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INSIGHT

MONTHLY COMMENTARY

Loan Review – January 2019

DREW SWEENEY | 15 FEBRUARY 2019

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Mr. Sweeney is a Senior Vice President in the Fixed Income group where he trades leveraged loans. Mr. Sweeney joined TCW in 2015 from Bradford & Marzec, LLC where he managed loan strategies for both total return and CLO accounts as well as serving on the investment committee where he helped direct the firm's overall investment strategy. Prior to Bradford & Marzec, Mr. Sweeney worked for Macquarie Group (fka Four Corners Capital Management) in Los Angeles, where he managed both bank loan and high yield bond investments. Prior to Four Corners, he evaluated leverage loan and bond opportunities for Columbia Management (Ameriprise Financial, Inc.). He also worked as an Analyst with ING Capital Advisors and as a member of the investment banking team at First Union Securities where he gained additional experience in underwriting, structuring and syndicating leveraged transactions. Drew holds an MBA from the University of North Carolina Kenan-Flagler Business School and a BS from Rutgers University.

"In like a lion, out like a lamb" has been a proverb signifying the end of winter and the beginning of spring in March. That adage seemed appropriate for loan returns in January as the index roared in the first eight days of the month and then traded quietly, range-bound for the remainder. There were a few interesting takeaways from the month. The first, and perhaps, foremost was liquidity. The loan market traded higher on relatively little volume. Billion-dollar term loans would push 1, 2 and even 3 points higher with scant transaction volume. Once the market bounced higher, it found relative equilibrium as retail loan funds continue to experience outflows and CLOs began slowly to ramp and print deals again.

The second interesting takeaway was the fact that there was so much merger & acquisition activity and that this activity led to many loans being 'taken-away' from our market. Over $12 billion of loans had announcements representing future pay downs: Fiserv's acquisition of First Data ($7.2 billion of institutional term loans), ETE's repayment of over $2.0 billion of bank debt, BrightStone's acquisition of PharMerica ($815 million term loan), Laureate's asset sales, which will prepay some portion of their debt ($1.2 billion term loan).

After essentially breaking down in December, the new issue loan market reopened, successfully syndicating deals again as a result of loans paying down, CLOs ramping up and loans presenting attractive relative value characteristics relative to high yield.

Performance

In January 2019, the Credit Suisse Leveraged Loan Index (CS LLI) and the S&P Leveraged Loan Index (S&P/LSTA) were up 2.30% and down 2.55%, respectively.

- For the 12 months ending January 31, the CS LLI was up 2.35% and the S&P/LSTA was up 2.02%.

In January, higher quality outperformed and moved first. Double Bs were the top performing category followed by Split Double Bs. After such a dramatic fourth quarter for risk assets, term loan lenders did not immediately jump back into distressed loans and consequently Triple Cs and Distressed debt underperformed during the month.

Total Return by Rating

	January	LTM
Split BBB	2.53%	2.38%
BB	2.94%	2.29%
Split BB	2.86%	1.92%
B	2.09%	2.44%
Split B	2.65%	4.01%
CCC/Split CCC	0.59%	2.11%
Distressed (CC, C and Default)	0.51%	-2.71%

Source: Credit Suisse Leveraged Loan Index

Sector Performance

In a complete reversal from December, all sectors in the CS LLI had positive returns in January. The top performing sectors were Food & Drug (3.65%), Metals/Minerals (3.01%) and Gaming/Leisure (2.83%).

The worst performing sectors for the month were Consumer Durables (1.86%), Transportation (1.81%) and Service (1.70%).

In the last 12 months, Retail, Transportation and Energy have led all sectors with total returns of 3.97%, 3.85% and 3.26%, respectively. Interestingly, Retail and Energy have also led defaults during the last 12 months. In contrast, Manufacturing, Media/Telecommunications and Consumer Durables were the worst performing sectors with returns of 1.53%, 1.42% and -2.64%, respectively. Consumer Durables is a segment dominated by one large company experiencing heavy competition from online retail and this has weighed on the returns for the broader sector.

