Collateral Thinking

Revised MSLFs – not good enough

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Leveraged Loan Strategy
United States

BofA Data Analytics

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Top of the stack

The Fed released details for their Main Street Lending Facilities (MSLF) and also added a new facility targeting levered middle market companies. The revised language relaxes some criteria compared to the original version, but also adds in some new conditions.

In making these changes, the Fed has addressed many market issues: broadening the borrower eligibility, permitting EBITDA adjustments, and letting companies use proceeds raised to service debt. The Fed has also switched the base rate to LIBOR to expedite transactions, suggesting that they want to help the real economy more than stick to any self-imposed LIBOR transition timeline. On the contrary, other more restrictive conditions such as fixed coupon rates, stringent amortization schedules and higher risk retention have been added.

Within the BSL market, we find allowable loan capacity to be ~12% of the issuer's total debt on average. As such, we see the MSELF as being beneficial only to companies looking for something to plug a finite hole, as opposed to stave off defaults. Between MSNLF and MSPLF, a majority of the $1.2tn middle market is poised to be covered. However, fees here are high, and we think that TLA/revolver issuers are unlikely to use these facilities unless they are in urgent need of funds. On balance, we still don't foresee a full utilization of these facilities in their current format.

Market technicals

Demand for loans totaled $2.7bn this week, materially higher than previous three weeks' average of $1.3bn, signaling a rise in investor confidence. Retail outflows trailed down to -$300mn from -$400mn last week. On the supply side, this week saw a jump in the primary market issuance as new supply surpassed $5bn, the highest since the week ending in Feb 7th, and nearly triple of last week's $1.8bn. YTD, demand has outweighed supply by $15.4bn.

Performance

Total return for loans in the LCD index for April was +4.5%, the best since 2009. Though last week turned back into negative territory, and the index lost -73bps. Within ratings, CCC loans outperformed with a small gain of +6bps while higher rated loans underperformed (BB -90bps and B -78bps) last week. YTD, loans sit at -9% returns, compared to HY at -10% and IG at +1%.

Primary market activity

Primary market turned up the gear with a total of nearly $5bn new issuance since we last published. YTD global USD issuance now stands at $98.2bn, slightly higher than 2019 for the same period ($95.8bn), though the same measure for US loans is running slower than last year. April issuance has totaled $9.1bn, materially higher than March's number, but still short of February's volume of $25bn. Among the 11 deals in April, 59% of the total amount issued was for acquisition, driven by the $4bn deal from T-Mobile.

Table 1: Loan performance

Index	Level	1wk Δ	2wk Δ	YTD Rtn
All Loan	86.1 pts	-0.1	-0.4	-9.1%
BBs	92.3 pts	-0.6	-0.8	-7.2%
Bs	87.4 pts	0.0	-0.0	-9.4%
CCCs	69.0 pts	1.6	2.5	-19.8%

Source: S&P LCD

Table 2: HY performance

Index	Level	1wk Δ	2wk Δ	YTD Rtn
US HY	763 bps	-24	+05	-9.8%
BBs	539 bps	-14	+15	-5.9%
Bs	798 bps	-82	-48	-11.2%
CCCs	1779 bps	+96	+108	-22.0%

Source: BofA Global Research

Table 3: Fund flows ($mn)

Asset	1wk	2wk	YTD	LTM
Loans	-481	-439	-30,616	-44,694
US HY	+1,610	+1,683	+11,203	-5,772
US IG	+4,221	+1,235	+186,886	+100,370

Source: EPFR Global

Refer to important disclosures on page 11 to 13. Analyst Certification on page 10. 12134765

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Top of the stack

The Fed released additional details regarding its Main Street Lending Facilities Thursday morning. The new term sheet relaxes some conditions compared to the original version, and provides additional details for the existing “New” (MSNLF) and “Expanded” (MSELF) facilities. The Fed also added a third facility called the Main Street Priority Lending Facility (MSPLF) to its program which targets levered middle market companies. Below is a summary of the prominent changes across the facilities, with the changes highlighted:

