PIMCO

Too Much of a Good Thing: Excesses and Opportunities in Corporate Lending

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Ten years into the post-crisis economic recovery, investors must now contend with increasing evidence that the corporate debt markets may be overheating. With issuance levels, underwriting standards, and structured product demand all evidencing signs of strong excess, investors must ask themselves whether the corporate market lending arena has experienced "too much of a good thing."

Although investors have generally dismissed concerns amid benign economic conditions, we see risks on the horizon. Today's public below investment grade corporate debt market has reached an all-time high of $2.5 trillion while the relatively new sector of private lending has grown rapidly to $900 billion, exceeding the size of the high yield bond market in 2007.[1] Moreover, the rapid increase in issuance – and the transition to new investors and leveraged vehicles to hold this debt – has led to deteriorating underwriting standards, weaker lender protections, and rising loan impairment risk. Corporate borrowers' leverage has reached a record high and credit profiles are weakening. Yet, the structured product and private credit investors that now dominate the market all have structural disincentives to holding underperforming debt. And alongside this credit deterioration, dealer liquidity has dropped dramatically since the financial crisis.

The combination of these fundamental (underwriting) and technical (ownership structure) risks may create not only an opportunity within public debt markets, but also significant disruption in the newly popular private middle-market debt market. A sharp oversupply of capital has accumulated as boutique direct lending managers have raised nearly $149 billion over the past three years alone to lend to middle-market companies, based on data from Preqin. This new capital has replaced lending by regulated, conservative bank programs and takes the form of leveraged vehicles: private debt funds, collateralized loan obligations (CLOs), and business development companies (BDCs). In addition to often utilizing significant leverage, many of these structures have strict credit ratings tests, require current yield, and may not be well-resourced to execute time-intensive debt restructurings. As a result, when the economy weakens, we expect many of these debt holders to need liquidity on their underperforming credit positions.

While a broad market downturn will likely broaden the investment opportunity, it is not a necessary condition for successful investment. Even in the current late-cycle economy we have been able to consistently identify cyclical challenges facing a range of companies and industries. Company-specific issues and/or industry micro-cycles often constrain the availability of capital for certain borrowers. For investors with the ability to source and evaluate those situations, this creates a range of opportunities.

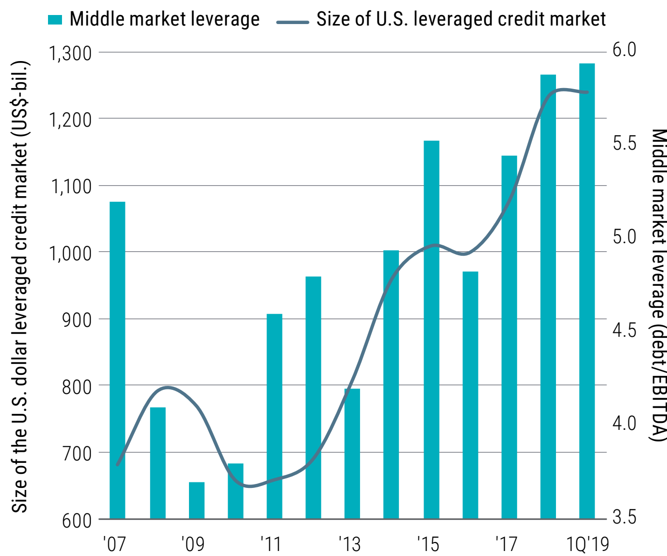
1 The size of the public below-investment-grade corporate market is based on Credit Suisse and Bank of America Merrill Lynch data; the private lending volume is from UBS.

THE TIPPING POINT: WHAT'S DIFFERENT THIS TIME?

Increased credit risk

Many investors evaluate the magnitude of distressed opportunities by drawing comparisons with previous cycles. The current market offers dramatic comparisons with the period before the global financial crisis in 2008–2009 (see Figure 1).

Figure 1: Bank loan market and middle-market leverage ratios climb to all-time highs



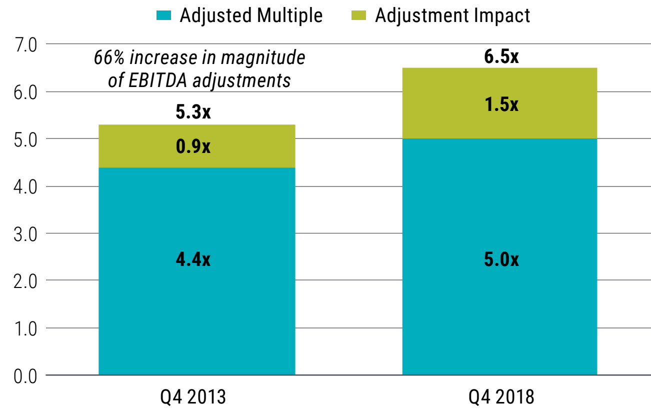
Source: Credit Suisse and S&P LCD as of 31 March 2019

The leverage profile of middle-market companies has risen dramatically over the past few years and indicates the vulnerability of these companies to any interruption in earnings growth, whether from customer loss, commodity price pressure, regulatory changes, or management changes – all of which are idiosyncratic headwinds independent of any broader market downturn. Of note, reported leverage multiples would be significantly higher if not for the growing practice among companies to include "proforma earnings adjustments" that reflect increased earnings and improved credit profiles at the time of their debt issuance (see Figure 2).

