via an interest rate swap). Still, a key difference to LLs is that former have better call protections, if exercised by the issuer. Whilst LLs are usually callable at par (and then subsequently often rolled over) HYBs can only be called by the issuer offering a premium to investors. At times, there can be a significant gap between a HYB´s trading price and the call price due, resulting in material price gains for investors.

Recently, though, LLs have started to look more like HYBs, as restrictions have eased and a trading market has developed. LLs were once normally protected by maintenance covenants that allowed lenders to continuously monitor a borrower’s performance and take action, f required: Such as forcing the sale of assets, if for example earnings deteriorated. Lately, however, many borrowers were able to eliminate vast sets of these covenants, with such LLs known as covenant-lite. Particular relevant is thereby the erosion of “key covenants”, which restrict asset transfers or forbid borrowers from selling collateral without paying down loans first: As a matter of fact, these covenants are not changing the probability of default rates, but they may drastically change the probability of recovery rates. - Since HYBs don’t have maintenance covenants, investors and borrowers increasingly regard covenant-lite LLs like HYBs.

Now, HYBs can relatively easily be traded on regulated markets with trades usually closing within three business days. LLs, on the other hand, are not regulated and therefore require also less disclosure, less transparency. So settling a loan trade may take weeks till the cash rolls into the seller´s box. Also, LLs can be equipped with permission requirements prior to trading them or restrictions on who may buy them. – Having said this, LLs are frequently packaged up and sold to investors as bonds (collateralized loan obligations or CLOs). Not least this has enhanced their popularity and made them an increasing source of funding for LBOs.

Against the background of covenants-light, for issuers LLs have become an increasingly attractive option over HYBs given reduced lender oversight, that they can be paid down at will, are cheaper than HYBs to issue and benefit from their reduced call protection. By the end of 2018, additional features are the anticipation of a higher interest rate environment as well as the European Central Bank´s withdrawal of stimulus measures (foremost focused on bonds).