FINANCIAL TIMES
TUESDAY 12 FEBRUARY 2019

OPINION

Head to Head

# Do leveraged loans pose a threat to the US economy?

## **No** — They are resilient and stable, with fears about them based on fiction rather than fact

**DWIGHT SCOTT** - BLACKSTONE

When sentiment diverges from reality, as it did in the leveraged loan market late last year, it can create great opportunities for long-term investors, writes Dwight Scott. However, some recent rhetoric about this important capital source has become so far removed from the evidence that it is important to lay out the facts.

Keep in mind this critical statistic. After the 2008 crisis, when the US economy suffered its worst downturn since the 1930s, the realised loss rate for collateralised loan obligations — portfolios of leveraged loans — was just above 1 per cent, compared with losses of nearly 40 per cent in the broader structured finance market.

The loans are so resilient because they sit at the top of the credit structure, secured by virtually all of the borrowing company's assets. This provides substantial protection when a borrower runs into difficulty and has allowed leveraged loans to provide a positive return to investors in 18 of the last 20 years. Moreover leveraged loans are made at floating rates, typically repriced every 30 to 90 days: this is important in a dynamic rate environment.

The facts also do not back up assertions that the current leveraged loan market is creating meaningful risks to the financial system and broader economy. Let's look at their claims of lower credit quality, rapid growth in issuance, and reduced investor protections, known as covenants.

Today, the issuers of leveraged loans are performing well and the overall levels of indebtedness of seasoned borrowers have continued to trend downward through 2018. This reflects solid underlying credit quality and a strong economic environment.

Revenue at the public companies included in the S&P/LSTA Leveraged Loan Index grew at double digit rates for the last four quarters, and ebitda growth reached a seven-year high of 13 per cent in the third quarter of 2018. While investors always must be cognisant of the risk of a future economic downturn, a majority of borrowers have recently refinanced, reducing interest costs and extending maturities, further strengthening their credit profile.

Companies on average have cash flow that is more than 4.5 times their interest payments, the highest ratio since at least 2001. Most borrowers do not have to refinance any time soon: only 4 per cent of outstanding loans are due to mature within the next two years.

Fears that a "liquidity mismatch" as occurred in 2008 will recur in the leveraged loan market are misplaced. Back then, subprime mortgages were held by deposit-funded banks or off-balance sheet vehicles backed by short-term liabilities. When investors fled, a squeeze developed. Now, a majority of leveraged loans are funded with long-term, locked up capital: CLOs, with stated maturities of 10 to 12 years. These are mostly held by institutional investors, providing more stable funding.

The US leveraged loan market has recorded a compound annual average growth from 2008 to 2018 of less than 4 per cent, far smaller than the 35 per cent annual growth rate experienced during the five years leading up to 2008. And the new issuance activity in recent years has been dominated by refinancing rather than new company debt.

The increase in "covenant lite" loans is not necessarily a sign of imprudent lending. Rather, it reflects the evolution of this market. Unlike banks, which often hold loans until repaid, today's more diverse investor base actively buys and sells loans, making certain types of covenants less useful. If a loan's risk profile changes, investors can sell.

The market still has robust underlying protections: during a downturn a secured loan is better positioned to protect investors than many similar credit investments. The most important factor in assessing credit risk is and has always been the underlying strength of the company and its capital structure.

None of this is to say that investors should be complacent about the potential risk. They have a fundamental responsibility rigorously to analyse companies, credit quality, and the structure of every loan agreement. But it is also vital to separate fact from fiction. And right now, the discussion over the leveraged loans has trended toward the latter, rather than the former.

*The writer is president of GSO Capital Partners, Blackstone's credit platform*

© THE FINANCIAL TIMES LIMITED 2019