

We're Not So Different, High Yield Bonds and Leveraged Loans

Late last year we authored [an article](#) detailing the growing differences between the high yield and leveraged loan markets, particularly the overall quality in the high yield market versus that of leveraged loans. Today, some of those most pronounced differences appear to be abating, which should translate to a more convergent outlook for the two markets as it relates to security, structure, recovery, covenants, and ultimately, performance. With the Fed poised to begin cutting rates in 2024, we felt it was important to address these emerging trends before the start of the new year.

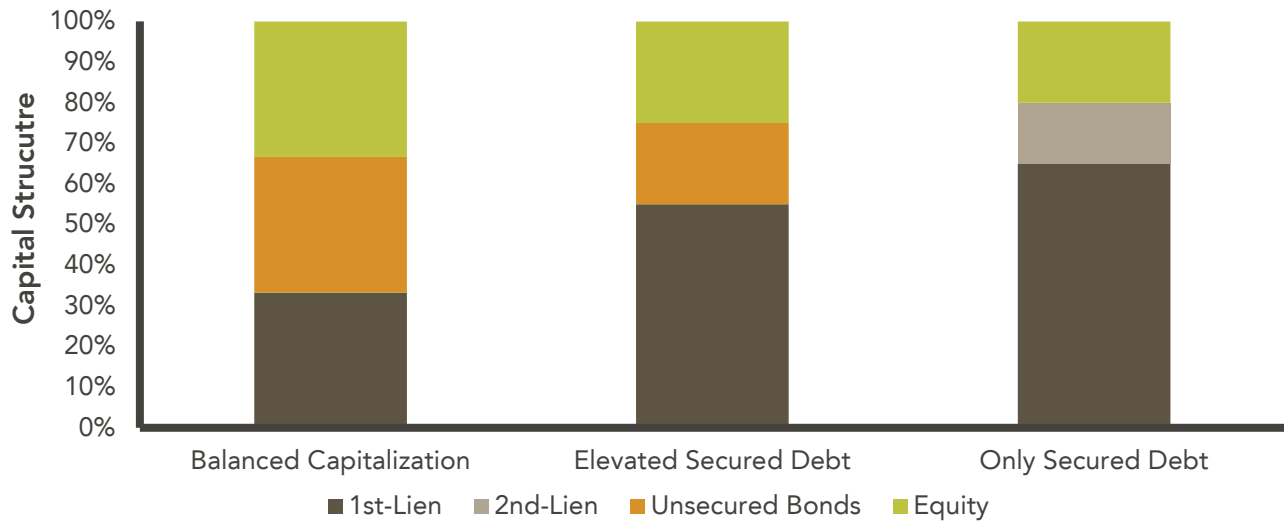
Structure & Security

There is a belief in the leveraged finance space that "If the entire capital structure is secured, then nothing is secured." Typically, when investors think about capital structure, they envision the one on the left in Exhibit 1 on the following page, which features a balance between senior secured debt, unsecured debt, and equity (as a matter of background, secured debt is typically in the form of leveraged loans, where the debt is "secured" by the assets of the borrower, while unsecured debt — high yield bonds — is not). As we have previously mentioned, since the Fed engaged in its zero interest rate policy (ZIRP), leveraged loans have become the preferred financing vehicle method for private equity takeovers and leveraged buyout deals (LBOs), which has transformed capital structures to consist primarily of loans, as shown by the middle and right columns in Exhibit 1.



