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MONTHLY COMMENTARY

Loan Review – March 2017

DREW SWEENEY | APRIL 12, 2017

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Mr. Sweeney is a Senior Vice President in the U.S. 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.

While the loan market backed off of its recent highs in March, demand continued to remain supportive. With nearly two-thirds of the loan market trading at or above par, re-pricing existing-term loans dominated issuance.

In mid-March price action became surreal. High yield bonds and loans within retail, portions of the pharmaceuticals industry and commodity-driven businesses all declined in price. Furthermore, earnings results were mixed in March and with the broader markets feeling a bit nervous, disappointing results were penalized severely.

However, the loan primary market danced to a tune no others could hear. Despite the nervous tone to the market, the re-pricing trend that has dominated the last six months, remained ever strong.

Performance

In March 2017, the Credit Suisse Leverage Loan Index ("CS LLI") and the S&P Leveraged Loan Index ("S&P/LSTA") were both up 0.08%.

- For the first quarter ending March 31, 2017, the CS LLI was up 1.20% and the S&P/LSTA was up 1.15%.
- For the twelve months ending March 31, 2017, the CS LLI was up 9.74% and the S&P/LSTA was up 9.72%.

Sector Performance

Index loan prices were down during the month, largely offset by coupon. Higher-beta sectors sold off more than higher-quality borrowers. As a result, commodity-driven industries and secularly-challenged sectors like retail, struggled.

Consumer Durables, Gaming/Leisure and Consumer Non-Durables were the top performing sectors for the month of March with returns of 0.60%, 0.42%, and 0.41% respectively. Twelve of the 20 sectors below managed to post positive results during the first quarter.

Total Return by Sector

Sector	March	Sector	QTD	Sector	LTM
Aerospace	-0.01%	Aerospace	0.94%	Aerospace	8.15%
Chemicals	0.21%	Chemicals	1.07%	Chemicals	7.93%
Consumer Durables	0.60%	Consumer Durables	1.43%	Consumer Durables	9.93%
Consumer Non-Durables	0.41%	Consumer Non-Durables	1.32%	Consumer Non-Durables	7.65%
Energy	-1.45%	Energy	4.62%	Energy	52.99%
Financial	-0.08%	Financial	1.00%	Financial	8.75%
Food And Drug	-0.22%	Food And Drug	0.70%	Food And Drug	5.83%
Food/Tobacco	-0.07%	Food/Tobacco	0.78%	Food/Tobacco	5.82%
Forest Prod/Containers	0.28%	Forest Prod/Containers	0.71%	Forest Prod/Containers	7.08%
Gaming/Leisure	0.42%	Gaming/Leisure	1.45%	Gaming/Leisure	10.00%
Healthcare	0.19%	Healthcare	1.31%	Healthcare	6.66%
Housing	0.25%	Housing	1.03%	Housing	6.87%
Information Technology	0.26%	Information Technology	1.10%	Information Technology	9.61%
Manufacturing	0.22%	Manufacturing	1.41%	Manufacturing	10.08%
Media/Telecommunications	0.17%	Media/Telecommunications	1.23%	Media/Telecommunications	8.23%
Metals/Minerals	0.29%	Metals/Minerals	3.16%	Metals/Minerals	45.57%
Retail	-0.78%	Retail	-2.44%	Retail	1.35%
Service	0.38%	Service	1.94%	Service	9.20%
Transportation	-0.06%	Transportation	1.36%	Transportation	9.24%
Utility	-0.28%	Utility	0.59%	Utility	10.49%

Source: Credit Suisse Leveraged Loan Index

Utility, Retail and Energy were the worst performing sectors for the month of March with returns of -.28%, -.78%, and -1.45% respectively. Energy loans backed-up after a torrid pace of appreciation in January and February. This softness coincided with some fundamental price weakness in WTI Crude. However, much of that weakness was ameliorated by the end of the month as WTI prices rose back above 50. Retail was the sole sector to produce a negative return in the first quarter and this was primarily a result of the number of bricks-and-mortar businesses struggling in the apparel segment. To hammer home this point, Payless ShoeSource filed for bankruptcy in the first few days of April 2017. Utility felt heavy for most of the month as concerns surrounding green energy increased and growth in wind, solar and battery capacity all weighed on power prices.

