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SFA Research Corner

Leveraged Loans and CLOs – The (Credit) Squeeze is On

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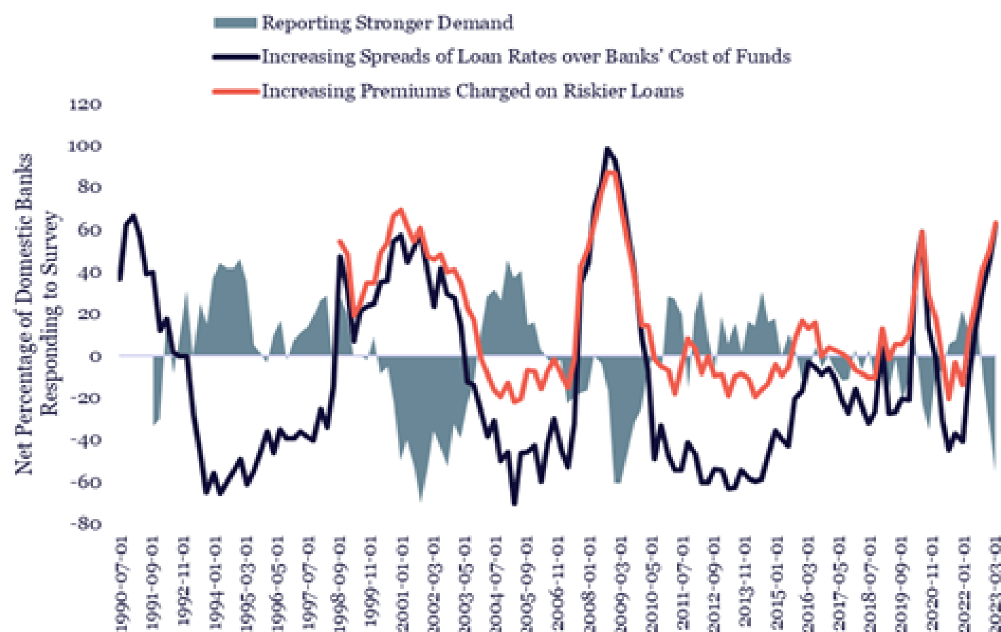
Leveraged Loans and CLOs – The (Credit) Squeeze is On

More banks reported tighter lending standards on commercial and industrial loans in the first quarter of 2023 (46% versus 44.8% in 4Q 2022) according to the April Senior Loan Officer Opinion Survey on Bank Lending Practices. Banks cited "uncertain economic outlook, reduced tolerance for risk, worsening of industry-specific problems, and deterioration in their current or expected liquidity position" as reasons for the shift. More banks reported that they increased the cost of loans (from 47.8% to 62.3% of respondents) and the premium charged on riskier loans (50% to 62.9%), levels not seen since 2009. Other changes to terms include shorter maturities, reduced credit lines and tighter loan covenants. Over the same period, demand for loans weakened further—55.6% reported weaker demand versus 38.8% the quarter before. Below we look at the impact of tighter credit on leveraged loans and CLOs.

More Banks Tightened Access to Loans. Demand Also Falls



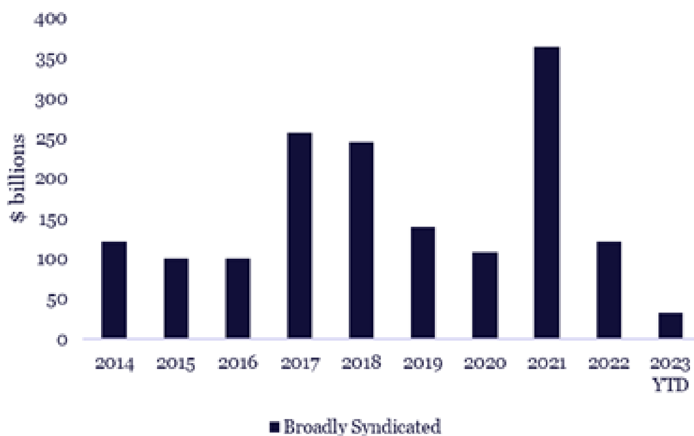
Source: Board of Governors of the Federal Reserve System, Senior Loan Officer Opinion Survey on Bank Lending Practices

