TCW

INSIGHT

MONTHLY COMMENTARY

Loan Review – May 2018

DREW SWEENEY | JUNE 14, 2018

May witnessed the second highest level of institutional loan issuance in the history of the market. Per S&P Leveraged Commentary and Data, $66 billion of issuance led a 2% increase in the S&P Leveraged Loan Index ("S&P/LSTA") size. According to JP Morgan, new issuance (including amended repricings), topped $100 billion. Non-repricing/refinancing activity resulted in just under $30 billion of actual new issuance, which means the overwhelming majority of the new issue calendar was focused on opportunistic transactions (repricing activity).

When new issuance is robust and repricing activity is high, secondary loan prices typically decline. First, high dollar-priced loans that are at risk of being repriced begin to trade lower. Second, new issue buyers often need to create capacity for the primary market by selling existing positions. Both of these elements, in combination with the Italian turmoil in May, led to lower average prices for the month. Loan prices are down roughly 37 basis points from April's high and the percentage of loans trading above par dropped 19.5% from April levels to 56.1% at the end of May.

The remediation in price felt healthy for the market. While prices were softer, there was still a strong bid for loans on weakness. There were no outflows from retail accounts and the CLO market printed $11.2 billion of new CLOs during the month.

Last month we mentioned when demand overwhelms supply, it can allow for bad things to happen. No sooner than the beginning of June did we witness one such example involving a particular borrower. Back in 2016, the borrower raised money in the loan and bond markets to support its LBO. The overwhelming demand allowed for a very loose initial credit agreement. Last year, the borrower raised incremental debt to finance an acquisition, the target of which had negative EBITDA. This acquisition increased leverage on the borrower's capital structure that already had high levels of debt.

By the beginning of this year, the borrower's capital structure loan was trading at distressed levels. Online competition and a more competitive market backdrop generally pressured the borrower's fundamentals and pricing of its securities. Despite the stress being realized by the company and the distressed trading levels of its debt, the company and sponsor took advantage of the loose credit agreement and removed one third of the purchased asset (the acquisition) from the borrower. Regardless of the outcome with this borrower, we believe the overwhelming demand for bank loans and investors' willingness to accept weaker terms laid the groundwork to allow for this behavior.

Notwithstanding the scenario described above, the broader market continues to perform well. Loan returns on a YTD basis remain compelling and EBITDA growth for loan borrowers was almost 9% in 1Q18, according to an LCD report. This, in combination with a subdued default rate, points to the very thesis that has underpinned the investment into loans for the last few years.

Drew Sweeney
Senior Vice President
Fixed Income

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.

Performance

In May, the Credit Suisse Leveraged Loan Index (CS LLI) and the S&P/LSTA were up 0.19% and 0.17%, respectively.

- Year to date, ending May 31, the CS LLI was up 2.26% and the S&P/LSTA was up 2.04%.
- For the 12 months ending May 31, the CS LLI was up 4.50% and the S&P/LSTA was up 4.20%.

Lower quality names generally outperformed during the month of May despite the fact that the Index actually declined in price. Double B loans only produced a 9 bps return. They remained under repricing pressure and many drifted closer to par in anticipation of repricing activity. Single Bs also experienced price declines and produced a return of 20 basis points for the month, the second lowest monthly return of the year. Split Single Bs and Triple Cs continued to outperform with returns of 72 basis points and 69 basis points, respectively.

Total Return By Rating

	May	YTD	LTM
Split BBB	0.13%	1.73%	3.32%
BB	0.09%	1.76%	3.95%
Split BB	0.03%	1.78%	3.48%
B	0.20%	2.27%	4.84%
Split B	0.72%	3.89%	8.03%
CCC/Split CCC	0.69%	4.96%	6.75%
Distressed (CC, C and Default)	-0.27%	6.80%	3.57%

Source: Credit Suisse Leveraged Loan Index

Sector Performance

Eighteen of 20 sectors in the CS LLI provided a positive return during the month. The top performing sectors in May were Metals/Minerals (+1.00%), Transportation (+0.81%) and Food and Drug (+0.33%).