Industry Returns

Sector	January	LTM
AEROSPACE	2.66%	2.17%
CHEMICALS	2.54%	2.95%
CONSUMER DURABLES	1.86%	-2.64%
CONSUMER NON-DURABLES	1.98%	1.57%
ENERGY	2.40%	3.26%
FINANCIAL	2.06%	2.70%
FOOD AND DRUG	3.65%	2.97%
FOOD/TOBACCO	2.27%	2.01%
FOREST PROD/CONTAINERS	2.62%	1.88%
GAMING/LEISURE	2.83%	2.65%
HEALTHCARE	2.53%	2.74%
HOUSING	2.68%	2.13%
INFORMATION TECHNOLOGY	2.19%	2.39%
MANUFACTURING	1.89%	1.53%
MEDIA/TELECOMMUNICATIONS	2.50%	1.42%
METALS/MINERALS	3.01%	2.60%
RETAIL	2.71%	3.97%
SERVICE	1.70%	2.18%
TRANSPORTATION	1.81%	3.85%
UTILITY	2.01%	3.18%

Source: Credit Suisse Leveraged Loan Index

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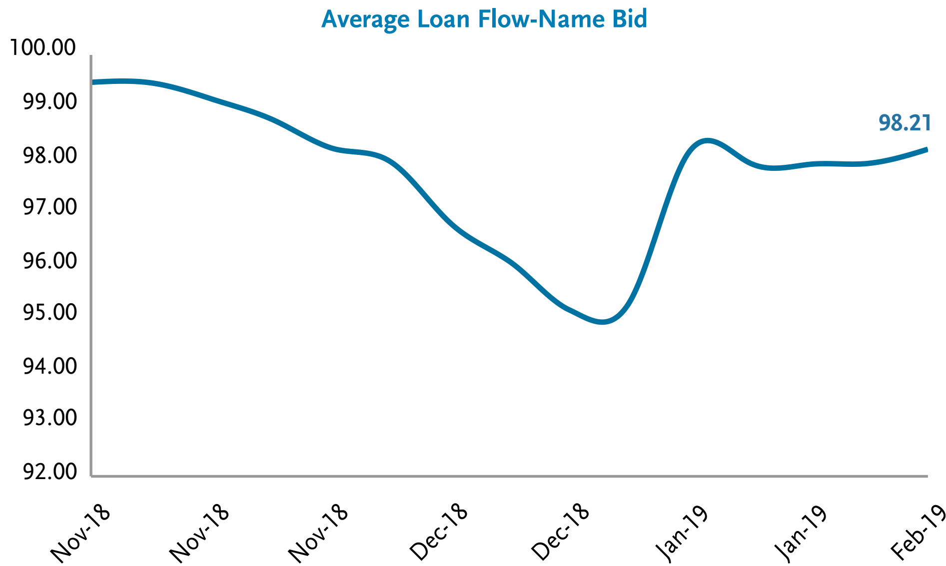
CS LLI prices increased 172 basis points in January while the average bid of the S&P LCD flow-name loan composite jumped 292 basis points from 95.29 to 98.21, almost completely re-tracing December's losses.

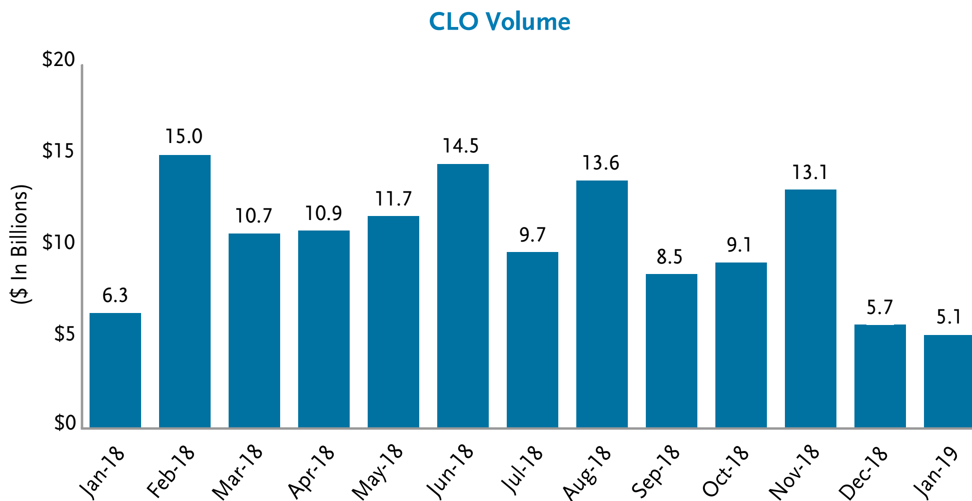


Source: LCD, an offering of S&P Global Market Intelligence

Technical Conditions

Leveraged loan funds reported an outflow of approximately -$3.7 billion for the month ending January 31, which compares to a nearly -$10.4 billion withdrawal in the prior month. The AUM for the loan mutual fund base is down to $125 billion from as high as $154 billion in October. Outflows in January were down from -$4.7 billion year-over-year.

