STRUCTURED FINANCE ASSOCIATION

SFA Research Corner

Middle-Market CLOs Resilient in Early Days of Pandemic as Labor Market Point To Rough Days Ahead

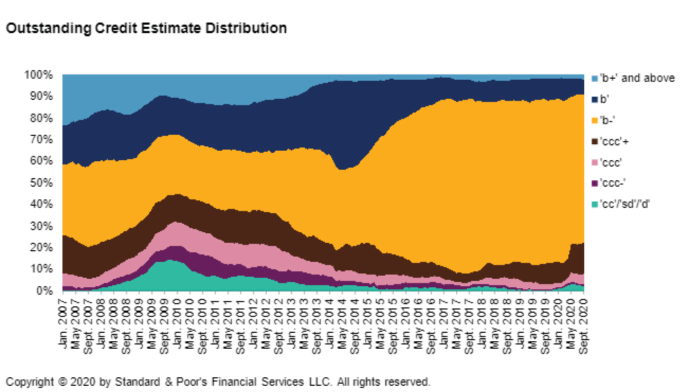
December 7, 2020

WHAT WE'RE WATCHING

S&P Global reports that despite the pandemic-related decline in the credit quality of underlying obligors, middle-market CLOs have held up "relatively well" compared with conventional CLOs backed by broadly syndicated loans. Middle-market CLOs are backed by loans to highly leveraged middle-sized companies with annual earnings of $100 million or less and limited access to bank financing. This combination makes middle-market obligors riskier than the large-sized obligors found in a broadly syndicated CLO. To compensate for the riskier credit profile, middle-market CLOs are structured with more credit support than conventional CLOs. The more robust structure has served them well as the pandemic put downward pressure on the earnings and revenue of middle-market companies. S&P notes that "out of the 464 downgrades taken on U.S. CLO ratings in the third quarter due to COVID-19, only seven tranches were downgraded from MM [middle-markets] CLOs (the rest were downgrades to ratings from US BSL [broadly syndicated loans] CLO ratings)." S&P attributes the resilient performance to robust structures--"[t]he [middle-market] CLO 'AAA' tranche, for example, might have par subordination of 40% to 45%, compared to about 35% par subordination for a typical [broadly syndicated loan] CLO 'AAA' tranche."

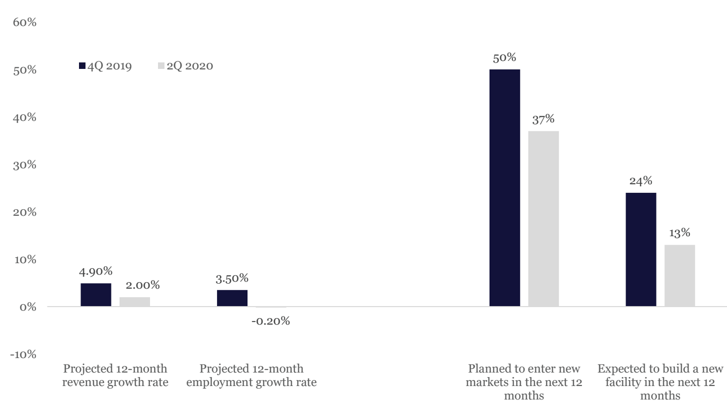
A reversal in the nascent economic recovery is a significant threat to middle-market companies, and CLOs backed by loans to middle-market companies, in the near term. In a June survey of 1,000 middle-market executives, only 37% planned to enter new markets within a year, compared with 50% in the fourth quarter of 2019, and only 13% expected to expand their facility, compared with 24% in 2019. The executives expected to see revenues grow at less than half of the rate expected in December (2.90% vs 4%) and employment to shrink. Moreover, since the start of the pandemic, 56% of companies surveyed sought government financing through PPP loans and tapped their banks for financing.