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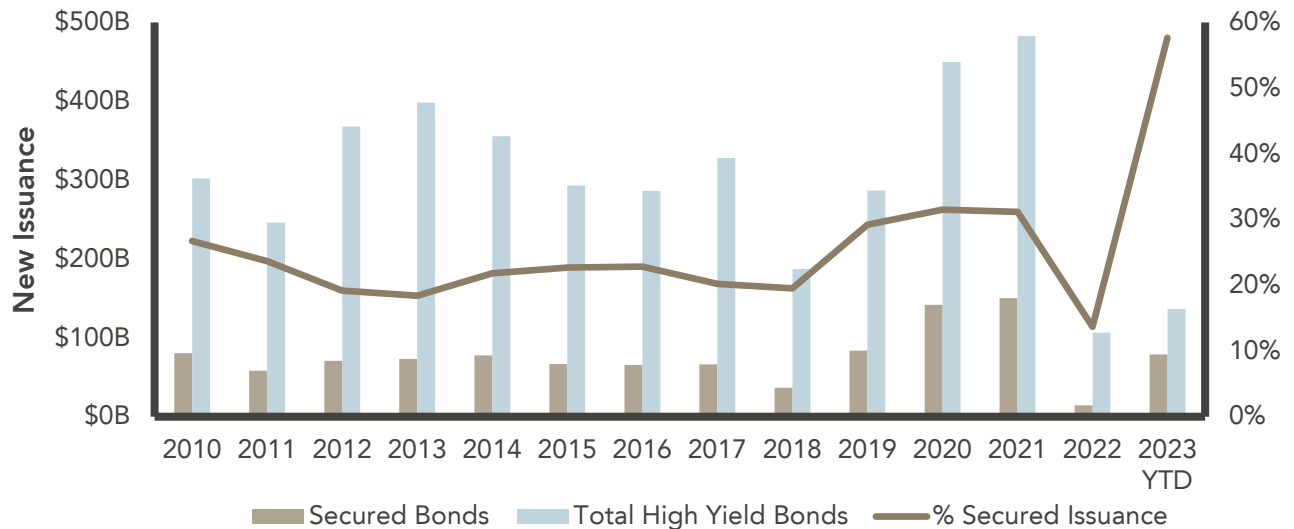
Exhibit 1: As LBOs have become more prevalent in the loan market, capital structures have evolved



For illustrative purposes only.

These shifting capital structures have led to a substantial increase in secured debt via both leveraged loans and senior secured high yield bonds. Overall new bond issuance has decreased but the amount of senior secured bond issuance represents a historically large share of high yield new issuance in 2023. As rates and rate volatility have increased, borrowers are evaluating their most favorable financing options. Thematically, one of the most notable changes we have seen this year is that borrowers who normally utilize floating-rate debt have recently been issuing senior secured bonds instead.

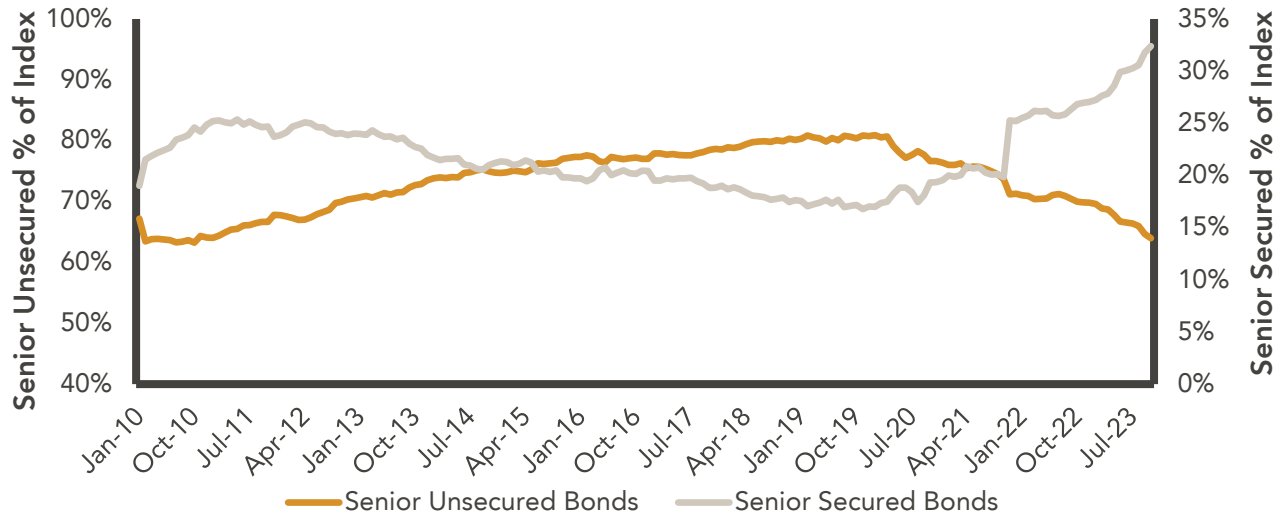
Exhibit 2: Senior secured bond issuance as a share of overall high yield issuance is at a record level in 2023



