Loomis on Loans

A quarterly look at data and topics in the syndicated loan market

DEMYSTIFYING CLO DEMAND FOR LEVERAGED LOANS

We often talk about leveraged loans and the beneficial characteristics that make them distinct within the fixed income universe: they're floating rate instruments, senior in a company's capital structure, secured by collateral, and tend to have short average lives. Those traits make them attractive to investors seeking yield potential with typically lower volatility, and those investors have different options for accessing the loan market. Some institutions invest through separately managed accounts or commingled vehicles, while individuals might choose to access the market through mutual funds and ETFs. But the biggest source of demand for loans, especially over the last year, has been Collateralized Loan Obligations, or CLOs. A wide variety of investors come together to form each special purpose vehicle, and they help provide stability to the loan market through multi-year commitments. Representing 59% of the leverage loan investor base at September 30, 2020, and 72% of new loan purchases for the last 12 months ending September 30, 2020, it's important to understand how CLO managers behave and what incentives they have.

CLO managers buy the same types of loans that are bought in other loan accounts, but they must adhere to a strict set of tested covenants that help ensure diversification and other requirements. While they are seeking a high total return for the investors who own the equity of the structure, they cannot breach the indenture guidelines without the prospect of the structure being downgraded. Therefore, in addition to the credit research work that must be done to understand each company and the prospects for being repaid, each loan must be evaluated within the portfolio overall to make sure that all of the guidelines are met. That imperative can lead CLO managers to behave in ways that impact the loan market overall. We believe CLO behavior is a factor that all loan managers should consider when making their own credit selections.

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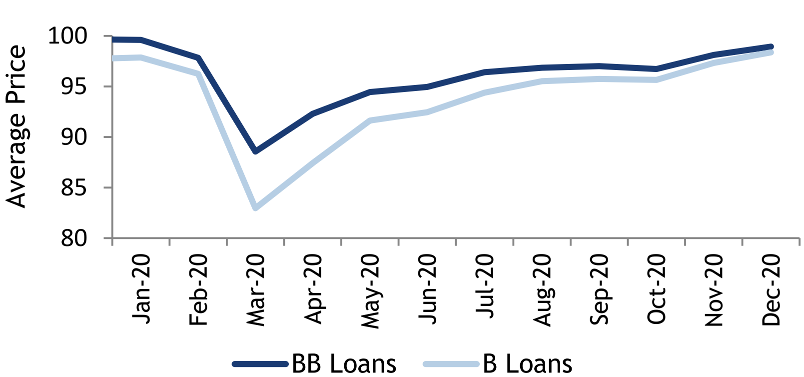
LOAN MARKET QUICK TAKE

S&P/LSTA Index	4Q 2020	YTD 2020	Price	12-Mo. Price Change	Nominal Spread
"All" Leveraged Loan Index	3.81%	3.12%	96.19	-0.96%	L+375
BB Index	2.75%	0.75%	98.93	-0.72%	L+281
B Index	3.88%	3.80%	98.35	0.67%	L+407

B-rated Loans Closed the Pricing Gap



Performance Rebound

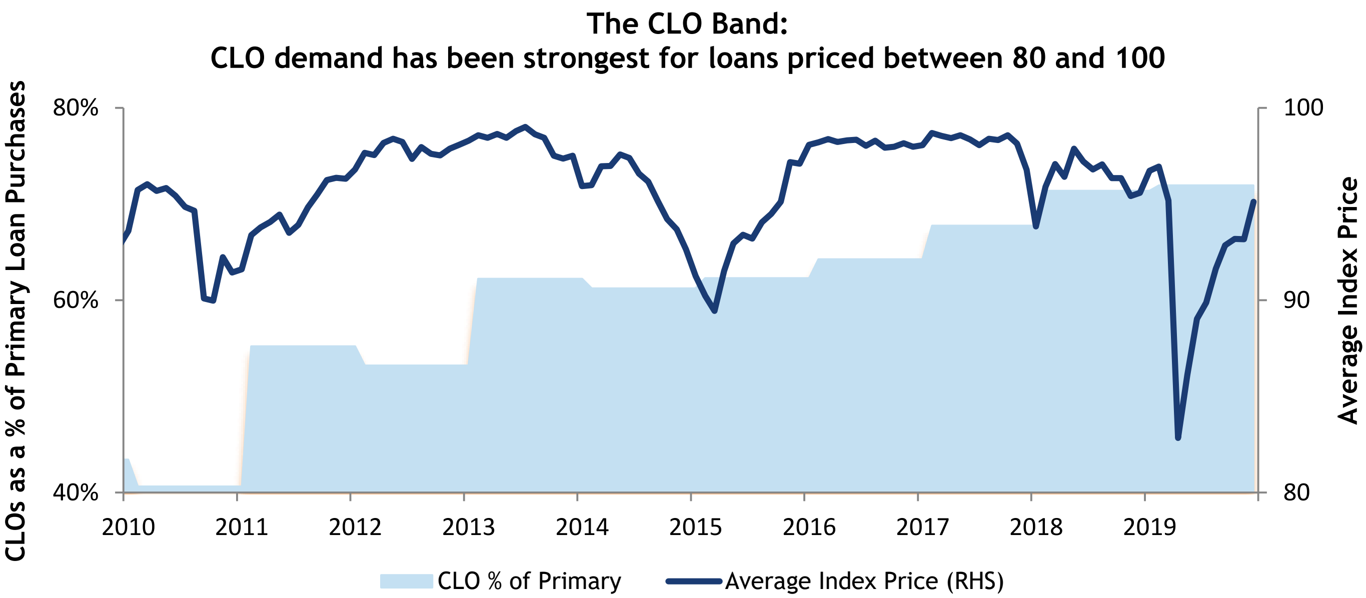
Price recovery for lower-rated and COVID-impacted loans continued in the fourth quarter due to positive vaccine news and increased certainty around domestic political outcomes. The pace of rating agency downgrades has slowed considerably, and the size of the loan market is nearly the same as at the start of 2020.

