STRUCTURED FINANCE ASSOCIATION

SFA Research Corner

CLO Update—From Uncertainty to Thriving, But Mind the Zombies

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WHAT WE'RE WATCHING

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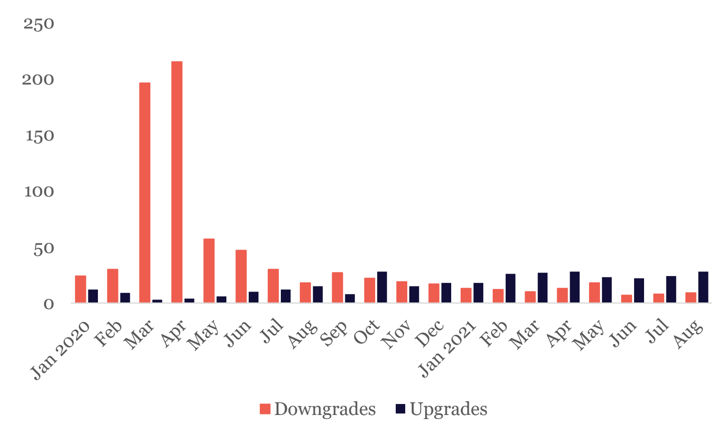
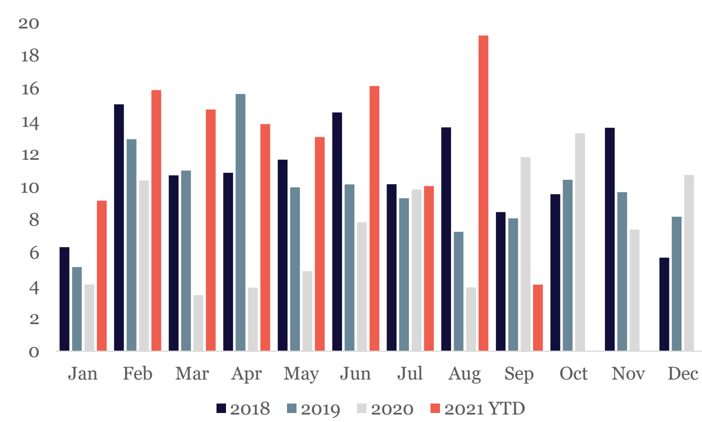
CLO collateral pools have "improved notably" since the beginning of the year, according to a recent S&P Global's SF Credit Brief. For the universe of leveraged loans held by U.S. broadly syndicated CLOs, the rating agency reports that credit rating upgrades have outpaced downgrades every month so far in 2021. In 2021, upgrades have outpaced downgrades 2 to 1 (196 versus 90). This is a welcome reversal of the trend in 2020, when downgrades surpassed upgrades by 5 to 1 (702 versus 140). Moreover, the percentage of loans with a negative outlook is down 50% from 32.4% at the beginning of the year to the current level of 16.4%. "Thanks to markets that are now awash with liquidity following the implementation of the Federal Reserve's crisis-stemming quantitative easing measures, the transition from default cycle to benign credit cycle in leveraged loans has occurred at a swift pace," noted S&P Global. In its August 2021 Monthly U.S. CLO Index Fitch notes that defaulted loans held by CLOs represent only 0.3% of the aggregate portfolio, a vast improvement from 1.4% recorded in July 2020, and below the 0.4% recorded in December 2019.

Upgrades and Downgrades of Loans Held by U.S. BLS CLOs: 2020 Versus 2021



Source:Standard & Poor's Financial Services

Monthly CLO Issuance 2018 to September 2021



Source: Market Compilation

As vastly improved credit fundamentals and a search for yield have kept investor demand in CLOs high, an end-of-year LIBOR transition deadline and record issuance of leveraged loans have stoked supply of new-issue CLOs. So far, $112 billion of CLOs were issued in 2021. This represents an increase of 23% over 2020's full-year level and is just 6% shy of 2019's full-year record. Average monthly issuance in 2021 has been $13 billion, well above the monthly average of $10 billion of 2020 and $11 billion of 2019. August issuance was particularly robust with over $19 billion, a post-2008 record for the sector. Market prices held firm as investors handily absorbed the surge in CLO supply. And the leveraged loan pipeline does not look like it is slowing down anytime soon. CLOs purchase 60-70% of leveraged loans issued, and with an estimated $110 billion of U.S. high-yield bonds and loan sales coming to market in September alone, we expect CLO issuance to remain vigorous in the coming weeks.

