The leveraged credit market, which encompasses syndicated loans and high yield bonds, is generally far healthier than in the days leading up to the Lehman collapse. However, signs of deterioration have become prevalent in the past few years. As early as June 2011, Fed officials (including future Fed Chair Janet Yellen) and regulators were voicing concerns over prices, terms and imbalances in leveraged credit; they pointed out that strong demand was leading to increases in leverage ratios and deterioration in deal structures, which in turn was “raising the possibility of large losses going forward.” The frequency and uneasy tone of such warnings has been steadily increasing (see Figure 1).

PIMCO shares these concerns and agrees that strong demand in both syndicated loans and high yield, driven by steady flows from retail and institutional investors, has indeed led to a deterioration of terms in leveraged credit.
One of the starkest examples of issuer-friendly terms is the increase in “covenant-lite” loans. Covenant-lite loans lack maintenance covenants (regular evaluations of the borrower’s financial strength), although they still have incurrence covenants (evaluations that take place only under certain specific circumstances). The issuance of covenant-lite loans has grown significantly: up from about 6% of total loan issuance in 2010 to 55%–60% in 2013, according to S&P LCD (Leveraged Commentary & Data). And as of the end of February 2014, covenant-lite loans represented 51% of the total market outstanding, up from 22% when Yellen spoke about emerging imbalances in 2011 (per S&P LCD). Rating agencies may have allowed a rise of covenant-lite loans by permitting a higher percentage of them in collateralized loan obligations (CLOs).

In the high yield bond market, the return of payment-in-kind (PIK)/toggle bonds is yet another indicator of an accommodative market; these bonds allow the issuer to defer interest payments by adding interest to principal due.

Another warning sign is that after a few consecutive years of deleveraging, we are beginning to see an overall rise in leverage for leveraged credit issuers, driven by a rebound in leveraged buyout (LBO) and mergers and acquisitions (M&A) transactions along with an increase in the use of incremental issuance for dividend payments to equity holders and share buybacks. In 2013, 10.2% of issuance was used for dividend payouts, up from 1.8% in 2008 (per S&P LCD).

It’s not all bad news

All that said, leveraged credit markets are stronger in many respects than they were pre-crisis. Balance sheets overall are still relatively healthy. Although leverage is creeping higher, overall levels remain below 2008–2009 peaks. And with low rates, interest coverage remains high and cash flows are strong. Defaults remain low at under 2% (per J.P. Morgan, 2010–2013), and with stronger balance sheets, issuers have been able to push out maturities for several years – only 9% of the combined leveraged credit market matures between early 2014 and the end of 2016 (per BofA Merrill Lynch). Therefore, we expect the low-default environment will continue for at least the next 18 to 24 months (excluding a few overlevered 2006 LBO deals, which are widely anticipated to undergo restructuring).

In addition to reasonable leverage and lower debt expense, capital structures are also in better condition today. The share of senior secured debt in a typical leveraged credit issuer capital structure stands at 44% as of February 2014, compared with 53% at the end of 2008 (per PIMCO analysis, J.P. Morgan and BofA Merrill Lynch). LBOs are also being structured with larger equity components, up from an average of 34% of the total purchase price in 2004–2008 to 40% in 2009–2013 (per PIMCO analysis and S&P LCD). This is particularly important given the increase in covenant-lite issuance – with more robust capital structures (higher equity checks in LBOs and a good slug of bonds beneath the senior secured debt), recovery prospects are improved. We monitor these factors closely as indicators of overall quality and ultimate recovery for debt.

Finally, there is also considerably less leverage in the entire system, and more supply discipline in the markets. In 2008, the rapid unwind of CLO warehousing (i.e., when CLOs use lines of credit to accumulate loans prior to the actual launch) and total return swap (TRS) financing, coupled with a massive overhang of new issues that banks had committed to fund but had not yet sold to investors, converged to cause a record sell-off in loan markets and, subsequently, in high yield bond markets.
The bank loan market is very different today. Prior to the crisis, CLOs routinely used warehouse lines of credit; today, warehouse financing has all but disappeared. TRS financing facilities have decreased in size and allow significantly less leverage. Other features of the loan markets, such as extended underwriting commitments for new loans from banks to issuers, which caused a large overhang of issuance in 2008, have also become shadows of their former selves.

