STRUCTURED FINANCE ASSOCIATION

Research Corner

September 28, 2020

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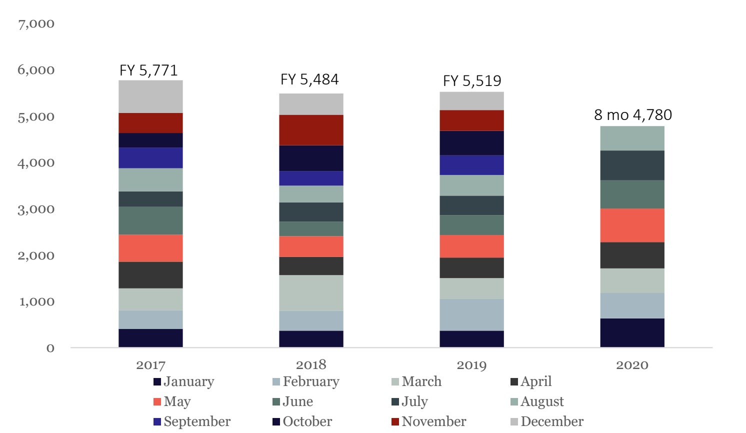
SFA Research Corner: Corporate Bankruptcies Hit Highest Levels in 9 Years

What We're Watching

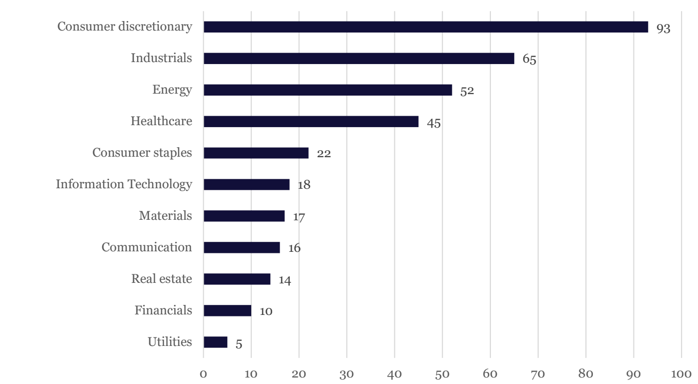
What we're watching – As of August month-end, 4,780 companies have sought Chapter 11 bankruptcy protection, 28% above the number of filings for the same period in 2019. A recent S&P Global Market Intelligence reports that corporate bankruptcies, which are defined as companies with public debt where either assets or liabilities at the time of the bankruptcy filing are greater than or equal to $10 million, totaled 470 between January and September 2020, the highest number of filings for any comparable period in the past nine years. Of these, 36 were so-called mega-bankruptcies as these companies had more than $1 billion in liabilities at the time of filing. Consumer discretionary, industrials and energy sectors led the bankruptcy filings.

Chapter 11 filings rose 28% from the same period in 2019



Source: Epiq Systems as reported by the American Bankruptcy Institute

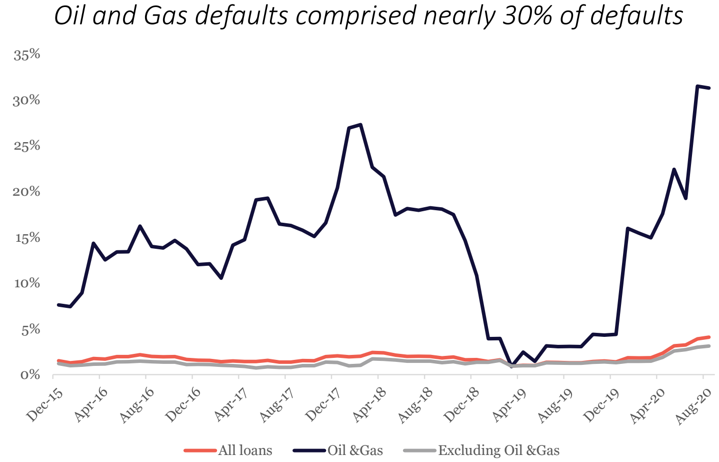
2020 corporate bankruptcies led by consumer discretionary, industrial and energy sectors



Source: S&P Global Market Intelligence

The rise in bankruptcy filings have no doubt contributed to the uptick in leveraged loan defaults, which rose to 4.08% in August, 2.5 times above its three-year average. The oil and gas sector alone has contributed nearly 30% of the defaults, as measured by loan amount, which has risen precipitously since December 2019 and reached 31.25% in August. This sector has been challenged with historically low oil prices, a condition exacerbated by a massive drop in demand due to global lockdowns.

