INSIGHT

LOAN & CLO REVIEW

Pronounced Bifurcation in the Market and a Hollow Rally

DREW SWEENEY & PALAK S. PATHAK | 10 OCTOBER 2019

Loan prices snapped back in the month of September but price dispersion continued to grow. Nearly 10% of loans at the end of the month traded below the price of 90. Not all sectors have been viewed similarly and despite the broader market rally – metals/minerals, energy and consumer durables still provided negative returns for the month. Higher beta/distressed loans fell further as some lower-rated loans became uninvestable for the ratings-sensitive CLO universe. Finding a bid on an all-private loan when the CLO universe can no longer participate is not a simple exercise of needing to sell a loan ½ point lower; but rather, that bid can sometimes be 5-10 points lower from a hedge fund.

The bifurcation of higher quality versus lower quality was also felt in the primary market. While syndications generally went very well in the first three weeks of the month, the last week of the month saw single B issuers continually have to widen talk and increase the OID to get deals priced. Higher quality names (four B issuers) typically found oversubscription.

September's rally felt hollow as so many sectors and loans were left behind. Total repayments in August reached $46bn, the second highest level of all time, behind the $51bn set in March 2011. That left cash for investors to reinvest, which helped buoy September loan prices for most of the month. However, a heavy new issue calendar and retail outflows quickly exhausted the rally and left the market feeling a bit weak by the end of the month.

Compounding the problems of lower quality loans was the increase in activity from the rating agencies. September represented a record month in single-B net downgrades. The increase in downgrades and negative outlooks have added to CLOs triple C baskets and spiked WARF scores. Consequently, it becomes a virtuous circle as the lower ratings create forced selling and lower prices, which in turn, seem to attract more agency attention.

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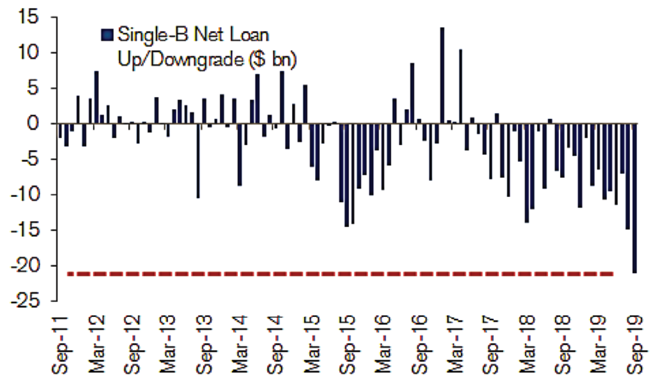
Pronounced Bifurcation in the Market and a Hollow Rally

Chart of the Month: Record Single-B Net Downgrades



Source: Credit Suisse

Performance – Loans

In September 2019, the Credit Suisse Leveraged Loan Index (CS LLI) and the S&P Leveraged Loan Index (S&P/LSTA) were up 0.42% and 0.47%, respectively.

- For the quarter, the CS LLI was up 0.92% and the S&P/LSTA was up 0.99%.
- Year-to-date, ending September 30, the CS LLI was up 6.39% and the S&P/LSTA was up 6.79%.
- For the 12 months ending September 30, the CS LLI was up 3.11% and the S&P/LSTA was up 3.10%.

During the month, higher quality paper outperformed lower quality loans. Triple Bs and double Bs outperformed all other categories. Triple Cs and distressed loans were down roughly -81 and -224 basis points (bps), respectively. Single B loans were up 49 bps; however, the lowest-rated portion (B3 loans, which performance cannot be seen below) was down -0.35% in September.

On an LTM basis, triple Bs and double Bs outperformed single Bs. Triple Cs and the distressed categories have posted negative returns during this time period.