The worst performing sectors for the month were Gaming and Leisure (0.08%), Aerospace (-0.07%) and Consumer Durables (-0.40%).

In the last 12 months, Metals, Utility, and Manufacturing led all sectors with total returns of 7.83%, 7.08% and 5.31%, respectively. In contrast, Consumer Non-Durables, Retail and Consumer Durables were the worst performing sectors with returns of 2.30%, 1.51% and -3.39%, respectively. The changing landscape of how consumers shop continues to weigh on these sectors. Results for these three sectors have been a mixed bag. Some of the borrowers are being directly impacted by a transition to online shopping and other loans are lower based on the fear of the Amazon effect.

TCW

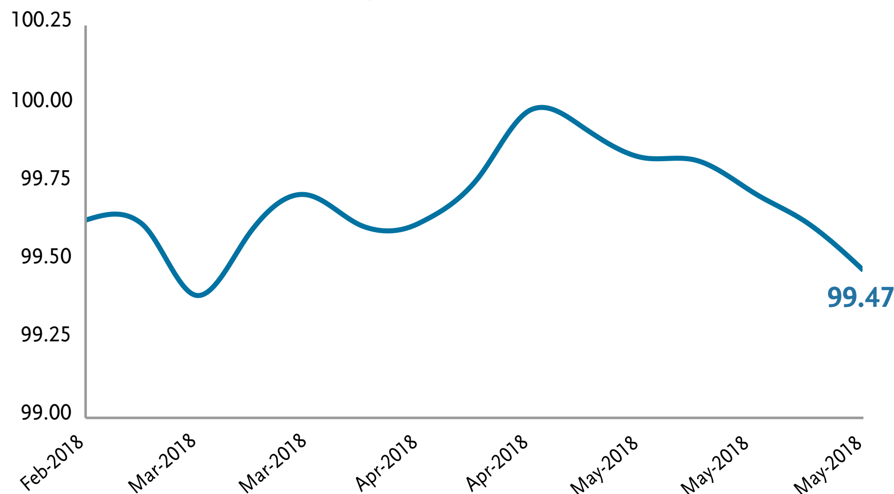
Industry Returns

	May	YTD	LTM
Aerospace	-0.07%	1.81%	4.56%
Chemicals	0.23%	2.08%	4.64%
Consumer Durables	-0.40%	-0.58%	-3.39%
Consumer Non-Durables	0.30%	1.76%	2.30%
Energy	0.28%	3.84%	4.39%
Financial	0.15%	2.15%	5.24%
Food and Drug	0.33%	3.04%	3.80%
Food/Tobacco	0.12%	1.95%	4.25%
Forest Prod/Containers	0.16%	1.63%	4.39%
Gaming/Leisure	0.08%	1.74%	4.45%
Healthcare	0.16%	2.30%	4.94%
Housing	0.24%	2.11%	4.84%
Information Technology	0.10%	2.18%	4.81%
Manufacturing	0.30%	2.31%	5.31%
Media/Telecommunications	0.22%	2.18%	4.27%
Metals/Minerals	1.00%	4.86%	7.83%
Retail	0.12%	3.70%	1.51%
Service	0.15%	2.03%	4.79%
Transportation	0.81%	2.77%	4.26%
Utility	0.24%	2.36%	7.08%

Source: Credit Suisse Leveraged Loan Index

CS LLI prices declined 27 basis points in May while the average bid of the S&P LCD Index was down 20 basis points. The S&P LCD flow-name loan composite started the month at 99.83 and ended the month lower at 99.47.

