MEKETA
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# Bank Loan Credit Quality

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**Since the Global Financial Crisis, the acceptance of syndicated bank loans ("bank loans") by institutional and retail investors has increased significantly, due to 1) their higher yield relative to other public credit alternatives, and 2) their floating rate coupon that would increase with increasing interest rates. As a result of their increased investor acceptance, there has been a proliferation of bank loan issuance and the composition of the market has evolved meaningfully from what it was before the Global Financial Crisis. This includes trends such as covenant-lite loans, bank loan-only capital structures, increased leverage multiples, and changes to the industry allocation of the asset class. These changes have attracted the scrutiny of U.S. Senators, former Federal Reserve Chairmen, as well as investors themselves who have called into question the deterioration in quality of leveraged loans and whether they pose significantly more risk now than in prior periods.**

**We have investigated these issues, as we believe investors should think critically about the relevance of the historical performance characteristics of the asset class given these recent trends and whether it will be as resilient during an economic downturn. We believe these changes could lead to higher default rates, lower recovery rates, and thus lower total returns when the next credit downturn occurs. Importantly though, we do *not* think there are systemic issues in the bank loan market that would cause us to recommend eliminating the exposure for our clients. We believe that discerning bank loan managers should be able to capitalize on some of the changes in the bank loan market and the uncertainty they may bring.**

## Evolution of the bank loan market

The growth in bank loan issuance after the Global Financial Crisis led to many changes in the composition and characteristics of the market. Since 2009, the market has grown approximately 60% to over $1.2 trillion today. Some of the changes in the market could cause the asset class to perform differently from its historical behavior in various environments.

### Covenant lite

The most notable trend over the past 10 years has been covenant-lite issuance, which existed prior to the Global Financial Crisis, but has become much more prevalent since.

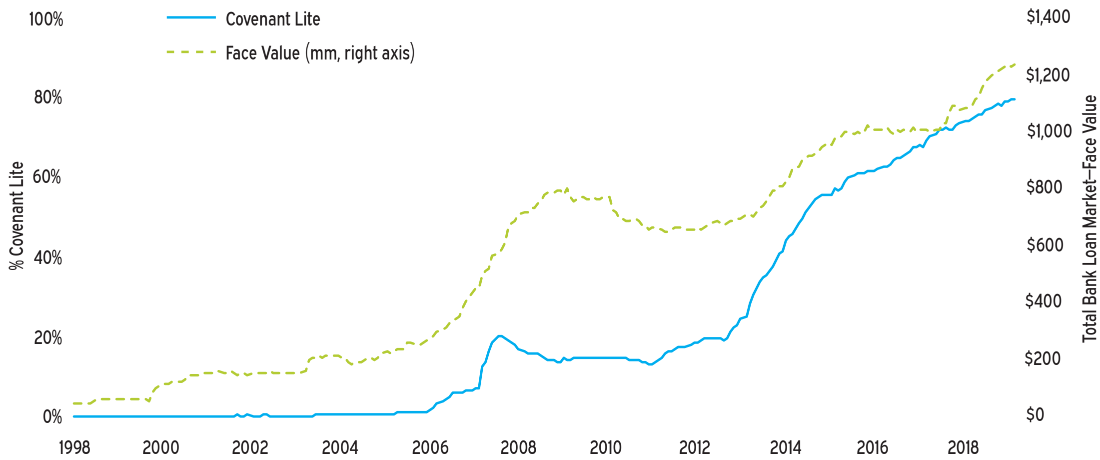


CHART 1

**Growth in Bank Loan Market Size & Covenant—Lite**[1]

[1] Source: Credit Suisse.

Covenant-lite loans are simply defined here as loans without a maintenance covenant. This covenant requires a borrower to "maintain" certain financial metrics which are most commonly related to EBTIDA, leverage, interest coverage, and total fixed charge ratios. The maintenance covenant is what historically distinguished the covenant package of a typical bank loan from a high yield bond. It is important to understand that covenant-lite does not mean "covenant-less." Still, the strength of these covenants has deteriorated recently as well. Interestingly, in the current market, covenant-lite loans actually trade at lower yields than loans *with* covenants. While it is difficult to provide a general explanation for this phenomenon, it is likely because the market has avoided making covenant-lite loans to the poorest credits and only allowed the issuers deemed to have lower credit risk to issue covenant-lite. The true value of a covenant is realized when an issuer experiences some negative change in their business though, so this current pricing dynamic could easily change if issuers begin to underperform.

## Industry composition

The industry composition of the index has also changed during the most recent credit expansion. The proliferation of companies within the technology industry and transformation to the "SaaS" or software-as-a-service model are new developments for the bank loan asset class.

