Looking past the “noise” to focus on the loan market’s true value

- The 5.76% yield on loans (as of September 30) is second only to high yield among domestic fixed-income sectors.
- With near-zero duration, loans have proven their value as a portfolio diversifier in this rising rate environment, as they have in prior similar periods.
- While all other bond sectors, save high yield, have lost money this year through September 30, the S&P/LSTA Leveraged Loan Index has returned 4.03%, outpacing most bonds by a wide margin.
- Despite strong fundamental footing, we have seen a significant pick-up in negative media coverage, focusing on trends such as covenant-lite, “loan only” issues, and other concerns.
- This Q&A offers Eaton Vance’s perspective on why it is important for investors to understand the “noise” and focus on the value in the loan market.
With three quarters of 2018 in the books, floating-rate loans have stood out in a difficult year for fixed income. While all other bond sectors, save high yield, have lost money this year through September 30, the S&P/LSTA Leveraged Loan Index has returned 4.03%, outpacing most bonds by a wide margin. For example, the Bloomberg Barclays Aggregate Index has lost 1.6% over the same period.

Several key advantages of loans have driven their strong performance this year:

- The 5.76% yield on loans (as of September 30) is second only to high yield among domestic fixed-income sectors.
- Yields have risen as the common benchmark for loans (Libor) has moved up along with rate increases by the U.S. Federal Reserve.
- With near-zero duration, loans have proven their value as a portfolio diversifier in this rising rate environment, as they have in prior similar periods.

With valuations at what we believe to be at a fair level (320 basis points over Libor), prices close to par, and the prospect of further rate hikes from the Fed, loans are still a compelling option for investors, in our view.

However, whenever an asset class has the kind of attention that floating-rate loans have received, there are inevitably questions from investors and the press. In particular, questions have been raised about the impact of credit structures such as covenant-lite and "loan-only" issues. This Q&A offers the perspective of the Eaton Vance floating-rate loan team on such trends, and how investors can look past the headline "noise" and focus on the true value in the market.

The floating-rate loan market has grown in 2018, elevating loans outstanding by 14% to $1.089 trillion as of September 30. What kinds of deals are you seeing?

For most of the year, we have seen a resurgence of M&A-related activity, including leveraged buyouts (LBOs), while the great refinancing wave of last year has diminished. Exhibit A shows how LBO and private equity (PE)-backed deals have increased. The $193 billion raised in LBO and PE offerings through September 30 already eclipses the $181 billion in 2017, helped by strong investor demand from both institutions and retail investors.

Exhibit A

Source: LCD, an offering of S&P Global Market Intelligence, as of September 30, 2018.
Thanks to continuing strong demand, issuers have had greater ability to push for more “issuer-friendly” (i.e., weaker) credit structures. For example, there have been “loan-only” deals, where there is no subordinated cushion of high-yield bonds below the loans in the capital structure. Can you address this?

Loan-only deals have grown from about one-third of the market in 2011 to more than half currently (Exhibit B), and comprised about 70% of issuance in 2018, through September 30, according to JPMorgan. There are a couple of related reasons for this. For yield-hungry investors, they have offered a premium of about 95 basis points (bps) over structures with a traditional high-yield cushion, according to JP Morgan. Also, high-yield bonds typically are not callable for five years, while loans normally do not have this restriction. This makes loan-only issues attractive to PE issuers, who often look to “flip” their ownership within a shorter time frame.

A few other other facts are relevant when considering the impact of loan-only issuance:

- Half of this year’s loan-only deals include second-lien loan layers, which effectively take the place of the high-yield bonds in the capital structure as a cushion for first-lien investors.

- Equity contributions are higher in many cases, meaning that loan-only does not necessarily mean higher leverage (see discussion below about credit statistics remaining in check).

- Most issuers of loan-only deals are at the smaller end of the capitalization spectrum.

So for investors like Eaton Vance who invest in larger deals and buy first-lien loans, the issue is largely mitigated. However, the first line of defense for us has always been our credit underwriting. The primary considerations are the strength of the business model and durability of cash flow. Of course, deal structure is important too, but a high-yield cushion is meaningless if there isn’t a sound investment rationale for the loan to begin with.

