Leveraged Loans

Lessons from January's Large Supply

CORE

Despite recent volatility stemming from coronavirus concerns, last month had the second-highest January supply since the financial crisis. Given the recent activity, we evaluate new issue trends in the loan market and find that issuers were able to bring weaker deals with less OID this year as a result of heightened demand.

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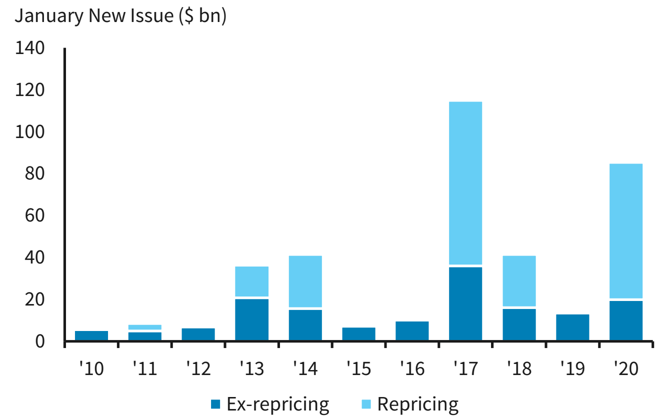
Markets experienced heightened volatility over the past two weeks because of risks posed by the coronavirus, with at least five planned refinancing or repricing transactions pulled from market as a result. Still, the new issue market has been very active so far this year. Last month represented the second-highest supply level for a January since the crisis, led by a flurry of repricings.

Excluding repricings, last month's new issue accounted for the third-largest January on record and was up 50% from 2019's level (Figure 1). Over the past decade, January has represented roughly 5% of the year's ex-repricing supply on average, which suggests 2020 full-year new issue of roughly $425bn. While we expect the actual total to be well below that figure, this highlights the elevated nature of the January new issue market.

Although the repricing activity was led by higher-quality credits, single-B issuers were able to take advantage of the accommodative market conditions, representing more than 75% of the January ex-repricing supply. This compares with the historical average of roughly 48% since 2010. The elevated single-B supply corresponds with slightly higher-than-average LBO volume, as strong investor demand supported issuance while refinancing activity was in line with historical averages.

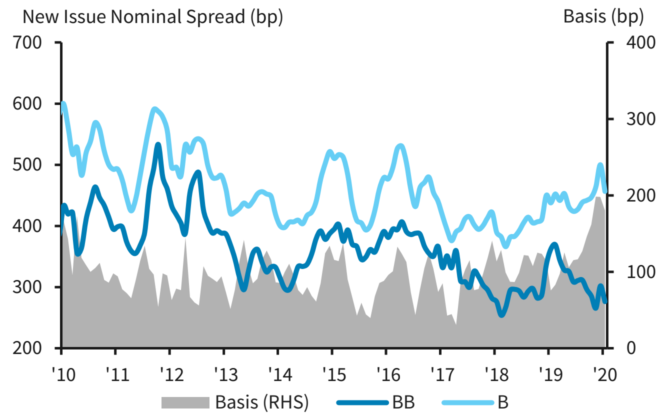
When we take a deeper look at supply trends for loans, we find that the stigma around single-Bs remained, as seen by elevated spreads in the primary market relative to BBs, even though secondary levels have come in. However, with more positive demand dynamics, issuers were able to come to market with weaker covenant packages and provide less original issue discount (OID) to investors. If demand remains strong, there will likely be some compression in the B versus BB spread differential in the primary market in the coming months, although if covenant trends continue to deteriorate, investors may feel the need to hold the line on spread instead.

FIGURE 1. **January Supply Was the Second Largest since the Crisis**



Source: S&P LCD, Barclays Research

FIGURE 2. **New Issue Basis between Single-Bs and BBs Widened in 2019**



Note: Three-month rolling average. Rating based on S&P facility rating.
Source: S&P LCD, Barclays Research

Increased Basis between Single-B and BB New Issue Spreads

Despite yield compression between single-Bs and BBs in the secondary market in late 2019, the basis between the two ratings buckets has expanded for new issues, reaching the widest level since the crisis at the end of the year (Figure 2). While the basis compressed modestly in January behind supportive new issue demand, it was still wide of the average basis in recent years, highlighting investors' concerns about lower-rated loans (see *More Drag from More Downgrades* for more details).

Decline in OID but a Rebound in Gain on Break

Another indication of the strong demand and issuer-friendly new issue environment to start the year is the original issue discount. The weighted average OID price in January of $99.75 was the highest since 2007. Despite the record-low new issue discount, the average gain on break (defined as break price net of OID) increased in January (Figure 3). The gain on break that investors have earned has trended down since 2010, but supportive demand helped it rebound in January.