There were $5.1 billion of CLOs issued in January, which is down from $5.7 billion in December 2018 and down year-over-year from $6.3 billion. CLO issuance for 2018 represented the all-time highest volume for the market since inception.



Source: LCD, an offering of S&P Global Market Intelligence

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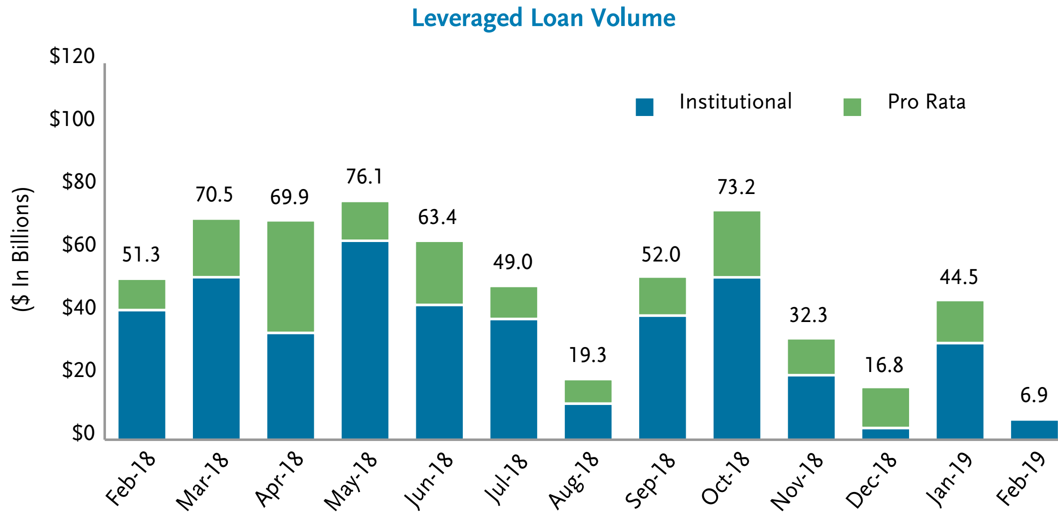
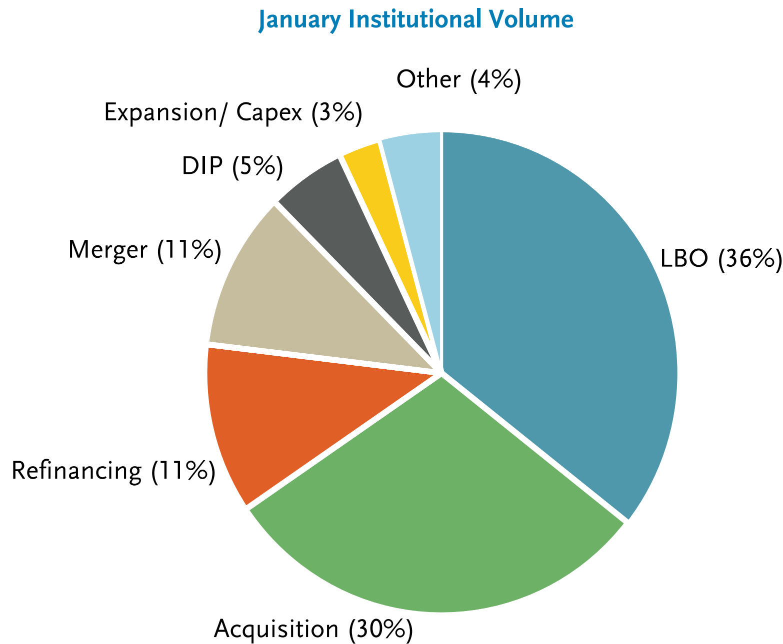
Institutional new issuance was surprisingly strong in January as deals that were unable to launch in December came back to market. The new issue market broke down in December and transaction financing M&A activity was unable to syndicate. In January, institutional issuance was approximately $31 billion, up from $3.8 billion in December.



