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Investors steer clear of riskier assets

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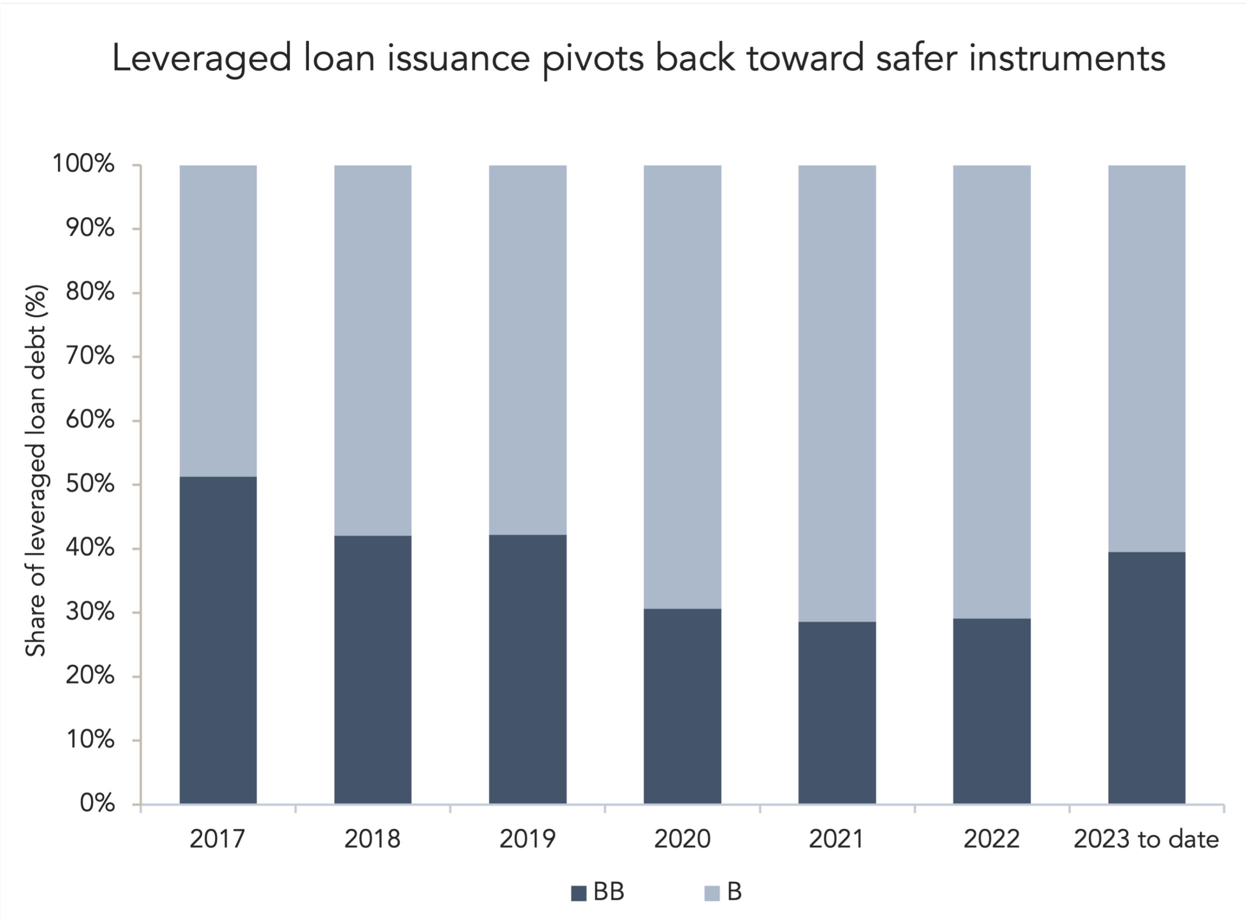

Source: Debtwire Par

Debt issued in the institutional leveraged loan market has shifted back towards the favor of double B facilities over single B rated tranches. So far in 2023, almost 40% of activity has been double B rated, marking the highest percentage in the last five years.

The bond market has followed a similar trend, with the share of debt issued as secured notes having remained at record levels of near 60% over the past three quarters. The historical average ranged between 25%-45% in the last decade, highlighting the current move towards safer assets.

In both markets, leverage can be seen to be falling as investors rush towards safer assets as investors lending on higher leverage ratios becomes unpalatable. Net leverage for 1H23 stands at 4.5x, while gross leverage is currently at 4.9x.

In the deals that do make it over the line, investors have been requiring higher yields to compensate for their investments in these riskier assets. Yields on first-lien institutional loans jumped to an unprecedented 10.6% so far in the second quarter, and the weighted average yield in the bond market stands at 8.7%. While this figure has decreased by over one percentage point from highs in 4Q22, the yield remains significantly above levels seen in recent years.

Despite these higher yields, refinancing activity continues to be a cornerstone of the current market, with high yield bond issuance having skyrocketing to USD 34bn so far in 2023 – near double the same period last year. Refinancing is similarly buoying the leveraged loan market, up 16% year on year despite overall leveraged issuance having fallen 30% to just under USD 300bn year to date. This shows that even with the headline figure of the leveraged market appearing solid, there is a notable lack of new capital being deployed in the sector.

As a result of the lack of supply from M&A transactions, dividend recaps have begun to resurface as sponsors realise exit opportunities are slim. A further USD 900m was issued for shareholder payments in April, bringing the total year to date value to USD 3.6bn.

With the leveraged market in its current state, eventually something will have to give. Issuers are currently paying over the odds to refinance debt, push out maturities in the short term at exceptionally high interest rates, which are unsustainable over the long term. The market is in an eerie calm with overall volumes looking respectable. However, money being moved away from lower rated assets, refinancing dominating issuance, and a lack of a solid M&A pipeline all point to an unsustainable market with issuers set up to be unable to pay the higher interest rates demanded by investors for the risk taken.

If interest rates were to drop materially in the next few years to allow borrowers to refinance at manageable interest rates, then a material rise in defaults could be avoided. However if the market remains in its current state, the ominous markers above show difficult road ahead.

(Past performance is no guarantee of future results.)