Collateral Thinking

Main Street Lip Service

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Leveraged Loan Strategy
United States

BofA Data Analytics

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Top of the stack

This morning, the Fed provided details of the latest round of stimulus to keep credit flowing through corporate America. Overall, the Fed today made impressive inroads into leveraged credit by offering loans to small/medium sized businesses, proposing to buy leveraged ETFs, and agreeing to backstop Fallen Angels. For the loan universe, the most important aspect of today's announcement was the creation of two Main Street Lending Facilities.

However, looking closer we think that the impact on the loan market is likely to be limited. While the borrower eligibility criteria of revenues and employment keeps a large majority of the loan market in play, eligibility criteria surrounding issuer leverage and loan maturity/spread are too stringent to have any meaningful direct funding impact. Overall, we think < 10% of loan issuers will ultimately meet all eligibility criteria. Further, given a mandatory 5% stake in loans, as well as pricing them off of SOFR, banks are likely to be hesitant. Finally, the inclusion of CLO AAAs in Term Asset-Backed Securities Loan Facility (TALF) is also unlikely to create much upside for loan demand.

We think middle-market issuers will ultimately benefit the most from the Main Street Lending facilities. BSL issuers will likely only benefit indirectly from the trickle down impact coming from HY where the Fed impact is poised to be more direct. Perhaps the most important consequence of today's events is the messaging. By reaching into parts of the credit market which just a few weeks ago, many thought was a tall order, the Fed has indicated that it stands ready to do whatever it takes to support the market. As such, today's rally in our minds is emanating from the psychological implications of the Fed backstop, not necessarily the direct impact of the lending programs.

Market technicals

Over the last two weeks, demand totaled $2.5bn, a decent bounce back from previous two weeks of negative demand, as retail outflows slowed down: a total of -1bn has flowed out MTD. YTD, demand has surpassed supply by $14bn, mostly driven by the increase in repayments and low supply.

Performance

Loans in the LCD index returned 3% last week, continuing the positive trend since the end of March. Within ratings, higher quality buckets maintained dominance, with BB loans returning 4% last week while CCC loans losing -2%. Double-Bs have outperformed YTD with a -8% loss, while CCCs stand at -24%. On the asset class level, loans have outperformed HY bonds with a smaller YTD loss of -11% (HY has lost -14%).

Primary market activity

We saw marginal activity with one deal sized at $250mn in April, clearing the market at record ~14%. Since Feb. 26th when the first case of suspected local transmission was reported in the United States, the primary market has churned a total of $1bn in deals.

Table 1: Loan performance

Index	Level	1wk Δ	2wk Δ	YTD Rtn
All Loan	84.4 pts	1.9	6.5	-11.1%
BBs	90.8 pts	2.5	9.6	-8.5%
Bs	85.0 pts	2.4	6.7	-11.7%
CCCs	63.9 pts	0.3	1.2	-23.6%

Source: S&P LCD

Table 2: HY performance

Index	Level	1wk Δ	2wk Δ	YTD Rtn
US HY	881 bps	-30	-130	-13.5%
BBs	633 bps	-35	-130	-9.9%
Bs	973 bps	-26	-134	-14.9%
CCCs	1854 bps	-4	-50	-24.3%

Source: BofA Global Research

Table 3: Fund flows ($mn)

Asset	1wk	2wk	YTD	LTM
	-503	-1,790	-30,616	-35,029
US HY	+5,598	-502	+11,203	+6,484
US IG	-6,952	-41,854	+186,886	+314,772

Source: EPFR Global

Top of the stack

This morning, the Fed provided details of the latest round of stimulus to keep credit flowing through corporate America. While the past iteration was dedicated to large IG issuers and very small businesses, this round includes support for fallen angels as well as medium sized leveraged issuers. For the loan universe, the most important aspect of today's announcement was the creation of two Main Street Lending Facilities as described below, which have the combined capacity to lend $600bn on the basis of a $75bn of equity contribution from the Treasury.

Main Street New Loan Facility: Eligible borrowers can get new unsecured loans equal to the lesser of i) $25mn or ii) debt needed to get the issuer to 4x gross leverage; provided that other loan eligibility criteria are met.

