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Four Reasons Security Matters Right Now

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Amid the late stages of an elongated credit cycle, Martin Horne, Barings' Head of Global High Yield, discusses four reasons why global senior secured bonds—a lesser known and perhaps underappreciated subset of high yield—could be an attractive option in the event of defaults.

Capital Structure Seniority

Defaults have remained near historical lows in recent years, but inevitably they will begin to rise when the credit cycle ultimately turns. In such an environment, being senior in the capital structure will be critically important. Senior secured bonds, as their name indicates, sit at the top of the capital structure alongside senior secured loans. In the event that a corporation defaults on its debt obligation to investors, and therefore fails to repay the bond it issued, it can be forced into bankruptcy liquidation. In such a case, its assets are sold off to repay its debts, which are repaid in a prescribed order of priority—with senior debt first, ahead of junior/subordinated debt. If a bond is classified as secured versus unsecured, it is backed by issuer collateral, or some form of assets, and has capital structure seniority, thereby placing it at the top of the repayment order. Collateral can take the form of various assets—including real estate, equipment, vehicles, and intangible items like software or trademarks—and may be used to satisfy any outstanding claims by the senior secured lenders, making them the most preferred creditors in a company's capital structure.

Higher Recovery Rates

Because senior secured bonds are the first to get paid out in the capital structure, and due to their backing by hard assets, in the event that a company defaults, they tend to have a higher recovery rate than traditional unsecured high yield bonds—meaning a greater proportion of the debt is repaid. Based on the debt and equity cushion beneath the instruments, the senior secured bonds tend to be covered by twice the value when first issued. This generally tends to lead to a higher recovery rate,

compared to the broader high yield bond markets. Historically—although weighted toward retail and commodity defaults, which are areas of traditionally lower recovery—during the period from 1987–2019 (YTD) the average recovery rate for defaulted senior secured bonds was 62.1%.[1] Though the rate of recovery depends on a number of factors—including the nature of the collateral assets, the current market for them, and the legal and practical steps involved in recouping the principal assets—secured lenders will always have a seat at the table in negotiations regarding a restructuring, and will be treated as senior throughout the process. Particularly amid a maturing credit cycle, this priority standing can be attractive to investors who may be wary of investing in a sub-investment grade asset class.

A Broad and Growing Opportunity Set

Another valuable consideration for debt investors is the sheer size of the opportunity set, as well as its historically low correlations with other asset classes—which offer the additional benefit of diversification. The senior secured high yield bond market has experienced substantial growth since the global financial crisis (GFC), particularly in Europe. This is due largely to the emergence of the asset class as a viable source of funding for companies, whereas other capital-raising avenues—including loans and unsecured bonds—have faced limitations as banks pared lending during and after the GFC. Today, the value of the market is in excess of $315 billion.[2]

Consistent Returns Through the Headlines

Senior secured bond returns have been compelling on a historical basis—having delivered average returns of approximately 7.0% per annum over the last 15 years.[3] It is worth noting that such returns were generated through several periods of geopolitical uncertainty—including the GFC, the sovereign debt crisis, the "Taper Tantrum," the commodity cycle, and Brexit, to name a few. So, particularly in the event of broader market weakness—for investors willing to give up a minor amount of spread, and withstand some short-term volatility—senior secured bonds can offer a degree of principal protection that unsecured bonds cannot, while still generating an attractive return.

A version of this article was published in the Nordic Fund Selection Journal.

1 Source: Moody's Corporate Default & Recovery Rates. As of March 31, 2019.

2 Source: Bank of America Merrill Lynch. As of March 31, 2019.

3 Sources: Barclays, Bank of America Merrill Lynch, Credit Suisse. As of March 31, 2019.

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