Source: J.P. Morgan as of September 30, 2023

Senior secured bonds have always been a constituent of the high yield market. However, over the past few years, their share of the overall index has increased dramatically and is now at a record level of the market. While the coupon structure is different, senior secured bonds are “secured” by the assets of the borrower, much like leveraged loans. This recent development — the growth of senior secured bonds as an overall percentage of the high yield market — blurs the lines between these markets and may lead to increasingly similar behavior between the markets.

Exhibit 3: Senior secured bonds now constitute one-third of the domestic high yield market

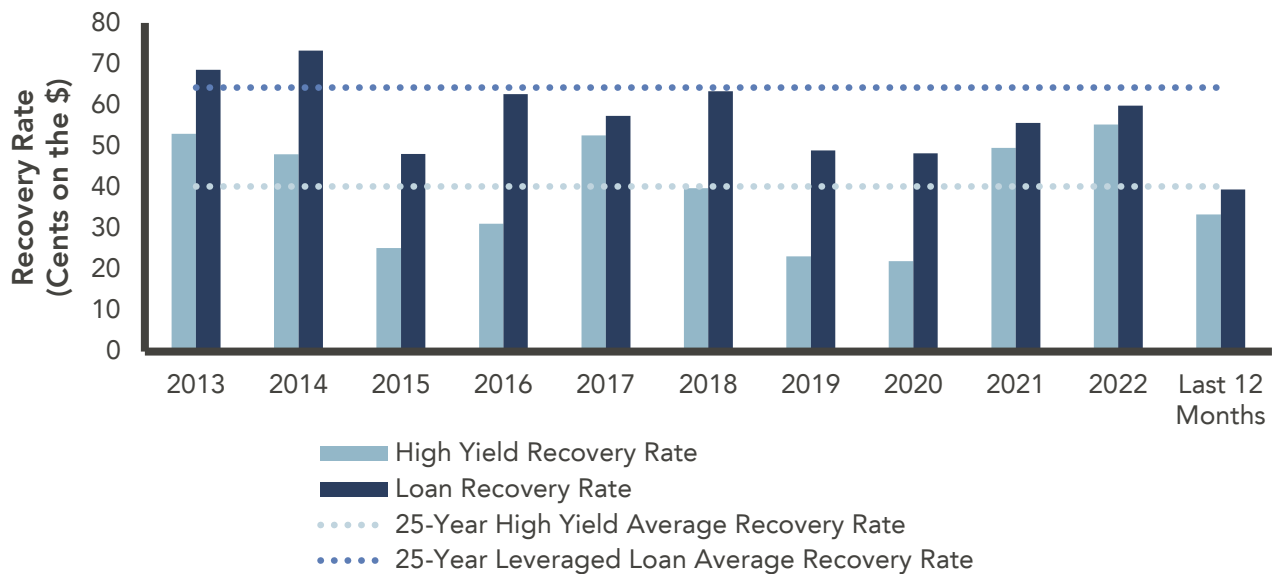


Source: J.P. Morgan as of October 31, 2023

Recovery Rates

The evolving capital structures and new issuance trends are expected to tighten the historical spread between recovery rates¹ on leveraged loans and high yield bonds. Historically, the recovery rates for leveraged loans and high yield bonds were 65% and 35%, respectively.² The recovery rate for loans is higher due to their senior position in the capital structure and thus their “secured” nature. However, as mentioned above and in last year’s newsletter, there are more issuers that utilize loan-only capital structures as three out of four issuers in the loan market feature loan-only capital structures.² In a loan-only capital structure there are no bonds below the loans to absorb losses and predictably, this new trend has driven the current recovery rate on leveraged loans to historical lows.