The flow-name prices below illustrate overall index performance during the month. Prices backed up for most of the month before showing signs of stabilization. Much of the weakness was driven by loans being re-priced or the expectation that higher-priced loans will have their coupons reset. This was also compounded by the weakness in high yield, which led to high-yield investors selling loans.

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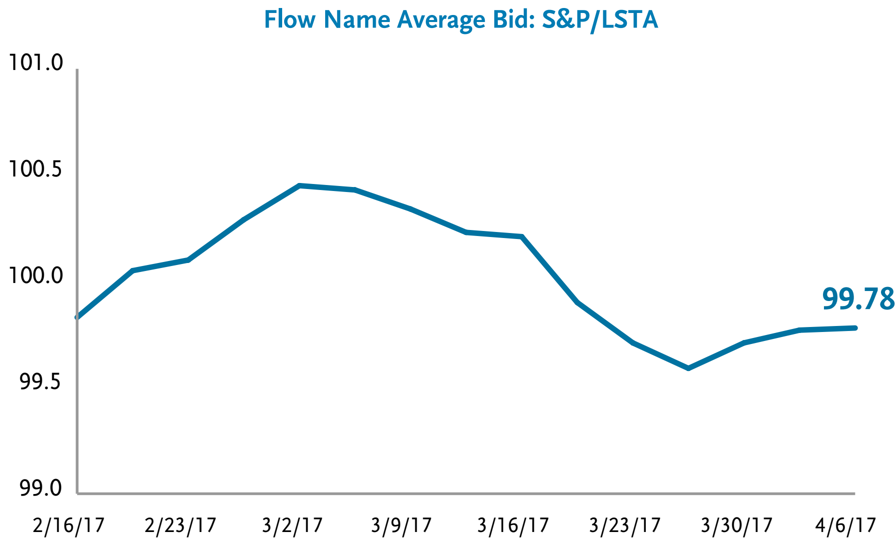
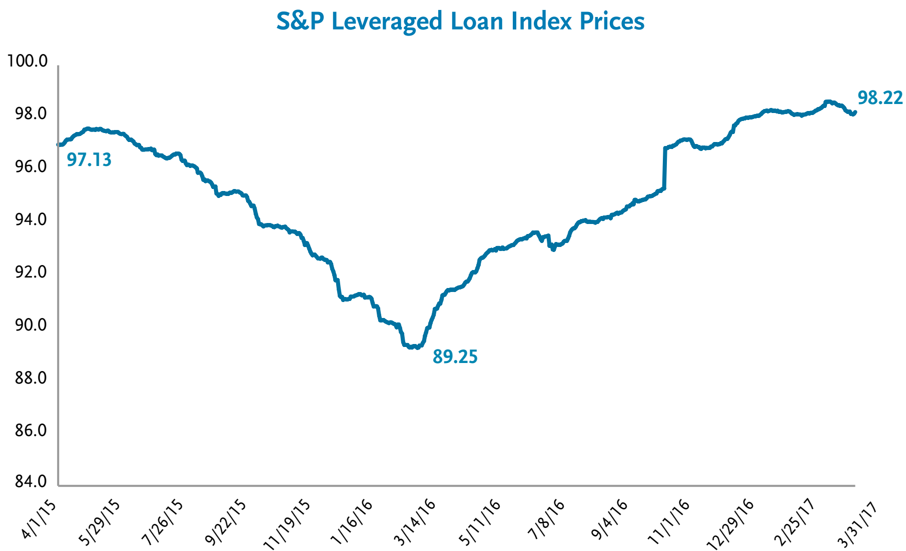


Source: LCD, an offering of S&P Global Market Intelligencex

Prices of the SPLLI below demonstrate the snapback in prices that have taken place during the last 12 months despite any subtle weakness demonstrated in March.



