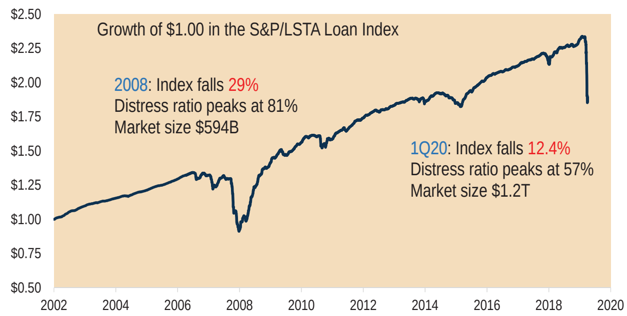
S&P Global Market Intelligence

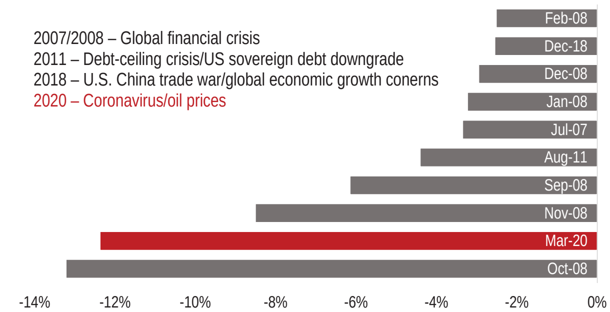
LCD Quarterly Review

A record credit cycle ends abruptly ...



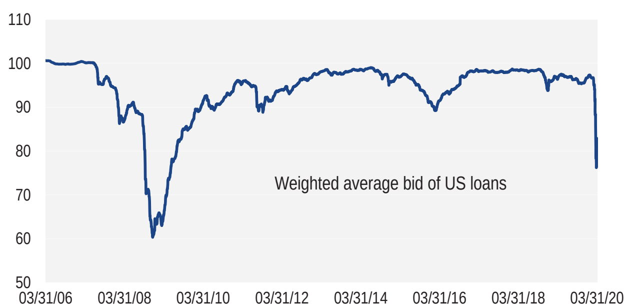
Sources: LCD, an offering of S&P Global Market Intelligence; S&P/LSTA Leveraged Loan Index

... as leveraged loans suffer losses rivaling 2008 ...



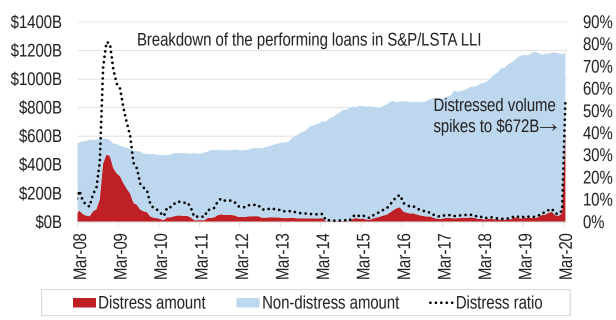
Sources: LCD, an offering of S&P Global Market Intelligence; S&P/LSTA Leveraged Loan Index

... and prices plunge from near-par levels.



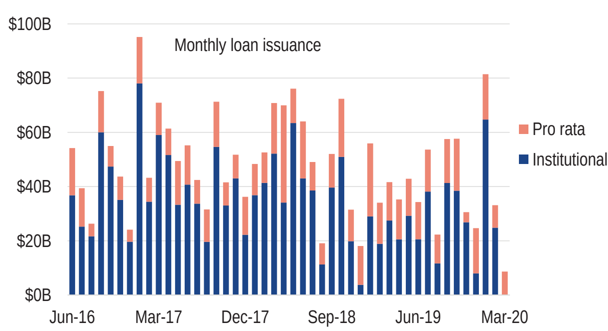
Sources: LCD, an offering of S&P Global Market Intelligence; S&P/LSTA Leveraged Loan Index

The result: a record amount of distressed debt ...



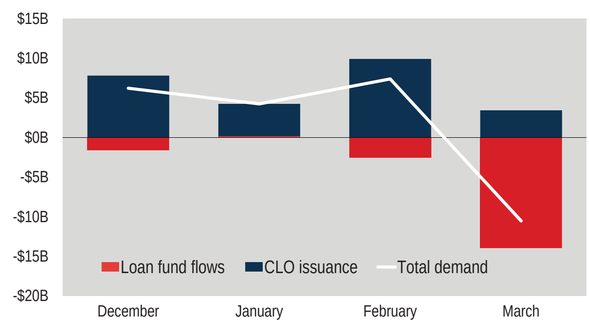
Data as of March 23, 2020.
Sources: LCD, an offering of S&P Global Market Intelligence; S&P/LSTA Leveraged Loan Index

... and a shut-down in the new-issue market ...



