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MONTHLY COMMENTARY

Loan Review – September 2017

DREW SWEENEY | OCTOBER 13, 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.

Up, up and away. September ushered in the making of a loan rally as the CLO manufacturing machine continued its relentless pace of issuance. Despite a robust new issue loan calendar, the loan market was easily able to digest the M&A driven activity and still push secondary prices slightly higher.

In the beginning of the year there was angst surrounding the impact of risk retention on CLO issuance. Projections called for something close to $50-$60 billion of newly minted CLOs, which would reflect a 25%+ decline from 2016 issuance. However, as the year moved on, it was clear that risk retention was having no impact on the dollar-amount of issuance. Investment banks began to move their 2017 projections to $100 billion. By the end of September, approximately $80 billion of CLOs had been issued and some projections are now calling for upward of $105 billion for 2017. This would mean that despite all the anxiety regarding risk retention that 2017 would finish as one of the largest years for CLO volume of all-time.

Meanwhile, despite strong underlying performance, investment banks continue to push the envelope with EBITDA adjustments and total leverage. Average debt multiples of large corporate loans (with EBITDA of more than $50mm) crept up from 5.0x to 5.1x. In a similar vein, average debt multiples of large corporate LBO loans increased modestly from 5.9x to 6.0x (inclusive of sub debt). The trailing 12-month default rate increased to 1.53% by principal amount in September. Toys "R" Us joined the growing list of failed retailers, propelling the retail sector default rate to 7.7%. So far, $3.4 billion of retail loans have defaulted year-to-date, compared to just $277 million in all of 2016.

Despite the aggressive underwriting standards and the further degradation of the retail sector, September registered a solid performance. As the month ended, the primary loan market's visible new issue supply began to diminish and forward net new issuance actually turned negative (net of visible loan repayments). The technical dynamics have become so one-sided, that it is difficult to craft a scenario where loans do not trade higher through the remainder of the year — barring a broader credit market event.

Performance

In September 2017, the Credit Suisse Leveraged Loan Index (“CS LLI”) was up 0.41% and the S&P Leveraged Loan Index (“S&P/LSTA”) was up 0.39%.

- Quarter-to-date ending September 30, 2017, the CS LLI was up 1.06% and the S&P/LSTA was up 1.04%.
- Year-to-date ending September 30, 2017, the CS LLI was up 3.04% and the S&P/LSTA was up 2.97%.
- For the 12 months ending September 30, 2017, the CS LLI was up 5.36% and the S&P/LSTA was up 5.30%.

Lower quality loans outperformed higher quality loans in September as the distressed category and split single B loans led all categories. Split triple B and split double B lagged all categories. This continued a similar trend that we have seen in the last 12 months as the distressed category, triple C and split-rated single B loans more than doubled the returns of single B and double B loans.

Total Return By Rating

	September	YTD	LTM
Split BBB	0.22%	1.76%	2.96%
BB	0.40%	2.35%	3.66%
Split BB	0.26%	2.20%	3.91%
B	0.43%	3.29%	5.29%
Split B	0.79%	6.20%	12.60%
CCC/Split CCC	0.59%	5.31%	13.93%
Distressed (CC, C and Default)	1.28%	6.99%	15.13%

Source: Credit Suisse Leveraged Loan Index

Sector Performance

Eighteen of the 20 sectors posted positive returns during the month. The top performing sectors in September were Energy (+1.63%), Metals/Minerals (+0.89%) and Financial (+0.58%).

The worst performing sectors were Consumer Durables (-0.23%), Food & Drug (-0.21%) and Retail (+0.02%). Consumer Durables continue to lag as one borrower represents nearly 25% of the sector in the CS LLI and has traded poorly post the second quarter results. The Food & Drug category is dominated by retail grocery stores and those borrowers continue to trade heavily for the third consecutive month post the news that Amazon entered the bricks and mortar business. The Retail segment continues to be hurt by concerns surrounding secular changes. The bankruptcy filing of Toys “R” Us did little to allay those fears. The surprise filing increased the retail sector default rate to 7.7%, from 4.36% previously.

On a year-to-date basis, Services, Metals and Healthcare led all sectors with total returns of 4.28%, 4.03% and 4.01%, respectively.