Exhibit 4: Leveraged loan recovery rates are trending lower



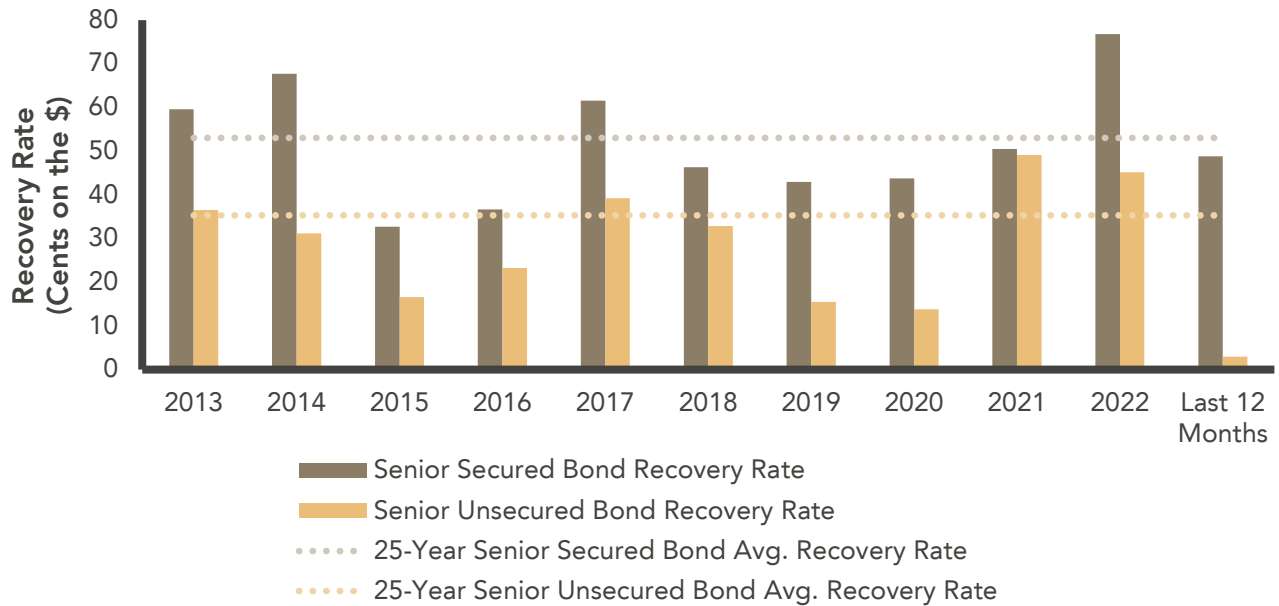
Source: J.P. Morgan as of October 31, 2023

¹ The recovery rate is the percentage of the original loan recovered on a defaulted loan or bond.

² J.P. Morgan as of October 31, 2023

The structure of an issue materially impacts the amount that is recovered. Looking more granularly at recovery rates in the high yield market, senior secured bonds have displayed higher recovery rates than senior unsecured bonds, which is not surprising given they are secured by assets of the issuer. Notably, senior secured bonds have seen a higher recovery rate over the last twelve months than leveraged loans, which is atypical. As senior secured bonds occupy a larger percentage of the overall high yield market, the overall recovery rate of the high yield market may increase. Given that this trend is in conjunction with a drop in recovery rates for leveraged loans, it would not be surprising to see the recovery rates between leveraged loans and high yield converge.