Average Loan Flow Name Bid



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

TCW

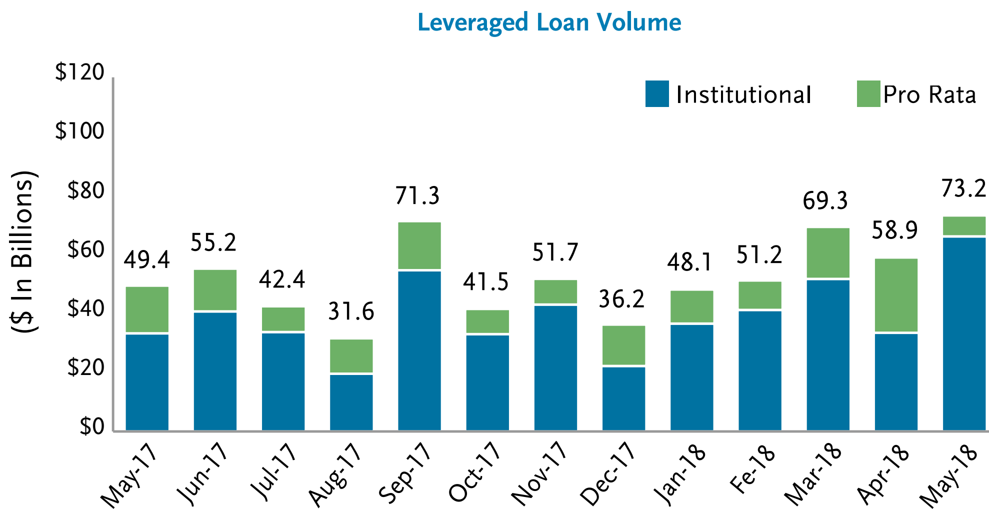
Technical Conditions

Leveraged loan funds reported an inflow of $3.7 billion for the month of May up from $2.2 billion in April. The wild swings in Treasury yields as a result of the Italian turmoil did not heavily impact retail inflows. Retail assets under management now total $144 billion for dedicated loan mutual funds and are approaching the all-time high of $154 billion set in April 2014. Inflows year to date for loan mutual funds total $9.7 billion versus a $13.1 billion inflow in 2017.

CLO inflows remained quite heavy as May became the second highest monthly total of 2018. May was the seventh largest month for issuance since January 2015. On a year-to-date basis, CLO issuance is up approximately 46% from the prior year.

Institutional new issuance grew 98% in May from April and total leveraged loan primary volume increased roughly 25% month over month. On a year-to-date basis, institutional new issuance was down 10.6% from 2017.

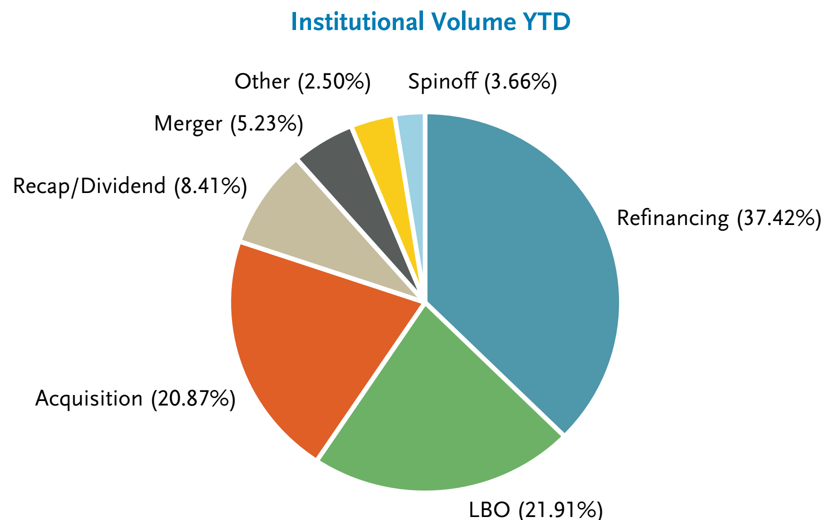
Leveraged Loan Volume



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

Gross institutional volume in May was $100.6 billion of which only $29.6 billion represented non-refinancing institutional loan volume. Excluding repricing done via amendment, $66.1 billion of institutional loans were priced in May, 37% of which was for refinancing purposes.