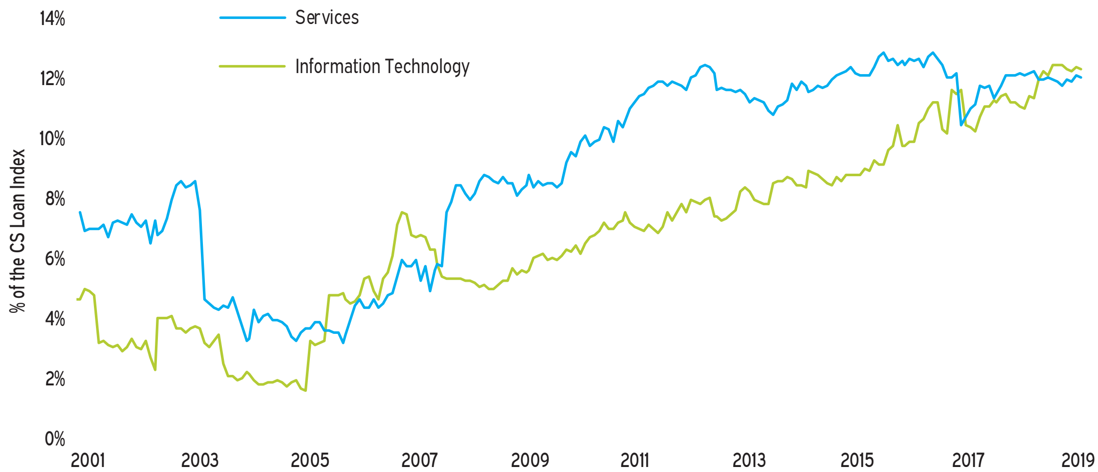


CHART 2

**Growth of Information Technology & Services Industries in the Loan Market[2]**

[2] Source: Credit Suisse.

Information Technology and Services together accounted for approximately 12% of the overall market just before the Global Financial Crisis, but now they account for over 24%. Both of these industries tend to have lower tangible assets, which could influence recovery values in the event of default. In addition, these industries have experienced the biggest growth in enterprise value and leverage multiples, which would stretch a company's cash flow and limit its ability to make interest payments if the business falters.

## EBITDA adjustments

Related to rising debt ratios is the growth in EBTIDA adjustments and add-backs. These are changes made by private equity sponsors at the time of a transaction to boost EBITDA and thus lower the leverage ratio. For example, issuers will adjust EBTIDA to account for prospective acquisition synergies or to write off charges or expenses that happened recently, but are expected to be isolated. While these adjustments have been a part of the market for many years, they are just another example of ways borrowers can push lenders during a period of credit expansion. In some cases, private equity sponsors have "adjusted" EBITDA up to 40%, meaning the stated leverage of 5x would actually be 7x (140% of 5x) based on unadjusted EBTIDA. If the company is unable to realize these adjustments, lenders will have a much more highly levered borrower, and likely one without maintenance covenants.

## Capital structures

Corporate capital structures have also evolved during the past few years as investor demand for loans has increased to match, or even exceed at times, high yield bond demand. As a result, the typical capital structure for a leveraged company is not just the combination of a first lien loan and high yield bond, but also includes loan-only and first lien plus second lien capital structures. While the overall leverage looks the same, the recovery proposition if the issuer defaults or needs to restructure will be different due to the lower subordinated debt cushion and different rights of second lien lenders versus owners of unsecured debt (i.e., high yield bonds).

### Aggressive equity owners

The last transformation in the loan market relates to a change in the behavior of equity owners. Over the past ten years, there have been many instances of equity owners, which in most cases are private equity sponsors, taking action to protect their claim and preserve some optionality when the company is facing stress. This could come in the form of dividend payments, asset sales, or asset transfers to other entities outside the reach of the lien of the loan. Recent examples of asset sales and transfers include Caesars, J. Crew, and Neiman Marcus. Each case had a different outcome of whether the asset sale ultimately was allowed, but the commonality was that many millions of dollars of advisor and legal fees would result in value leakage. This change appears to be both evolutionary and revolutionary, as it is normal for loan documentation to deteriorate during a benign default environment, but there seems to be a new playbook for private equity sponsors when a company experiences a period of stress. Private equity general partners are now being much more aggressive with lenders when it appears default is imminent with their portfolio companies. These changes could further negatively impact loan recoveries.

## Forward looking expectations

Predicting how the aforementioned changes in the bank loan market will impact losses and ultimately performance during the next economic downturn is difficult at best, as it largely depends on what type of downturn is experienced. If it is a shorter period, similar to the 2008 2009 cycle, default rates are unlikely to reach prior historical highs as looser lender protections will delay the time it takes for a restructuring or default. If the duration of the downturn is prolonged, however, there will eventually be a time of reckoning for borrowers as cash flows decline and they struggle to make regular interest payments or pay off principal when maturities approach.

> Recovery values in the next default cycle are likely to be lower than the historical averages, as recovery rates (like default rates) tend to be very cyclical.

