Leveraged Loans and High-Yield Bonds

Against the background of historically low interest rates, Leveraged Loans (LLs) as well as High-Yield Bonds (HYBs) have grabbed the attention of yield-conscious investors, as both instruments converge into a single leveraged finance asset class.

To start with, both, LLs and HYBs are funding tools for corporates with non-investment grade credit ratings (Moody´s Ba1 / 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 the London Interbank Offered Rate, LIBOR, or similar) which increases as the loan gets riskier. In the case of a corporate default, LLs, which are secured by tangible assets, are paid off prior to (unsecured) HYBs, which historically have widely been used to fund LBOs. - Therefore, also historically, LLs have always had higher recovery rates.

Whilst typically 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, if required: Such as forcing the sale of assets, if, for instance, earnings deteriorated. Lately, however, many borrowers were able to eliminate vast sets of these covenants, with such LLs known as "Covenant Light" (cov-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, but they may drastically change the probability of recovery rates. - Since HYBs don't have maintenance covenants, investors and borrowers increasingly regard cov-lite LLs like HYBs. Now, HYBs can be relatively easily 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. Hence, 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 is allowed to 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 increasingly relevant source of funding for LBOs.

Against the background of cov-lite, 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. Investors may see these aspects in a different light, though.

	LEVERAGED LOANS	HIGH YIELD BONDS
COUPON	FLOATING	FIXED
RATING	BELOW INV. GRADE	BELOW INV. GRADE
SECURITY	SENIOR SECURED	UNSECURED
STRUCTURE	SENIOR	SUBORDINATED
COVENANTS	MAINTENANCE BEST COVENANTS	LIGHT/ INCURRANCE TEST
RECOVERY RATE	HIGHER	LOWER
CALLABILITY	USUALLY NO	USUALLY CALL
AMORTIZATION	QUARTERLY PRINCIPAL	BULLET AT MATURITY
LIQUIDITY	LESS	MORE

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