Understanding the importance of the capital structure in credit investments: Why being at the top (in loans) is a better risk position

Before making any investment decision, whether it's in equity, fixed income or property it's important to consider whether you are adequately compensated for the risks you are taking. Understanding where your investment sits in the capital structure will help you recognise the potential downside that could result in permanent loss of capital.

Within a typical business there are various financing securities used to fund existing operations and growth. Most companies will use a combination of both debt and equity. The debt may come in different forms including senior secured loans and unsecured bonds, while equity typically comes as preference or ordinary shares. The exact combination of these instruments forms the company's "capital structure", and is usually designed to suit the underlying cash flows and assets of the business as well as investor and management risk appetites.

The most fundamental aspect for debt investors in any capital structure is seniority and security in the capital structure which is reflected in the level of leverage and impacts the amount an investor should recover if a company fails to meet its financial obligations.

Seniority refers to where an instrument ranks in priority of payment. Creditors (debt holders) normally have a legal right to be paid both interest and principal in priority to shareholders. Amongst creditors, "senior" creditors will be paid in priority to "junior" creditors. Security refers to a creditor's right to take a "mortgage" or "lien" over property and other assets of a company in a default scenario. Senior secured loans and bonds will typically have a first ranking claim over both the cash flow and assets of a borrower. Other forms of debt may be senior in payment but without any security ("senior unsecured") or be junior in both payment and security ("subordinated") but will still have a contractual right to both interest and principal. Payments of subordinated bonds can be subordinated at discretion of management and maybe deferred or even deferred and non-cumulative in the case of some hybrid securities.

The figure below outlines a typical capital structure of a company and leverage. As highlighted by the seniority to other securities – senior loans offer clients downside protection in the event of default.

Senior secured loans generally have a shorter tenor (5-8 years), compared to senior unsecured bonds (7+ years), subordinated debt (10+ years), preference equity (perpetual and generally callable) and ordinary equity (perpetual).

Normally, debt investors are paid an additional credit spread for investing in securities with lower seniority and security. While equity can provide the highest potential total return, it also comes with higher risk of permanent capital loss. Equity holders share in the profit and also the losses of a company, and are paid after other obligations are fulfilled (sometimes referred to as "it representing a residual claim in the assets of a business, ranking behind all other claims in payment). Reflecting the higher risk, equity markets are significantly more volatile than debt markets.

For example, over the past 24 years, global equity markets have a volatility of 14.8% pa, compared with Senior secured loans of just 5.35% pa.

Figure 1: Risk/Return in a Typical Capital Structure

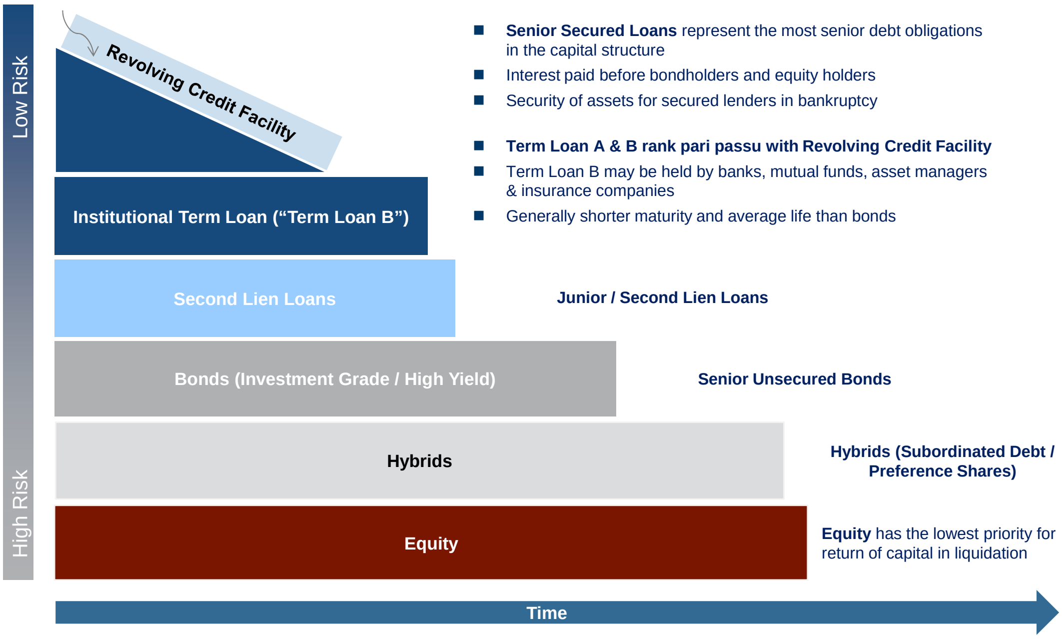

Table 1: Hypothetical Capital Structure and Leverage

($ millions, unless otherwise stated)	Years to Maturity	Interest Rate	Amount Outstanding	Leverage x EBITDA	% of Cap
RC due			0.0		
Senior Secured Term Loan B	7	L+450	500.0		
Total Senior Secured Debt			**500.0**	**2.00x**	**22.2%**
Senior Unsecured Debt	10	7.50%	500.0		
Total Senior Debt			**1,000.0**	**4.00x**	**44.4%**
Subordinated Debt	12	10.0%	250.0		
Toal Debt			**1,250.0**	**5.00x**	**55.6%**
Cash			(250.0)		
Net Debt			**1,000.0**	**4.00x**	**44.4%**
Equity	NA	NA	1,000.0		
Total Capitalization			**2,250.0**	**9.00x**	**100.0%**

Reflecting their seniority in the capital structure, Senior Secured Loans typically fare better than other corporate debt instruments in the event of default. In a bull market, senior secured loans tend to perform well as underlying corporate fundamentals improve.