The lack of a maintenance covenant will likely delay, but not eliminate, the possibility of a default. The absence of this covenant provides more flexibility to management and ownership as they try to keep their equity option open, potentially to the detriment of lenders.

Capital markets have long accepted that higher leverage multiples give companies less margin for error, and that loan-heavy capital structures give lenders less cushion to protect against principal loss. Recovery values in the next default cycle are likely to be lower than the historical averages, as recovery rates (like default rates) tend to be very cyclical. We believe that loan recoveries will likely be somewhere between 50% and 60%, which is between where first lien loans and secured high yield bonds have been during periods of high defaults. Moody's expects first lien recoveries to be approximately 61%, compared to their long-term average of 77%.

Another factor that will influence losses is whether the downturn is isolated to one or a few industries or if it is broad-based. Certain industries are much larger constituents in the loan indices than the high yield indices, so it is possible that loan default rates could diverge and be higher than high yield default rates (or vice versa). The opposite example of this was seen in 2016 in the energy sector, as it was more than 15% of the high yield market but less than 5% of the bank loan market.

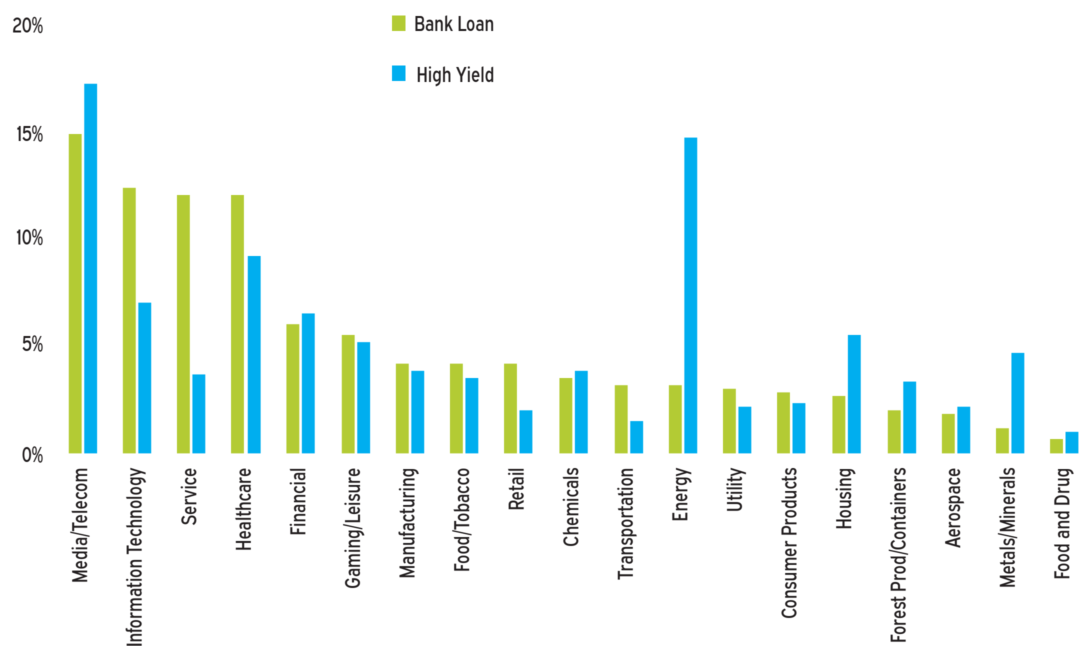


CHART 3

**Bank Loan & High Yield Industry Weights[3]**

[3] Source: Credit Suisse as of March 31, 2019.

The bank loan market has been very supportive of the business model and cash flow characteristics of the Technology and Services industries recently. However, if sentiment changes, there could be liquidity or refinancing issues if the market starts to demand higher interest rates to compensate for higher credit risk in those industries. In addition, if issuers fail to quickly realize adjusted EBTIDA, lower earnings will put a strain on a company's cash flows and their ability to grow and service debt. These industries have low tangible assets and the highest leverage levels. While most issuers are likely to hold up well through a downturn due to their high percentage of recurring revenue and high cash flow conversion, the companies that are less resilient will likely have limited value for lenders to recover.

## Conclusion

It is natural for credit standards to oscillate with the economic cycle. Thus, it should not be surprising to see borrower-friendly migration with respect to documentation, covenants, leverage levels, and EBTIDA adjustments in today's new bank loans given the current economic backdrop. Unprecedented central bank intervention and a prolonged period of low to-zero interest rate policy are factors that will continue to influence these dynamics in the loan market. We believe these changes could lead to potentially higher default rates, almost certainly lower recovery rates, and thus lower total returns when the next credit downturn occurs. Importantly, while we acknowledge credit risk is higher than in the past, we do not see any major systemic issues with the asset class and believe that skilled and disciplined credit managers should be able to take advantage of the uncertainty that will arise as a result of these changes.

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