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#Yield Signs

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Deep inside a cave some 200 miles east of Cape Town, South Africa, archeologists uncovered ancient markings that represent the earliest evidence of human drawing.

The hashtag precurser – six parallel lines criss-crossed by three diagonals – was etched by a prehistoric artist over 73,000 years ago with a red ochre crayon on a small stone the size of two thumbnails. “I think it’s definitely a symbol and there’s a message there,” said Dr. Christopher Hensilwood, the lead researcher, of the discovery.

Observers of the loan market are also experts at digging for meaning among otherwise inscrutable signs. Of late relative credit spreads are getting focused attention.

As we enter the last weeks of the quarter, how primary issuance is priced gives investors a clue how markets are viewing relative risk. When should the caution light go on? As one top credit manager pointed out, why do syndicated loan arrangers persist in setting second-lien spreads at only a 400 bps premium to first-liens?

In fact, while both first and second-lien loan spreads are up, the gap between them is shrinking (see our *Chart of the Week*). Given how stretchy total leverage has become (and that’s mostly on *adjusted* ebitda), does L+800 continue to make sense?

As a market share matter, second-lien takes a distant back seat to firsts. S&P LCD reports only 3% of all institutional leveraged bank and bond volume so far this year is comprised of seconds. That’s about $20 billion. And only a tiny fraction (1%) of the total $2.6 trillion debt outstanding are second-liens.

Apart from the syndicated loan market, there are second-lien opportunities for direct lenders to refinance larger corporate loans. A recent Thomson Reuters LPC piece estimates about $50 to $70 billion in seconds come due over the next several years. The amount of private credit dry powder available suggests there should be plenty of appetite to finance those maturities.

But as this stage of the cycle extends into its ninth year, how should investors think of risk-return for syndicated second-lien? Rating agencies warn that, thanks to higher leverage, weaker structures, and lack of covenants, recoveries for both first and second-lien loans will be worse in the next downturn than 2008-09.

Using recent post-default prices of liquid loans, Fitch estimates second lien recoveries for the twelve months ending July 31 to be 21.5 cents on the dollar. Admittedly, this is on a small data set. But compare that to 72.6 for first-lien recoveries. Since 2007, the average recoveries for second-lien and first-lien have been, respectively, 32.2 and 62.

How then, some ask, can you truly offset the downside of late cycle second-lien losses with loans only paying L+800? With no end in sight for this issuer-friendly market, experienced credit investors are beginning to see the writing on the wall.