In addition to higher corporate leverage, the advent of "unitranche" financing is raising the risk in middle-market lending. Senior lenders are increasingly advancing the borrowers' entire capital needs in a single loan without the benefit of junior debt to absorb any credit losses (see Figure 3).

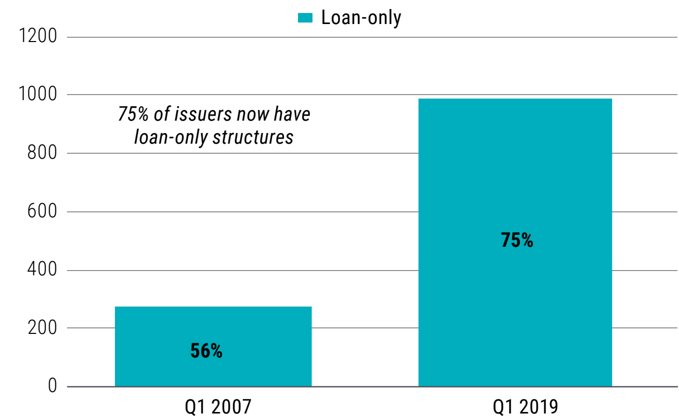
We believe that this lack of subordinated positions, combined with the minimal loan covenants that have also become more common, will likely lead to credit impairment for first-lien positions in any dislocated market.

Figure 2: Impact of adjusted EBITDA on leverage multiples



Source: Lincoln Financial as of 31 December 2018. Based on data for 1,200 middle-market companies (2.4% public, 97.6% private), with a median company EBITDA of $28.4 million. The companies come from a diverse set of industries: energy, healthcare, industrials, technology, consumer, and business services.

Figure 3: Number of U.S. issuers with loan-only capital structures



Source: JP Morgan as of 31 March 2019

Structurally challenged investment vehicles

Historically, middle-market lending was dominated by commercial banks with established credit underwriting processes that benefited from industry lending groups and loan workout teams overseen by banking regulators. Today, commercial banks own only a fraction of outstanding middle-market private loans and have ceded ground to direct-lending funds and public closed-end funds, including CLOs and BDCs.

Not only are these funds levered vehicles, which creates performance risk for investors, but they face income-generation requirements, strict portfolio credit quality restrictions, and resource constraints, all of which are strong disincentives to holding underperforming debt. We anticipate pricing dislocations as a result of selling by these vehicles if loan credit quality weakens.

Withdrawal of traditional liquidity providers

Contrary to a commonly held view, pricing dislocations are typically caused not by increasing default rates (which are generally a trailing indicator of credit health), but rather by an accelerated need for liquidity from existing debt holders. During a market dislocation, daily liquidity funds (e.g., mutual funds and exchange-traded funds) are typically motivated to sell holdings on the back of investor redemptions, while private fund managers often seek liquidity to remove the resource burden, credit rating impact, and short-term price volatility of underperforming credit.

Public market liquidity as measured by dealer capital has dropped meaningfully since the financial crisis. For example, only an estimated $2 billion was available from dealers at the end of the first quarter to support the trading of public high yield bonds – down from $26 billion in 2007, based on Credit Suisse data. Diminished liquidity is likely to have far-reaching effects for the bank loan market. Because most CLOs are strictly disincentivized from holding loans with low credit ratings and defaulted loans, and there are few other buyers without rating constraints, pricing dislocations are quite likely when these investors need to sell.

Even in healthy markets, private loans are generally challenging to trade in the secondary market due to their limited transparency, and could be expected to offer even higher illiquidity premiums during market downturns.

FITTING AN OPPORTUNISTIC CREDIT STRATEGY INTO AN INVESTMENT PORTFOLIO

Strategies that are less correlated to the public debt markets or that seek to capitalize on economic weakness, market downturns, and idiosyncratic company issues can offer investors diversification within a fixed income allocation.

PIMCO's approach to corporate special situations focuses on financing companies that are challenged currently but that we believe have strong trajectories and asset values. The performance of these opportunistic strategies often relies on company selection rather than the beta of the public debt markets. PIMCO's mandate is broad, providing investors with exposure to capital solutions as well as stressed, distressed, and idiosyncratic opportunities in both public and private markets. We thus aim to address the burden for investors to tactically rotate among strategies that focus on either performing credit or distressed credit.

Investors can also look to special situation and distressed credit strategies as alternatives to middle-market direct lending, where spreads have narrowed significantly, covenant protections have weakened, and leverage profiles have risen.

The risks

Opportunistic credit strategies are well positioned to invest during weak economic periods and in cyclical sectors. While investments can be structured with attractive terms and return potential, there can be elongation risk: In a prolonged downturn, some companies may be unable to refinance, thereby extending the holding period for lenders. Also, a prolonged downturn could create more challenges to earnings growth for companies, resulting in the need for additional capital to bridge them to an economic recovery.

For investors with longer time horizons who can tolerate these risks, we believe corporate debt can offer attractive opportunities for diversification and added return potential.

Past performance is not a guarantee or a reliable indicator of future results.

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