1) Issuer eligibility criteria for total revenues and number of employees has been increased to **$5bn** and **15k** respectively
2) Ebitda calculation for the purpose of meeting respective leverage guidelines can now contain appropriate **adjustments**
3) Issuer can now use proceeds to pay mandatory **interest** and principal payments
4) Maturity criteria has been clarified to encompass all loans with at least **18 months** remaining
5) A hard **3% coupon rate**, instead of a range, has been set for transaction
6) The base rate for fees calculation has been changed from SOFR to **LIBOR**
7) Maximum loan size under MNELF has been modified such that total amount borrowed is equal to the lesser of i) $**200mn** or ii) debt needed to get the issuer to 6x **adjusted** gross leverage or iii) **35%** of borrower’s existing **pari-pasu** debt
8) New amortization schedules have been added for year 2, 3, 4 (no payment in year 1). 15%, 15%, 70% for MSPLF and MSELF, and 33% each year for MSNLF
9) Program has been extended to both secured and unsecured loans, and in the case of MSELF revolvers as well
10) Minimum loan size is increased to 10mn for MSELF, decreased to $500k for MSNLF and MSPLF
11) Fee schedules have been changed such that borrower incurs a total of 250bps (MSELF) and 300bps (MSNLF) to access a Fed facility

In addition the guidelines restrict eligible borrowers to have <=49% participation by foreign entities in case of a JV, specifically lays out some businesses ineligible to tap the facilities. It also needs the loan to have an internal risk rating equivalent to a “pass” in the Federal Financial Institutions Examination Council’s (FFIEC) supervisory rating system. The new language also broadly shifts the burden of proof of financial stability to the lender and the issuer.

Amongst things that have not changed, the program seeks to maintain the seniority of its loans on the issuer and lender. It places restrictions preventing out of turn payments on an issuers existing loans, or termination of existing credit access with the lender. It also needs the issuer to comply with other terms and conditions of the program such as those surrounding compensation, stock repurchase, capital distributions, and reasonable efforts to maintain payrolls. And also needs companies to certify eligibility to participate in the programs.

Main Street Priority Loan Facility

The biggest change in the current version of the Main Street program is the introduction of MSPLF. At a maximum dollar amount of $25mn, and leverage cap of 6x, this program seems to be targeted towards levered middle market issuers. In return eligible lenders are asked to retain 15% of the funds, as opposed to 5% for the other two facilities.

Note that its sister program, the MSNLF also targets medium sized issuers given the $25mn maximum loan amount, but has a lower leverage threshold of 4x indicating preference for higher rated loans. The amortization schedules also suggest the divide: while the MSPLF will allow issuers to make a balloon payment of 70% at the end of the 4 year term, funds borrowed under the MSNLF have to be paid a third at a time starting year 3.

Impact on the broadly syndicated loan market

In making these changes, the Fed has taken note of many constraints market participants were facing with the original structure of the program. Increasing the threshold for revenue and payroll criteria, as well as letting companies make appropriate ebitda adjustments for calculating leverage, is incrementally positive for the loan market as it allows more issuers to quality. Additionally, letting issuers use proceeds from these facilities to pay off principal and interest due means that they can now prevent entering into a distressed situation, though they cannot still opportunistically refinance their existing debt.

Finally, basing loans off of LIBOR is an encouraging sign, and makes it easier for banks to issue loans all things equal. This change shows the Fed mindset more than anything. The Fed has indicated that it wants banks to channel resources towards lending, rather than building SOFR infrastructure. It's a very reasonable step by the Fed in our opinion given the circumstances, suggesting that they want to help the real economy more than stick to any self-imposed timelines around LIBOR transition. It is also an acknowledgement from the Fed that there are material challenges with transitioning the loan market to SOFR. This further tilts risks towards an extension of the LIBOR transition, as we have flagged here.

At the same time, other details have been added that seem to be more restrictive to us than the original version of the program. For example, we don't see the upside of changing the coupon rate to be a singular rate rather than a range. And while letting issuers include EBITDA adjustments to calculate leverage is a welcome change, most of that benefit is offset by the mandatory inclusion of undrawn credit facilities in the gross debt portion. We estimate that using adjusted EBITDA bumps up the eligibility in BSL space by 11% but including undrawn capital sets it back 13%. The amortization schedule is also more restrictive than what traditional TLBs generally have (5% annually).