Institutional Volume YTD

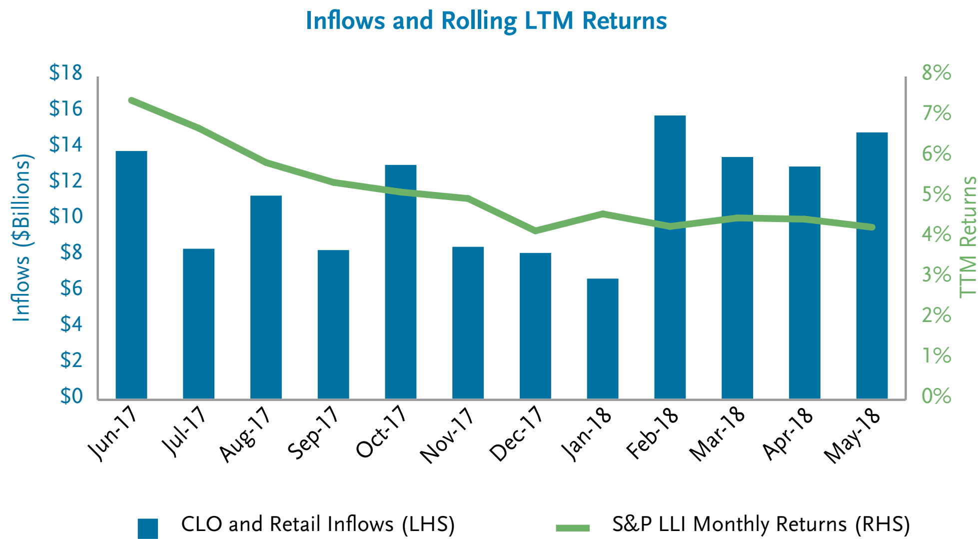


Source: LCD, an offering of S&P Global Market Intelligence

TCW

Amid strong inflows, the trailing 12-month returns continued to pace close to 4.3%. The combination of lower LIBOR spreads and price declines resulting from repricing activity have 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 May are -12.7% tighter for double Bs and -7.4% tighter for single Bs. The CS LLI spread ended May at roughly L+346 basis points. This is the tightest spreads have been for the CS LLI index since October 2010.

New Issue Spread Changes

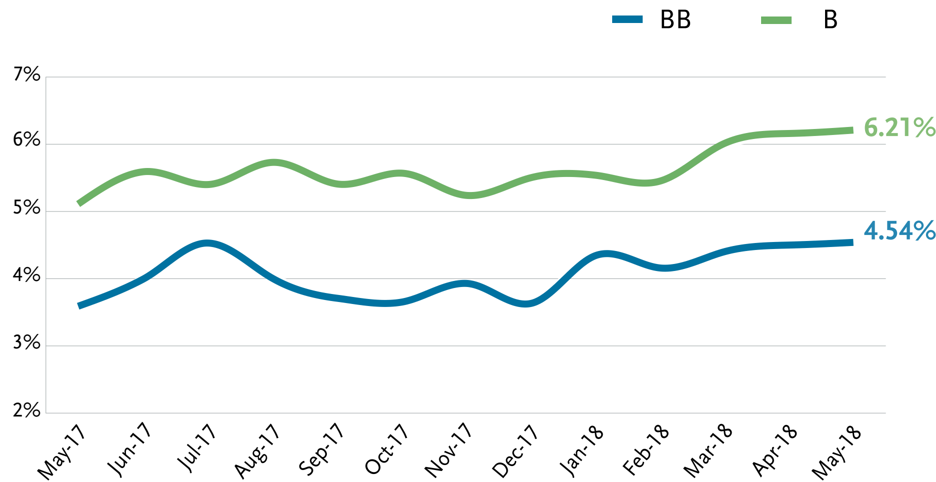
	BB/BB-	B+/B
Jun-17	240	370
Sep-17	243	373
Dec-17	233	375
Mar-18	224	341
Apr-18	217	344
May-18	204	347
Month-Over-Month Change	-6.2%	1.0%
YTD Change	-12.7%	-7.4%
LTM Change	-15.1%	-7.2%

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

TCW

LIBOR spreads during the last 12 months for new issue Double B loans have tightened -15.1%. New issue Single B loans have tightened -7.2% during the last 12 months. Rising LIBOR has offset much of the tighter spreads and yields for Double B and Single B loans widened during the month to 4.5% and 6.2%, respectively.