Source: S&P Leveraged Loan Index

Technical Conditions

CLO global supply hit a quarterly record of $76.36 billion in Q1 2017 following last quarter's $67.5 billion. Volume has been overwhelmingly driven by refinancing and reset activity as opposed to actual new issuance.

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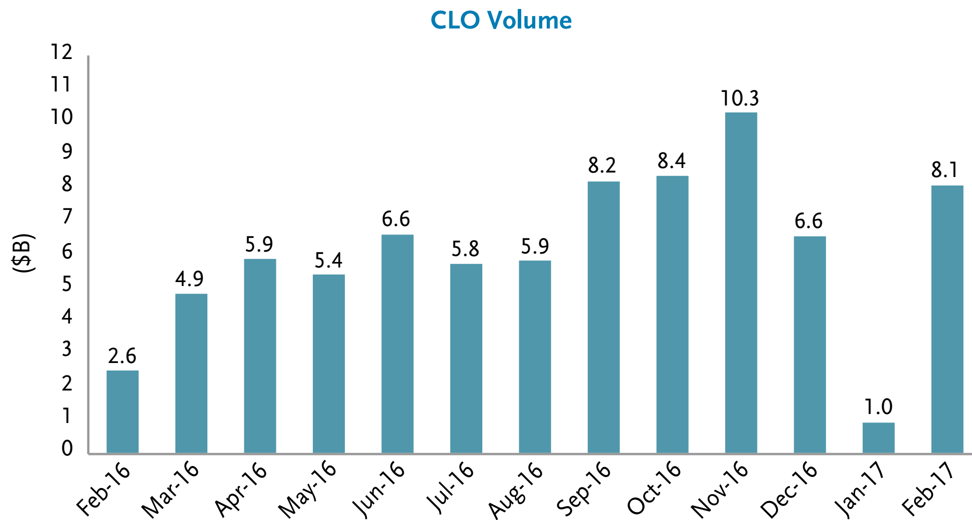
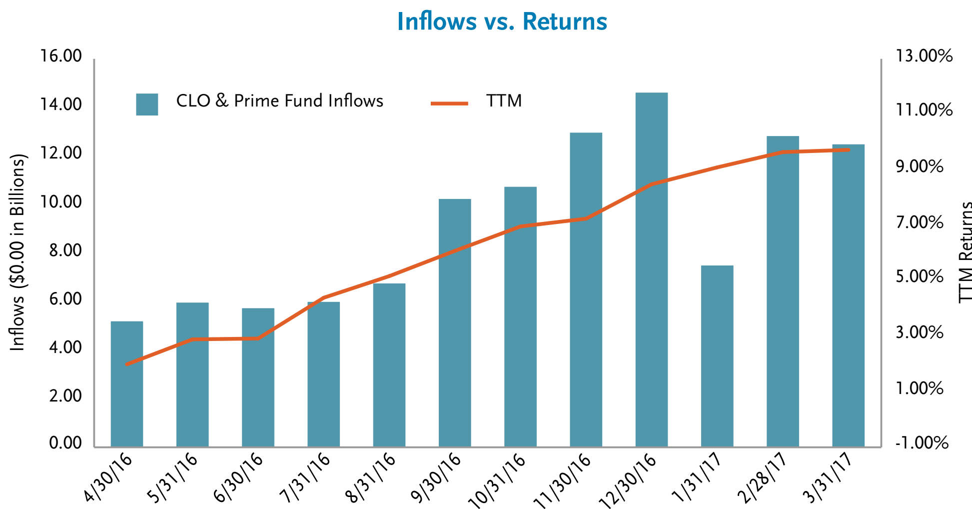
New issue US CLO volumes this quarter were relatively muted by historical issuance levels with approximately $17 billion dollars priced in the first quarter. Access to assets continued to be the primary difficulty for ramping CLOs. Loans trading above par, with high levels of re-pricing activity and little actual true M&A activity has led to slow and difficult ramps for newly minted CLOs. Q1 2017 produced the second-lowest quarter of new issue US CLO supply since the beginning of 2014.