Exhibit B
“Loan-only” issues have become more common (% of par amount outstanding).

Source: JPMorgan, as of September 30, 2018.
The rise of covenant-lite loans has been another long-running trend. What are the differences between so-called “covenant-lite” and traditional covenants?

Covenant-lite loans were first introduced in 2006 and are considered more issuer-friendly than traditional “covenant-heavy” loans. However, it’s important for loan investors to understand that they share very similar bedrock obligations that go beyond what is found in other credit sectors. Both covenant-lite and traditional covenants:

■ Bind issuers to first-lien security and other provisions that limit an issuer’s ability to purposefully alter the fundamental risk profile.

■ Are secured and benefit from priority status in bankruptcies and reorganizations.

■ Contain affirmative obligations that require issuers to regularly produce financial statements and compliance certificates. They must notify lenders promptly of material events, and must allow for inspection of property and financial records.

■ Contain negative obligations that impose restrictions on actions such as paying dividends, taking on additional debt or liens, or selling collateral.

The key distinction is that traditional covenants use maintenance tests (typically quarterly) to ensure that certain leverage and coverage ratios remain within set limits. Covenant-lite issuers generally have a similar general type of limit, but those are enforced by incurrence, rather than maintenance, tests. For example, a covenant may specify that debt may not exceed 5x EBITDA - in the lite variety, the limit is enforced when the issuer seeks to incur new debt.

What is the impact of covenant-lite issues on the loan market?

When considering the impact of covenant-lite loans, which now comprise about 80% of outstanding loans, we believe several points are key:

■ Covenant-lite loans are often issued by stronger, more-creditworthy companies. They can strike a good balance between protecting creditor interests and providing leeway to companies working through a choppy patch in their businesses.

■ This balance is seen in the fact that since 2010, the average trailing 12-month default rate for covenant-lite issuers has been just over 1%, compared with 2.8% for covenant-heavy issuers, according to S&P/LCD (Exhibit C).

■ We see the covenant-lite trend as one more step in the natural evolution of loans from a closely held bank-only arrangement to a global, $1 trillion-plus capital market. The liquidity available in today’s market constitutes a major creditor protection that did not exist when traditional covenants were first devised.

■ There are more than 1,500 disparate loans that trade in the U.S. and Europe today, each with a unique credit agreement that typically runs hundreds of pages. The effectiveness of covenants for any given issuer can only be determined by a skilled professional, in the context of thorough investment analysis based on fundamental credit quality and relative value.

To what extent do weakened credit structures increase the likelihood of lower recoveries following future defaults?

From the standpoint of covenant-lite deals, we have seen no erosion of recovery rates, based on Eaton Vance’s experience or industry research. For the 2015-2017 period, we have had 17 defaults in our portfolios — 11 were covenant-lite, and six had traditional covenants. Our recovery experience was similar for both kinds of covenants, comparable to the 77% long-term industry average found by Moody’s.

Industry research by Covenant Review reported comparable results from 2010 through September 2018, the decade when covenant-lite loans began to dominate the market. For the 55 defaults in its sample over that period, recoveries were 71% — statistically indistinguishable from Moody’s long-term recovery rate noted above.

A more pertinent question for future recovery rates is the size of the capital cushion, which Moody’s research has shown to be positively correlated with higher recovery rates. Similarly, the Covenant Review study found that among the 55 defaults analyzed, deals with capital cushions — the “loans and bonds” offerings — had 79% recovery rates, compared with 58% for loan-only issues.

Our response to these trends has been to maintain the strict underwriting criteria we have employed since 1989. As noted earlier, this includes investing in larger deals, buying first-lien loans and seeking to maximize the capital cushion through bonds or second-lien loans. The loan market is robust enough to allow us to turn down 75% of the deals we are offered, accepting only those that meet our criteria for a sound business model and solid capital structure.
Exhibit C
Covenant-lite loans have had lower average default rates than covenant-heavy loans.

Exhibit D
The strong economy has boosted corporate cash flow.
Quarterly EBITDA growth of issuers in the S&P/LSTA Leveraged Loan Index.
Are rising rates hurting the ability of issuers to service their debt?