Total Return by Rating

	September	QTD	YTD	LTM
Split BBB	0.60%	1.82%	7.47%	4.62%
BB	0.58%	1.57%	7.62%	4.20%
Split BB	0.67%	1.31%	7.29%	3.50%
B	0.49%	0.87%	6.15%	3.12%
Split B	-0.98%	-3.24%	4.17%	-0.68%
CCC/Split CCC	-0.81%	-1.25%	1.48%	-2.59%
Distressed (CC, C and Default)	-2.24%	-3.85%	2.91%	-6.49%

Source: Credit Suisse Leveraged Loan Index

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Sector Performance

Three of 20 sectors provided negative returns in the CS LLI for the month of September. The top performing sectors were Housing (0.83%), Healthcare (0.79%) and Aerospace (0.78%).

The worst performing sectors for the month were Metal/Minerals (-2.08%), Energy (-1.71%) and Consumer Durables (-0.54%). There was a 291 bps difference between the top and bottom sectors in September, which was the third highest level of industry dispersion for 2019.

For the quarter, Housing (2.02%), Aerospace (2.01%) and Financials (1.97%) led all categories while Metals/Mining (-4.15%), Energy (-3.94%) and Retail (-0.20%) lagged.

In the last 12 months, Financial, Gaming/Leisure and Food & Drug have led all sectors with total returns of 4.92%, 4.92% and 4.84%, respectively. Metals/Minerals, Energy, and Retail provided the worst performing sectors with returns of -5.00%, -3.88% and -1.64%, respectively.

Industry Returns

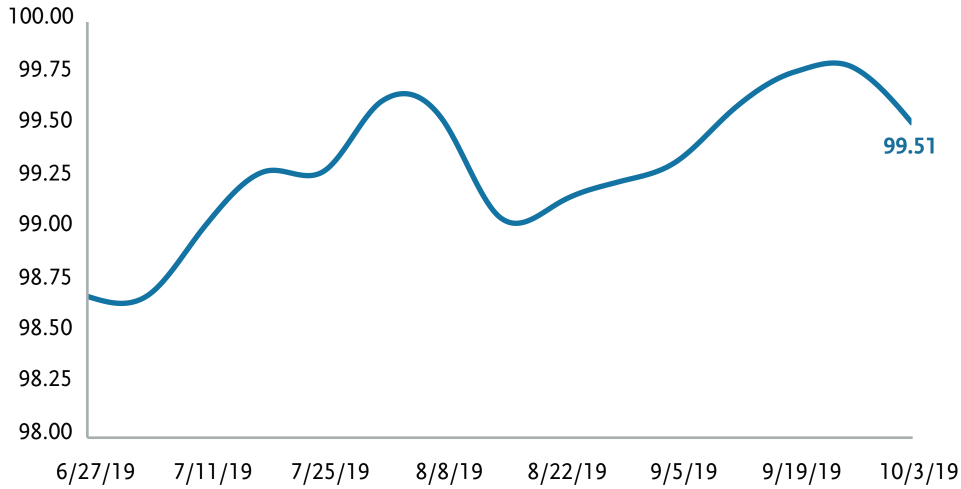
Sector	September	QTD	YTD	LTM
Gaming/Leisure	0.63%	1.85%	7.91%	4.92%
Financial	0.72%	1.97%	7.58%	4.92%
Food and drug	0.73%	1.87%	9.70%	4.84%
Utility	0.35%	0.85%	6.90%	4.61%
Aerospace	0.78%	2.01%	7.61%	4.58%
Housing	0.83%	2.02%	8.44%	4.44%
Chemicals	0.65%	1.16%	6.97%	4.01%
Media/Telecommunications	0.62%	1.36%	7.82%	3.93%
Food/Tobacco	0.19%	1.22%	6.51%	3.69%
Forest prod/Containers	0.60%	1.72%	7.06%	3.60%
Service	0.41%	0.94%	5.99%	3.47%
Transportation	0.36%	0.84%	5.40%	3.32%
Information technology	0.38%	1.20%	6.55%	3.25%
Healthcare	0.79%	0.64%	5.97%	2.73%
Consumer non-durables	0.30%	0.61%	5.90%	2.62%
Manufacturing	0.12%	0.56%	5.58%	2.02%
Retail	0.58%	-0.20%	4.97%	0.19%
Consumer durables	-0.54%	0.78%	1.08%	-1.64%
Energy	-1.71%	-3.94%	0.44%	-3.88%
Metals/Minerals	-2.08%	-4.15%	-0.51%	-5.00%

Source: Credit Suisse Leveraged Loan Index

Pronounced Bifurcation in the Market and a Hollow Rally

CS LLI prices (excluding defaults) decreased -10 bps in September while the average bid of the S&P LCD flow-name loan composite increased 18 bps from 99.33 to 99.51. The average flow name bid is up 422 bps on a year-to-date basis.

