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INSIGHT

MONTHLY COMMENTARY

Loan Review – February 2018

DREW SWEENEY | MARCH 12, 2018

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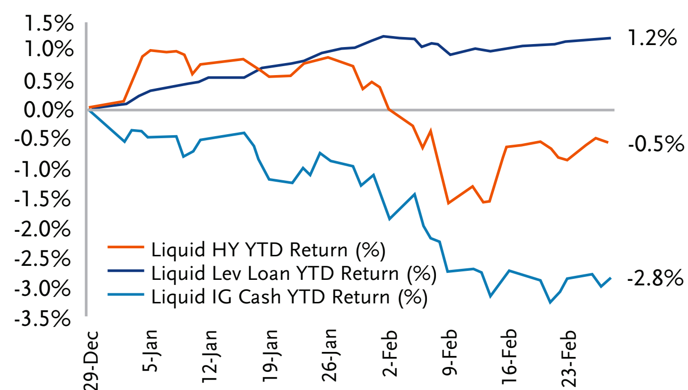
Mr. Sweeney is a Senior Vice President in the Fixed Income group where he trades leveraged loans. Mr. Sweeney joined TCW in 2015 from Bradford & Marzec, LLC where he managed loan strategies for both total return and CLO accounts as well as serving on the investment committee where he helped direct the 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 February, leveraged loans represented a stable asset class in a volatile capital market environment. Concerns surrounding rising interest rates, equity market volatility and high yield weakness, did not create any sustained selling in the loan market. Loan performance has been driven by investor interest in floating rate products and the pipeline of CLO warehouses that seem to be constantly adding assets. The 23-basis point spike in 3-month LIBOR further heightened interest in the asset class. It is notable that 3-month LIBOR moved above 2.0% for the first time since 2008. Triple A liabilities priced close to L+100 basis points in February. The compression of CLO liabilities has made the equity arbitrage for CLOs more compelling.

Outperforming Other Areas in U.S. Credit



Source: Credit Suisse

However, the compression of spreads for the underlying CLO collateral offset some of the benefit from the lower liabilities costs. Despite 2017's massive repricing activity, 73.2% of the JPMorgan Leveraged Loan Index still traded above par at month end. This is barely below early February's four-year high for this metric.

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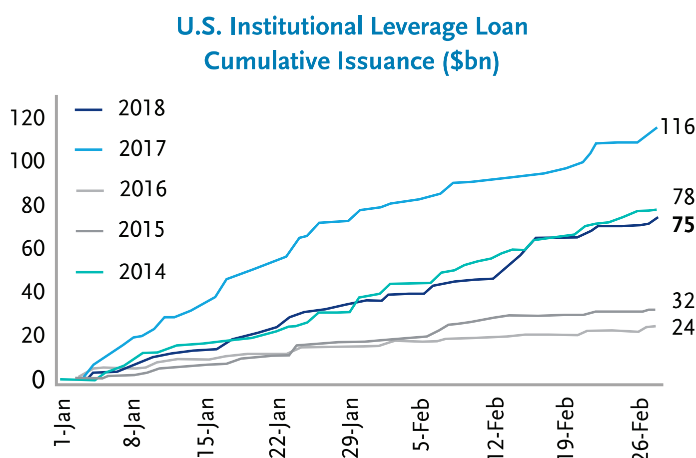
U.S. Institutional Leverage Loan Cumulative Issuance ($bn)



Source: Credit Suisse S&P LCD; Includes launched, but not yet priced deals.

2018 repricing activity was significantly below the prior year. However, current loan prices would suggest the market can sustain more repricing activity. New issue represented roughly $38 billion during the month, which was similar to January but a fraction of the year-to-date issuance seen in the prior year. In February, a few large transactions provided bookends to the month. Cineworld issued a $3.0 billion loan in early February and then SS&C issued a $7.0 billion tranche at the end of the month. Both deals were easily absorbed without any market indigestion. In March, issuance is expected to pick up and be closer to $50 billion on a mix of acquisition activity and refinancings.