With credit benign and investor demand keeping pace with supply, some may argue that the CLO market is as good as it gets. However, some fear that the earnings shock experienced by many corporations in 2020, coupled with the unprecedented level of Federal Reserve support and the subsequent surge in corporate debt, which jumped 9% in 2020 versus an average annual rate of 5.5% between 2010 and 2019, has supported a rise in zombie companies. These are companies that are economically unviable and would be out of business if not for the financing that has allowed them to service their debt. In November 2020, Bloomberg had estimated that more than 200 corporations became zombie firms that year, adding almost $1 trillion of debt to their balance sheets. Many of these corporations may be found in sectors that were hardest hit by the pandemic, such as hotel, gaming and leisure, travel and tourism, and retail. CLOs with exposure to such firms will be negatively impacted; however, the magnitude of that impact will depend on various factors including the strength of the financial markets, the skill of the CLO manager, and the CLO structure itself. That said, 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.

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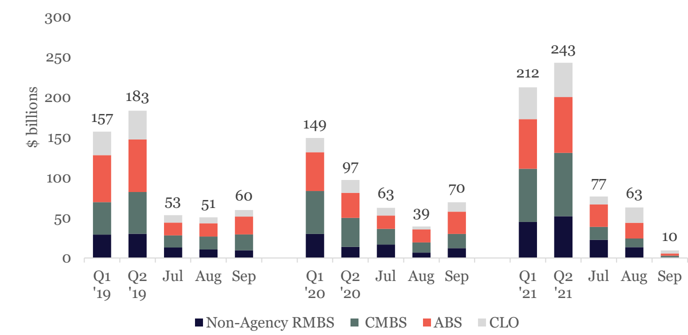
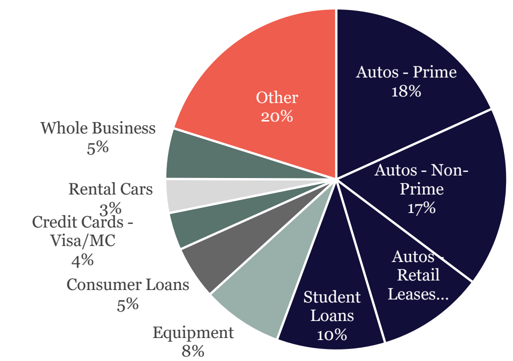
MARKET SUMMARY

Issuance* for Non-Agency RMBS, CMBS, ABS, and CLO 2021 ($595 Billion) Versus 2019, 2020



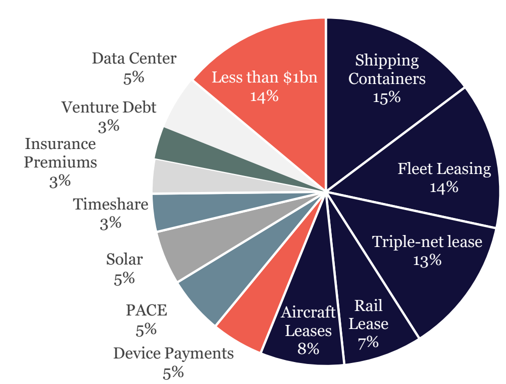
*Revised to include Agency CMBS issuance and updated non-Agency RMBS.
Source: Deutsche Bank, Market Compilation

ABS Only 2021 YTD: $179 billion



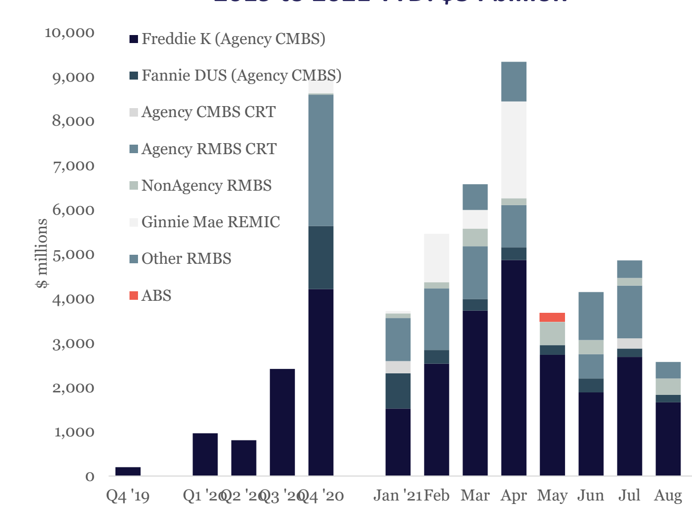
Source: Deutsche Bank, Market Compilation