Main Street Expanded Loan Facility: Eligible borrowers can upsize existing secured loans such that total amount borrowed is equal to the lesser of i) $150mn or ii) debt needed to get the issuer to 6x gross leverage or iii) 30% of borrower's existing debt; provided that other loan eligibility criteria are met.

In both cases there are other eligibility criteria that borrowers need to meet:

i) Borrowers have generated no more than $2.5bn in revenues, or employed no more than 10k employees in 2019

ii) Borrowers cannot used funds raised through this facility to pay down existing debt obligations, but have to set them aside for running business operations including reasonable efforts to retain its employees and maintain payroll.

iii) The loan should have a 4 year maturity (we interpret this as <=4)

iv) The loan should have a rate between SOFR + 250bps - 400bps.

v) The loan should have features allowing borrowers to defer amortization payments for one year, and prepay without penalty.

vi) Usage of this facility requires a 5% participation in the lending commitment from banks underwriting these loans.

There are other important aspects of today's Fed announcement that are relevant for the leveraged credit market in general:

i) The newest version of the **Primary Market Corporate Credit Facility** expands the size of the facility to $500bn, and now includes support for Fallen Angels. By modifying language to include erstwhile IG borrowers, who can maintain at least a BB- rating, the Fed has squarely targeted large Fallen Angels such as Ford, realizing the systemic importance of such large borrowers in the context of providing employment.

ii) The newest version of the **Secondary Market Corporate Credit Facility** expands the size of the facility to $250bn, and now includes a limited amount of HY bond ETF buying.

Impact on the loan market

Overall, the Fed today made impressive inroads into leveraged credit by offering loans to small/medium sized businesses, proposing to buy leveraged ETFs, and agreeing to backstop Fallen Angels. However, looking closer we think that the impact on the loan market is likely to be limited. While the borrower eligibility criteria of revenues and employment keeps a large majority of the loan market in play, eligibility criteria surrounding issuer leverage and loan maturity/spread are just too constricting to have any meaningful direct funding impact.

For new loan facilities, $25mn loan size up to 4x gross leverage neither provides enough issuer coverage, nor sufficient liquidity per issuer. For the extended facility where the Fed can potentially buy and upsize existing loans, meeting all conditions filters out a large portion of the existing loan universe. Consider the following:

Close to 90% of the issuers in our loan index are eligible to use the two Main Street facilities based on the Fed's revenue and employment guidelines. Of these:

i) 45% or 477 have an original spread in the range of 250-400bps

ii) 50% or 233 of them have a <=4 year maturity

iii) Likely <50% or ~100 of them have additional leverage capacity

On point iii), our frame of reference involves the publically reporting universe. In our sample of ~250 issuers that reported in 2019, >30% (80) reported leverage >6x, 65% (165) were under 6x, and the rest had negative ebitda. We hesitate to extend the 65% to the overall loan market as private issuers tend to have 1-2x more turns of leverage. As such leniently, the proportion of eligible issuers is likely under 50%. Further, even for the publically reporting market, where we have much more clarity, the total amount of debt that these 165 issuers can float before reaching their 6x leverage limit is ~$300bn, averaging $20mn per issuer- hardly an amount that will prove to be a lifeline for these BSL issuers.

In addition, there are other hurdles. Criteria such as deferment of amortization for a year and no prepayment penalty will likely need amendments as no existing loans cater to these today. Further, given a mandatory 5% stake in the loan, banks are likely to underwrite only the most qualified candidates. Floating the loan off of SOFR, which most banks are not prepared for poses additional operational challenges, which banks may not want to undertake for a 50bps annual fee. Finally, inclusion of CLO AAAs in TALF seems to be met with the same criticism as ours, providing limited upside to loan demand as a result of the Fed efforts.

Impact on the middle market

We think that middle-market issuers are poised to benefit the most from these Main Street Lending facilities. They are well beneath the Fed's revenue/employment thresholds. They also tend to have lower leverage than their BSL counterparts, though they also have higher spreads all things equal. Most importantly, the scope of the program is such that it is likely to make the most meaningful impact on mid-sized issuers. While $150mn is a drop in the ocean for BSL issuers, there are many middle-market issuers with total cap structures under $500mn, which would theoretically make them eligible to tap 30% of their debt outstanding, leverage allowing.