On balance, the changes are incrementally positive for the loan market but will have a limited impact on the BSL market. Note that the only reasonable way for large companies that issue broadly syndicated loans to access the Fed program is through the MSELF given its higher borrowing cap, now increased to $200mn. Increasing the revenue and payroll criteria will only have a marginal impact here since 90% of BSL issuers were already eligible under the old program. Increasing revenue/payroll caps now push that eligibility to 97% of the loan index. In reality those numbers are lower given the affiliation criteria will rule out a relatively larger chunk of the sponsored BSL market than the middle market. But even assuming the best case scenario, the revised numbers don't represent a meaningful improvement over the original program for the BSL market.

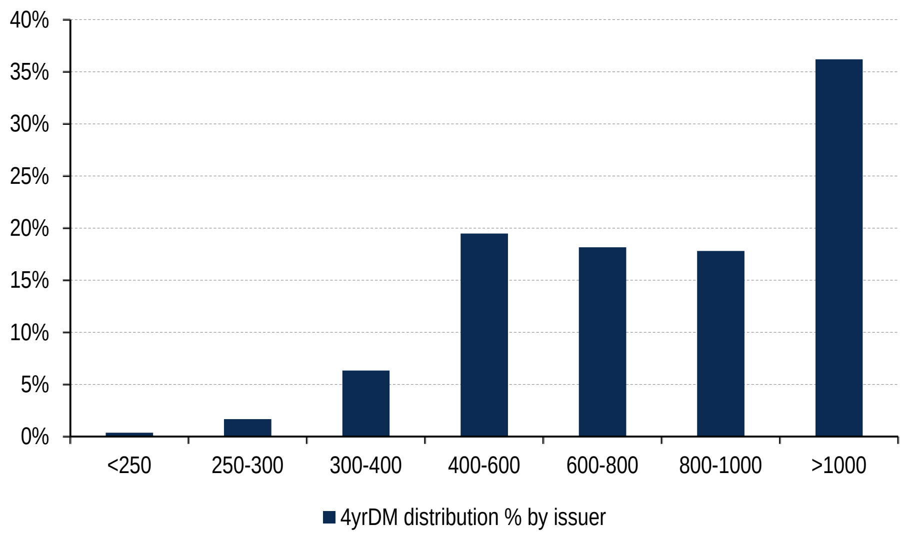
Assuming we start with 1100 issuers that pass the revenue/employee criteria:

1) 90% of these or 1000 issuers meet the 18 month maturity criteria.
2) 25% of these or 250 issuers could then qualify for the 3% coupon criteria
3) 50% of these (unchanged from our last analysis) or 125 issuers then qualify under the <6x leverage criteria

This is marginally better than in the previous version of the MSELF.

On 2) we assume that issuers with >300bps current secondary spreads will also be able to place a loan with a 3% coupon rate by allowing attractive OIDs. We think that the upper limit to what kind of issuers can get financing will be limited to those with current par-weighted spreads to 4yr maturity of up to 600bps, so as to keep the risk in check, as well as to allow OIDs to remain the 90s. Issuers with spreads below 3% obviously will have better prospects elsewhere. This 300-600bps spread range represents ~25% of the current issuer base (Chart 1).

Chart 1: Issuers with spreads in the 300-600bps range represent 25% of the index



Source: BofA Global Research, S&P LCD

On 3) we note that other eligibility criteria of the maximum loan size clause severely limit the amount an issuer can borrow (outside of leverage). We use our publically reporting universe as a sample to demonstrate this. Out of 275 issuers, about 65% have leverage between 0 and 6. Amongst these issuers, additional debt capacity satisfying the 6x leverage criteria is ~$1.7bn per issuer. Under the 35% of pari-pasu debt criteria, the capacity drops to $450mn per issuer, which gets further constricted by the $200mn cap on an individual loan. Applying all 3 criteria, gives us ~$26bn in total additional loan capacity, averaging ~$170mn per issuer, or ~12% of the issuer's total debt on average. While this is definitely capital that wasn't previously available, it doesn't seem to us as being the agent of change in a company's fortune.

Impact on the middle market

We think that between MSNLF and MSPLF, a majority of the $1.2tn middle market is poised to be covered. 75% of middle market funding comes from bank loans, which has yields at 3% at the moment (spreads ~200bps). As such, a large section of these issuers should be able to apply for new loans with their banks under the facility's 3% coupon criteria. Only some of the sponsor-owned companies may potentially fail eligibility criteria given the affiliate language, but this group is limited to about 15% of middle market loans outstanding as we have detailed in our loan primer.