Average Loan Flow-Name Bid



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

Performance – CLOs

CLO performance improved in September, returning 0.40% during the month vs. 0.12% in August. CLOs outperformed Investment Grade and High Yield credit but slightly underperformed loans (+0.47% return). Since January, CLOs have returned 4.42%, continuing to underperform Investment Grade, High Yield and Leveraged Loans on a year-to-date basis.

Over the month, AAAs tightened 5-7 bps. Short AAAs remain in high demand with spreads moving inside 90 dm. Value was placed on discount paper; however, given the magnitude of tightening, the discount has become close to negligible with some short AAAs trading at par or even at a premium. Top tier, longer duration AAAs tightened a few bps to inside 120 dm, widening the basis between primary and secondary by almost 15 bps.

AA and single A spreads tightened 5-10 bps. Insurance demand for single As increased over the month possibly due to 1) a slowdown in the decline of 3 month LIBOR (down 5 bps in Sept vs. 13 bps in August) and 2) limited single A availability in primary due to increased demand from non-insurance accounts.

BBBs remained weak with this tranche tightening the least over the month on an absolute basis. BBB basis remains unusually wide with over 100 bps between high and low quality bonds. BBs finally found a floor, tightening 10-15 bps over the month. MVOCs remained stable with loan prices flat to slightly higher over the month. Demand for short, top tier, well covered BBs increased with bonds trading inside 600dm as the dollar price discount remained attractive, especially on shorter paper. Longer duration BBs were mostly in the 700dm range, with very well covered paper in the high 600s. Single Bs didn't move much given thin trading volume in the tranche.

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With loan prices flat over the month, equity NAVs were unchanged with the median NAV at $45.

BWIC activity increased to almost $3bn in September, a 55% increase from August. The increase is unsurprising as August is typically a very slow month for secondary trading. AAAs regained the majority of BWIC volume followed by AAs and BBs.

Secondary CLO 2.0 Total Returns

	September	YTD	LTM
Total	**0.40%**	**4.42%**	**3.40%**
AAA	0.34%	3.79%	3.52%
AA	0.43%	4.79%	3.61%
A	0.67%	5.61%	3.04%
BBB	0.59%	6.51%	2.82%
BB	0.45%	7.58%	2.69%
B	0.87%	7.19%	2.03%

Source: JPM CLOIE Index

Secondary CLO 2.0 Spreads (DM)

	September	MoM Change (bps)
AAA	85-135	-7
AA	160-190	-5
A	220-280	-8
BBB	330-420	-5
BB	685-790	-15
B	1000-1200	0

Source: TCW

Technical Conditions – Demand

Weekly flows turned briefly positive during September and broke the 43 consecutive weeks of outflows; however, the flows for the month remained negative. September's outflows totaled $1.2 billion, the lightest since October 2018 and outflows since the beginning of 4Q now total $50.3 billion. AUM for the loan mutual fund base is down to $104 billion from a high of $154 billion in October 2018.

CLO primary issuance totaled $8.3bn in September, a 15% increase from August. Primary spreads were flat to slightly wider over the month. Tier 1 AAAs remained in the 133-134 dm area. New issue AAA basis is 10-12 bps with deals on the wider end of the range pricing at 145dm. AA / As were unchanged over the month in the 180-200 dm range for AAs and 250-300 dm range for single As. Of note, a few BBBs issued over the month were split into a senior BBB+ tranche (~14% ce) and a junior BBB- tranche (~12% ce). On average, BBBs were issued in the 375-400 dm range, many pricing with OIDs. BBs struggled over the month with the majority pricing 15-25 bps wide of initial guidance. Tier 1 BBs priced in the low 700s dm while others priced high 700 - 800 dm. Almost all BBs were issued with an OID.