Higher funding costs and tighter lending conditions have been impacting loan supply. Issuance of broadly syndicated institutional leverage loans, the largest segment of the leveraged loan market, dropped from a record $615 billion in 2021 to a 12-year low of $225 billion in 2022, according to S&P LCD data. These commercial loans, of which over $1.6

trillion are outstanding, are made to companies with non-investment grade ratings across various industries. The loans are arranged by investment banks and broadly syndicated to institutional investors or banks. The typical loan is a floating rate, senior secured, first-lien instrument with an average tenor of 5-7 years. Many include some degree of maintenance covenants, which are financial tests that must be met on a regular basis.

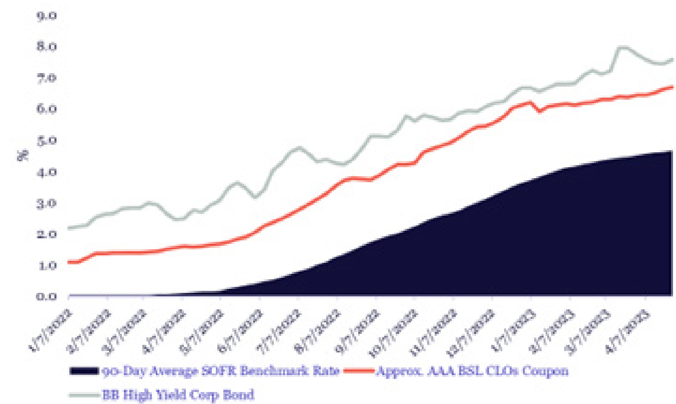
Collateralized Loan Obligations (CLOs) are funding vehicles backed by pools of these leveraged loans. CLOs are the largest buyers of these instruments. As loan supply dropped and risk aversion rose on broader market volatility, CLO issuance pulled back. In 2022, issuance reached $121 billion, a drop of 66% from 2021's level of $364 billion according to Finsight. Issuance so far in 2023 is on track to reach $85 billion, another 30% year-over-year decline.

CLO Issuance, Backed by Broadly Syndicated Leveraged Loans, Continues Its Steep Decline...



Source: Finsight

... As Funding Costs Steepen



Source: Market Compilation

In addition to curbing growth, higher funding costs and tighter lending standards also mean fewer opportunities to refinance existing debt. Refinancing and repricing have been crucial financial tools for many leveraged loan borrowers, as borrowers are able to push out maturities, lower debt service and increase borrowing facilities. To put this into perspective, at the start of 2021, $421 billion of leveraged loans were set to mature before the end of 2025. By the end of 2021, one of the strongest years of issuance for leveraged loans, 46% of these loans (totaling $193 billion) had been refinanced and their maturities extended.

Although abundant refinancing opportunities can provide a lifeline to viable albeit more highly leveraged companies—companies that need some financial runway to turn performance around —they could also support the rise of so-called zombie companies. In a 2021 study, the Federal Reserve estimated 10% of public firms and 5% of private firms were zombies. The Fed characterized these companies as "unable to generate enough profits to cover debt-servicing costs and that need to borrow to stay alive." The same study assessed that, at the time, zombie firms were "not an important feature of the U.S. economy" but cautioned that it was "too early to dismiss concerns that the current economic conditions may be breeding new zombie firms." In 2022, Bloomberg estimated that 20% of public firms were zombies, noting that these companies were the "creations of easy credit, beneficiaries of central bank largesse." Given weak performance and limited cash, strategic refinancing, and in some cases repeated refinancings, at low interest rates has allowed these companies to stave off negative rating actions, default or bankruptcy. As the economic outlook softens and funding costs that are four times higher than where they were only 12 months ago, refinancing as a strategy will become increasingly challenging and, for some lower quality corporate borrowers with the weakest credit rating, it may be inaccessible. It's a situation that is slowly unfolding.