Exhibit 5: Senior secured bonds feature a higher recovery rate than their unsecured counterparts



Source: J.P. Morgan as of October 31, 2023

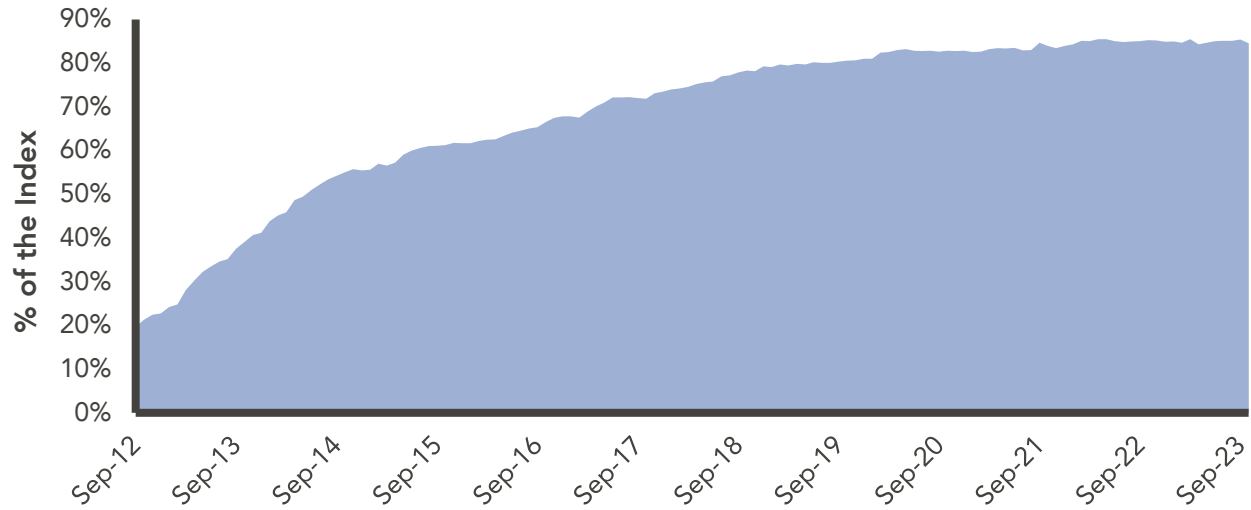
Additionally, senior secured bonds offer a meaningful yield premium relative to unsecured bonds within the high yield market; current yields for senior secured bond coupons are close to those of leveraged loans. For context, senior secured bonds presently offer a 100 basis point yield premium to unsecured bonds, with yields of 10.3% to 9.3%, respectively.³ This is another data point that speaks to convergence between the high yield and leveraged loans markets.

Covenants

While capital structure and security issuance are newer trends, a longer-term trend that has driven convergence in market behavior is covenants. Historically, leveraged loans contained maintenance covenants and high yield bonds contained incurrence covenants. Maintenance covenants are measured frequently and allowed lenders to step in to extract value as soon as the business began to underperform. Incurrence covenants are also known as cov-lite; they are only tested when a borrower “incurs” additional debt or engages in a transaction. Loans issued today primarily contain only incurrence covenants or are cov-lite. High yield bonds have always been cov-lite but now that loans carry the same less-strict covenants, it seems the two markets have converged from a covenant perspective as well. This dynamic may also contribute to increasingly similar behavior between the two markets.

³ J.P. Morgan as of October 31, 2023

Exhibit 6: Cov-lite loans continue to occupy the majority of the leveraged loan market



Source: Credit Suisse Leveraged Loan Index as of October 31, 2023

Conclusion

Many — including us — have highlighted in the past how the high yield and leveraged loan markets seemed to be moving in opposite directions as it relates to structure, security, recovery, and covenants. However, more recent trends suggest that some of these historically contrasting characteristics are starting to reverse, to the point that the markets appear to be converging more than diverging in terms of underlying characteristics, which will impact both risk and return for the two sectors. With the Fed poised to cut rates in 2024, that will undoubtedly be the headline story in fixed income markets, should that come to fruition. However, the potential convergence as suggested by the data in this article also bears watching and may translate to more similar behavior between leveraged loans and high yield bonds in future years. ■

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