We also think that middle-market issuers that have the benefit of dedicated private capital through direct lending platforms have one more lifeline to tap. Having access to Private Equity capital is also beneficial. Here we think that deployment of this dry powder will depend on what the expectation of business performance is. By most accounts if the business is expected to recover within 3 months, we think there will be a private backstop available. However capital availability for anything with a longer recovery is questionable.

Impact on overall leveraged credit

While clearly the steps taken by the Fed will go a long way in providing liquidity to credit issuers, we think direct positive impact is a lot more for the HY bond market than the loan market. Within HY, the Fed is directly participating by supporting Fallen Angels and ETFs. Today's attempt by the Fed in our minds was not to bail out the leveraged finance market, but to dip its toes into it. As such we think loans will benefit indirectly from the trickle down impact from bonds. This is especially true to bond-loan capital structures where bonds may pull up loans.

Perhaps the most important consequence of today's events was the messaging. By reaching into parts of the credit market which just a few weeks ago many thought was a tall order, the Fed has indicated that it stands ready to do what it takes to support the market. As such, today's rally in our minds is emanating from the psychological implications of this backstop, not necessarily the direct impact of the lending programs themselves. The value of this backstop is as important for sentiment, as it is hard to quantify.

Having said that, a few conclusions can be made:

i) All things equal, Fed's inroads into leveraged credit is bullish for our markets, and will reduce corporate liquidity pressures on the margin.

ii) The Fed is ready to plug the holes, and we may not have seen the last of the stimuli.

iii) At the same time today's measures are largely psychological and do not offer much to alter the path of market level downgrades and defaults. The ultimate path of those will depend on the economic trajectory. In our base case of YoY GDP contraction of -6%, followed by an extended U-shaped recovery, we are still expecting a 7% default rate with 50% of the loan market getting hit with downgrades. If the economy contracts to a lesser degree, or the rebound is more V-shaped due to the monetary and fiscal support, then the severities of both those measures will be lesser, as defined by our scenario analysis.

Market Technicals

Over the last two weeks, demand totaled $2.5bn, a decent bounce back from previous two weeks of negative demand, as retail outflows slowed down – a total of -1bn has flowed out from the loan market since April while a total of -3bn flew out during the last two weeks of March. CLO creation resumed last week to ~$500mn, as CLO arbitrage ticked up slightly (Chart 5). Primary market finally saw some activity last week with one new issuance deal sized $250mn. YTD, demand has surpassed supply by $14bn, driven by the increase in repayment and the inactivity of new issuance.

Table 4: Weekly Technicals ($mns)

	YTD as of 4/3/20	4/10/20	4/3/20	3/27/20	3/20/20
Retail flows (a)	-11,345	-244	-813	-1,075	-2,254
CLO creation (b)	15,770	477	0	0	503
Coupons (c)	18,010	821	2,212	935	971
Demand (a+b+c)	22,435	1,054	1,399	-140	-780
Issuance Ex-repricings (d)	89,482	250	0	0	0
Repayments (e)	81,671	NA	9,170	1,647	1,850
Supply (d-e)	7,811	NA	-9,170	-1,647	-1,850
Demand net of Supply	14,624	NA	10,569	1,507	1,070

Source: S&P LCD, EPFR Global.
Values in $mn. Weekly coupon values are estimated by dividing each month's coupon payment by 4.

Performance by segment

Loans in the LCD index have returned 3% last week, continuing the positive trend since the end of March. 2nd Lien and Middle Market loans kept disappointing investors with a loss of -85bps and a slight gain of 50bps respectively. Within ratings, higher quality buckets maintained dominance, with BB loans returning 4% last week while CCC loans losing -2%. Double-Bs also outperformed on the YTD basis with a smaller loss of -8% while CCCs have tripled the loss at -24%. The most liquid loans as per the LCD Leveraged Loan 100 benchmark have returned 3%, in line with the broader All Loans index. On the asset class level, loans have trumped HY bonds with a smaller YTD loss of -11% (HY has lost -14%).

