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Senior Secured Loans: Why Now?

INSIGHTS

With further rate hikes on the horizon and volatility testing financial markets, loans are gaining traction for their potential to offer protection against both credit and interest rate risk.

Natalie Heawood, CFA
Director, European High Yield

Casey McKinney
Managing Director, U.S. High Yield

Looking across the markets today, Russia's invasion of Ukraine is clearly of great concern—and markets have reacted accordingly in recent weeks, with yield curves flattening and both stock and bond markets experiencing extreme volatility. Reinforcing this uncertainty, the price volatility across oil and other commodities has led to questions around whether consumer and corporate earnings may be negatively affected going forward. At the same time, rising inflation and the potential for further rate hikes remain top of mind. In this environment, senior secured loans may be an option worth considering, as the asset class offers a unique blend of attractive yield potential with a degree of protection against both credit and interest rate risk.

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An Inflection Point for Loans

Senior secured loans are issued by below investment grade companies and used for a range of purposes, such as financing acquisitions, refinancing existing debt and supporting expansion plans. The loans are underwritten by a lead bank and syndicated (or sold) to other banks and institutional investors. They pay a floating interest rate—a base rate, plus an additional fixed coupon—to compensate for the credit risk of lending to a below-investment grade company.

EXAMPLE:

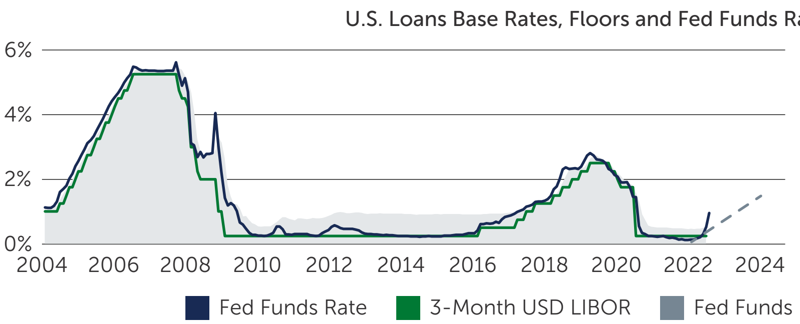
Interest Rate Paid by Senior Secured Loan Borrower =
Base rate (Libor, SOFR, Euribor, etc.) + Fixed coupon/spread

Following the global financial crisis, as interest rates fell to historically low levels, the base rate component of the loan no longer offered investors an attractive return. Consequently, base rate floors became common features on newly issued loans. A floor sets a minimum base rate to be paid on a floating-rate instrument, in this case the senior secured loan.

The presence of floors also impacts how quickly a rate rise will be reflected in a loan's coupon payment. For instance, when the U.S. Federal Reserve raised rates in 2015—kicking off the short rate-hiking cycle that came to an end after the onset of the pandemic in early 2020—much of the loan market had floors between 100–125 basis points (bps). This means that in order for the base rate component of the loan to "float" and contribute to a higher coupon payment, interest rates would have had to exceed 1.00%–1.25%.

By contrast, heading into today's rate-hiking cycle, a large portion of the senior secured loan market has a lower floor, typically 0 bps in Europe and 0-50 bps in the U.S. **(Figure 1)**. This means that a much more significant portion of the asset class has or will become truly floating rate in a much shorter time frame than was the case during the last rising-rate period. As an example, 3-month U.S. Libor reached 95 bps as of March 18, which means that loans with Libor floors of 90 bps or lower have essentially passed their inflection point and should begin to offer an attractive incremental coupon, in addition to the fixed coupon/spread, going forward. Of note, that's over 85% of the U.S. market.

Figure 1: A Large Portion of the Loan Asset Class Will "Float" in a Fairly Short Time Frame



	March 22	Floor Level	% of Market
3M LIBOR	0.95%	No Floor	0.62%
3M SOFR	0.51%	0–25 bps	39.66%
		50 bps	25.91%
		75 bps	20.67%
		100 bps or >	13.14%

Sources: Barings; Credit Suisse; Bloomberg.