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 declined 25 basis points to 2.12% by principal amount in May. There was one default (Proserv in the Oil & Gas segment).

The last 12-month default tally is 21. Retail defaults lead all categories with seven while Oil & Gas is close behind with six.

Lagging 12-Month Default Rates

Actual	**Feb-18**	**Mar-18**	**Apr-18**	**5/31/18**
By Number	1.94%	1.93%	1.95%	1.72%
By Principal Amount	2.00%	2.42%	2.37%	2.12%
Shadow Default Rate*				
By Number	0.43%	0.54%	0.65%	0.97%
By Principal Amount	0.98%	0.65%	0.80%	0.90%

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 461 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 (388 basis points) hovers closest to the tightest levels for the 3-year discount margin since October 2007.

The DM spread differential between double Bs and single Bs has widened from June 2017 to May 2018 by 6 basis points and is still 35 basis points wider than the historical spread differential.

3-Year Discount Margin Differential Between BBs and Single Bs

1/1992-5/2018 Average	84.4
May-17	113.1
Apr-18	119.4

Source: Credit Suisse Leveraged Loan Index

CS LLI Snapshot

YTD Total Return*	2.26%
Average Price	98.14
Spread	346.27
Coupon	5.75%
Current Yield	5.85%
Yield (3-year life)	6.63%
Discount Margin (3-year life)	388 bp

*S&P LLI YTD Total Return 2.04%

Source: Credit Suisse Leveraged Loan Index

	Spread	DM (3-Year Life)
Split BBB	202 bps	200 bps
BB	261 bps	262 bps
Split BB	313 bps	320 bps
B	381 bps	407 bps
Split B	528 bps	829 bps
CCC/Split CCC	656 bps	1,027 bps
Distressed (CC, C and Default)	886 bps	4,483 bps

Source: Credit Suisse Leveraged Loan Index

Summary & Looking Forward

As of May 31, the S&P/LSTA Index imputed default rate was 1.22%, the third lowest level since November 2007. The fundamentals of loan borrowers remain intact. EBITDA growth and low default rates underpin the investment thesis of buying high yield corporate debt. Despite the Italian turmoil and the subsequent impact on rates, funds continued to flow into loans.

May seemed to represent a month where technical characteristics dominated the market and allowed for new issue spreads to compress while prices weakened. CLO activity allowed the loan market to reach the second highest level of monthly institutional loan issuance in its history. The issuance was driven by opportunistic loan borrowers, reducing their interest burden via repricings.

Loan spreads have been tightening during the last two years in conjunction with lower borrowing costs for CLOs. CLOs represent almost 60% of the buyer base, so these liabilities often drive collateral spreads. From time to time, retail funds or crossover investors become the marginal investor but at the end of the day, CLOs consistently dominate the landscape.

Interestingly, for much of 2018, we have seen liability spreads widen and collateral spreads tighten. This is happening in part because of the magnitude of CLO resets. These resets often have to occur on the coupon date, creating a glut of CLO liability pricings. The increase in CLO paper has led to widening liability spreads. However, reset CLOs are able to buy a much wider selection of collateral, which creates increased demand for new issue. The combination of these two factors alongside new CLO generation, is actually allowing for loan spreads to continue to compress while liabilities widen. This is obviously not sustainable and we expect that as summer ends the technical pressure will begin to subside.

The CLO arbitrage has faced a second stress during the last several months and that is the mismatch between LIBOR rates for the underlying liabilities and the collateral in the vehicle. CLO liabilities are pegged to 3-month LIBOR while loan borrowers are more frequently choosing to peg their interest payments to 1-month LIBOR. Nearly 60% of the borrowers are borrowing with 1-month LIBOR. Why? Because 1-month LIBOR is almost 30 basis points lower.