Middle-Market CLO Exposure To Lower-Rated Collateral Increased During Pandemic



Source: S&P Financial Services LLC

Middle-Market Executives Project Slower Revenue Growth and Reduction in Employment in 2021



Source: National Center for the Middle-Market

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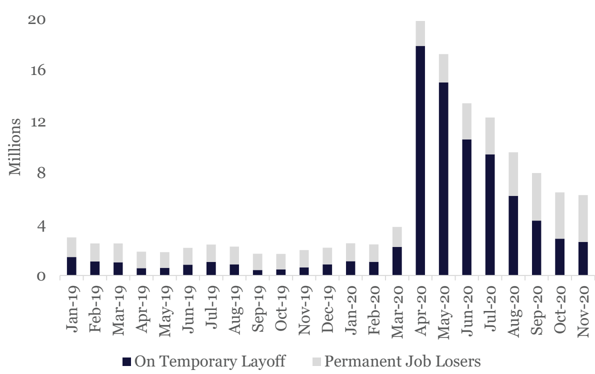
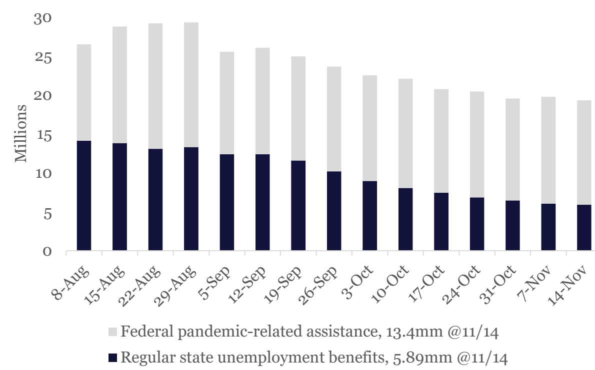
The headline unemployment rate edged lower to 6.7% as 245,000 jobs were added to the economy in November. While the number of Americans on temporary layoff has improved by 85% since reaching a high of 18 million in April, the number of Americans who have permanently lost their jobs has nearly doubled from 2 million in April to 3.7 million. This is a troubling trend as it could indicate a lasting economic disruption. Perhaps more pressing is the weekly jobless claims data. This data set shows that of the 20 million Americans claiming some sort of unemployment benefit, 13 million are tapping into federal pandemic-related assistance. Without an additional stimulus package, this assistance is slated to roll off at the end of the year, setting the stage for a very difficult start to the new year.

Since April, Number of Individuals on Temporary Layoff Decreased by 85% as the Number Permanently Losing Their Jobs Has Nearly Doubled



Source: *Bureau of Labor Statistics*

Number of Individuals Receiving State Unemployment Benefits Continues To Fall as the Number Receiving Federal Pandemic Related Assistance Remains Around 13 Million



Source: *Department of Labor*

MARKET SUMMARY

In November, the securitization market saw $20.5 billion of new bonds backed by consumer and commercial loans and leases, non-agency commercial and residential mortgages, and corporate leveraged loans. The new-issue supply for the month stands in stark contrast to the $68 billion recorded in November 2019. Heading into the last month of the year, total new-issue supply stands at $389 billion, one-third below the 2019 volume at this time. With supply constrained in the new-issue market, investor demand over the month pushed bond prices in the secondary market slightly higher, and bid-ask spreads incrementally tighter, across benchmark products. For many asset classes, prices have rebounded handily from the early days of the pandemic and are at or near historic highs.

The Fed's announcement to terminate the Term Asset Loan Facility (TALF) at year-end did not dampen market tone. The $100 billion lending facility was intended to support the flow of credit to consumers and businesses via the securitization markets. Without a doubt, TALF succeeded in its intention. The Fed's quick response in early April 2020 to address the completely stalled financial markets at the outset of the pandemic's known reach in the U.S. was so successful that the mere announcement of TALF and the other Fed programs stabilized the pandemic-induced free fall in the securitization markets. Within a few months, organic investor demand made the need for funding through TALF almost superfluous for most of the market. Consequently, uptake was modest. As of November 13, TALF had made $3.8 billion of loans to eligible borrowers, 52% of which were used to support small businesses, and 30% were directed to commercial real estate.