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

While the CLO market has slowed, retail fund flows continue to contribute to overall demand. With $16.0 billion of retail inflows in the first quarter nearly equaling CLO demand, and additional inflows from separate accounts, the technical characteristics of loan demand continued to provide a stable environment to produce positive returns. As inflows grew during the last 12 months, returns surged. As inflows moderated, returns flattened.



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

As can be seen below, loan new issuance in the first quarter was driven by repricing, refinancing and dividend activity. A full 75% of all issuance fell into these three categories while 18% of all loan issuance was actually driven by merger and acquisition activity.

LevFin Insights LF Pricing Report

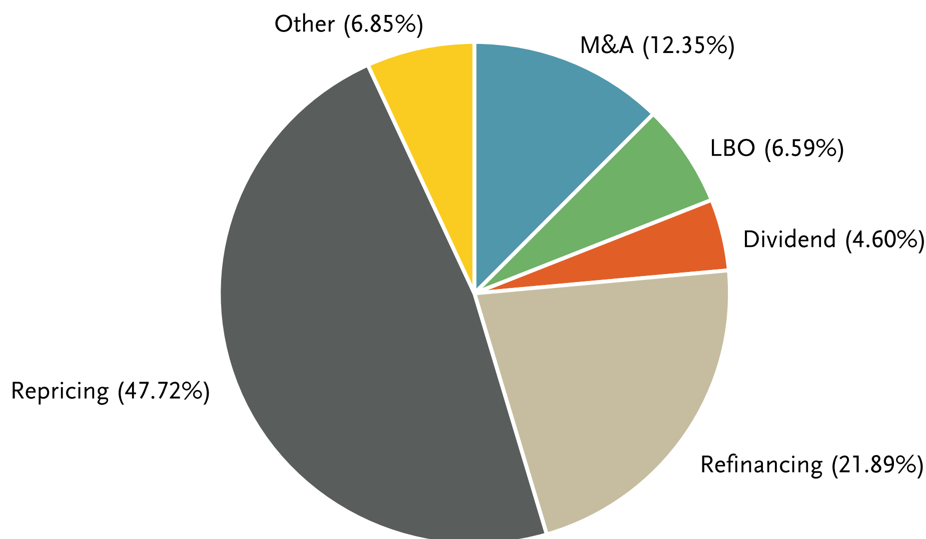
	4B			
	Spread (L+)	Floor	OID	YTM
Sep-16	266.7	0.50%	99.82%	3.61%
Oct-16	275.0	0.50%	99.81%	3.73%
Nov-16	293.8	0.66%	99.88%	3.94%
Dec-16	258.3	0.33%	99.83%	3.63%
Jan-17	238.4	0.29%	99.90%	3.47%
Feb-17	248.6	0.26%	99.90%	3.60%
Mar-17	250.0	0.19%	99.89%	3.70%
Change	-16.7	-0.31%	-0.07%	-0.09%

	3B			
	Spread (L+)	Floor	OID	YTM
Sep-16	310.4	0.71%	99.74%	4.12%
Oct-16	353.3	0.73%	99.50%	4.64%
Nov-16	318.2	0.66%	99.48%	4.37%
Dec-16	271.9	0.44%	99.97%	3.74%
Jan-17	266.7	0.39%	99.86%	3.78%
Feb-17	300.0	0.50%	99.78%	4.18%
Mar-17	289.4	0.48%	99.88%	4.13%
Change	-21.0	-0.23%	-0.13%	-0.01%