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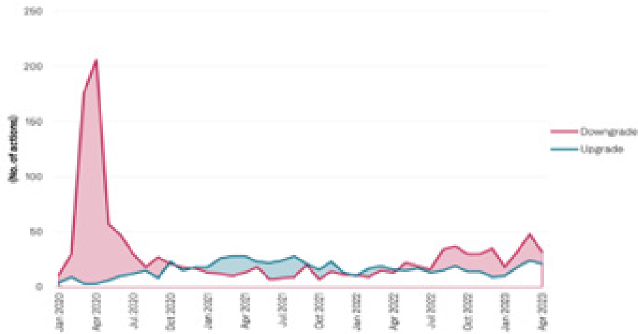
Spec-Grade Corporate Rating Actions in BSL CLO Collateral Pools (Jan 2020-Apr 2023)



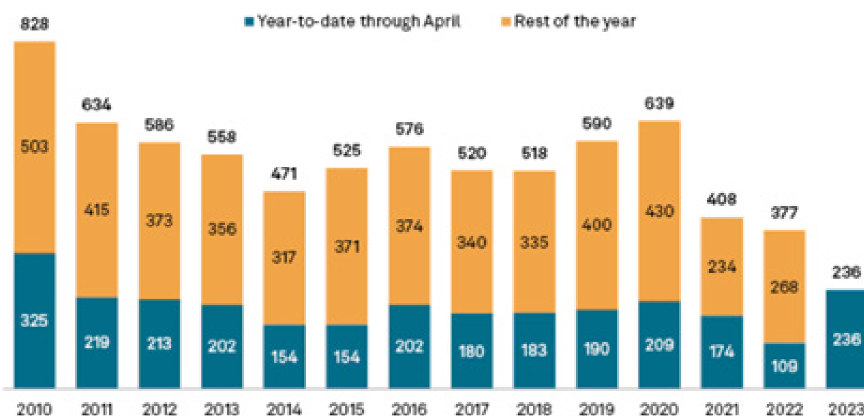
Source: S&P Global Ratings

Between January 2022 and mid-March 2023, according to S&P Global Ratings, "the rise of debt service costs and deceleration of profit growth led to more credit issues for U.S. corporates with an uptick in negative rating actions, especially among borrowers at the lower end of speculative grade." The rating agency has downgraded 87 corporate ratings from the B- to CCC category (CCC+, CCC and CCC-) since January 2022, noting "more severe and persistent free operating cash flow deficits." Historically, companies rated 'B-' are more likely to see a downgrade to the CCC category, which the rating agency views as likely to default, than companies rated one notch above or higher. These characteristics could be troubling for CLOs as companies rated B- represented 30%, the largest rating cohort, of obligors across CLOs as of March 2023.

Refi, Reprice, Restructure

For borrowers that can't refinance, reprice or restructure their loans, bankruptcy may be the last resort. As of April month-end, 236 companies across 11 sectors had filed for bankruptcy in the U.S., the highest year-to-date tally since 2010, according to S&P data. The consumer discretionary sector leads the way (with 30 filings), followed by the industrial and financial sectors, with 23 and 18 filings, respectively.

March U.S Corporate Bankruptcy Filings Push Q1 Total to Highest Since 2010



Source: S&P Global Market Intelligence

Deteriorating corporate credit has seeped into CLO pools. Since May 2022, corporate rating downgrades have exceeded upgrades in CLO portfolios monthly, according to S&P. Additionally, the share of obligors in BSL CLO pools with a negative ratings bias has increased to 17.6% from a low of 9.4% reached in May 2022. Data from S&P also shows that the exposure to the borrowers in the CCC category has climbed to 5.76% from a pandemic low of 3.68%

recorded in August 2022. CLO structures are particularly sensitive to CCC exposure, which are typically set to 7.5%, due the perceived increased likelihood of default in the rating category. When a transaction exceeds its pre-determined CCC concentration limits, cash flow is usually diverted to deleverage the transaction and trading restrictions are put into place to limit the credit risk profile of the transaction further.

In the near term, the impact that credit deterioration will have on CLO structures will depend on various factors including the skill of the CLO manager to trade out of underperforming corporate names, the strength of the financial markets, and the CLO structure itself. Because CLOs are typically backed by a diverse pool of syndicated bank loans across industries and ratings, absent a widespread decline in corporate credit, we expect this diversity to serve CLOs. Moreover, the flurry of refinancings in 2021 means that maturity dates of many of the underlying loans are pushing out to 2026 and beyond leaving these companies time to improve operational performance or find other sources of capital, hopefully in a stronger economy, before they face an immediate call for cash.