The wider liabilities and the mismatch in the 1-3 month LIBOR will ultimately have to be reflected in the collateral spreads; however, this is taking a few quarters to be reconciled. ■

Copyright © 2018 by S&P Global Market Intelligence, a division of S&P Global Inc. All rights reserved.

No content (including ratings, credit-related analyses and data, valuations, model, software or other application or output therefrom) or any part thereof (Content) may be modified, reverse engineered, reproduced or distributed in any form by any means, or stored in a database or retrieval system, without the prior written permission of S&P Global Market Intelligence or its affiliates (collectively, S&P). The Content shall not be used for any unlawful or unauthorized purposes. S&P and any third-party providers, as well as their directors, officers, shareholders, employees or agents (collectively S&P Parties) do not guarantee the accuracy, completeness, timeliness or availability of the Content. S&P Parties are not responsible for any errors or omissions (negligent or otherwise), regardless of the cause, for the results obtained from the use of the Content, or for the security or maintenance of any data input by the user. The Content is provided on an "as is" basis. S&P PARTIES DISCLAIM ANY AND ALL EXPRESS OR IMPLIED WARRANTIES, INCLUDING, BUT NOT LIMITED TO, ANY WARRANTIES OF MERCHANTABILITY OR FITNESS FOR A PARTICULAR PURPOSE OR USE, FREEDOM FROM BUGS, SOFTWARE ERRORS OR DEFECTS, THAT THE CONTENT'S FUNCTIONING WILL BE UNINTERRUPTED OR THAT THE CONTENT WILL OPERATE WITH ANY SOFTWARE OR HARDWARE CONFIGURATION. In no event shall S&P Parties be liable to any party for any direct, indirect, incidental, exemplary, compensatory, punitive, special or consequential damages, costs, expenses, legal fees, or losses (including, without limitation, lost income or lost profits and opportunity costs or losses caused by negligence) in connection with any use of the Content even if advised of the possibility of such damages.

Credit-related and other analyses, including ratings, and statements in the Content are statements of opinion as of the date they are expressed and not statements of fact. S&P Global Market Intelligence's opinions, analyses and rating acknowledgment decisions (described below) are not recommendations to purchase, hold, or sell any securities or to make any investment decisions, and do not address the suitability of any security. S&P Global Market Intelligence assumes no obligation to update the Content following publication in any form or format. The Content should not be relied on and is not a substitute for the skill, judgment and experience of the user, its management, employees, advisors and/or clients when making investment and other business decisions. S&P Global Market Intelligence does not act as a fiduciary or an investment advisor except where registered as such. While S&P Global Market Intelligence has obtained information from sources it believes to be reliable, S&P Global Market Intelligence does not perform an audit and undertakes no duty of due diligence or independent verification of any information it receives.

S&P keeps certain activities of its business units separate from each other in order to preserve the independence and objectivity of their respective activities. As a result, certain business units of S&P may have information that is not available to other S&P business units. S&P has established policies and procedures to maintain the confidentiality of certain non-public information received in connection with each analytical process.

S&P may receive compensation for its ratings and certain analyses, normally from issuers or underwriters of securities or from obligors. S&P reserves the right to disseminate its opinions and analyses. S&P's public ratings and analyses are made available on its Web sites, www.standardandpoors.com (free of charge), and www.ratingsdirect.com and www.globalcreditportal.com (subscription), and may be distributed through other means, including via S&P publications and third-party redistributors. Additional information about our ratings fees is available at www.standardandpoors.com/usratingsfees.

This material is for general information purposes only and does not constitute an offer to sell, or a solicitation of an offer to buy, any security. TCW, its officers, directors, employees or clients may have positions in securities or investments mentioned in this publication, which positions may change at any time, without notice. While the information and statistical data contained herein are based on sources believed to be reliable, we do not represent that it is accurate and should not be relied on as such or be the basis for an investment decision. The information contained herein may include preliminary information and/or "forward-looking statements." Due to numerous factors, actual events may differ substantially from those presented. TCW assumes no duty to update any forward-looking statements or opinions in this document. Any opinions expressed herein are current only as of the time made and are subject to change without notice. Past performance is no guarantee of future results. © 2018 TCW