Table 5: Total Returns (price plus coupon return), bps

	4/3/2020	3/27/2020	3/20/2020	3/13/2020
All Loans	285	297	-1,117	-586
BB	405	569	-1,180	-571
B	287	223	-1,135	-587
CCC	-222	-403	-1,041	-789
2nd Lien	-85	-168	-907	-690
LL100	304	797	-1,227	-582
Middle Market	50	-307	-672	-486

Source: S&P LCD

Middle market defined as $50mn EBITDA or less. LL100 composed of the 100 largest issuers (by face value) in the S&P LCD Leveraged Loan Index.

Primary market activity

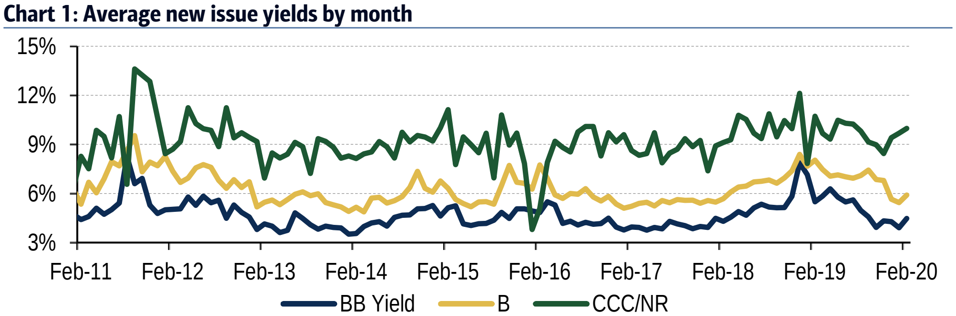
Primary activities have resumed slightly with one small size deal in April. The deal came from Landry's Finance in a $250mn first-lien term loan with price talking at L+1,200 and 1% LIBOR floor. Since Feb. 26th when the first case of suspected local transmission was reported in the United States, the primary market only generated a total of $1bn new issuance.

Table 6: Recent loan new issues

Launch Dt	Issuer	Deal Name	Size	New Inst. Money	Moody's	S&P	ABL	Cov Lite	Proceeds	Sector	Country
4/6/2020	Landry's Finance	Landry's (5/20)	250	250	B1	B+	No	No	GCP	Restaurants	United States
3/5/2020	SGG	IQ-EQ (Add-on 3/20)	50	50	B2	B-		Yes	Acquisition-related	Services & Leasing	Luxembourg
3/3/2020	Inspired Education	Inspired Education (Add-on 4/20)	100	100	B2	B		Yes	Refinancing	Not for Profit	United Kingdom
2/27/2020	Science Applications International Corp	SAIC (Add-on 3/20)	600	600	Ba1	BB+	No	Yes	Acquisition	Computers & Electronics	United States
2/26/2020	Atlas Technical Consultants	Atlas Technical (3/20)	321	281	B3	B	No	No	Acquisition	Building Materials	United States
2/25/2020	Gerflor Group	Gerflor (TL 3/20)	850	850	B2	B		Yes	Acquisition-related	Home Furnishings	France
2/25/2020	Duravant LLC	Duravant (Add-on TL 3/20)	155	155	B2	B-	No	Yes	Acquisition	Manufacturing & Machinery	United States
2/25/2020	Duff & Phelps LLC	Duff & Phelps (US TL 3/20)	1,225	1225	B2	B-	No	Yes	LBO	Services & Leasing	United States
2/25/2020	Duff & Phelps LLC	Duff & Phelps (EURO TL 3/20)	300	300	B2	B-		Yes	Acquisition-related	Services & Leasing	United States
2/25/2020	Cook & Boardman	Cook & Boardman (Add-on 3/20)	75	75	B3	B	No	No	Acquisition	Building Materials	United States
2/25/2020	Service Logic	Service Logic (Add-on 3/20)	140	140	NR	NR	No	No	Acquisition	Manufacturing & Machinery	United States
2/21/2020	Civica	Civiva (Add-on 3/20)	81	97	NR	NR		Yes	Refinancing	Services & Leasing	United Kingdom
2/20/2020	Hornblower Yachts Inc	Hornblower (Add-on 3/20)	25	25	B2	B	No	Yes	Refinancing	Entertainment & Leisure	United States
2/20/2020	SnapAV	SnapAV (Add-on 2nd Lien 3/20)	100	100	NR	B	No	No	Acquisition	Computers & Electronics	United States
2/20/2020	SnapAV	SnapAV (Add-on TL 3/20)	290	290	B2	B	No	Yes	Acquisition	Computers & Electronics	United States
2/20/2020	Tosca Services	Tosca Services (3/20)	310	310	B2	B	No	Yes	Acquisition	Chemicals	United States
2/20/2020	Vistage Worldwide	Vistage (Add-on TL 3/20)	80	80	B2	B	No	Yes	Refinancing	Services & Leasing	United States
2/19/2020	Genesis Care Pty Ltd	Genesis Care (US 3/20)	350	350	B1	B	No	Yes	Acquisition	Healthcare	Australia
2/19/2020	Kissner Group	Kissner (TL 3/20)	900	900	B3	B	No	Yes	Acquisition	Chemicals	Canada
2/19/2020	Polynt-Reichhold	Polynt-Reichhold (RC 3/20)	100	100	B1	BB-		No	Recapitalization	Chemicals	Luxembourg