The repeal of risk-retention requirements for CLOs was announced earlier this month and it garnered a lot of attention. Last year, for the first time, managers were required to own 5% of the deals they managed via a vertical strip (owning 5% of each tranche) or horizontally (ownership across the equity tranche equating to 5% of the size of the entire structure). Interestingly, if the intent of this regulation was to slow issuance, it had little effect. 2017 issuance was the second largest in CLO history. Would it have been larger without any such regulation? Perhaps. But more important has been the compression of liability spreads and the ability of equity buyers to lock in compelling long-term liability levels. While the removal of this risk-retention will help loan market demand on the margin, far more important will be the economic cycle and liability costs.

Performance

In February 2018, the Credit Suisse Leveraged Loan Index ("CS LLI") and the S&P Leveraged Loan Index ("S&P/LSTA") were both up, 0.18% and 0.20%, respectively.

- Year-to-date the CS LLI was up 1.26% and the S&P/LSTA was up 1.16%.
- For the 12 months ending February 28, the CS LLI was up 4.39% and the S&P/LSTA was up 4.22%.

Distressed loans provided the strongest returns in February and lower quality loans (Split B and CCC) provided the strongest returns during the last 12 months. In fact, split single B returns more than doubled the return of higher quality (Double B) loans both in February and during the last 12 months.

Total Return By Rating

	Feb-18 (%)	YTD (%)	LTM (%)
Split BBB	0.12	0.83	3.08
BB	0.03	0.84	3.77
Split BB	0.10	0.97	3.45
B	0.19	1.26	4.87
Split B	0.67	2.77	8.29
CCC/Split CCC	0.37	3.23	5.61
Distressed (CC, C & Default)	2.13	4.22	2.43

Source: Credit Suisse Leveraged Loan Index

Sector Performance

Sixteen of twenty sectors in the Credit Suisse LLI provided a positive return during the month with Energy (+0.51%), Service (+0.31%) and Healthcare (+0.25%) delivering top performance.

The worst performing sectors for the month were Consumer Durables (-2.16%), Metals/Minerals (-0.14%) and Food & Drug (-0.11%). Consumer durables is dominated by one borrower and that loan gave up a few points after a dramatic rally higher in December and January.

In the last 12 months, Manufacturing, Metals and Service led all sectors with total returns of 5.43%, 5.26% and 5.23%, respectively. In contrast, Consumer Durables, Retail and Energy were the worst performing sectors with returns of -0.28%, 1.05% and 1.98%, respectively.

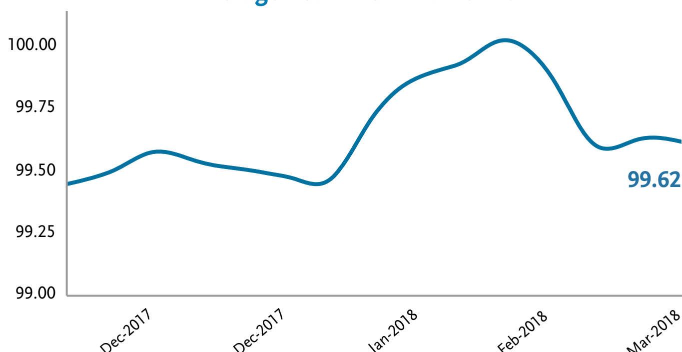
Total Return By Sector

Sector	Feb-18 (%)	YTD (%)	LTM (%)
Aerospace	0.18	1.15	4.91
Chemicals	0.16	0.88	4.65
Consumer Durables	-2.16	1.08	-0.28
Consumer Non-Durables	0.23	1.78	2.96
Energy	0.51	2.27	1.98
Financial	0.18	1.04	4.87
Food And Drug	-0.11	1.51	2.83
Food/Tobacco	0.16	1.14	4.12
Forest Prod/Containers	0.11	0.75	4.65
Gaming/Leisure	0.11	0.84	4.93
Healthcare	0.25	1.24	5.18
Housing	0.23	1.01	4.73
Information Technology	0.16	1.10	5.06
Manufacturing	0.19	1.20	5.43
Media/Telecommunications	0.19	1.24	4.24
Metals/Minerals	-0.14	2.03	5.26
Retail	-0.02	2.72	1.05
Service	0.31	1.13	5.23
Transportation	0.18	1.26	2.96
Utility	0.19	1.35	4.68