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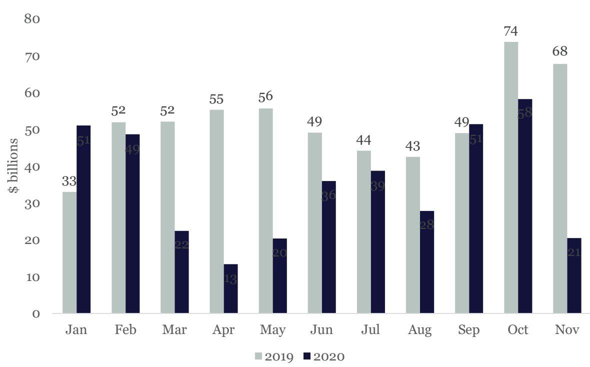
NEW ISSUE ACTIVITY

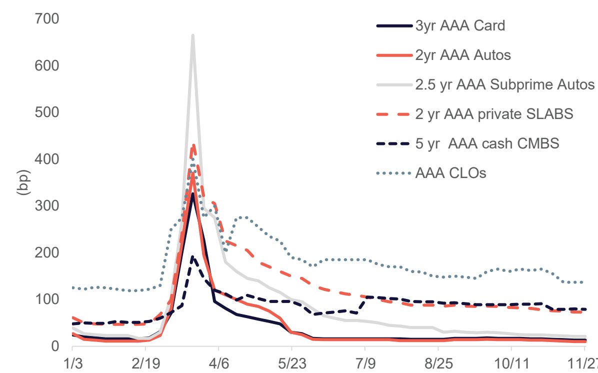
(bps)	Week Ending 27 - Nov	Week Ending 20 - Nov
3-yr AAA Card	13	13
2-yr AAA Autos	10	10
2.5-yr AAA Subprime Autos	21	21
2-yr AAA Private SLABS	73	73
5-yr AAA Cash CMBS	79	80
AAA CLOs	137	137

New Issue Remains Muted in November



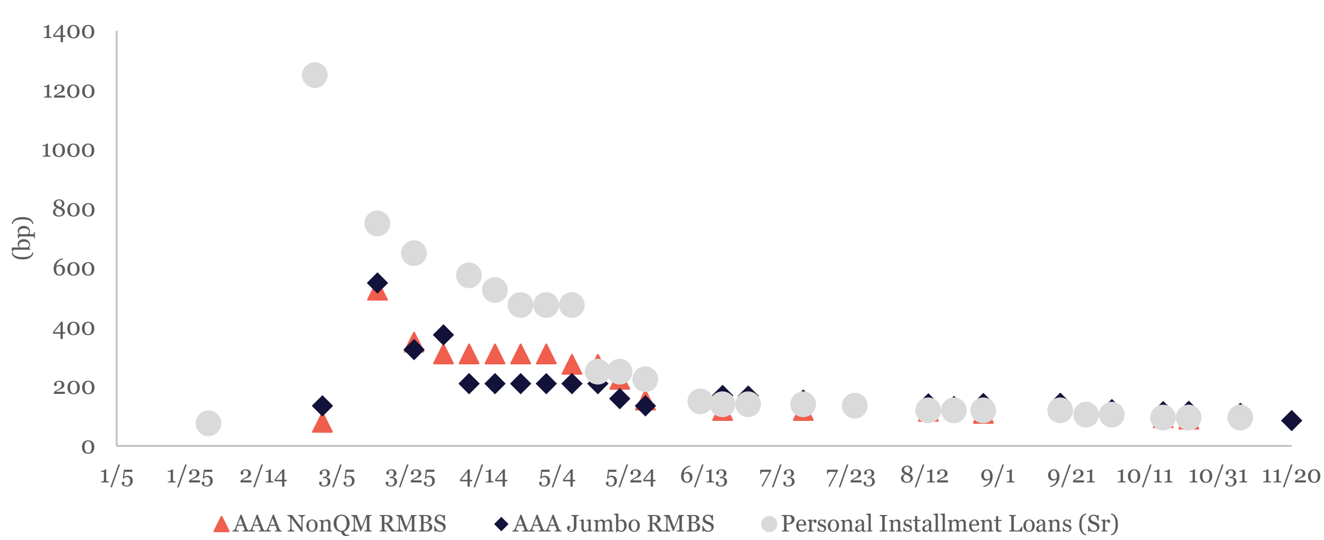
Source: Bloomberg, Deutsche Bank Research

Secondary Market Spreads



Source: Bloomberg, Deutsche Bank Research

SECONDARY MARKET SPREADS



Source: Market Compilation