Leveraged loan default rate rose for the sixth straight month to 4.08%,
Oil and Gas defaults comprised nearly 30% of defaults



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

What We're Watching

Rising bankruptcies and leverage loan default rates pose unique challenges to CLOs, which are structured to be passive investors and therefore are constrained to actively engage in the loan workouts or restructurings that typically occurs with distressed borrowers. According to Poh-Heng Tan, founder of CLO Research Group, "the inability to participate in the new exit debt could potentially put CLOs in an inferior position. If the rating of the new exit term debt is poor, CLOs may find it difficult to participate as they are also structurally limited by triple-C or portfolio rating tests which must be maintained or improved (if the tests are failing). CLO managers must also consider any eligibility and concentration limits before actively engaging in workouts and restructurings." Tan notes that "CLOs could potentially get together and put up new money for Debtor-In-Possession loans, which they can hold (typically up to 5-10 % of collateral). Rated DIP loans are generally a preferred option as CLOs could benefit from a potentially decent rating, good economics as well as the ability to protect their existing positions. More deals might see a separate supplementary reserve account which afford managers greater leeway to participate in a workout situation." Tan continued, "with the updated Volcker amendments, CLOs are now able to invest in non-loan assets such as bonds and notes – which is one less constraint for existing CLO deals and supportive during this challenging period."

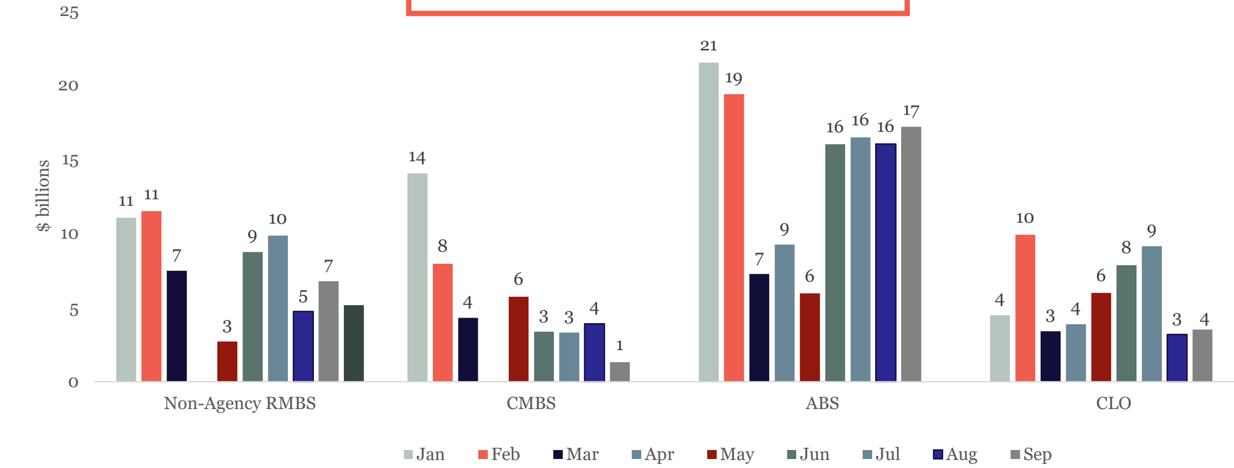
SFA Research Corner: Market Signals

Market summary – Over $16 billion of bonds came to the private securitization market last week. Supply was led by $9 billion of consumer and commercial loan ABS and over $5 billion of non-agency RMBS. CMBS and CLOs each contributed about $1 billion to the week's total. Total issuance year-to-date now stands at $271 billion.

Constrained supply in the new issue market continued to support prices in the secondary market. Demand for benchmark credit card and prime auto ABS was sufficient to absorb market supply without an increase in price, keeping the bid-ask spread for these products unchanged for the month of September, so far. Strong demand for higher yielding products, such as ABS backed by subprime autos and private student loans, as well as RMBS and CLOs, pushed prices up slightly, tightening the bid-ask spreads incrementally for these products.