To the contrary — the economy’s strength has helped loan issuers.

- The EBITDA of issuers in the S&P/LSTA Index grew by 12.1% in the second quarter (the latest available) — its fastest growth rate in four years (Exhibit D). That kind of growth rate has more than offset increased interest cost.

- Interest coverage ratios have been increasing since the fourth quarter of 2016, even as the U.S. Federal Reserve has kept tightening. The interest coverage ratio, at 4.42x, for the second quarter of 2018 (the latest available), is the highest it has been in at least 16 years, the length of S&P’s records.

- Issuers with interest coverage of below 1.5x (a level historically indicative of a company struggling to service its debt) comprise just 5% of the market, compared with an average of 8% for the six years following the global financial crisis, starting in 2012. (At the height of the crisis, this figure was 18%).

What about LBO issuers? Is their leverage comparable to what it was in the financial crisis?

Covenant Review completed a study that analyzed the 12 largest LBOs of 2017 and the 12 largest in 2006/2007. The leverage multiple in the pre-crisis period for those issuers was 8x EBITDA, compared with 5.9x for last year. A little over half of those large issuers had debt multiples of 6x or more last year, compared with 92% pre-crisis. For the higher-levered deals of greater than 7x, we saw just 7% in 2017, compared with 77% pre-crisis. So there hasn’t been the same kind of excess debt we saw back then.

Has the stronger environment helped keep default rates low?

Yes. The trailing 12-month default rate is 1.8%, well below the long-term average of about 3% (Exhibit E). The distress ratio, which reflects the percentage of loans trading at a price of 80 or below, is a common forward-looking indicator of credit problems. That stands at 1.4%, compared with its long-term average of 6.7%.

Exhibit E
Loan default rates are below their 3% long-term average.
S&P/LSTA Leverage Loan Index default rates. Last 12 months as a % of par outstanding.

Source: LCD, an offering of S&P Global Market Intelligence, as of September 30, 2018. The S&P/LSTA Leveraged Loan Index is an unmanaged index of the institutional leveraged loan market. Unless otherwise stated, index returns do not reflect the effect of any applicable sales charges, commissions, expenses, taxes or leverage, as applicable. It is not possible to invest directly in an index. Data provided are for informational use only. Past performance is no guarantee of future results.
What is the outlook for default rates? If they rise from cyclical lows, what impact would it have?

According to S&P/LCD, most asset managers expect default rates to reach the 3% historical average level over the next couple of years. If we assume a 3% default rate, combined with a 77% recovery rate (Moody's latest long-term level), the net principal loss to investors from the defaults would be 69 bps.\(^1\)

To keep this in perspective, the yield on the S&P/LSTA Leveraged Loan Index was 5.76% entering the fourth quarter. Assuming default losses reduce that by 69 bps, the net return would still be over 5% — greater than the yield on all other U.S. fixed-income sectors except high yield\(^2\), as of September 30, 2018. It’s also important to remember that yields on loans are expected to rise as the Fed continues on its path of lifting short-term rates. In contrast, rising rates often hurt other bond sectors.

We have made the case above that a well-constructed loan portfolio is likely to maintain the historical recovery rate of around 77%. Nevertheless, it is useful to apply the same arithmetic to see the results if recoveries were to drop to 58%, as Moody’s suggests may happen for loan-only issues. In that case, if defaults are 3%, the net principal loss to investors from the defaults would be 126 bps. Keeping the same 5.76% assumed yield for loans, the theoretical net return would be 4.5%.

Loans historically have proven to be effective diversifiers in rising-rate environments and steady providers of mid-single-digit returns. We believe that these alternative recovery scenarios do little to reduce loans’ value as a tactical and strategic portfolio allocation.

What threat does the volatility of flows of retail investors pose to the market?

In our view, very little. Retail mutual funds owned just 14.7% of loans outstanding. In contrast, 85.3% of the market is owned through institutional investors, including a 50.6% component represented by collateralized loan obligations (CLOs) as of September 30, 2018 (Exhibit F). While the retail component of the market affects overall pricing and volatility at the margin, institutional investors have been the backbone with steady participation over two decades.

Exhibit F
Retail mutual funds are a small part of the loan market.

