Private Credit vs. Public Debt (Third of a Series)

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The fundamental thesis governing credit risk for bond holders relative to loan holders is that the latter is advantaged by the seniority and secured position in the issuer's capital stack. As our *Chart of the Week* shows, these two elements work together to give loan investors the best chance for the highest recovery in case of a default.

All things being equal, the weaker position held by bonds is offset by the higher coupons of those instruments. However, as we discussed in the first installment of our special series [link], supply/demand technicals often play a larger role in relative yields than structural fundamentals.

Another factor to consider besides seniority is the type of cushion below you. Having unsecured and truly subordinated debt, along with the sponsor's cash equity, under your senior secured loan provides additional capital to protect you in a liquidation.

S&P LCD data bears this out. For facilities with a greater than 50% capital cushion below them, the average discounted recovery is 85%. When the cushion drops below 50%, the recovery also drops, down to 50%.

Beyond capital structure, the mere size of financings can sway credit risk. For example, the preponderance of energy-related credit is owned by large institutional (rather than middle market) investors. Saying we're in the ninth year of an economic recovery is quaint for companies in the oil patch. Since the price of crude plummeted from $107/bbl in June 2014 to $46 in January 2015 (eventually hitting bottom at just under $30 last February), the energy sector has been in its own sustained recession.

To illustrate the effect of this industry downturn on issuers of debt, let's look at the corporate default rate. According to S&P, that rate fell to 4.4% in February (from 5% in January). Embedded in that number was an almost 25% default rate for the energy/resources sector. Strip that out and the overall rate drops to only 2.1%.

This impact is also evident when comparing default rates for tranches greater than $350 million with those less than $350 million. Over each of the past fifty months, the default rate for the large loans has exceeded that of smaller loans in all but four instances.

Finally, experienced managers know that no single factor contributes more to greater credit risk than excess borrower leverage. High-yield bonds historically carry higher leverage, in part because bonds are typically refinanced, not amortizated from cash flow.

Recent S&P data show LBO bonds with total debt to ebitda of almost 6.4x. Compare that with broadly syndicated loan leverage of 6.10x (per Thomson Reuters LPC most recent data) and middle market loan leverage of 5.33x.

Interestingly, LPC's metrics gleaned from private club (i.e. non-syndicated) senior debt deals show even lower leverage of 4.62x. That's a telling statistic for investors considering the relative credit risk proposition between private credit and public debt.

Next week we conclude by examining other private vs. public debt issues.