Source: S&P LCD

Chart 1: Average new issue yields by month

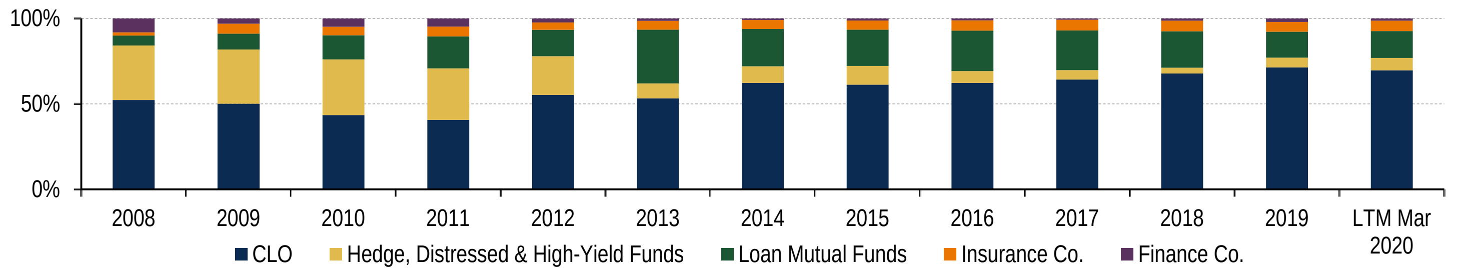


Source: S&P LCD

Appendix

CLOs are an important factor to consider in the loan market given they are the single biggest buyer of loans and represent 70% of the primary demand within this asset class. Loan retail funds are the second largest buyers although their participation has shrunk since the peaks of 2013. Since then, we have seen increasing activity from CLO managers. At the same time, hedge, distressed & high yield funds have played a lesser role in the primary market.

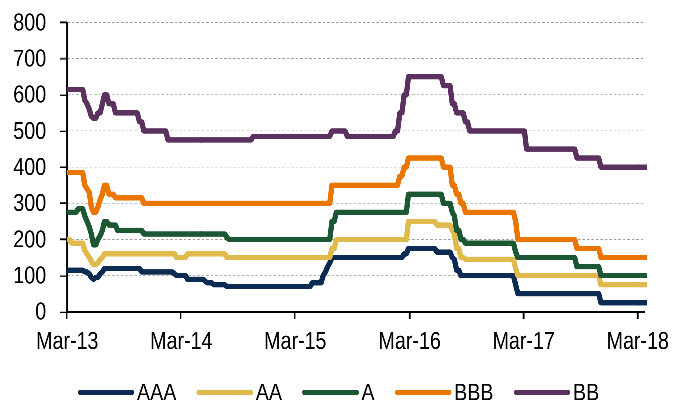
Chart 2: Primary institutional investor market by type