On a year-to-date basis, Retail, Food & Drug and Consumer Durables were the worst performing sectors with returns of -3.79%, -0.27% and 1.32%, respectively. All three sectors are being impacted to some degree by e-commerce.

Total Return by Sector

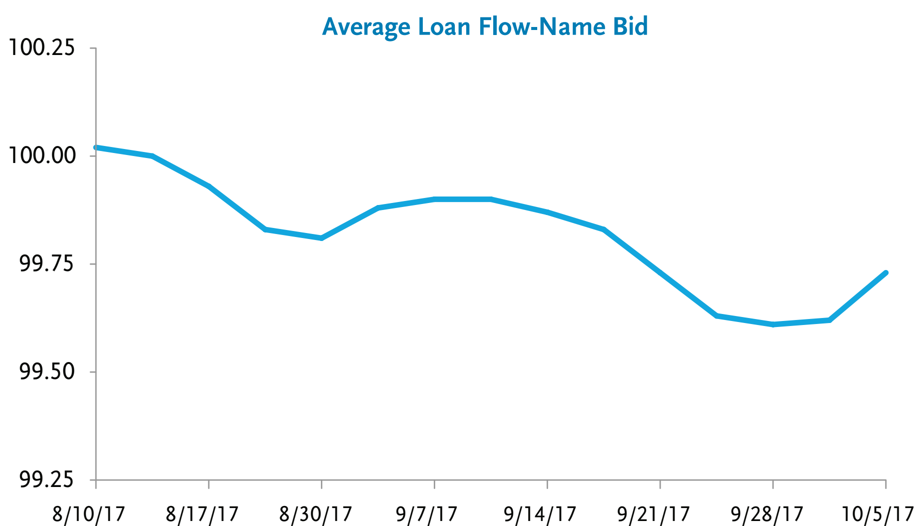
Sector	September
Aerospace	0.53%
Chemicals	0.51%
Consumer Durables	-0.23%
Consumer Non-Durables	0.45%
Energy	1.63%
Financial	0.58%
Food & Drug	-0.21%
Food/Tobacco	0.52%
Forest Prod/Containers	0.53%
Gaming/Leisure	0.38%
Healthcare	0.50%
Housing	0.58%
Information Technology	0.39%
Manufacturing	0.57%
Media/Telecommunications	0.18%
Metals/Minerals	0.89%
Retail	0.02%
Service	0.37%
Transportation	0.25%
Utility	0.10%

Sector	YTD
Aerospace	3.53%
Chemicals	3.47%
Consumer Durables	1.32%
Consumer Non-Durables	2.63%
Energy	3.78%
Financial	3.57%
Food & Drug	-0.27%
Food/Tobacco	2.90%
Forest Prod/Containers	2.92%
Gaming/Leisure	3.80%
Healthcare	4.01%
Housing	3.30%
Information Technology	3.62%
Manufacturing	3.92%
Media/Telecommunications	2.84%
Metals/Minerals	4.03%
Retail	-3.79%
Service	4.28%
Transportation	2.09%
Utility	1.99%

Sector	LTM
Aerospace	5.41%
Chemicals	5.15%
Consumer Durables	3.19%
Consumer Non-Durables	4.84%
Energy	16.08%
Financial	6.09%
Food & Drug	1.20%
Food/Tobacco	4.17%
Forest Prod/Containers	4.78%
Gaming/Leisure	5.72%
Healthcare	5.22%
Housing	4.96%
Information Technology	6.39%
Manufacturing	6.38%
Media/Telecommunications	4.94%
Metals/Minerals	11.93%
Retail	-4.32%
Service	6.53%
Transportation	4.05%
Utility	4.16%

Source: Credit Suisse Leveraged Loan Index

Despite the overall performance of the loan index, flow-name prices in the S&P Index (below) decreased during the month approximately 20 basis points. More liquid names sold off more as retail funds sustained some outflows and larger, liquid loans allow managers to raise cash more easily.



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

The average bid of the broader loan Index is up materially during the last year while September loan prices remained basically flat for the month. Given the volume of M&A driven new issuance, it provided a very strong signal that loan demand is growing post a weak month in August.