Refi activity increased slightly with five refis pricing. AAA spreads were in the 115-117 dm range. Resets declined with only one reset pricing. Five-year resets are tough to get done at the moment, especially as the appetite for seasoned mezz is low. In addition, many deals would need to be re-capitalized in a reset due to par erosion.

Also of note, no middle market CLOs priced over the month, a dramatic decrease from the $2bn of middle market deals that priced in August.

CLO cost of debt increased slightly by 1 bp to 192 bps due to wider BB spreads. Equity arb remained flat with loan spreads unchanged over the month.

CLO New Issuance

	September	YTD 2019	YTD 2018	YoY %Δ
New Issue ($bn)	$8.30	$89.60	$99.60	-10%
Refi (#)	5	48	59	-19%
Reset (#)	1	28	184	-85%

Source: TCW

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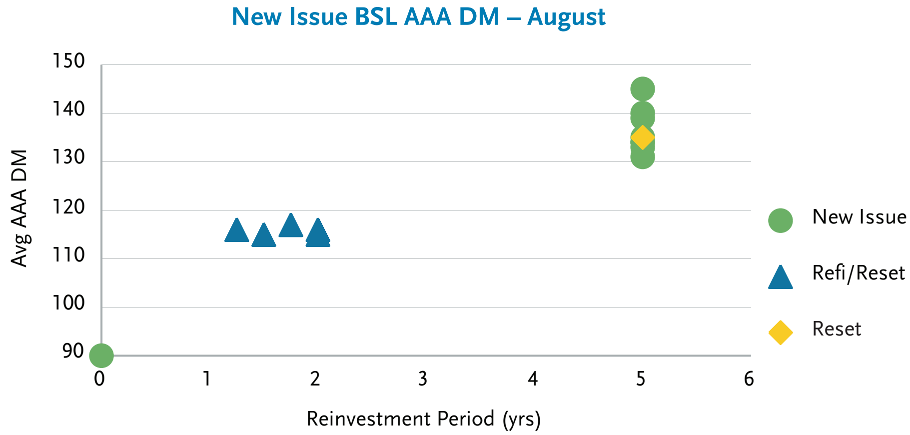


Source: TCW

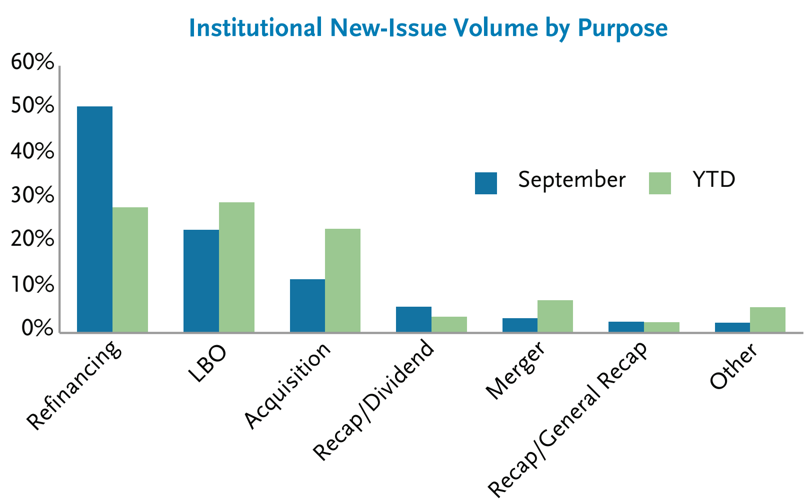
Tier 1 New Issue Spreads (5 yr reinv)

	September	MoM Changes	YTD Changes
AAA	133	0	5
AA	180	0	-20
A	250	0	-20
BBB	385	0	-15
BB	715	15	-5

Source: TCW

Technical Conditions – Supply

September saw a spike in refinancing activity in the loan market and while that trend had also been evident in August it was a clear departure from what has occurred in the prior seven months. A few items allowed companies to refinance their existing deals. First, there was a record setting amount of loan prepayments which left many CLO managers with cash. Second, companies (often higher rated borrowers) looked to extend maturities. Given the need for higher-quality paper in CLOs, most of these refinancings met little resistance. On a year-to-date basis, M&A and LBO activity has accounted for roughly 60% of new issues while in September, M&A and LBO activity only accounted for 39% of new issuance.