On the flip side, high fee structures and amortizations could be a pain point for these issuers. The cost to a borrower to access funding through MSNLF and MSPLF is 300bps over 4 years. The cost for MSELF is 250bps over the same period. These fees are in the same ballpark as in a committed TLB underwriting scenario. However, most middle market companies are financed via bank loans (TLAs), where a typical transaction incurs about 50bps in fees, which makes MSLFs' fee structures punitive for these issuers. The 15% risk retention in loans to levered companies through MSPLF might also be a challenge for banks, only surmountable to the extent banks want to preserve a corporate relationship.

Summary

Within the BSL market, we see the MSELF as being beneficial to companies looking for something to plug a finite hole, as opposed to stave off defaults. Even amongst going concerns, we think only the ones needing funds urgently will be willing to comply with the punitive amortization and compliance structures.

The MSNLF and MSPLF are designed to help middle market issuers, and will have the highest impact in this section of the loan market. However, we think that issuers that finance themselves with TLAs/revolvers are unlikely to use these facilities unless they are in dire need of funds.

On balance, we still don't foresee a high utilization of these facilities in their current format. Aside the limitations highlighted above, impact from self-certification, and inclusion of FFIEC's ratings also need to be fully understood. To incentivize overall utilization, some key aspects for the Fed to consider going forward are: relaxing the affiliate criteria for borrower eligibility, increasing the $200mn MSELF cap, and lowering the fees under MSNLF given its lower leverage tolerance and stringent amortization schedule typically designed for TLAs.

Market Technicals

Demand for loan was $2.7bn this week, materially higher than previous three weeks' average of $1.3bn, signaling a rise in the confidence level in the loan market. CLO market continued to show increasing activeness as CLO creation reached nearly $1bn this week. Retail flows trailed down to -$300mn from -$400mn last week. On the supply side, this week saw a jump in the primary market activities as new issuance surpassed $5bn, the highest since the week ending in Feb. 7th this year, and nearly triple of last week's $1.8bn. YTD, demand has overweighed supply by $15.4bn, 14% higher compared to the net demand in 2019 for the same period ($13.6bn).

Table 4: Weekly Technicals ($mns)

	YTD as of 4/24/20	5/1/20	4/24/20	4/17/20	4/10/20
Retail flows (a)	-17,893	-299	-461	-349	-198
CLO creation (b)	18,140	906	743	1,149	477
Coupons (c)	20,542	2,188	828	883	821
Demand (a+b+c)	20,788	2,796	1,110	1,683	1,100
Issuance Ex-repricings (d)	93,122	5,075	1,895	970	425
Repayments (e)	87,775	NA	3,413	511	2,180
Supply (d-e)	5,347	NA	-1,518	460	-1,755
Demand net of Supply	15,441	NA	2,629	1,224	2,855

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

Total return for loans in the LCD index for April was +4.5%, the best since 2009. Though last week turned back to the negative territory, and the index lost -73bps. Within ratings, CCC loans continued to outperform with a small gain of +6bps while higher rated loans underperformed (BB -90bps and B -78bps). The CCC dominance may further imply investors' continued interests in higher yield loans disregarding greater risks. YTD, loans sit at -9% returns, compared to HY at -10% and IG at +1%.

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

	4/24/2020	4/17/2020	4/10/2020	4/3/2020
All Loans	-73	189	334	285
BB	-90	181	339	405
B	-78	203	354	287
CCC	6	266	205	-222
2nd Lien	41	171	186	-85

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

	4/24/2020	4/17/2020	4/10/2020	4/3/2020
LL100	-133	123	432	304
Middle Market	4	158	103	50