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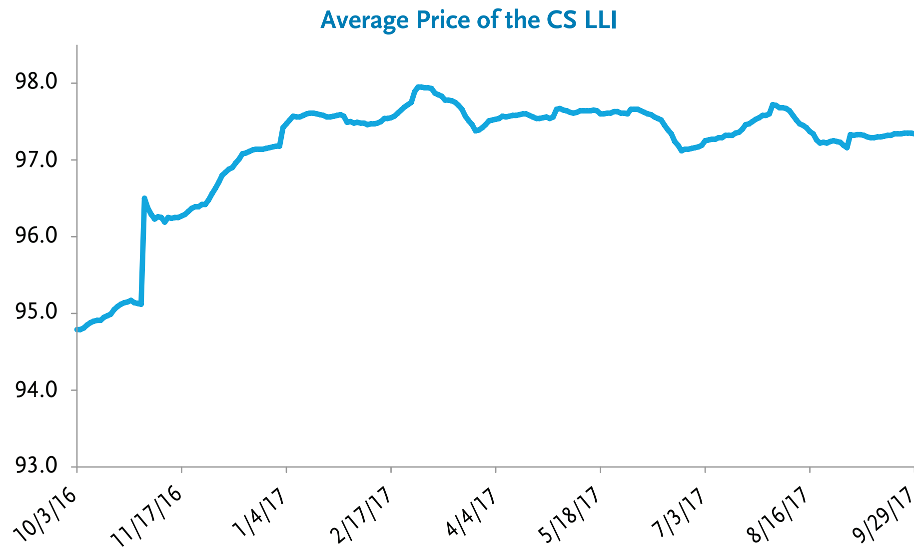
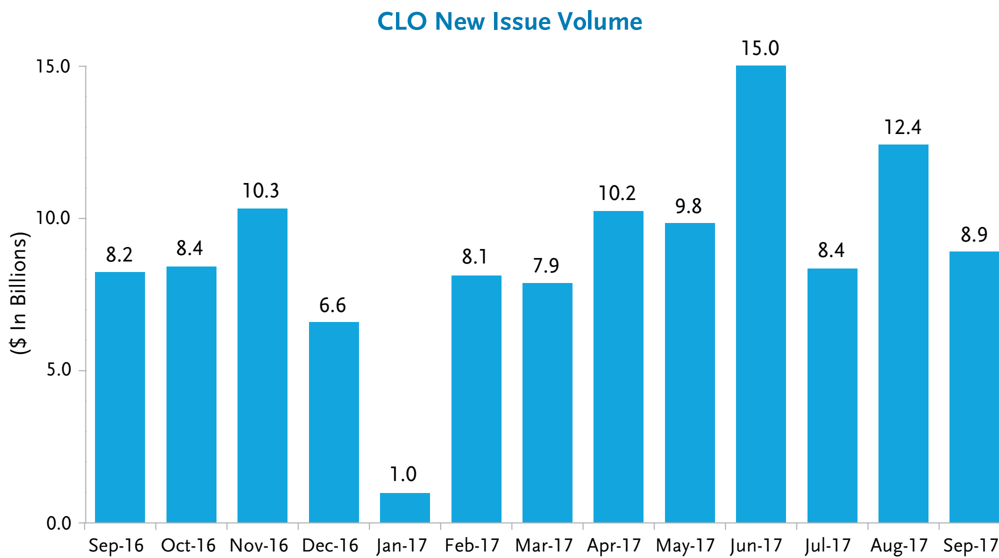


Source: CS, LLI, LCD, an offering of S&P Global Market Intelligence; S&P/LSTA Leveraged Loan Index

Technical Conditions

CLO new issue supply was $8.9 billion in September, down 28% from August. However, CLOs generally ramp over a period of several months and most market intelligence suggests that an additional $20 billion will price before the year end. In other words, there is simply a lot of loan demand. Year-to-date, over $81.8 billion of CLOs have been issued.



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

Institutional new issue volumes increased month-over-month by 165% while pro rata new issuance remained flat. The fact that the loan market issued nearly $70 billion of loans in September (the 3rd largest month of the year) and loan prices did not pull back at all, demonstrates the overwhelming strong demand for loans.