Ownership of S&P/LSTA Leveraged Loan Index

- **50.6%** CLOs
- **34.7%** Other Institutional
- **14.7%** Loan Funds

Source: Refinitive, LSTA Q3 Trade Study, as of September 30, 2018. The S&P/LSTA Leveraged Loan Index is an unmanaged index of the institutional leveraged loan market. Unless otherwise stated, index returns do not reflect the effect of any applicable sales charges, commissions, expenses, taxes or leverage, as applicable. It is not possible to invest directly in an index. Data provided are for informational use only. Past performance is no guarantee of future results.

\(^1\) If default rates are 3% of principal, and 77% of that is recovered, it is equivalent to recovering 2.31% and losing 0.69% of principal.

\(^2\) For this simplified comparison, we ignore the fact that high-yield bond yields are also reduced by defaults.
Some observers have drawn parallels between collateralized debt obligations (CDOs), which cratered in the financial crisis, and (CLOs), which are a mainstay of the floating-rate loan market. The implication is that CLOs may pose a comparable threat in the future. Can you address this?

CLOs and CDOs share superficial similarities in that they both are a form of structured finance. The cash flow from a pool of debt is carved up to create tiered “tranches” with differing levels of risk and return potential. The lower-rated tranches carry higher yields than the AAA-rated tranches, but they also act as a capital cushion for them as well — losses from defaults on the underlying debt are first passed through to the lower-rated tranches.

The reputation of CDOs became tarnished during the financial crisis when they were used to repackage subprime mortgages, many of which were the product of extremely loose underwriting standards. When the recession crisis hit, the value of BBB subprime, as represented by the Markit ABX.HE.BBB Index, traded to near zero, and never recovered. In contrast, subprime AAA CDOs, represented by the Markit ABX.HE.AAA Index, went to about 20, but recovered to par over the next 10 years.³

CLOs can be distinguished from the subprime CDOs in several key respects.

- First and foremost, in the loan market there has been nothing like the race to the bottom in underwriting standards that characterized the subprime fad of the years prior to the crisis. For example, many subprime loans had zero down payments with five-year low “teaser” rates that soared at the end of the period beyond the borrower’s ability to repay. Of course, corporate lending has its own risks, especially at the smaller end of the capitalization spectrum. That is why we prefer issues of major companies like Sprint, Hilton, Dell and Charter Communications, where our loans are backed by the top 40% of their capital structure.

- The tools for evaluating the risks are readily available for an institutional CLO investor base that has been well established for two decades, and loans have maintained leverage between 4x and 6X EBITDA over that period, all of which is audited by accountants and monitored by investors. In contrast, the subprime mortgages backing CDOs were notorious for their “low documentation” and “no documentation” features that made their true degree of leverage impossible to analyze.

Exhibit G
The post-crisis rebound of CLOs showed their fundamental value.

![Graph showing the post-crisis rebound of CLOs](image)

Source: Citigroup Global Markets, as of September 30, 2018. CLO tranches AAA through BB are proprietary Citigroup indexes designed to reflect the performance of AAA-rated, AA-rated, A-rate, BBB-rated and BB-rated CLOs. Unless otherwise stated, index returns do not reflect the effect of any applicable sales charges, commissions, expenses, taxes or leverage, as applicable. It is not possible to invest directly in an index. Data provided are for informational use only. Past performance is no guarantee of future results.

³The Markit ABX.HE.BBB Index and the Markit ABX.HE.AAA Index are proprietary indexes designed to reflect the performance of BBB-rated and AAA-rated CDOs. Unless otherwise stated, index returns do not reflect the effect of any applicable sales charges, commissions, expenses, taxes or leverage, as applicable. It is not possible to invest directly in an index. Data provided are for informational use only. Past performance is no guarantee of future results.
Most CLO institutional investors have long-term investment horizons and view loans as strategic investments.

This is borne out by the performance of CLOs issued prior to the financial crisis (Exhibit G). AAA CLO tranches bottomed out at about 68 in April 2009, and two years later were trading at around 94, according to Citigroup data. BBB CLO tranches bottomed at about 6 at the same time, and two years later were trading at 78 — a rebound north of 1,000%, followed by full recovery in subsequent years. By way of comparison, the S&P/LSTA Leveraged Loan Index bottomed at 62 in December 2008, and two years later was priced at 94.