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

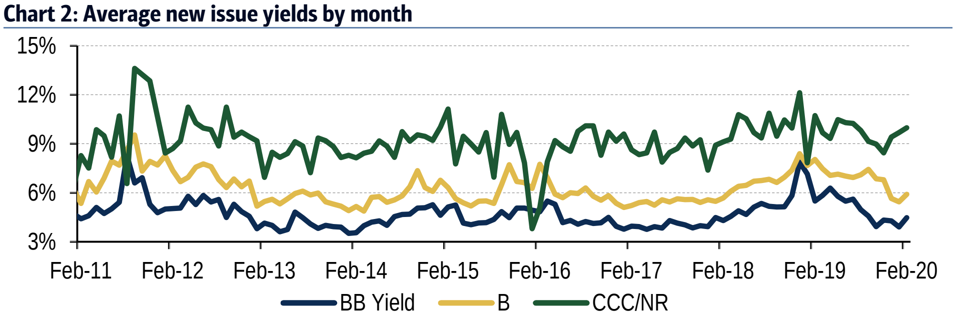
Primary activities turned up the gear with a total of nearly $5bn new issuance since we last published. YTD global USD issuance stood at $98.2bn, slightly higher than new issuance in 2019 for the same period ($95.8bn), though the same measure for US loans is running slower than last year. April issuance has totaled $9.1bn, materially higher than March's number, but still short of February's volume of $25bn. Among the 11 deals in April, 6 were issued for general corporate purposes and 3 were issued for acquisition purposes. On the dollar basis, 59% of the total amount issued was for acquisition, driven by the $4bn deal from T-Mobile. T-Mobile launched $4bn first-lien term loan to support its acquisition of Sprint. Price talk was at L+300, with a 0% LIBOR floor and an OID of 98.5.

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
4/29/2020	Samsonite IP Holdings	Samsonite (Add-on 5/20)	500	500	Ba1	BBB-	No	No	GCP	Textile & Apparel	Luxembourg
4/27/2020	T-Mobile US Inc	T-Mobile (TL 5/20)	4,000	4000	Baa3	BBB-	No	Yes	Acquisition	Telecom	United States
4/24/2020	AppLovin Corporation	AppLovin (Add-on 5/20)	300	300	B1	B+	No	Yes	Refinancing	Computers & Electronics	United States
4/23/2020	Delta Air Lines Inc	Delta Air Lines (5/20)	1,500	1500	Baa2	BBB-	No	No	GCP	Transportation	United States
4/21/2020	American Gaming Systems	AGS (Add-on 5/20)	95	95	B3	B	No	No	GCP	Gaming & Hotel	United States
4/16/2020	Surgery Partners	Surgery Center (5/20)	120	120	B2	B-	No	No	GCP	Healthcare	United States
4/14/2020	Revlon Consumer Products Corp	Revlon (5/20)	850	850	Caa2	CC	No	No	Refinancing	Consumer Nondurables	United States
4/10/2020	Cornerstone OnDemand	Cornerstone OnDemand (5/20)	1,000	1000	B1	B	No	No	Acquisition	Computers & Electronics	United States
4/8/2020	Everi Payments	Everi Payments (Add-on 5/20)	125	125	B1	BB-	No	No	GCP	Services & Leasing	United States
4/6/2020	Landry's Finance	Landry's (5/20)	300	300	B2	B	No	No	GCP	Restaurants	United States
4/2/2020	Culligan Holding S àr L	Culligan (Add-on 5/20)	350	350	B2	B	No	Yes	Acquisition	Manufacturing & Machinery	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

Source: S&P LCD

Chart 2: Average new issue yields by month

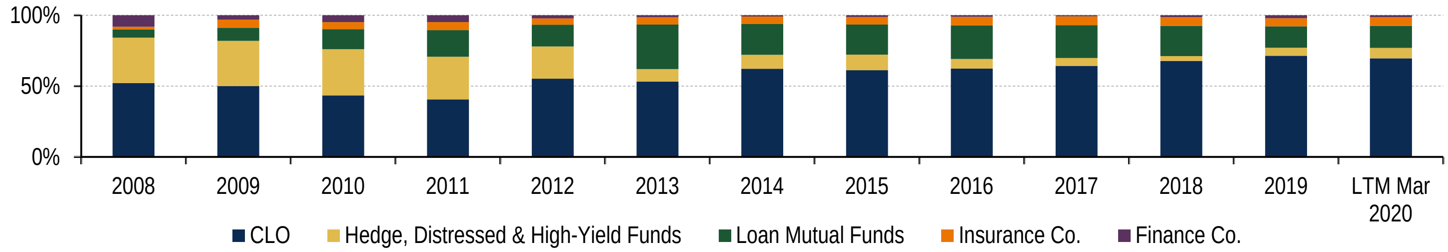


Source: S&P LCD

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.