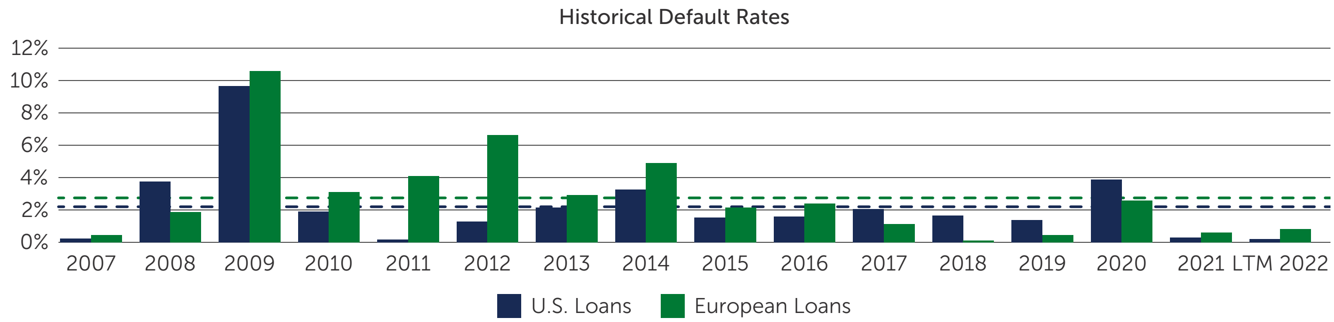
Still-Strong Fundamentals

The benefit of a true floating-rate coupon today is in the context of a still-strong fundamental backdrop. While Russia's invasion of Ukraine has roiled markets in recent weeks and escalated concerns around rising inflation, developed market companies today have lower leverage and quite a strong liquidity profile, thanks in part to elevated issuance over the last two years. Revenues, cash flows and EBITDA, in many cases, have returned to or surpassed 2019 levels. At the same time, many high yield issuers were able to capitalize on favorable market conditions to refinance their debt, which pushed out companies' maturities and has resulted in a limited number of near-term maturities across the loan markets. As a result of these factors, many of the issuers in the loan market today have a positive buffer to get through the inflationary pressures at hand. It is also worth emphasizing that the average issuer in the leveraged loan market is now materially larger compared to the great financial crisis and sovereign debt crisis. Larger businesses translate into larger and typically more resilient balance sheets, with senior secured loans generally issued on a conservative ~50% LTV basis.[1]

Combined with the strong fundamental picture, this evolution of the market has helped defaults remain manageable, and we expect them to stay below long-term historical averages in the near term **(Figure 2).** Supporting this outlook, only a small portion of the market (1.2% in the U.S. and 0.7% in Europe) was trading at distressed levels—or below 80 cents—at the end of February.[2] For context, in past periods when defaults were higher, such as in 2014, 2.2% of U.S. loans and 4.5% of European loans were trading below 80.[3] Further, although defaults do entail a potential loss of principal, there are typically opportunities to recover a portion of that through a restructuring process. Historically, loans have offered a relatively high recovery rate of 72.6%.[4]

1. Based on Barings market observations.
2. Source: Credit Suisse. As of February 28, 2022.
3. Source: Credit Suisse. Figures represent the 12-month average for the U.S. and Europe.
4. Source: Moody's Annual Default Study. As of January 2021. Global average corporate debt recovery rates measured by ultimate recoveries.

Figure 2: Defaults are Expected to Remain Below Long-Term Averages



Sources: S&P/LSTA Leveraged Loan Index; S&P European Leveraged Loan Index. As of February 28, 2022.