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

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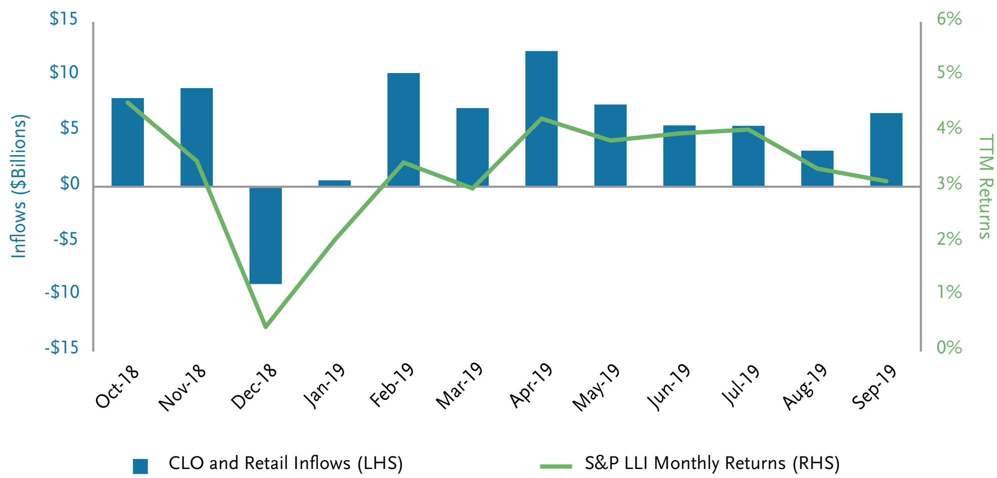
YTD U.S. CLO new issue supply of $90bn is now down -10% year-over-year but remains on pace to produce the third strongest year in CLO history. September saw $8.3 billion of issuance and Q3 2019 was the lightest quarter of issuance during the year. Despite only moderate CLO inflows and mild retail outflows, the market managed to produce solid returns for the month. This was in part due to the large amount of repayments made in August.

Inflows and Rolling LTM Returns



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

New issue spreads in September widened 1.3% month over month and were -12.8% tighter on a year-to-date basis. New issuance spreads remain 8.3% wider than 12 months prior.

New Issue Spread Changes

	All Loans
Oct-18	364
Dec-18	452
Mar-19	404
Jun-19	404
Sep-19	394
Month-Over-Month Change	1.32%
YTD Change	-12.84%
LTM Change	8.29%

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

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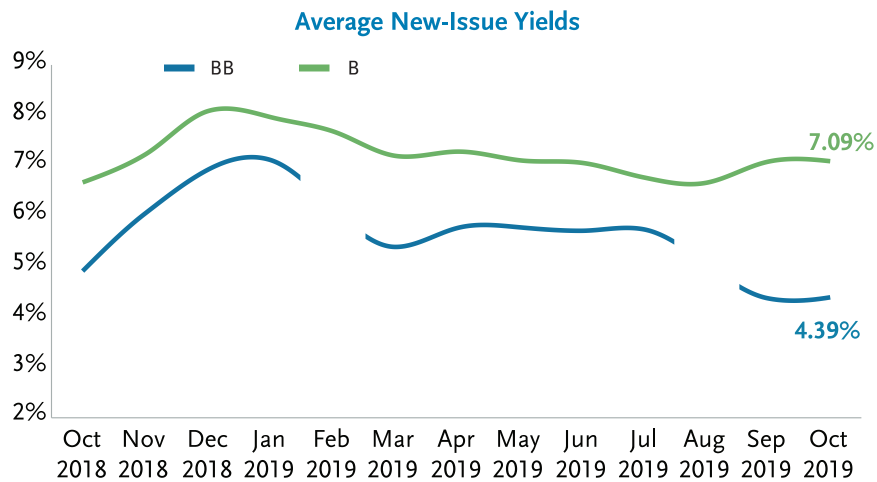
New issue yields continued to decline primarily as a result of a declining LIBOR rate.