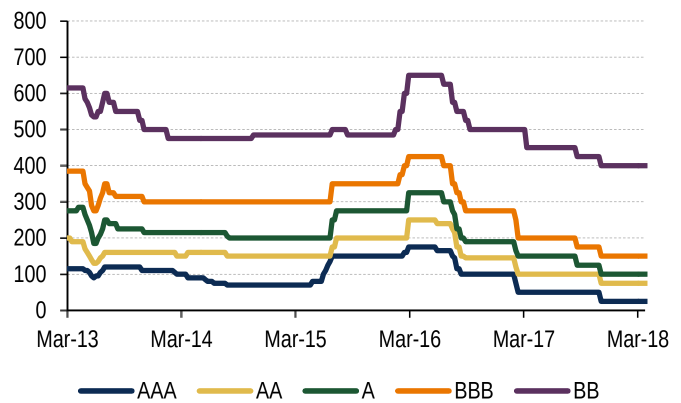
Chart 3: Primary institutional investor market by type



Source: S&P LCD

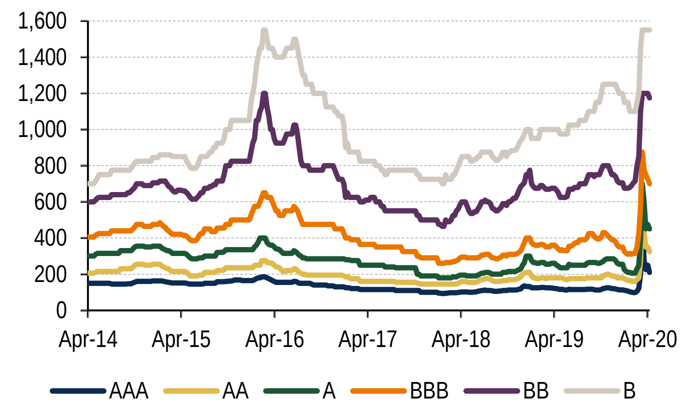
Three generations of CLOs exist today, CLO 1.0 (pre-crisis), and CLO 2.0/CLO 3.0 (post-crisis). The market is primarily driven by the latter. Below charts show CLO spread levels by tranches.

Chart 4: US CLO 1.0 indicative spread levels (bps)



Source: BofA Global Research

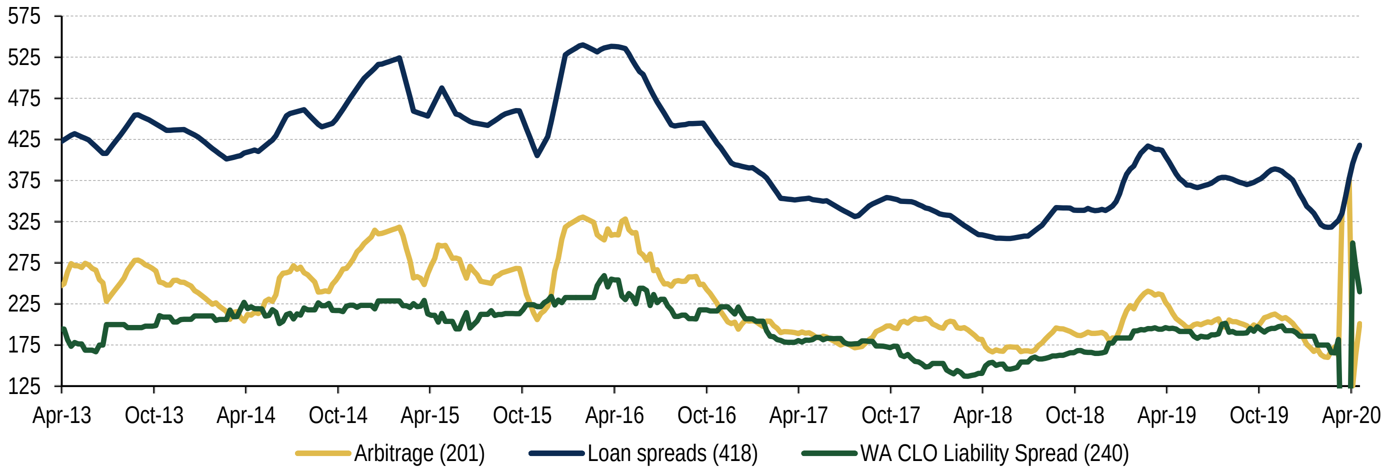
Chart 5: US CLO 2.0/3.0 indicative spread levels (bps)



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.