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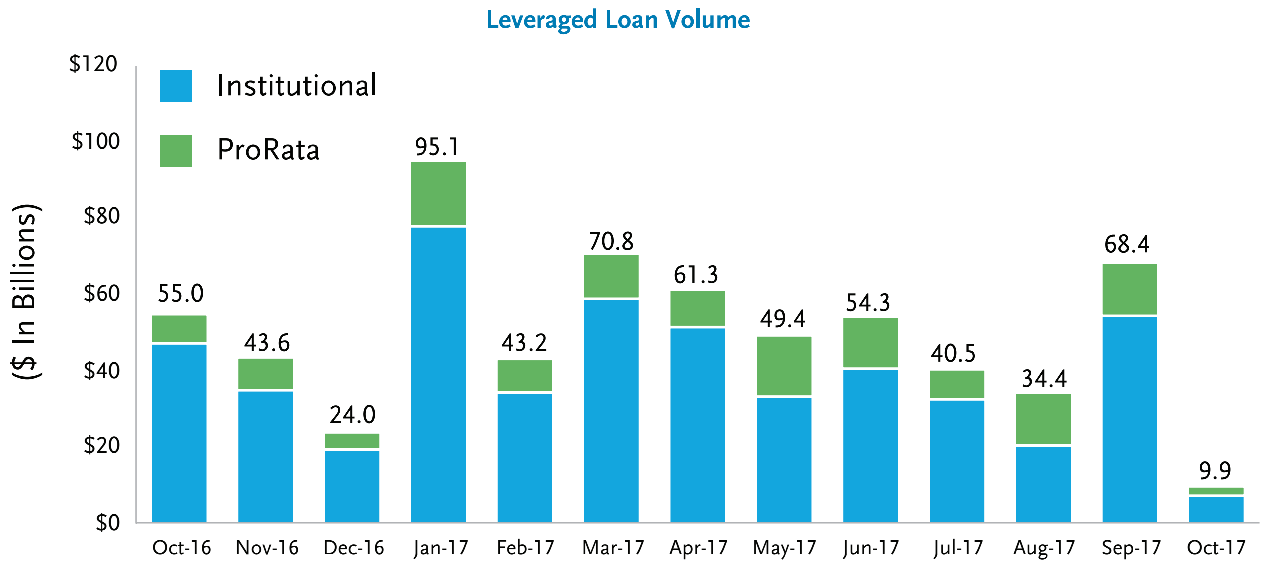
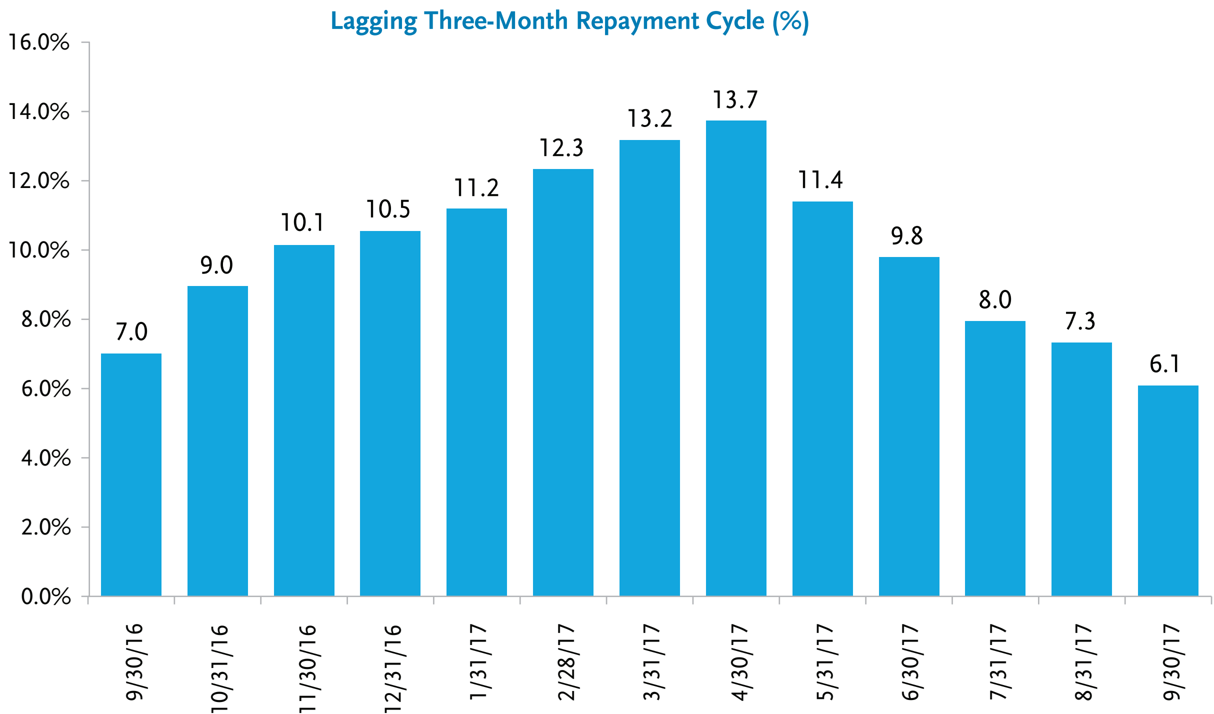


