T. ROWE PRICE INSIGHTS
ON U.S. FIXED INCOME

Attractive Yields, Slowing Bank Loan Downgrades Support CLOs

Analysis can uncover value in collateralized loan obligations.

September 2020

KEY INSIGHTS

- Total collateralized loan obligation (CLO) issuance in 2020 is likely to be meaningfully below the 2019 level, providing technical support for the market.
- The pace of credit rating downgrades in the bank loan market has moderated over the last few months, and capital markets have reopened to loan issuers.
- These supportive factors, combined with the attractive yields and solid structures of some CLOs, have allowed us to find value in certain CLOs.

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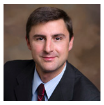

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Total CLO issuance in 2020 is likely to be meaningfully below the level from 2019, with new CLO deals continuing to lag last year's pace in 2021. While the bank loan market experienced heavy credit rating downgrades in March and April, the pace has moderated over the last few months, and capital markets have reopened to loan issuers. Combined with the attractive yields and solid structures of some CLOs that enhance their credit, these factors have allowed us to find attractive value in certain segments of the market.

Portfolios of Bank Loans

CLOs are portfolios of bank loans,[1] corporate debt that typically has high yield credit ratings, that are structured into slices, or tranches. Unlike other types of securitized credit, a third-party collateral manager actively manages the underlying loan portfolio. Most of the CLO debt tranches have credit ratings that range from AAA to BB, depending on the amount of credit enhancement—support from the cash flow structure of the CLO. The equity tranche sits at the bottom of the capital structure, has no credit enhancement, and does not pay a coupon, instead receiving all remaining cash after debtholders have received their expected principal and interest payments.

Slowing New CLO Issuance

After issuance stalled at the peak of the market volatility earlier in the year, new CLO issuance increased month over month beginning in April. We believe that new deals will roll out at a rate of about USD 6 billion per month over the remainder of the year. This estimated pace would bring the total new 2020 issuance

[1] Also referred to as leveraged loans.

to about USD 70 billion, which would be a decrease of about 35% from last year. However, an increase in loan issuance or higher outflows from loan funds, which would boost available supply, could cause the 2020 new CLO total to be modestly higher. Compared with 2019, we also anticipate lower CLO issuance in 2021 unless there is a meaningful pickup in mergers and acquisitions or private equity activity that boosts loan issuance.

This muted outlook for new CLO supply should be a supportive technical factor for the market, with all else being equal. However, because CLOs are a major source of demand for bank loans, a slower pace of new CLO issuance is a negative technical factor for the underlying loans that make up CLOs. Overall, we expect the positive technical support from a lower level of CLO issuance to outweigh the technical headwinds for the loan market.

Less than 10%

As of July 31, less than 10% of the bank loan market was at distressed levels.

Rapid Credit Rating Downgrades of Underlying Loans

The economic recession triggered by the coronavirus pandemic has obviously impacted the businesses of many bank loan issuers. Moreover, in our view, underwriting standards had deteriorated throughout 2018 and 2019. This shift was reflected in higher leverage and looser protective covenants.[2] The lower underwriting standards also negatively affected the ratings mix of the loan market, which becomes increasingly important in a downturn or recession when there is more downgrade activity.

Since March, the credit rating agencies have downgraded about 40% of the loan market, with most of the actions coming in March and April after the initial onset of the pandemic. The pace of downgrades has moderated since then. In July, both the number and total volume of loans upgraded outpaced the number and volume of downgrades. However, the rating agencies have been slower to downgrade CLOs, especially those rated higher than BBB. As a result, we could see some near-term rating actions on A and AA rated CLOs, particularly on those with weaker structures and collateral. However, we think that AAA rated CLOs are unlikely to see downgrades unless the agencies change their methodologies.

Anticipated Loan Default Rate Lower Than Originally Expected

During the depths of the economic shutdown in late March and early April, we anticipated a prolonged recessionary environment that would trigger a large spike in the default rate on bank loans over the next year. However, since then we have witnessed the effects of massive monetary and fiscal stimulus as well as the progress made toward containment and treatment of the virus. While defaults increased to 3.9% in July, the highest level in five years,[3] we now anticipate a lower peak default rate than we originally feared.

Furthermore, the number of bank loans trading at distressed levels of less than USD 80 has notably decreased, indicating that the loan market now also anticipates fewer defaults. At the end of March, 28% of the bank loan market was trading below USD 80, but as of July 31, less than 10% of the market was at distressed levels.[4]

Finally, in a positive sign for loan credit quality, second-quarter corporate earnings, while undeniably poor, have not been as devastating as originally anticipated. Also, the combination of lower rates, large inflows into high yield funds, and new CLO formations has provided loan issuers with liquidity. With loan market issuance limited in the immediate aftermath of the crisis, many loan issuers accessed the secured or unsecured high yield bond markets to

[2] Covenants provide legal protection for debt holders against a deterioration in the borrower's fundamental credit metrics.
[3] Data source: Standard & Poor's (see Additional Disclosures).
[4] Data source: J.P. Morgan (see Additional Disclosures).

meet their near-term debt obligations and generate cash buffers for use until revenue returns closer to historical levels. Since then, the loan new issue market has reopened, although it remains at lower issuance levels than in the high yield bond market.

Loan Defaults Slowly Working Into CLOs

As CLOs are actively managed, we expect loan default rates within CLOs to be lower. But the range of outcomes should be wide, with stronger deals as low as 1% and weaker structures over 10%. It will take time for the loan defaults to work into the CLO market, but we believe that the market is already pricing in this default scenario to a large degree. We anticipate that BB rated CLOs, as well as some BBB rated tranches with weaker structures, will ultimately experience losses from defaults.

Credit Analysis More Important Than Ever

The modestly better-than-expected economic backdrop and lighter new CLO issuance support our selective positions in higher-quality CLOs, which we have been adding to some of our diversified fixed income funds. These tranches offer higher yields than similarly rated corporate bonds. Also, the structural features of CLOs divert interest payments from the equity and lower-tier debt tranches to the higher-rated senior notes if overall credit quality deteriorates beyond a certain threshold, providing additional credit support.

The obvious risk to these positions is that a second wave of the virus prompts another broad shutdown of economic activity. However, we believe that our deep analysis of the credit quality and cash flow structures of our CLO holdings, paired with a strong high yield research platform, will allow us to find the deals and tranches that are well positioned to weather the ongoing uncertainty and volatility.

WHAT WE'RE WATCHING NEXT

A relatively small percentage of outstanding CLOs have recently been diverting interest payments away from their equity tranches, and some equity slices may be indefinitely separated from payments. It could be difficult for the managers of these poorly performing CLOs to issue new deals, illustrating the importance of evaluating and monitoring CLO collateral managers.

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