Source: Credit Suisse Leveraged Loan Index
Green Returns= Best Performing Sector; Red Returns= Worst Performing Sector.

The average bid of the S&P LCD's flow-name loan composite came in at 99.62% of par, down from January (100.03%).

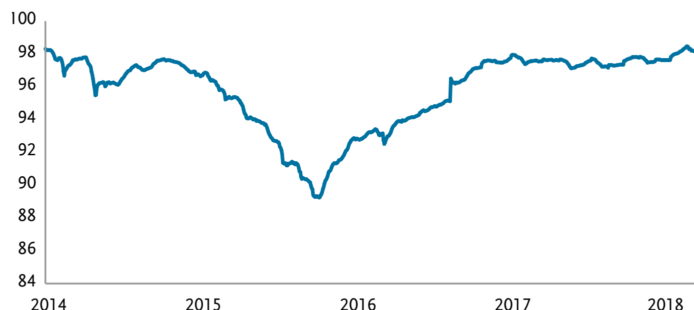
Average Loan Flow-Name Bid



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

While the CS LLI pulled off of the price highs of January and early February, prices remained elevated. In fact, over 73% of the JP Leveraged Loan Index trading above par. The following graph highlights the prolonged rally during the last 26 months.

CS LLI Average Price (9/2014 –2/2018)

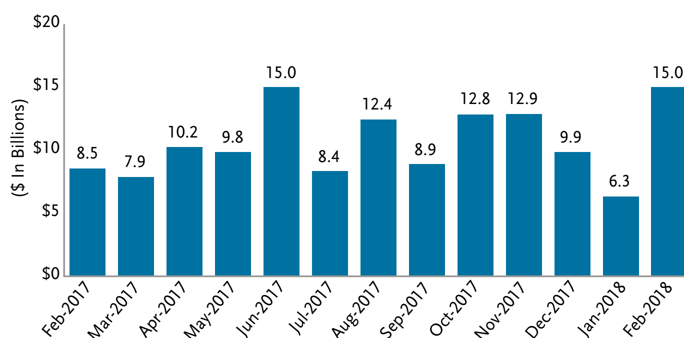


Source: CS LLI

Technical Conditions

In February, CLO markets printed the largest monthly issuance total (tied with June 2017) during the last12 months. A total of $15 billion in new deals priced during the month and demand for the underlying CLO liabilities continues to drive liability spreads compression. These tighter spreads also increase the interest in CLO equity as investors look to lock-in low rates through a credit cycle.

CLO Volume



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

Leveraged loan funds reported a $0.64 billion inflow in February. Following a very brief bout of outflows in mid-February, inflows for loan funds are now steady alongside a steep climb in rates, rallying equities, and stable credit prices.

AUM totaling $135 billion for the leveraged loan mutual fund base compares to an all-time high of $154 billion in April 2014. Inflows year-to-date for loan mutual funds total +$1.6 billion compared to a +$13.1bn inflow in 2017.

There was $48 billion of new issue placed in February 2018, almost 5% more than the prior month. Year-to-date issuance is down 32% year-over-year.