Source: LCD, an offering of S&P Global Market Intelligence

In September, the repayment rate dropped to the lowest level of the last twelve months. The repayment rate for the lagging three months was 6.1% compared to 7.3% in August and down from the average lagging three-month repayment rate in 2017 of 10.3%.



Source: LCD, an offering of S&P Global Market Intelligence; S&P/LSTA Leveraged Loan Index

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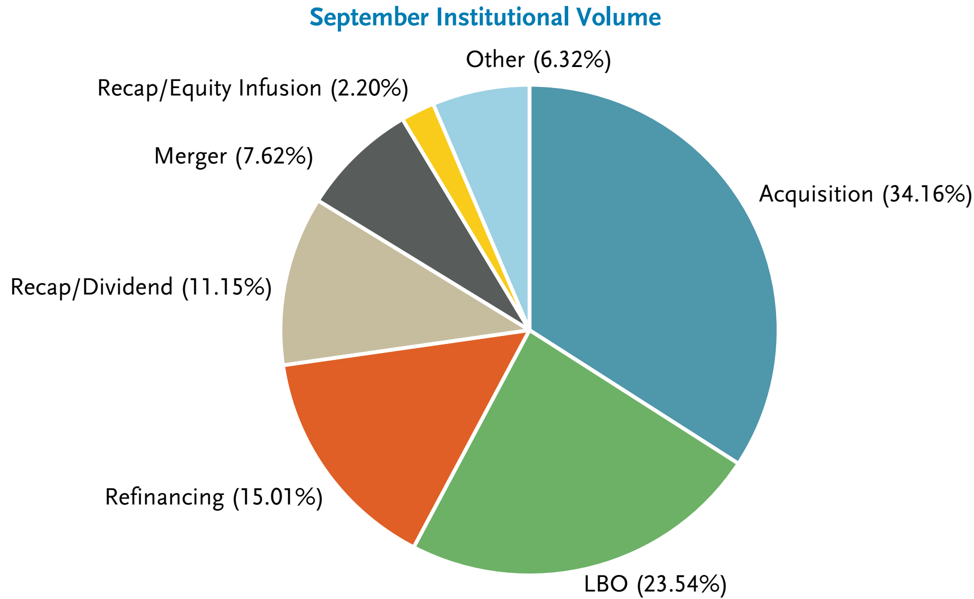
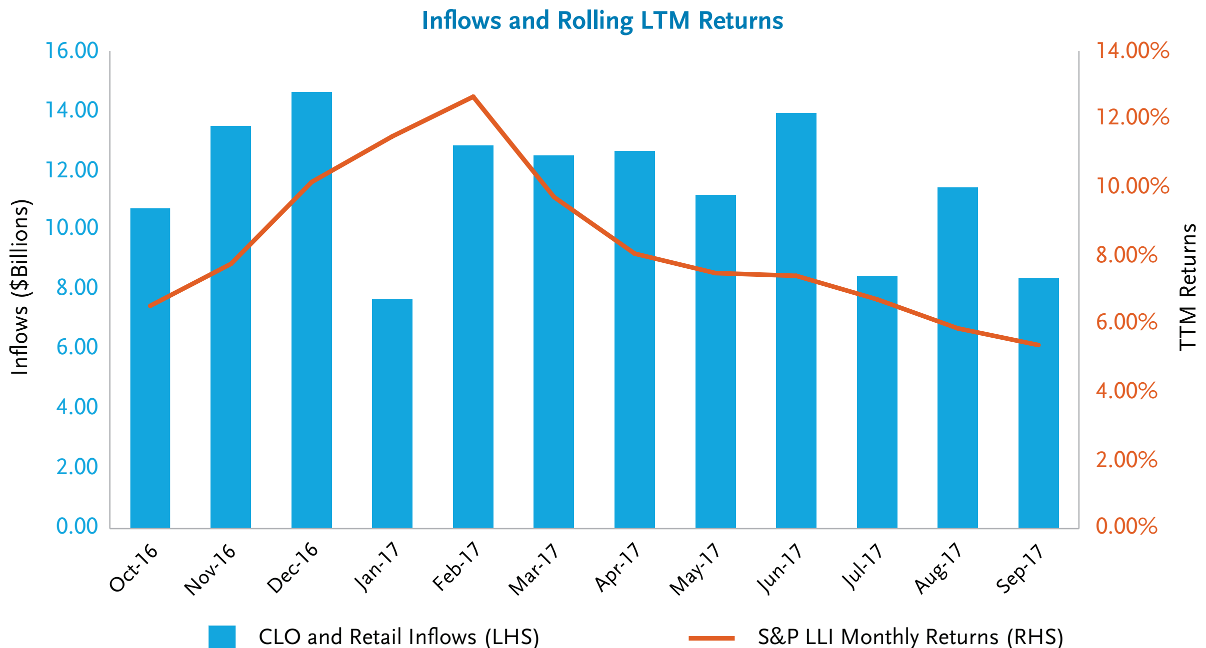
While most of the year the calendar has been dominated by repricings and refinancing activity, September was unique in that over 76% of institutional issuance was driven by new paper being issued in the market (acquisitions, leveraged buyouts, mergers, dividends). The combination of lower repayments, muted retail outflows and a high percentage new paper issued in the market was all offset by CLO demand.