In a bear market, the first-lien on assets provides a natural floor to loan prices. The table below outlines historical recovery rates for senior loans relative to other sub-investment grade credit instruments.

Apart from their position in the capital structure, other attributes of senior loans are diversity (with around 1200 issuers), an active secondary market with on average $US45bn traded every month and the fact that Senior Loans are floating in nature, which means they tend to perform well in a rising interest rate environment.

High-yield bond default and issuer-weighted recovery rates

		Recovery rates				
	Default Rate	All Bonds	Snr Sec	Snr Unsec	Snr Sub	Sub
1982	3.4%	35.3	72.5	35.8	48.1	30.0
1983	1.6%	44.5	40.0	52.7	43.5	41.1
1984	2.1%	45.5	na	49.4	67.9	44.3
1985	3.8%	43.6	83.6	60.2	29.6	39.7
1986	3.5%	47.4	59.2	51.1	46.8	41.4
1987	6.9%	51.3	71.0	63.8	46.5	46.9
1988	2.8%	38.8	55.4	45.2	33.4	33.8
1989	7.2%	32.3	46.5	45.1	34.6	26.4
1990	10.9%	25.5	33.8	37.0	25.6	19.1
1991	11.5%	35.5	48.4	36.7	41.8	24.4
1992	4.4%	45.9	62.1	49.2	49.4	38.0
1993	2.3%	43.1	na	37.1	51.9	44.1
1994	1.4%	45.6	69.3	53.7	29.6	38.0
1995	2.8%	43.3	62.0	47.6	34.3	41.5
1996	1.6%	41.5	47.6	62.8	43.8	22.6
1997	1.5%	48.8	75.5	56.1	44.7	33.1
1998	1.7%	38.3	46.8	39.5	45.0	18.2
1999	4.1%	33.8	36.0	38.0	26.9	35.6
2000	5.0%	25.3	38.7	24.2	20.8	31.9
2001	9.1%	21.8	35.0	21.5	19.8	15.9
2002	8.0%	29.7	49.0	29.5	21.4	24.5
2003	3.3%	40.4	66.3	41.9	37.2	12.3
2004	1.1%	58.5	73.3	52.1	42.3	94.0
2005	2.8%	56.0	71.9	54.9	26.1	51.3
2006	0.9%	55.0	74.6	55.0	41.4	56.1
2007	0.4%	54.7	80.5	53.3	54.5	na
2008	2.3%	26.85	28.27	33.70	18.32	10.25
2009	10.3%	22.41	30.07	23.39	22.75	5.38
2009 Adj.	-	35.68	42.86	42.98	26.12	4.75
2010	0.8%	40.95	51.85	36.51	22.17	na
2011	1.7%	48.56	63.72	36.22	31.17	7.00
2012	1.3%	53.23	60.45	38.53	10.50	na
2013	0.7%	52.74	59.57	36.47	46.00	1.00
2014	2.9%	48.05	67.74	31.22	33.75	na
2015	1.8%	25.19	32.69	16.60	12.96	na
LTM	**3.5%**	**25.48**	**31.07**	**18.13**	**0.25**	**na**
25-yr ann. avg.	**3.4%**	**41.41**	**55.47**	**40.23**	**33.14**	**30.26**

Notes: Recovery rates are issuer-weighted and based on price 30 days after default date. 2009 Adj. recoveries are based on year-end prices.

Leveraged loan default and recovery rates

	Def. rate	First-Lien	Second-Lien
1990	-	72.0	-
1991	-	67.9	-
1992	-	60.6	-
1993	-	53.4	-
1994	-	67.6	-
1995	-	75.4	-
1996	-	85.5	-
1997	-	78.8	-
1998	1.5%	56.7	-
1999	4.2%	73.5	-
2000	6.6%	68.8	-
2001	6.3%	64.9	-
2002	6.0%	58.8	-
2003	2.3%	73.4	-
2004	1.0%	87.7	-
2005	3.0%	83.8	-
2006	0.5%	83.6	-
2007	0.2%	68.6	-
2008	3.7%	58.09	32.78
2009	12.8%	48.33	31.90
2009 Adj.	-	61.36	36.44
2010	1.8%	71.18	13.33
2011	0.4%	66.97	1.31
2012	1.4%	55.29	18.33
2013	1.7%	68.62	56.67
2014	4.3%	73.31	37.67
2015	1.7%	48.15	34.34
LTM	**2.1%**	**49.88**	**21.54**
18-year ann. avg.	**3.3%**	**67.21**	**28.29**

Notes: Recovery rates are issuer-weighted and based on price 30 days after default date. 2009 Adj. recoveries are based on year-end prices.
Sources: Moody's Investors Service; J.P. Morgan; S&P LCD; Markit

Leveraged loan issuer-weighted recovery rates

2016	Sr Sec Term	Second-Lien
All loans	49.88	21.54
Loan-only issuers	53.91	24.68
Loan & bond issuers	44.06	9.00

Source: JP Morgan. As at 30 Sep 2016

Given the benefits outlined above (primarily the seniority in the capital structure and the high levels of recovery from default) senior loans are now an institutionally accepted asset class, and held by many of the world's leading pension and sovereign wealth funds.

They can reduce overall risk when added to portfolios of Government bonds and equities. Investors can lower overall volatility, and improve returns per unit of risk by allocating a portion of their portfolios to the asset class.