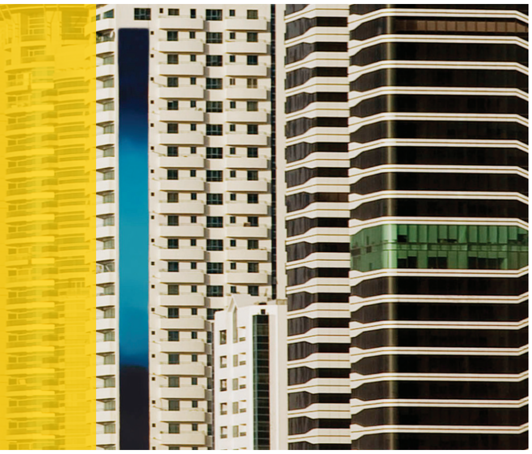

Loan Market Still Attractive For Discerning Investors Amid Overheating Concerns

By Paul Hatfield
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We believe there are still attractive opportunities. Even though most would agree that valuations have become a little stretched recently, the fundamentals remain solid.

Solid credit fundamentals and concern about rising interest rates have driven strong investor interest in floating-rate loans over the last few years. Secured loans offer investors less duration risk than fixed rate assets and a higher position in the capital structure than other credit investments. But after nearly two years in which money poured into the loan market and U.S. institutional loan issuance reached a record $455 billion in 2013,[1] some investors question whether loans still offer attractive opportunities. Paul Hatfield, Chief Investment Officer and Head of the Americas at BNY Mellon's Alcentra, one of the world's largest sub-investment credit managers, still sees opportunities for investors in loans, even as Alcentra takes care to watch for overheated valuations and deteriorating credit quality.

Paul, we've seen the headlines worrying about a bubble in the loan market. What's your view on the market?

We believe there are still attractive opportunities. Even though most would agree that valuations have become a little stretched recently, the fundamentals remain solid. Debt service is extremely strong because interest rates are still very low. Despite the well-publicized bankruptcy of TXU Energy, loan default rates are low and falling; according to S&P Capital IQ LCD, the default rate in June stood at a 21-month low of 1.08%.

Do those rising valuations offset the appeal of strong fundamentals?

We carefully consider the relationship between valuations and increased leverage. Higher valuations, particularly in technology, make it more difficult for private equity sponsors to win these businesses without bidding pretty strongly and using more leverage. Until April, as much as $1 billion per week was flowing into retail loan funds.[2] Those strong inflows, in turn, enabled the issuers to push for more aggressive terms, one of which was increased leverage. We also expect that sponsors will push for a bit more leverage so they can improve their returns in a low yield environment. Investors have been relatively comfortable with the increase in leverage because debt service is incredibly strong.

1 S&P Capital IQ
2 Lipper

Alcentra

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How do you interpret the outflows we've seen over the past two months?
We expected a reversal after 90 consecutive weeks of inflows. We don't see the shift in flows as a reflection of fundamental concern about credit quality. In our opinion, it's just a view on the interest rate cycle. We're in an interest rate cycle, not a credit cycle, and that's why people are allocating to other areas in addition to loans. Floating rate loans attracted a lot of investors who were positioning themselves for monetary policy normalization and rising interest rates. When (Federal Reserve chair) Janet Yellen and (European Central Bank president) Mario Draghi turned more dovish on monetary policy, it appeared to push the time when interest rates would rise further into the future. That perceived extension of the current low interest rate period prompted some investors to take profits from their loan investments and pursue risk-on investments in high-yield bonds for institutional investors and in emerging markets for retail investors.

How does the exit of those investors from the loan market reduce the concern that some observers may have about overheating?
Collateralized Loan Obligations (CLOs) are being issued at a good pace and are now the marginal bid in the market because of those retail outflows. That means more discipline in the market because of the tests that CLOs are subject to, plus they aren't mark-to-market vehicles. There is now much less pressure from retail funds to have to spend cash on whatever new issue comes out, irrespective of credit quality. As a result, we've seen as many upward flexes on pricing as we have downward flexes recently, and the U.S. market is actually now looking as attractive as the European in terms of spread per unit of risk.

So if that increase of discipline in the market has reduced the risk of overheating, what risks in the loan market are you watching most closely now?
We have seen some weaker sectors coming to market as well as some aggressive structures. In this strong market, some investors will take chances on those kinds of loans. We believe lenders should be focused on managing downside risk and therefore seek businesses that generate strong cash flows rather than those that might offer massive upside potential but with weaker fundamentals. Lenders should want to know whether a company will continue to generate cash and pay off its debt. We think it makes sense to avoid companies that have high fixed-cost bases, that don't generate a lot of cash and have vulnerable business models that are not appropriate for putting leverage on. Our main concern is capital preservation with a decent level of income, rather than stretching for extra return and taking excessive risk. For example, the restaurant sector is an area of concern because it's very competitive, has high fixed costs and struggles to generate cash during economic downturns.

We have become more selective in our lending; our approval rate for loans is roughly 1 in 4 today, down from 1 in 2 last year.

What about the increase in "covenant lite" issuance?

It is true that 70 percent of the US loan market can be regarded as covenant lite, and we are starting to see a loosening of terms in Europe as well. We take covenants very seriously when we are assessing a potential investment and still consider them important tools for getting companies back on track and securing repayment. That said, by next year we expect that the U.S. loan market will be almost entirely covenant lite and Europe will also see increased covenant lite issuance. Recently, a couple of covenant lite loans have been brought to market in Europe but it is too early to tell whether this is an established trend or just a one off.

We've also seen concerns about overheating in high yield markets as investors continue to reach for yield in this "lower for longer" rate environment. Is there a bubble in high yield and which areas of the market offer better relative value? How should investors think about allocating between loans and high yield in a diversified credit portfolio?

We've been concerned about the European high yield bond market for some time. We do not believe that current spreads adequately compensate investors for the risk involved. We are also concerned that the European market could prove more volatile than in the past if the strong inflows we have seen over the past year were to reverse. That said, the European high yield market remains strong in the near term as the ECB's guidance points to continued low rates and investors' search for yield continues.

Just as in Europe, valuations in the U.S. high yield market are also stretched. But U.S. high yield still offers good relative value compared to other asset classes, so we remain constructive on it. Duration has been an issue for the high yield bond markets. Most investors in high yield, including us, expected the 10 year Treasury rate to be higher than it is now. That has meant that short duration bonds have been a bit of a hinderance, while there have been opportunities to use longer duration bonds to enhance returns. Interestingly, while there has been some deterioration in U.S. credit quality over the past few years, it has mainly come from the higher rated issuers at the BB end of the spectrum. Meanwhile, CCC rated borrowers have generally reduced their leverage over the last year. Overall, fundamentals in the U.S. high yield market remain in good shape because corporate performance has been strong despite some weak GDP data.

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