**Regulation and its (perhaps unintended) consequences**

While the Fed has increasingly voiced concerns about the leveraged credit markets, so far its only action, together with the Office of the Comptroller of the Currency (OCC), has been to tighten guidelines for lending by banks. And tightening standards could seem to run contrary to the broader goal of fostering overall economic growth – a goal the Fed has pursued steadily via low interest rates and asset purchases, which in turn encourage investors to move out along the risk spectrum and help increase asset prices. Still, in light of concerns over leveraged credit, the Fed is trying (via supervisory guidance) to limit the supply of loans that exceed a certain level of leverage, which can also lead to inflated prices of loans in the rest of the market. A recent Shared National Credit (SNC) exam by the OCC “criticized” 42% of syndicated loans. But strong demand and supply that is comparatively insufficient mean that the market can find ways around new guidance and new loans can continue coming with terms that are more aggressive than the Fed and OCC guidelines. Moreover, these loans generally do not remain on the books of the banks that fall under Fed and OCC supervision. In the same week in February that Janet Yellen testified to the Senate that “supervisory guidance and special exams” are tools the Fed can use to manage the market, for example, a new LBO issuer altered its offering by increasing its leverage ratio to nearly 7x debt/EBITDA (earnings before interest, taxes, depreciation and amortization) with the addition of an unsecured loan while reducing the equity contribution by the same amount.

While the regulators want to help the ultimate investor in the leveraged credit markets avoid losses, and the regulatory efforts are well intended, the market's reaction has been muted thus far. Investors and issuers should also be careful in applying guidelines. For example, the recommendation for a maximum total leverage of 6x may be too lenient for an auto supplier with a more volatile earnings stream, but reasonable for many media and communications companies that have more predictable and consistent cash flows. And if the guidelines are met by investment banking and legal wizardry, such as EBITDA add-backs and other complexities that can alter the reported leverage, the underlying credits will likely disappoint.

Regulations could also have unintended consequences. For example, if issuance shifts to the high yield unsecured market as a result of blunt regulation tools, the impact may include higher costs to borrowers, increased volatility for investors in a rising rate environment and lower recoveries in an economic or credit downturn. It is also possible that increased regulation could cause a shift in underwriting and distribution away from banks to non-regulated entities, which may lead to further erosion in credit quality. Finally, with more restrictive guidelines going into place, existing leveraged issuers’ ability to refinance as they approach maturity will likely be hindered, possibly leading to an increase in restructurings of existing highly leveraged companies that otherwise would have been able to access the capital markets.

**An active manager's perspective**
Detailed bottom-up credit analysis with an emphasis on long-term fundamentals and loss avoidance has historically been the key to managing risk in the leveraged credit markets. Regulatory limits on leverage are too blunt a tool and are not a substitute for intensive credit analysis. At PIMCO we will continue to carefully monitor overall market conditions, keeping an eye on warning signs and being extremely selective with the loans and bonds we purchase for our portfolios.

Nevertheless, with continued heavy demand for bank loans and high yield bonds, and intense competition for underwriting among investment banks – both of which can lead to decreased underwriting standards – more finely tuned Fed intervention might be welcome.

Past performance is not a guarantee or a reliable indicator of future results. Investing in the bond market is subject to certain risks including market, interest-rate, issuer, credit, and inflation risk. Bank loans are often less liquid than other types of debt instruments and general market and financial conditions may affect the prepayment of bank loans, as such the prepayments cannot be predicted with accuracy. There is no assurance that the liquidation of any collateral from a secured bank loan would satisfy the borrower’s obligation, or that such collateral could be liquidated. High-yield, lower-rated, securities involve greater risk than higher-rated securities; portfolios that invest in them may be subject to greater levels of credit and liquidity risk than portfolios that do not. Floating rate loans are not traded on an exchange and are subject to significant credit, valuation, and liquidity risk. Some debt instruments may include senior and subordinated and secured and unsecured debt obligations (including investments in the senior, subordinate, hybrid debt instruments, and Collateralized Debt Obligations or CDOs and Collateralized Loan Obligations or (CLOs). Derivatives may involve certain costs and risks such as liquidity, interest rate, market, credit, management and the risk that a position could not be closed when most advantageous. Investing in derivatives could lose more than the amount invested. The credit quality of a particular security or group of securities does not ensure the stability or safety of the overall portfolio. Diversification does not ensure against loss. The value of most bonds and bond strategies are impacted by changes in interest rates. Bonds and bond strategies with longer durations tend to be more sensitive and volatile than those with shorter durations; bond prices generally fall as interest rates rise, and the current low interest rate environment increases this risk. Current reductions in bond counterparty capacity may contribute to decreased market liquidity and increased price volatility. Bond investments may be worth more or less than the original cost when redeemed.

There is no guarantee that these investment strategies will work under all market conditions or are suitable for all investors and each investor should evaluate their ability to invest long-term, especially during periods of downturn in the market.

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