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

Fundamentals – Loans

There were no loan defaults in September. The default rate changed from 1.24% in August to 1.29% in September, based on par outstanding.

The last 12-month default tally for the S&P/LSTA is 23. Retail leads all categories with six defaults while Services & Leasing is just behind with four defaults. Oil & Gas is the third leading category with three defaults.

Lagging 12-Month Default Rates

Actual	19-Jul	19-Aug	19-Sep
By Number	1.56%	1.54%	1.58%
By Principal Amount	1.00%	1.24%	1.29%
Shadow Default Rate			
By Number	0.49%	0.58%	0.47%
By Principal Amount	0.48%	0.52%	0.40%

*Shadow default rates includes potential defaults, including those companies that have engaged bankruptcy advisors, performing loans with SD or D corporate rating and those paying default interest
Source: LCD, an offering of S&P Global Market Intelligence

Fundamentals – CLOs

Headline fundamentals remained stable with OC cushions and % defaulted remaining flat month over month. Loan quality continues to decrease as WARF increased to 2900 due to underlying loan downgrades. In addition, the percentage of loans in CLOs trading below $90 rose to 8% from 6.5% at the beginning of August and the % of loans trading below $80 increased to almost 4%.

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 bps. The 3-year DM finished the month at 478 bps, which widened 5 bps from the prior month.

3-Year Discount Margin Differential Between BBs and Single Bs

1/1992-8/2019 Average	189.8
Oct-18	150.3
Sep-19	226.1

Source: Credit Suisse Leveraged Loan Index

CS LLI Snapshot

YTD Total Return*	6.39%
Average Price	96.18
Spread	356 bp
Coupon	5.75%
Current Yield	6.01%
Yield (3-year life)	6.32%
Discount Margin (3-year life)	478 bp

*S&P LLI Total Return 5.74%

	Spread	DM (3-Year Life)
Split BBB	202 bps	202 bps
BB	258 bps	281 bps
Split BB	309 bps	347 bps
B	387 bps	507 bps
Split B	540 bps	1,191 bps
CCC/Split CCC	670 bps	1,329 bps
Distressed (CC, C and Default)	534 bps	3,714 bps

Source: Credit Suisse Leveraged Loan Index

The DM spread differential between Double Bs and Single Bs is 75 bps wider from October 2018 to September 2019 and 36 basis points wider than the historical spread differential since inception.

As of September 30, the S&P/LSTA Index imputed default rate was 2.7%, up from 2.6% in the prior month.

Summary and Looking Forward

September was an odd month. Double B loans traded very well during the month and companies opportunistically came back to the primary market to refinance their deals. They would extend their maturities without adding coupon and sometimes even tightened the coupon. During the first 3 weeks of the month, with the exception of three sectors and lower-tier single B loans and triple C loans, we saw most of the loan market rally. During the last week of the month we saw the primary market begin to require higher spreads and bigger OIDs to complete syndications. We saw the secondary market begin to weaken and it was hit by both idiosyncratic stories and a general risk-off broader market environment.

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In terms of idiosyncratic stories there were a number of loans that dropped dramatically or surprised the market with announcements of the hiring of restructuring advisors. In terms of the broader markets influencing the loan market, we saw crossover investors begin to sell larger more liquid names which added to the poor sentiment to finish the month.

All in all, the bifurcation in the market is pronounced and the appetite for lower single Bs and triple C loans remains very limited as we begin October.

The CLO market found some support in September with secondary spreads tighter and new issue IG spreads flat. The primary pipeline continues to build with at least 20 deals actively marketing and 5-10 deals added to the pipeline on a weekly basis. Thus far, supply is getting absorbed fairly well; however, the recent macro volatility coupled with flat demand and increased supply could cause spreads to widen. In addition, fundamentals continue to deteriorate which is negative for mezz spreads and forward rate expectations remain low which is a negative for IG spreads. That being said, CLOs remain one of the few asset classes that have lagged the overall YTD rally in credit and structured products and thus still offers relative value vs. its peers. ■