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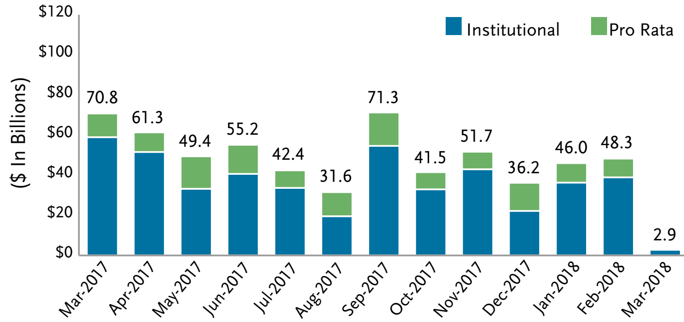
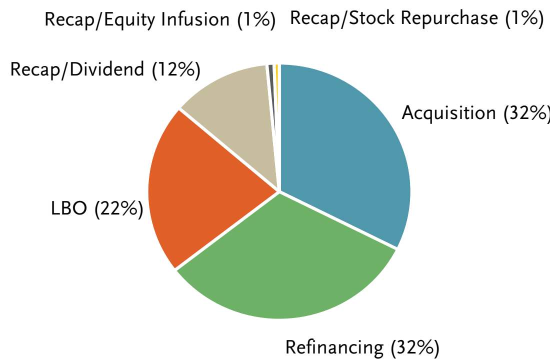
Leveraged Loan Volume



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

In terms of the year-to-date new issuance, roughly 32.0% of the primary market was related to refinancing existing deals while acquisitions and LBOs accounted for 54.0% of new issuance. If amendment activity is included then the mix of issuance so far this year has been 60% refi/repricing driven and 40% M&A and GCP related.

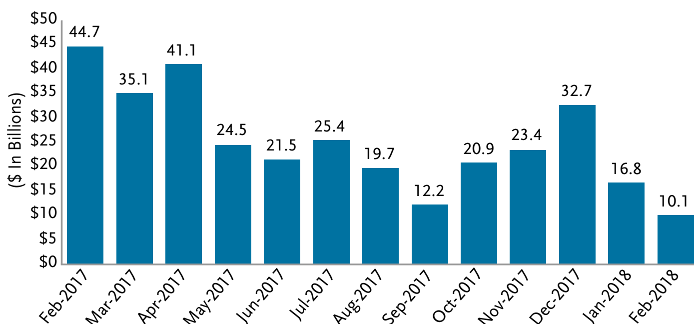
February 2018 Institutional Volume



Source: LCD, an offering of S&P Global Market Intelligence. As of February, 2018.

Monthly repayments fell to $10 billion following several months of high repayment activity. This decline eased the technical imbalance in the market.

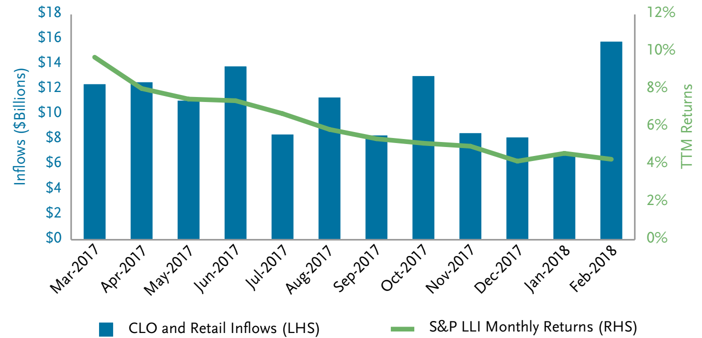
Monthly Repayments in the S&P/LSTA LL Index



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

Despite strong inflows, the trailing 12-month returns continued to move lower during the last year. The combination of lower LIBOR spreads and price declines resulting from repricing activity weighed on returns.

Inflows and Rolling LTM Returns



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

On a year-to-date basis, new issue spreads in February are -3.3% tighter for double Bs and -9.5% tighter for single Bs. The index spread for the CS LLI ended February at roughly L+355 basis points. This is the tightest spreads have been for the CS LLI index since March 2011.