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

The percentage of loans trading above par increased from 61.4% to roughly 66% in September. Given the fact that most loans trade near par and the fact that the average LIBOR spreads have declined as a result of repricings, the trailing 12 month return has declined.



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

Single B spreads in September tightened -3.1% from the prior month and -6.9% in the last 12 months. On a year-to-date basis, Double B spreads tightened -9.1% year-to-date 12.1% in the last 12 months.

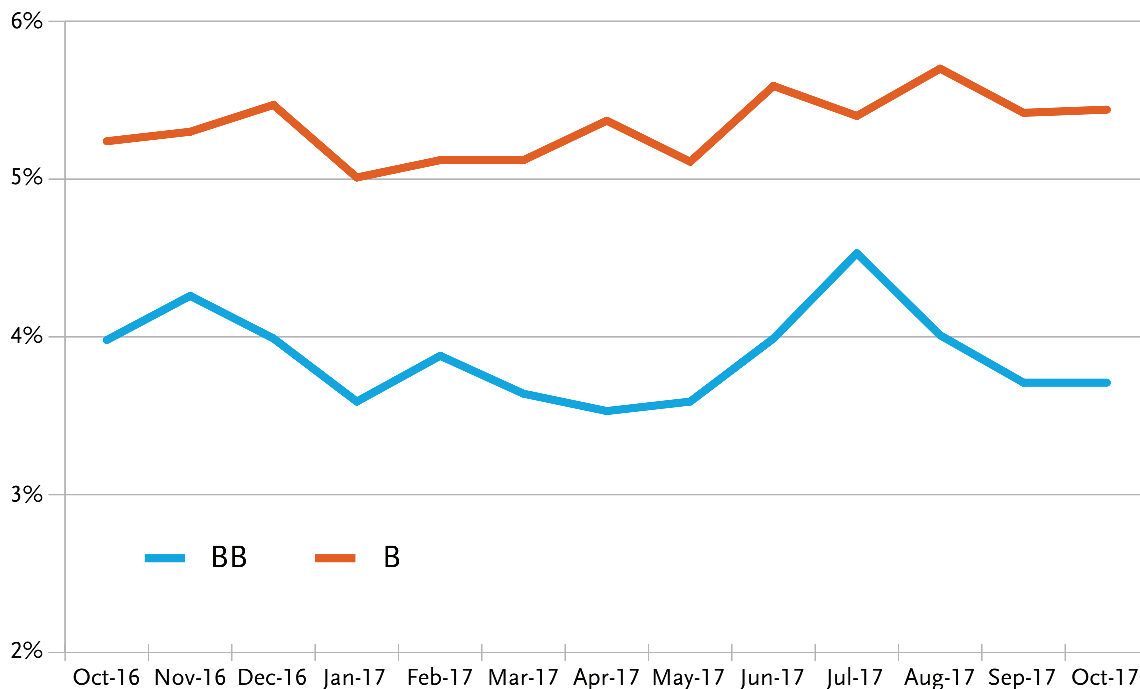
New Issue Spread Changes

	BB/BB-	B+/B
Sep-16	285	410
Dec-16	268	388
Mar-17	243	382
Jun-17	240	370
Sep-17	243	373
Month-Over-Month Change	-11.5%	-3.1%
YTD Change	-9.1%	-3.8%
LTM Change	-12.1%	-6.9%

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

Average new issue yields contracted month-over-month for Single Bs (-0.37%) and Double Bs (-0.28%).

Average New-Issue Yields



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

While there had been 22 defaults in the last 12 months, there was one in September. The LTM default rate increased based on a number of defaults (1.41%) and based on par amount outstanding (1.53%). Regardless of measurement, default rates remain very low on a historical basis.

Retail loans provided seven defaults in the last 12 months while commodity driven loans provided four. Given the secular changes in purchase patterns of consumers, it is likely that we will see Retail defaults increase. The shadow default activity remains low, suggesting that there will not be any broad-based increase in the next 12 months.

Lagging 12-Month Default Rates

Actual	Jul-17	Aug-17	Sep-17
By Number	1.29%	1.31%	1.41%
By Principal Amount	1.36%	1.36%	1.53%
Shadow Default Rate			
By Number	0.53%	0.54%	0.43%
By Principal Amount	1.44%	1.45%	1.27%

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 463 basis points. If the global financial crisis (2008 & 2009) is excluded, the 3-year discount margin for the CS LLI is 417 basis points. At month end, the 3-year DM was tight to the historical average, at 432 basis points and 4 basis points tighter than the prior month.