	2B			
	Spread (L+)	Floor	OID	YTM
Sep-16	388.1	0.97%	99.58%	5.04%
Oct-16	367.3	0.88%	99.62%	4.82%
Nov-16	377.3	0.92%	99.53%	4.95%
Dec-16	397.2	1.00%	99.54%	5.18%
Jan-17	355.2	0.90%	99.78%	4.70%
Feb-17	360.8	0.91%	99.79%	4.79%
Mar-17	356.1	0.80%	99.70%	4.85%
Change	-32.1	-0.17%	-0.12%	0.19%

As can be seen below, loan new issuance in the first quarter was driven by repricing, refinancing and dividend activity. A full 75% of all issuance fell into these three categories while 18% of all loan issuance was actually driven by merger and acquisition activity.

Total New Issue Loan Volume YTD



Source: LevFin Quarterly

While $222.9 billion of loans priced in the first quarter, $185.8 billion of the proceeds went to pay down existing loans. This meant that the net supply was actually $37.1 billion. In the first quarter there was roughly $38.4 billion of new demand, which means that demand outstripped supply and contributed to prices pushing higher on the quarter.

Technicals

	Jan-17	Feb-17	Mar-16	1Q17
Priced Deals	$119.7B	$103.2B	$114.8B	$222.9B
Associated Repayments	$96.1B	$89.7B	$92.3B	$185.8B
Net Priced Volume	$23.6B	$13.5B	$22.5B	$37.1B
CLO Issuance	$1.0B	$8.0B	$7.9B	$9.0B
Loan Mutual Fund Flows	$4.8B	$3.3B	$3.3B	$8.1B
Repayments Unrelated to New Issue	$11.6B	$8.5B	$9.2B	$20.0B
Estimated Quarter-end Amortizations	$2.2B	$0.0B		$2.2B
Total Inflows	$18.5B	$19.9B	$20.4B	$38.4B
Net Supply	-$5.1B	$6.4B	-$2.1B	$1.3B

Source: LevFin Insights 1Q2017 Quarterly Charts

Fundamentals

One standard of assessing the quality of issuance is by looking at the percentage of EBITDA adjustments. Adjustments are the amount of EBITDA add-backs/synergies that underwriters and companies market and provide for in their credit agreements. In the first quarter, average adjustment to EBITDA increased to 29.4%, up from 22.4% in the fourth quarter of 2016.

Average Adjustments for EBITDA Reconciliation*

• As of Reported EBITDA
Source: Covenant Review: CR Trendlines Topical Report Leveraged and EBITDA Adjustments Rise in the First Quarter, March 20, 2017

While leverage for M&A transactions on an adjusted basis remained constant from the prior quarter, leverage on an unadjusted basis crept higher. On an unadjusted basis, leverage went from 6.6x in Q4 2016 to 7.0x in Q1 2017.

While leverage increased during the first quarter, yields from year-end declined by 36 basis points for double Bs and 21 basis points for single Bs.

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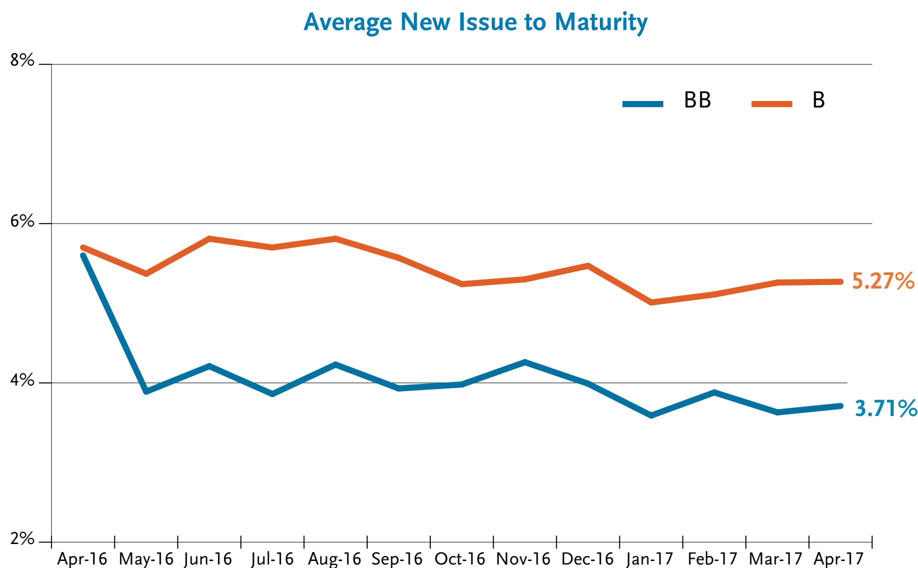