CLO issuance has exceeded $100 billion in 2018 through mid-October — just the third time it has hit that threshold, on an annual basis, since S&P/LCD began tracking volume in 2011. We view that as a sign of the loan market’s underlying strength, not a source of concern.

There have been reports of a reduction in liquidity in fixed-income markets. Has this been true in the loan sector?

No, that has not been the case. We noted earlier how strong the demand has been from the institutional side, and that has helped maintain a very active two-way market. We are seeing a lot more issuance than in other sectors, such as high yield. In addition, the loan market has always been less dependent on dealer intermediaries in the secondary market to maintain liquidity. Banks that make markets in loans typically act as agents who match buyers and sellers, without risking their own capital the way a dealer would.

In the wake of the financial crisis, fixed-income dealers had been reducing inventory on their balance sheets, in large part due to restrictions like those in the Volcker Rule. As a result, other sectors are starting to trade a little more like the loan market has done all along. We have been relatively unaffected.

In July 2017, plans were announced to phase out Libor, which serves as a base-rate benchmark for about $1 trillion worth of floating-rate loans. What impact, if any, is this likely to have on the loan market?

The short answer is little to none, for several reasons:

- **Libor's demise was overdue.** Libor was originally designed to reflect the lending rates that banks charged each other. However, that market barely exists anymore, and most of the input for the rate reflects estimates, rather than actual transactions. That made it susceptible to manipulation and controversy.

- **Libor's phaseout is gradual.** U.K. regulators are targeting the end of 2021 for full decommission, but that is a recommendation, not a hard deadline. Libor could linger significantly longer. There will be plenty of time for the world, including the loan market, to adjust.

- **Loans are short-lived instruments.** Because of routine repayments, about a third of the $1 trillion market is refinanced each year, and each refinancing requires a new contract that specifies the benchmark. So in the natural course of the market, effectively all issuers will have the opportunity to switch from Libor by the earliest possible 2021 Libor phaseout date.

- **There are plenty of Libor alternatives.** The capital markets offer a number of valid benchmarks, such as the U.S. Treasury repo financing rate. Indeed most credit agreements already have the prime rate as a backup benchmark.

Years ago, the market made the transition from the prime rate benchmark to Libor without a ripple, and ensuring a smooth switch to Libor’s successor is a high priority for the industry’s trade group, the Loan Syndications & Trading Association (LSTA). We are confident that Libor’s sunset will be comparably tranquil. It’s a process, not a problem.
About Risk
An imbalance in supply and demand in the income market may result in valuation uncertainties and greater volatility, less liquidity, widening credit spreads and a lack of price transparency in the market. The secondary market for loans is a private, unregulated interdealer or interbank resale market. Purchases and sales of loans are generally subject to contractual restrictions that must be satisfied before a loan can be bought or sold. These restrictions may impede the strategy’s ability to buy or sell loans and may negatively impact the transaction price. It may take longer than seven days for transactions in loans to settle. It is unclear whether U.S. federal securities law protections are available to an investment in a loan. In certain circumstances, loans may not be deemed to be securities, and in the event of fraud or misrepresentation by a borrower, lenders may not have the protection of the anti-fraud provisions of the federal securities laws. There can be no assurance that the liquidation of collateral securing a loan will satisfy the issuer’s obligation in the event of nonpayment or that collateral can be readily liquidated. Investments in income securities may be affected by changes in the creditworthiness of the issuer and are subject to the risk of nonpayment of principal and interest. The value of income securities also may decline because of real or perceived concerns about the issuer’s ability to make principal and interest payments. Investments rated below investment grade (typically referred to as “junk”) are generally subject to greater price volatility and illiquidity than higher-rated investments. As interest rates rise, the value of certain income investments is likely to decline. Bank loans are subject to prepayment risk. Investments in foreign instruments or currencies can involve greater risk and volatility than U.S. investments because of adverse market, economic, political, regulatory, geopolitical or other conditions. Changes in the value of investments entered for hedging purposes may not match those of the position being hedged.
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