Source: S&P LCD

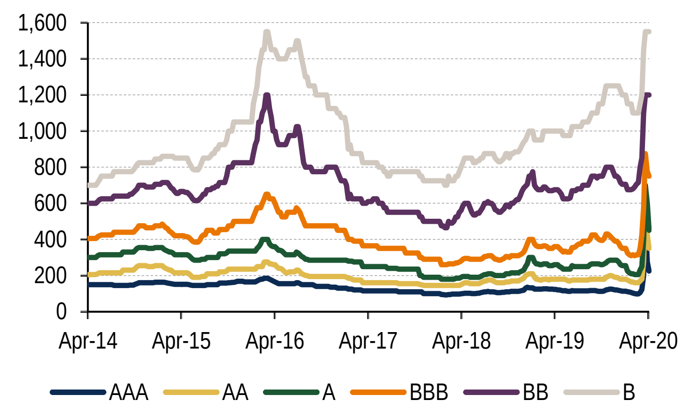
Three generations of CLOs exist today, CLO 1.0 (pre-crisis), and CLO 2.0/CLO 3.0 (post-crisis). The market is primarily driven by the latter. Below charts show CLO spread levels by tranches.

Chart 3: US CLO 1.0 indicative spread levels (bps)



Source: BofA Global Research

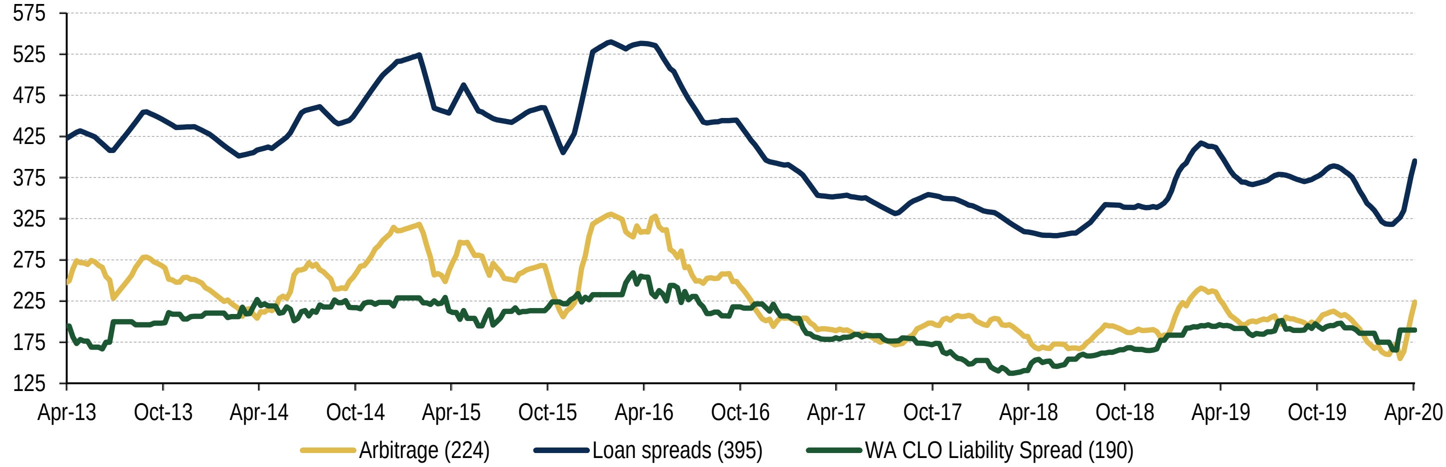
Chart 4: US CLO 2.0/3.0 indicative spread levels (bps)



Source: BofA Global Research

CLO arbitrage is a widely followed statistic in the loan market, and represents the theoretical spread that managers can capture by issuing CLOs. The below chart compares CLO asset (loan) spreads to the weighted average spreads of CLO liabilities. The difference between these two values is the theoretical arbitrage and represents the current attractiveness of creating new CLOs. A higher arbitrage number means a greater incentive for managers to bring new CLOs to the market, and thus provide incremental loan demand, and vice versa.