Source: LCD, an offering of S&P Global Market Intelligence

There have been 22 defaults in the last 12 months. Ocean Rig, hhgreg and Answers Corporation all defaulted in March. The LTM default rate increased slightly from 1.41% to 1.49%, based on a par amount outstanding. The default rate based on unique issuers declined to 1.36%. Regardless of measurement, default rates remain very low on a historical basis.

Lagging 12-Month Default Rates

Actual	**Jan-16**	**Feb-17**	**Mar-16**
By Number	1.77%	1.57%	1.36%
By Principal Amount	1.56%	1.41%	1.49%
Shadow Default Rate			
By Number	0.37%	0.85%	0.77%
By Principal Amount	0.10%	0.42%	0.42%

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

Commodity sectors continue to be the largest contributors to the default rate as 10 of 22 defaults that have occurred in the last 12 months are Energy- and Metals-related borrowers. Retail/Restaurants is the second largest contributor with three defaults. However, this amount does not include Payless, which defaulted in the first few days of April.

Shadow default activity remains very low, suggesting that there will not be any broad-based increase in the next 12 months.

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Valuation

Since 1992, the average 3-year discount margin ("DM") for the CS LLI, is 463 basis points. If the global financial crisis (2008 & 2009) is excluded, the 3-year discount margin for the CS LLI is 416 basis points. At month end, the 3-year DM was tight to the historical average, at 444 basis points and 4 basis points tighter than the prior month.

The DM spread differential between double Bs and single Bs has tightened from April 2016 to March 2017 by 102.2 basis points. It is also 31.2 basis points tight of the historical spread differential.

3-Year Discount Margin Differential Between BBs and Single Bs

1/1992 - 3/2017 Average	192.3
April 2016	263.2
March 2017	161.1

Source: Credit Suisse Leveraged Loan Index

CS LLI Snapshot

YTD Total Return*	1.20%
Average Price (excluding defaults)	97.78
Spread	378.50
Coupon	4.86%
Current Yield	5.00%
Yield (3-year life)	6.27%
Discount Margin (3-year life)	444 bp

*S&P LLI Total Return 1.15%
Source: LCD Loan Stats

	Spread	DM (3-Year Life)
Split BBB	248 bps	232 bps
BB	297 bps	295 bps
Split BB	357 bps	350 bps
B	407 bps	456 bps
Split B	578 bps	907 bps
CCC/Split CCC	653 bps	1,207 bps
Distressed (CC, C and Default)	556 bps	3,058 bps

Source: Credit Suisse Leveraged Loan Index

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Summary

As of March 31, the S&P/LSTA Index imputed default rate was 2.27%, down from the prior month. It remained considerably below the multi-year high in February 2016 of 7.3%. While the imputed rate implies that the market will see an increase in defaults, it is not implying a very high overall rate. The spread tightening that has taken place in the last 12 months suggests that loans' earnings are improving dramatically; however, we did not experience a concurrent level of earnings improvement in the first quarter. Year-to-date, re-pricing activity has been aggressive and underwriting standards have declined. However, despite weakening underwriting standards, default activity remains very low and is projected to remain low in the next six-12 months. As a result of these credit expectations and some concerns surrounding increasing rates, demand for loans has remained robust. ■

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