New Issue Spread Changes

New Issue Spread Changes	BB/BB-	B+/B
Feb-17	256	398
Mar-17	243	382
Jun-17	240	370
Sep-17	243	373
Dec-17	233	375
Feb-18	226	339
Month-Over-Month Change (%)	-1	0
YTD Change (%)	-3	-10
LTM Change (%)	-7	-11

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

Average new issue yields contracted month-over-month for Double Bs (-0.10%) and single Bs (-0.07%). Rising LIBOR has offset much of the tighter LIBOR spreads during the last 12 months. In February, 3-month LIBOR moved higher by another 23 basis points.

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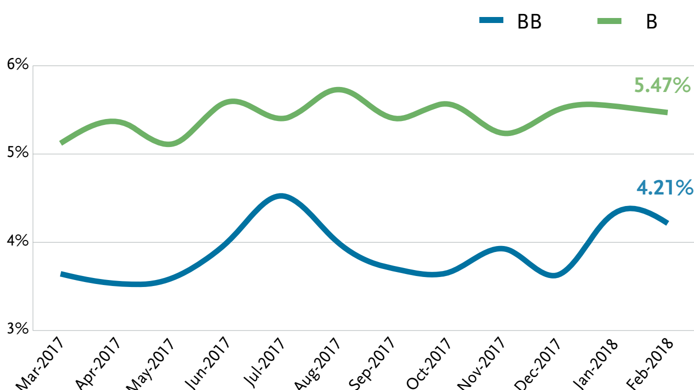
Average New Issue Yields



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

The default rate of the S&P/LSTA Leveraged Loan Index increased to 2.00% by principal amount in February. There was one default (Freedom Group). This level is still down from an 18-month high of 2.05% at the end of December.

The last 12-month default tally is twenty seven. Retail defaults lead all categories with seven while Oil & Gas is close behind with six.

Lagging 12-Month Default Rates

	Dec-17 (%)	Jan-18 (%)	Feb-18 (%)
Actual			
By Number	1.72	1.83	1.94
By Principal Amount	2.05	1.95	2.00
Shadow Default Rate*			
By Number	0.43	0.32	0.43
By Principal Amount	0.98	1.08	0.98

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

* 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 462 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 (396 basis points) and excluding January, this was the tightest 3-year discount margin since October 2007.

The DM spread differential between double Bs and single Bs tightened by 11 basis points from March 2017 to February 2018 and is still 41 basis points tighter than the historical spread differential.

3-Year Discount Margin Differential Between BBs and Single Bs

1/1992-1/2018 Average	190.9
Mar-17	161.1
Feb-18	150.3

CS LLI Snapshot

YTD Total Return*	1.26%
Average Price (excluding defaults)	98.23
Spread	354.83
Coupon	5.29%
Current Yield	5.39%
Yield (3-year life)	6.62%
Discount Margin (3-year life)	396 bps

*S&P LLI Total Return 1.16%

	Spread (bps)	DM (3 Yr Life) (bps)
Split BBB	209	203
BB	264	259
Split BB	322	317
B	388	410
Split B	554	780
CCC/Split CCC	664	1,080
Distressed (CC, C and Default)	443	1,721

Source: Credit Suisse

Summary

As of February 28, the S&P/LSTA Index imputed default rate was 1.27%, the second lowest level since October 2007.

Loans represented a stable asset class as the broader capital markets were turbulent. Loans outperformed high yield bonds for a fifth consecutive month, a feat which had not happened in the past decade. LIBOR continues to rise and with it, new investors migrate into floating rate retail funds as well as CLOs.

Despite general capital market weakness, the 3-month discount margin and the imputed default rate for CS and S&P indices remained at pre-crisis levels. It is also notable that many new issues in February priced at levels comparable to pre-crisis rates. Many double B loans priced inside of L+200, which had not been accomplished routinely since prior to the global financial crisis. Until there is enough supply to satiate demand, we do not expect to see broad-based selling in loans. While February did see several large deals syndicated, it will require significantly more mergers and transactions before demand can be met. ■

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