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

... as demand in the asset class evaporates.



Sources: LCD, an offering of S&P Global Market Intelligence; Lipper

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End of an era: Loans crash in March; volatility soars

The longest economic expansion in U.S. history came to an abrupt end in March, upending a record credit cycle during which the U.S. leveraged loan asset class doubled in size and became a dominant player in the capital markets.

Putting it mildly, the loan market collapse and volatility were unprecedented.

The S&P/LSTA Leveraged Loan Index plunged by 12.37% in March, the second steepest monthly decline in the 23-year history of the Index. Before COVID-19 swept the globe, the top three biggest losses for loans were during the global financial crisis following the Lehman Brothers bankruptcy in September 2008.

Prices in the usually staid loan market gyrated wildly last month. On March 18, the Index declined by 3.74%, the biggest daily loss on record. In fact, in the history of the Index there are only four instances of daily losses exceeding 3%—all of them last month. Likewise, there are only nine days on record when loans lost more than 2% per day. Six of these days were last month (the other three were in October and November 2008). That said, the biggest daily gain for the Index also was last month—3.33% on March 26, which followed a 2.05% gain on March 25, the third-biggest daily gain on record.

As a result, secondary market volatility—as measured by the standard deviation of daily returns—spiked to...

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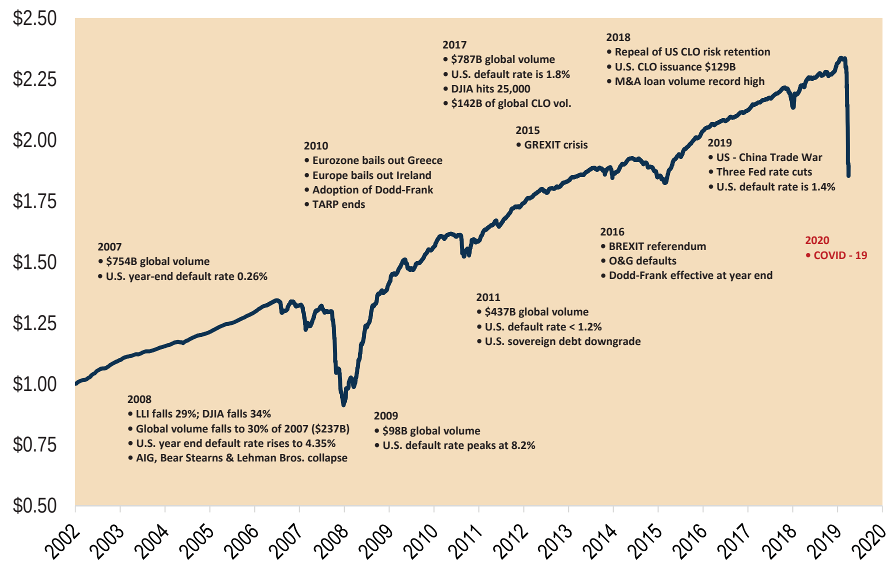
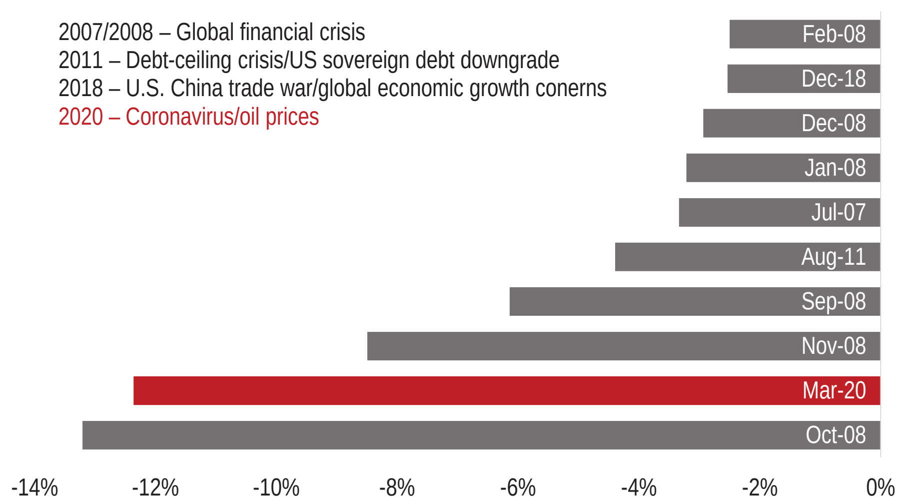
Chart 1: Growth of $1.00 in the S&P/LSTA Loan Index