The DM spread differential between double Bs and single Bs has widened from October 2016 to September 2017 by 10 basis points and is still 35 basis points wide of the historical spread differential.

3-Year Discount Margin Differential Between BBs and Single Bs

1/1992-8/2017 Average	83.4
Oct-16	108.3
Sept-17	118.5

Source: Credit Suisse Leveraged Loan Index

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CS LLI Snapshot

YTD Total Return*	3.04%
Average Price (excluding defaults)	97.79
Spread	362.84
Coupon	4.94%
Current Yield	5.09%
Yield (3-year life)	6.16%
Discount Margin (3-year life)	432 bp

*S&P LLI Total Return 2.62%
Source: LCD Loan Stats

	Spread	DM (3-Year Life)
Split BBB	222 bps	223 bps
BB	279 bps	284 bps
Split BB	331 bps	352 bps
B	397 bps	441 bps
Split B	583 bps	844 bps
CCC/Split CCC	633 bps	1,265 bps
Distressed (CC, C and Default)	546 bps	1,990 bps

Source: Credit Suisse Leveraged Loan Index

Summary

As of September 29, the S&P/LSTA Index imputed default rate was 1.76%, still one of the lowest levels since December 2007.

Buyers outpaced sellers by a good margin in September and without the overwhelming CLO pipeline, secondary levels would have weakened. Looking forward, investors still appear to have cash and are actively adding loans. Currently, we have seen approximately $82 billion of CLO issued year-to-date and it feels like we should reach between $100 billion - $110 billion by year end.

From a primary perspective, we had an enormous new issue calendar in September and we have a very small forward calendar. This suggests that we will likely see loan prices grind higher and re-pricing activity begin to increase again. Interestingly, despite a historic re-pricing and refinancing wave which has impacted 60% of the outstanding base, coupons are barely lower year-to-date due to a climb in 3-month Libor.

Given the technical dynamics of the market, we are seeing a primary market which is launching with new issue LIBOR Spreads at a 25 - 50 basis point discount to existing secondary spreads. The tighter spreads further suggest that there will additional repricing activity of secondary loans in the coming months.

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