Other ABS Only 2021 YTD: $35 billion



ABS with YTD volume that is less than $1 bn YTD include ABS backed by Canadian credit cards, venture debt, data centers, auto dealer floorplan loans, small business loans, tax liens, commercial loans, secured fund fee, oil contracts, UK credit cards, litigation funding, retail credit cards.
Source: Deutsche Bank, Market Compilation

SOFR (30 Day Average) Securitizations 2019 to 2021 YTD: $54 billion



Other RMBS includes mortgage insurance-linked securities.
Data begins Q3 2019. Source: Market Compilation

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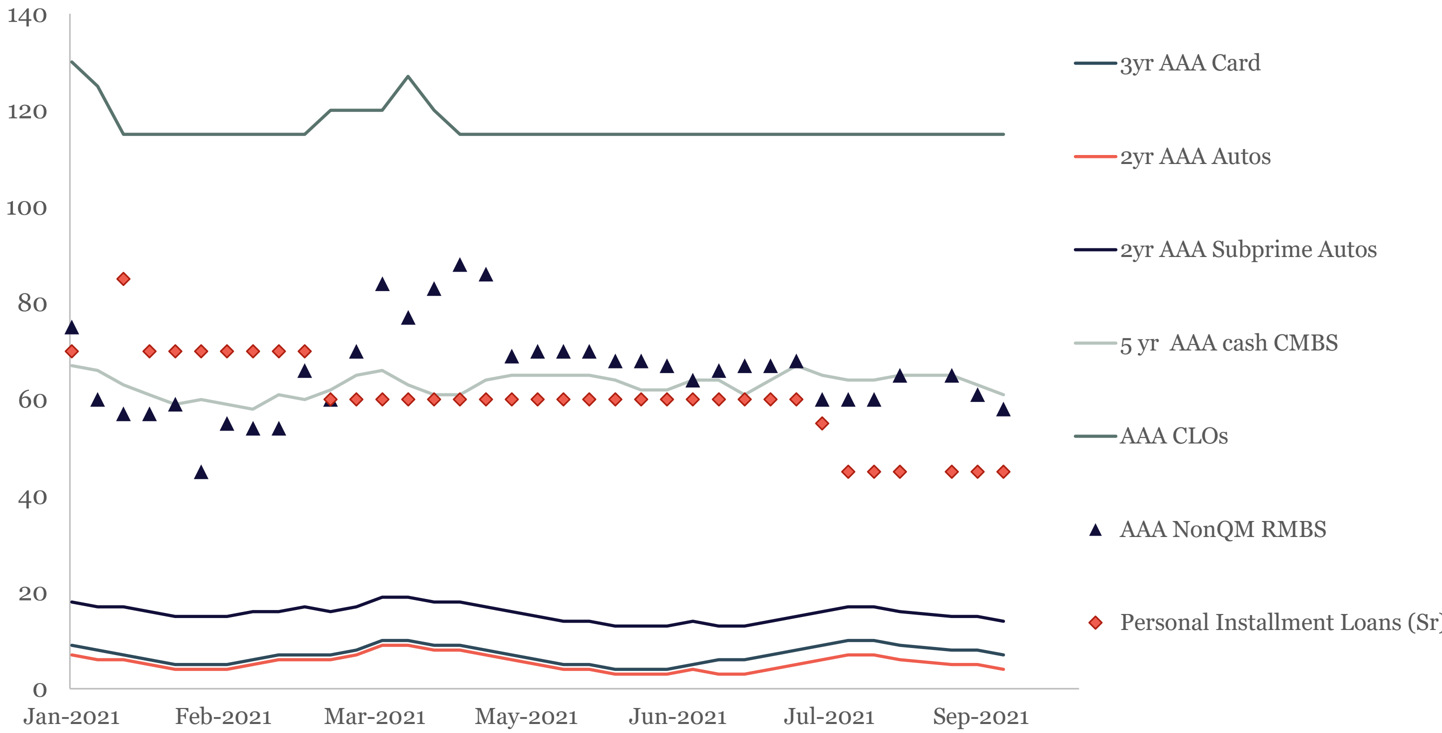
Secondary Market Bid-Ask Spreads (BP)



Secondary Market Bid-Ask Spreads		
(bps)	10-sep	3-sep
3yr AAA Card	7	8
2yr AAA Prime Autos	4	5
2yr AAA Subprime Autos	14	15
5yr AAA Cash CMBS	61	63
AAA CLOs	1115	115

Source: Market Compilation