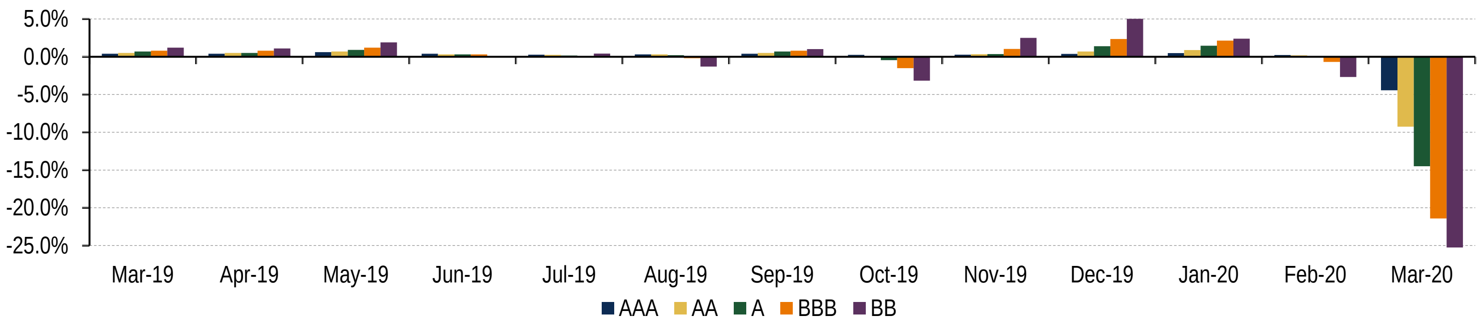
Chart 5: CLO arbitrage (bps)



Source: BofA Global Research, S&P LCD
Arbitrage: Loan asset spread - WA CLO spread X liability %.
Loan spreads (running avg 8 wks): 50% new-issue B+/B, 30% primary BB, 10% secondary BB. 10% secondary B.

Chart 6 shows monthly CLO returns as defined by the Palmer Square CLO index (price plus coupon returns).

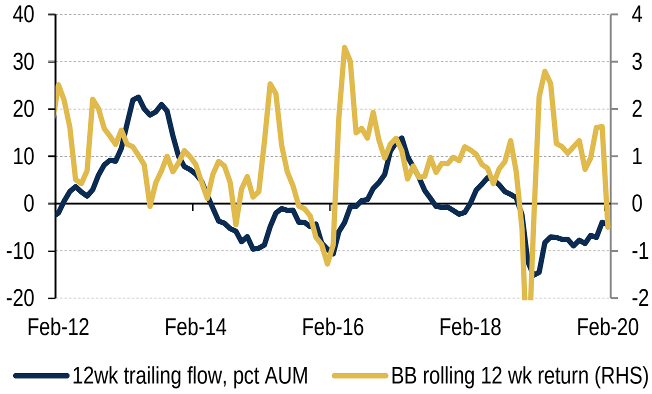
Chart 6: Monthly CLO 2.0 returns by rating



Source: BofA Global Research, Merrill Lynch PriceServe, Palmer Square CLO Indices, Bloomberg

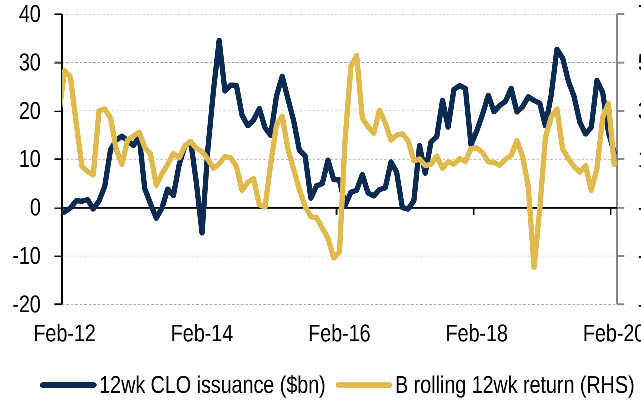
Since technicals play a big role in the loan market, following retail patterns is also essential. In general, we see that the performance of the BB section of the loan market correlates most with retail flows, while new CLO issuance seems to correlate to B Loan returns. This makes sense as mutual funds generally gravitate towards less risky investments while CLOs invest in single B rated assets on average. Chart 7 shows a measure of retail flows (12 week trailing retail flows as a percentage of outstanding AUM) vs. monthly BB Loan total returns, while Chart 8 depicts monthly CLO issuance vs. monthly B Loan total returns.

Chart 7: BB performance vs Loan retail flows



Source: S&P LCD, EPFR Global

Chart 8: B performance vs CLO creation



Source: S&P LCD, EPFR Global

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