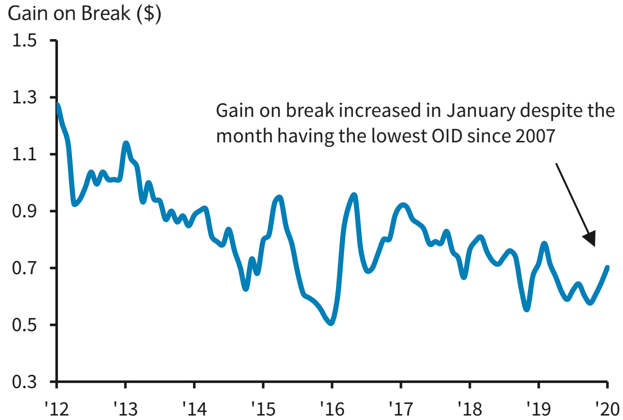
Understandably, lower-quality loans generally have to offer a higher discount than higher-quality loans in order to garner investor interest. In the back half of 2019, the basis between the OID of BBs and single-Bs widened meaningfully, averaging more than 1pt in the fourth quarter. However, given the strong demand in January, single-Bs did not need to offer large discounts, and the basis shrank to less than 20bp.

Libor Floors Remain Low

As new issue spreads have come down, particularly for higher-quality loans, the weighted average Libor floor for new issues has also declined (Figure 4). Prior to the financial crisis, loans rarely contained language for a Libor floor. However, with rates declining near zero in the wake of the crisis, many new deals have included a minimum Libor payment. Since 2010, roughly 95% of new issue loans (ex-repricings) have contained a Libor floor.

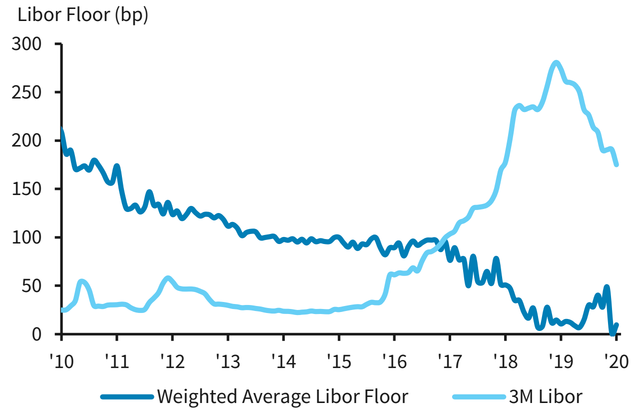
Recently, more than 90% of January's deals had a Libor floor of 0bp – a level rarely seen before 2017. The most significant decline in average Libor floor occurred in 2017 and the first half of 2018 as rates were rising. Issuers have conceded to giving new issues a Libor floor in almost all cases; however, they are not offering much protection, as new loans most commonly have a Libor floor of 0bp.

FIGURE 3. Average Gain on Break Increased in January



Note: Three-month rolling average.
Source: S&P LCD, Barclays Research

FIGURE 4. The Weighted Average Libor Floor Nears 0bp



Source: Bloomberg, S&P LCD, Barclays Research

Average Issuance Size Continues to Increase

Another trend in the new issue market is the increasing average size of new issue loans (Figure 5). The average deal size in 2020 has been almost $770mn, up significantly from last year's average of $550mn.

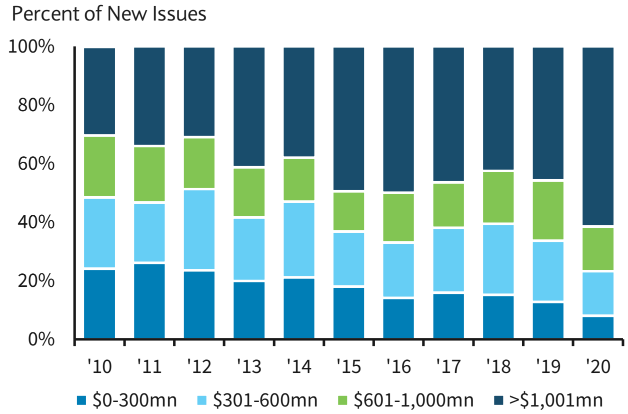
In 2010, only 30% of loans issued were larger than $1bn, while that number has climbed to 46% in 2019 and 61% in January 2020. Conversely, loans of $300mn or less represented just 8% of new issues in the first month of the year, the lowest level on record and well below the post-crisis average of 19%. This likely reflects an increased presence of private credit/direct lending at the smaller end of the size spectrum that is taking supply from the broadly syndicated loan market.