Source: LCD, an offering of S&P Global Market Intelligence

Acquisitions, mergers and LBOs represented 76% of the January transactions, while DIPs, Capital Expenditure Financings and Refinancing represented the remainder.



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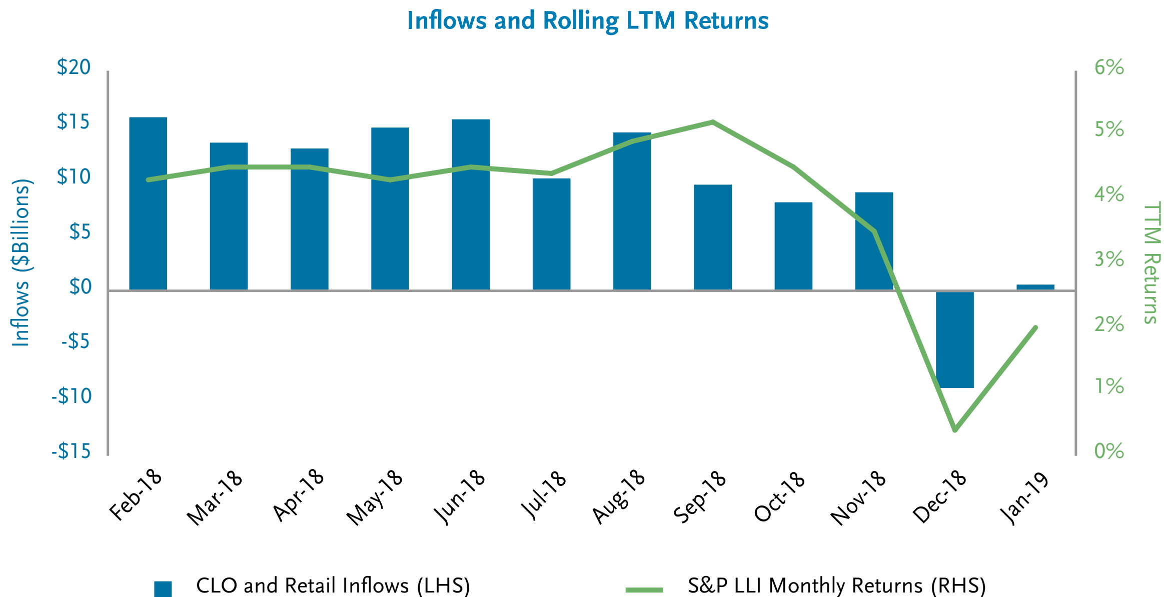
In January we saw positive CLO issuance and negative loan fund outflows net a positive number. With the positive flows into the market, cash on the sidelines, attractive relative value for crossover investors and a number of loans being paid down – loan returns gapped higher. Returns popped over 2.5% for the month, making up much of December's losses.

Inflows and Rolling LTM Returns



Source: LCD, an offering of S&P Global Market Intelligence

While January spreads narrowed month over month, there were barely any transactions in December, and they occurred in the beginning of the month before the market broke down. However, January new issue spreads were nearly 30% wider year over year. The new issue market returned to functioning status but spreads were wide on a relative basis and much wider than 2018 levels.

New Issue Spread Changes

	All Loans
Dec-17	346
Mar-18	317
Jun-18	362
Sep-18	378
Nov-18	401
Dec-18	452
Jan-19	434
Month-Over-Month Change	-3.99%
Year-over-Year	29.97%
LTM Change	36.1%