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

Chart 2: 10 worst monthly leveraged loan returns



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

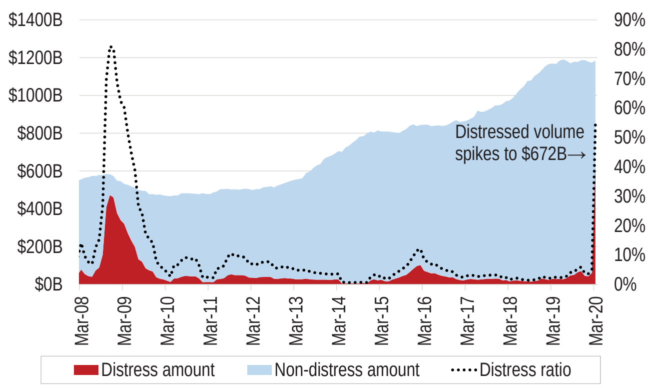
Coronavirus crisis vs 2008: a look at distress, CLOs, credit quality

The volume of loans priced below the often cited 80-level for distress has exceeded the 2008 crisis-era distress peak. The current landscape, however, is notably different versus 2008, both for better and worse. In this analysis LCD looks at the current crisis, and its predecessor, as well as shifts that could impact liquidity and valuations during the next downturn.

- **Market size**

March's historic plunge in the U.S secondary loan market pushed the volume of outstanding debt priced below 80 to $672 billion at the close on Monday, March 23, an increase of over 50% from the prior Friday's close and outpacing the prior record of $472 billion (in 2008) by 40%.

Chart 35: Breakdown of the performing loans in S&P/LSTA LLI



Data as of March 23, 2020.
Sources: LCD, an offering of S&P Global Market Intelligence; S&P/LSTA Leveraged Loan Index

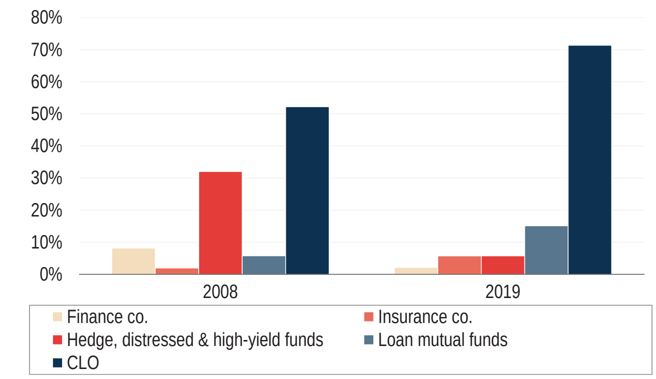
In today's $1.2 trillion leveraged loan market, the volume of loans below 80 represented a "distress" ratio of 57%, versus 81% at the 2008 distress ratio peak, when the size of the market was $594 billion (indeed, when the size of the market was less than the volume priced below 80 at the March 23 close).

While the absolute numbers are high, we are still well short of an 81% distress ratio—in today's market, that would amount to almost $1 trillion of distressed loans in the S&P/LSTA Leveraged Loan Index.

- **Buying trends**

In addition to market size, one of the biggest shifts during the bull-run was the increasing dominance of CLOs as the primary buyer of institutional leveraged loan paper in the primary market. According to LCD, CLOs accounted for 71% of allocations in 2019, compared to 52% at the 2008 distressed peak.

Chart 36: Primary institutional market by investor type (ex-banks)



Data as of Dec. 31, 2019.
Source: LCD, an offering of S&P Global Market Intelligence

This is important, as CLOs typically are sticky in terms of limited forced selling, with most not required to mark-to-market.

While there are limitations on characteristics such as ratings of the collateral (a typical CLO can only hold 7.5% of the collateral pool in triple-C debt), plummeting prices in the secondary do not force CLO asset sales.

This should help limit the vicious cycle that develops when managed accounts or retail funds are forced to sell assets in order to raise cash for outflows. This, in turn, causes further underperformance of loans, leading to more outflows, and so on and so on.

However, while CLOs are typically not forced to sell, they are unlikely to be buyers en masse of distressed debt, and are far from being the buyer of last resort. This is because CLOs often include specific provisions when purchasing assets below a documented threshold price, typically 80, sources explain, with these assets referred to as Discount Obligations (DO).

Criteria around buying DO vary from CLO to CLO, but tend to center on...

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