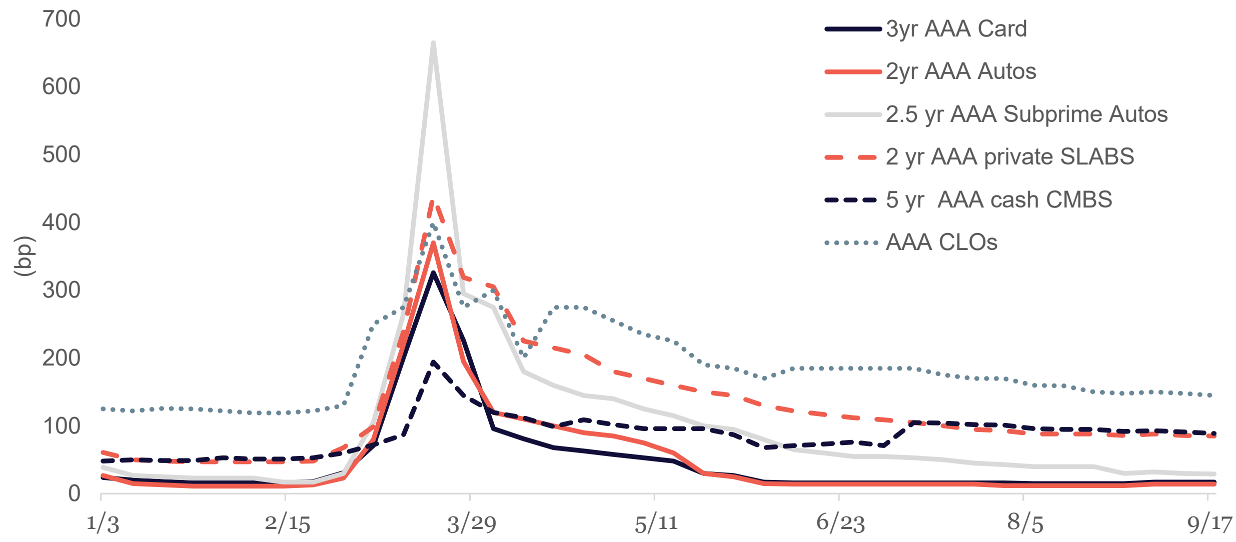
New Issue Activity

Sept. 2019: $50 bn
Sept. 1-22, 2020: $28.8 bn

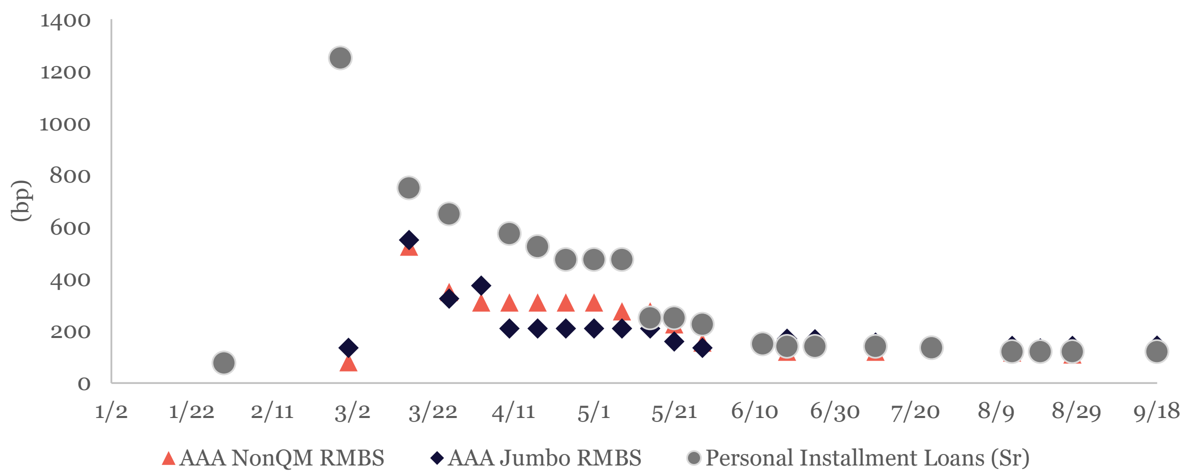


Source: Bloomberg, Deutsche Bank Research

Secondary Market Spreads



Source: Deutsche Bank Research



Source: Market Compilation