Source: LCD, an offering of S&P Global Market Intelligence

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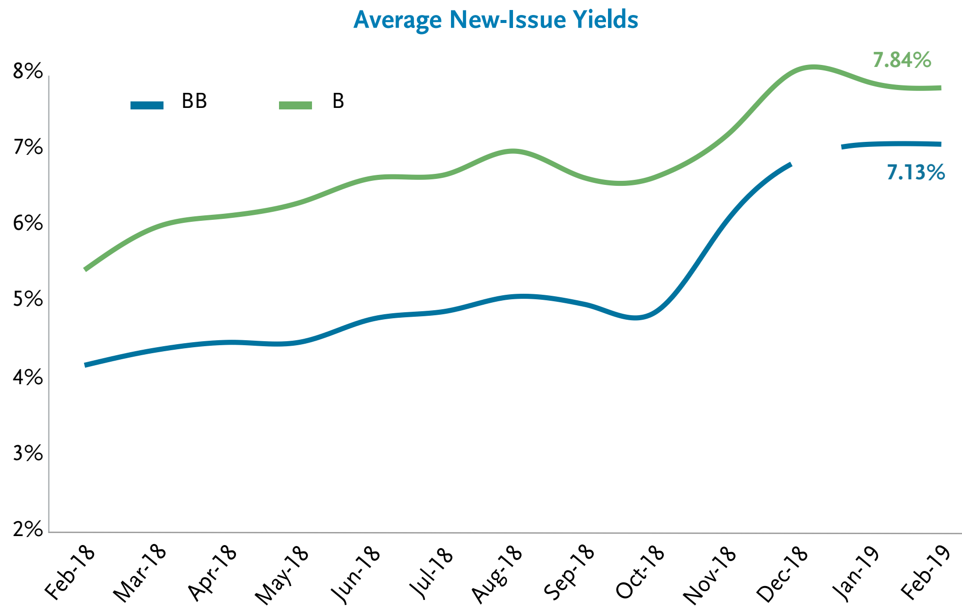
In terms of new issue yields, single Bs widened 69 basis points as compared to November 2018 (the last functioning new issue market). Double Bs widened 107 basis points from November levels.



Source: LCD, an offering of S&P Global Market Intelligence

There were no defaults in January and the default rate changed from 1.63% in November to 1.42%.

The last 12-month default tally for the S&P/LSTA 18. Retail leads all categories with six while Oil & Gas has declined to just two defaults.

Lagging 12-Month Default Rates

Actual	Oct-18	Nov-18	Dec-18	1/31/19
By Number	1.79%	1.56%	1.56%	1.44%
By Principal Amount	1.92%	1.61%	1.63%	1.42%
Shadow Default Rate				
By Number	0.75%	0.73%	0.73%	0.62%
By Principal Amount	0.50%	0.46%	0.39%	0.39%

Source: LCD Loan Stats

* Shadow default rate includes potential defaults, including those companies that have engaged bankruptcy advisors, performing loans with SD or D corporate rating and those paying default interest

Valuation

Since 1992, the average 3-year discount margin (DM) for the CS LLI is 460 basis points. If the global financial crisis (2008 & 2009) is excluded, the 3-year DM for the CS LLI is 417 basis points. The 3-year DM finished the month at 482 basis points, which is the second highest level since November 2016.

The DM spread differential between double Bs and single Bs has tightened from February 2018 to January 2019 by 0.2 basis points and is still 39 basis points wider than the historical spread differential.

3-Year Discount Margin Differential Between BBs and Single Bs

1/1992-1/2019 Average	85.4
Feb-18	124.4
Jan-19	124.2

CS LLI Snapshot

YTD Total Return*	2.30%
Average Price	95.81
Spread	347.44
Coupon	6.20%
Current Yield	6.48%
Yield (3-year life)	7.36%
Discount Margin (3-year life)	482 bp

*S&P LLI YTD Total Return 2.55%

Source: Credit Suisse Leveraged Loan Index

	Spread	DM (3-Year Life)
Split BBB	194 bps	253 bps
BB	257 bps	326 bps
Split BB	298 bps	399 bps
B	381 bps	510 bps
Split B	494 bps	876 bps
CCC/Split CCC	676 bps	1,170 bps
Distressed (CC, C and Default)	443 bps	3,293 bps

Source: Credit Suisse Leveraged Loan Index

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Summary & Looking Forward

As of January 31, the S&P/LSTA Index imputed default rate was 2.43%, down from 3.34% in the prior month. This level is more in line with 2015 and 2016.

Volatility has continued to be a hallmark of the loan market in the last four months. CLO demand has been offset by loan fund outflows. Crossover investors continue to move in and out of the market based on relative value and that seems to augment the volatility of the market. While loan prices spiked to begin the year, levels from the second week of January into early February have traded generally flat. The loan market did digest a reasonably large new issue calendar and that forward calendar in February has shrunk considerably. As a result, it feels as if loans are well bid with moderating loan outflows, increasing CLO generation and reduced supply. ■

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