Source : LCD, an offering of S&P Global Market Intelligence; S&P/LSTA Leveraged Loan Index, as of 12/31/20.

HERE ARE A FEW WAYS THAT CLOS CAN IMPACT THE LOAN MARKET

LOAN PRICING CLOs are incentivized to "build par" by buying loans at a discount. If they choose to purchase a loan above the $100 mark, they are penalized on their tests. When demand for loans is very high, it's not unusual to see higher quality loans trade at that premium level. But when demand levels are more reasonable, and dominated by the CLO buyer, it's less likely that the market will see many loans trading above par. This scenario can help keep loan prices (and yields) relatively attractive versus high yield bonds that are chased up to and beyond their call prices by yield-hungry investors.

On the flip side, CLO managers do not help their par tests when they purchase deeply discounted loans, or loans typically priced below $80. Without this lower barrier, it would be easy for CLO managers to improve failing tests by buying loans that might be to more troubled companies. When a loan's price is heading into this territory, it might be less attractive to CLO managers. This could reduce demand for low-priced loans at least temporarily, which non-CLO managers need to consider as they analyze challenging credits.



Source: S&P/LCD for the period 01/01/2010 through 11/30/2020

DOWNGRADES AND CCC'S One of the most important guidelines for CLO managers is the Weighted Average Rating Factor (WARF). This test takes the rating on each loan and converts it to a number, and a portfolio average is then calculated. Those results are compared to the results of other CLO managers, and it's a helpful way to gauge how risky a portfolio might be. It's a critical metric, and continuously evaluated, as ratings change all the time. CLO managers trade the loans in their portfolios to keep these results in line.

This was especially challenging at the start of the pandemic, when the rating agencies quickly downgraded a host of companies facing potential struggles in the ensuing year. Rating agencies were quick to downgrade, but haven't been as fast to upgrade ratings now that conditions have improved. When a loan comes to the market with a lower rating from the start, it's important for managers to consider what that rating's path might be. With most CLOs limited to a CCC bucket of just 7.5%, a loan with a lower single-B rating might seem unattractive to CLO managers, and liquidity could be thinner than for higher-rated loans.

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Past market performance is no guarantee of future results.

LOAN AND CLO ISSUANCE CLO portfolios average about $400 million and contain hundreds of individual loans. Their guidelines generally require them to be as fully invested as possible, since they do not need cash on hand for client redemptions. It's a bit like the chicken and the egg; CLOs need new loans to purchase and companies can only issue new loans if they can find enough investors. Those two types of demand tend to work together, and when there's a lot of CLO issuance, there is typically a bump in new loan issuance to help those portfolios get stocked. Otherwise, CLOs won't be able to form. With forecasts ranging from $90 - $120 billion in new CLOs in 2021, we're likely to see loans issued to help offset some of that new demand, and that can have ramifications for the secondary loan market as well.

As the investor base for leveraged loans continues to evolve, managers need to consider how that demand shapes trends in the market. When managing our portfolios, we might want to have more conviction regarding low single-B loans, and further manage that risk through position sizing. Deep credit work remains a critical component of how we manage, but just one of many that influence how we ultimately deliver on each investor's objectives. Acknowledging other market participants, both big and small, helps us remain competitive in the loan market.

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Questions or concerns about the bank loan market? Email Cheryl Stober to learn more.

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