Given the positive fundamental backdrop and expectations for low defaults going forward, certain areas of the market seem to be more than compensating investors for the fundamental risk they are taking. Factoring in long-term average recovery assumptions for loans can provide an idea of how current spreads compare with loss given default scenarios. For example: U.S. and European loans are currently offering average spreads of roughly 450 bps and 467 bps, respectively, over the base rate.[5] If an investor assumes a recovery rate of 60%–80%, which is in line with historical averages, a spread of 450 bps would imply that it would take a default rate of over 10%—which is well-above current expectations—in order to fully erase any excess spread that should be required over a risk-free opportunity **(Figure 3)**.

That is to say, absent a significant and unprecedented increase in default rates to above 10%, and in the context of historically higher recovery rates, we expect the loan asset class to continue to generate positive returns, even if we see some increase in defaults going forward. It is worth highlighting that the loan market has exhibited positive performance over time. In the U.S., for instance, since 1992, the asset class has delivered negative annual returns only twice.[6] Additionally, the market has historically offered carry return each month from income, which can help offset price volatility.

Figure 3: Current Loan Spreads Appear to be Fairly Compensating Investors in the Context of Defaults (Loss Given Default Scenarios)

		Recovery Rate Scenarios					
		80%	70%	60%	50%	40%	30%
Default Rate Scenarios	1%	20 bps	30 bps	40 bps	50 bps	60 bps	70 bps
	2%	40 bps	60 bps	80 bps	100 bps	120 bps	140 bps
	3%	60 bps	90 bps	120 bps	150 bps	180 bps	210 bps
	4%	80 bps	120 bps	160 bps	200 bps	240 bps	280 bps
	5%	100 bps	150 bps	200 bps	250 bps	300 bps	350 bps
	6%	120 bps	180 bps	240 bps	300 bps	360 bps	420 bps
	7%	140 bps	210 bps	280 bps	350 bps	420 bps	490 bps
	8%	160 bps	240 bps	320 bps	400 bps	480 bps	560 bps
	9%	180 bps	270 bps	360 bps	450 bps	540 bps	630 bps
	10%	200 bps	300 bps	400 bps	500 bps	600 bps	700 bps

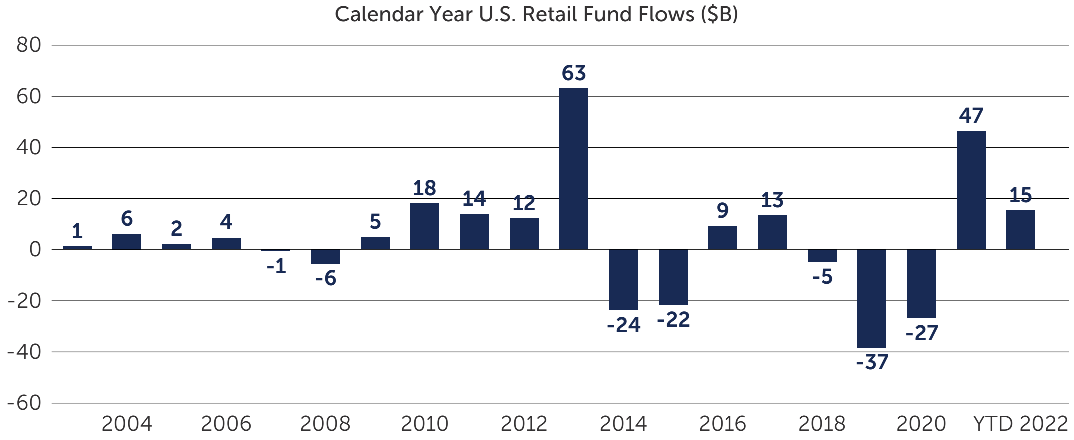
Source: Barings. Loss given default calculated as the default rate multiplied by one minus the recovery rate.
For illustrative purposes only. PAST PERFORMANCE IS NOT INDICATIVE OF FUTURE RESULTS.

5. Source: Credit Suisse. As of February 28, 2022. Loan spreads are based on 3-Year Discount Margin.
6. Credit Suisse. As of December 31, 2022.