Leverage Increased for Sponsor-Backed Deals

As seen in Figure 6, new issue total leverage in 2019 was unchanged relative to 2018 at 5.2x. Leverage through just the first-lien level increased, though, reaching 4.2x – the highest level on record.

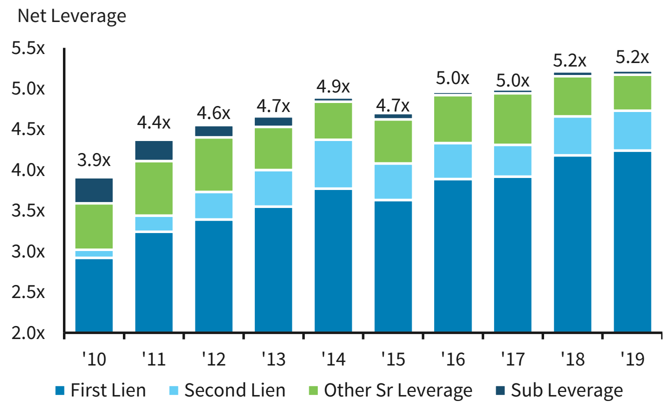
Sponsor-backed deals saw leverage increase slightly in 2019, with LBO new issue leverage of 6.0x in 2019, up from 5.9x the year prior. The relative increase in leverage for these loans is reflected in the premium required for sponsor-backed deals in the new issue market relative to non-sponsor backed deals, as the basis between the two is currently at a post-recession high (Figure 7).

FIGURE 5. **New Issue Deals Have Gotten Larger**



Source: S&P LCD, Barclays Research

FIGURE 6. **Total New Issue Leverage Was Flat in 2019**

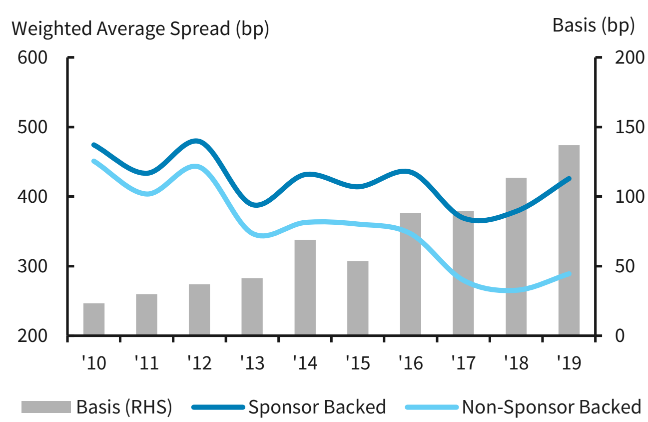


Source: S&P LCD, Barclays Research

Covenant Trends Worsened

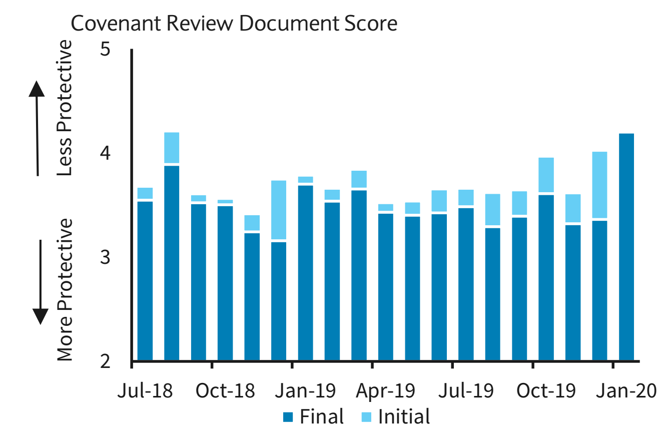
Given the relatively strong demand for new issues to start the year, issuers were able to tap the loan market with generally weaker covenants than at the end of 2019. As seen in Figure 8, Covenant Review Document Scores hit the highest level of the past 18 months (higher scores represent less protective covenants). Given the lack of change between initial and final terms, as well as the slate of repricing activity in January, this suggests that it was difficult for investors to push back on new issues to start the year. Figure 8 shows that in the last few months of 2019, investors were successful in getting covenants changed from initial terms, and this led to some demand for the primary market, where covenants were often tighter than some of the legacy deals in the secondary market. If the trend of January continues in 2020, we would expect this eventually to weigh on investors demand for single-Bs in the primary relative to the secondary market.

FIGURE 7. **The Premium for Sponsor-Backed Deals Has Increased**



Source: S&P LCD, Barclays Research

FIGURE 8. **Documentation Scores Were Less Protective in January**



Source: Covenant Review, Barclays Research

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