Improving Technical Backdrop

As interest rates have started to move higher, investor sentiment has shifted notably toward loans and away from fixed rate assets. This is evidenced by the increase in demand across both the U.S. and Europe. Following roughly two years of outflows, U.S. retail fund flows—a key demand driver in the asset class—turned positive last year, reaching roughly $45 billion **(Figure 4)**. At the same time, collateralized loan obligation (CLO) issuance, another demand driver for loans, surged in both the U.S. and Europe last year, and the pipeline for new deals remains robust. This demand dynamic has created a technical tailwind for global loans, and should continue to support the asset class going forward given the floating-rate nature of both broadly syndicated loans and CLOs, as well as an outlook that calls for higher short-term rates.

Figure 4: U.S. Retail Fund Flows Have Turned Positive



Source: J.P. Morgan. As of February 28, 2022.

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Key Takeaway

As we look across the markets today, we believe there is an interesting opportunity in loans, for a number of reasons:

- A large portion of the senior secured loan market has a low base rate floor, meaning **a significant portion of the asset class is or will become truly floating rate**, offering a higher coupon payment, in a fairly short time frame.
- Corporate fundamentals, overall, remain strong, and current loan spreads appear to be fairly compensating investors in the context of defaults.
- Loans are benefiting from a **technical tailwind** due to increased demand for the asset class heading into a rate-hiking cycle.

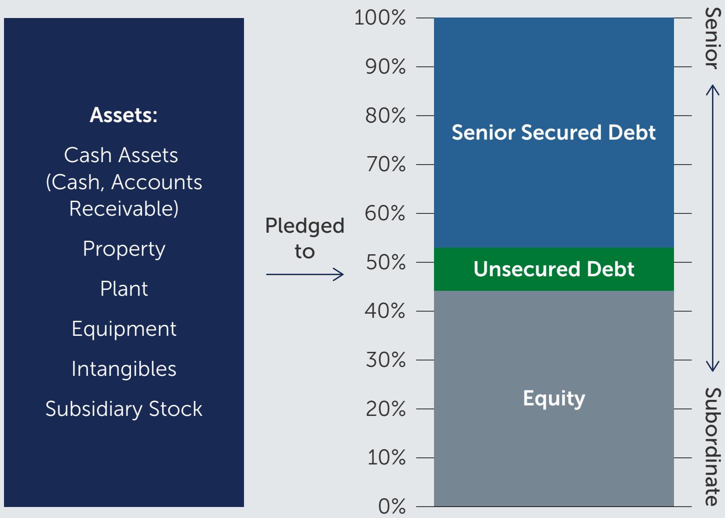
Of course, there is no shortage of risk factors to watch going forward. The long-term impacts of the Russia-Ukraine conflict are impossible to quantify at this stage, and have created considerable levels of uncertainty across markets. It is possible that things will get worse before getting better, and investors will undoubtedly be faced with volatile markets going forward. But it's important to note that periods of volatility can—and often do—result in opportunities for active, bottom-up managers to generate alpha. This has been the case through multiple market events, from the sovereign debt crisis, to the commodity crisis to the COVID-19 selloff. However, through these ups and downs, vigilance is key. If the past is any indication, a steadfast focus on fundamentals and bottom-up, credit-by-credit analysis can help identify issuers with the potential to thrive beyond today's events.

MULTIPLE LAYERS OF CREDIT RISK PROTECTION

Capital Structure Seniority:
Senior secured loans are typically senior to other outstanding debt, including high yield bonds, in an issuing company's capital structure. This seniority means that the loan's interest and principal payments must be paid before other creditors receive payment. In the event of default, senior loan holders also typically get paid back ahead of unsecured and junior debt, equity holders and other creditors. The lower portions of the capital structure (unsecured/junior debt and equity) can provide a cushion to senior debt against losses in a default situation.

Security:
Senior secured loans are secured by some or all of a borrower's assets. This security provides investors with additional credit risk protection as secured loans typically have first-priority claim on a borrower's assets in the event of default.

Illustrative Capital Structure—Senior Secured Loans



Source: S&P LCD Global and European Leveraged Lending Reviews.

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