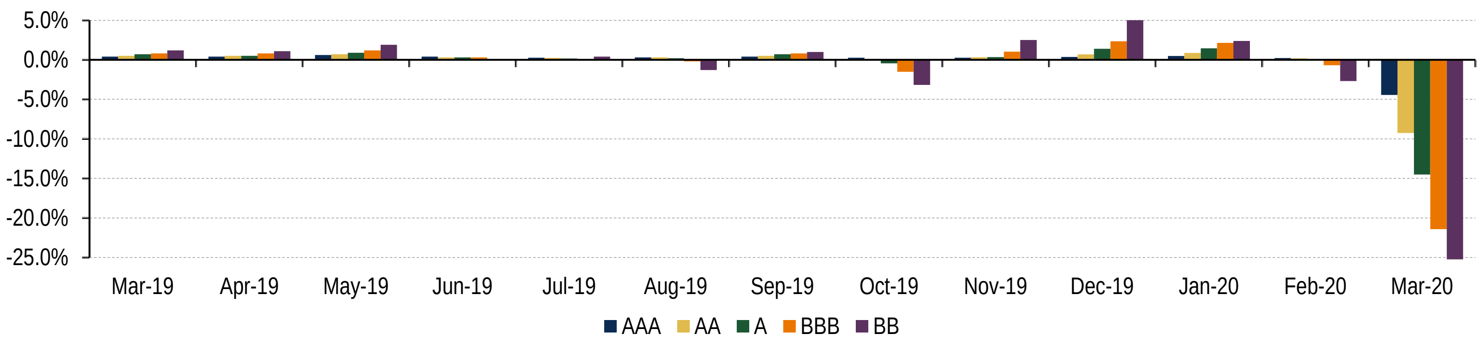
Chart 6: CLO arbitrage (bps)



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

Chart 7 shows monthly CLO returns as defined by the Palmer Square CLO index (price plus coupon returns).

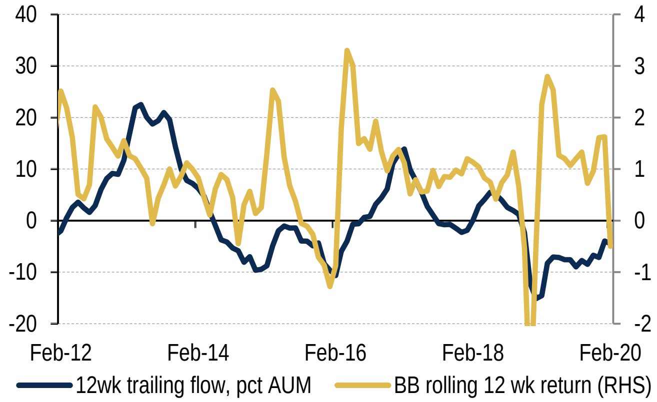
Chart 7: Monthly CLO 2.0 returns by rating



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

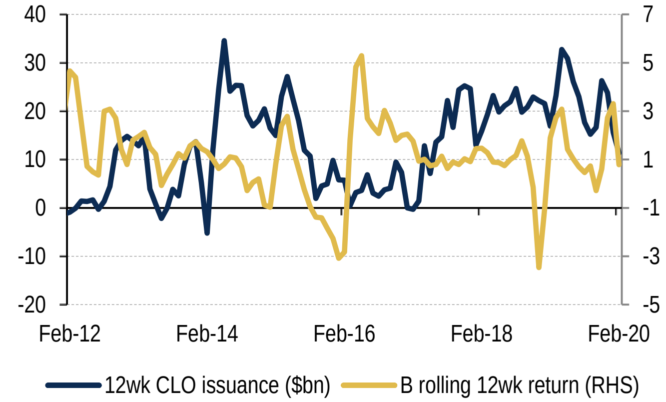
Since technicals play a big role in the loan market, following retail patterns is also essential. In general, we see that the performance of the BB section of the loan market correlates most with retail flows, while new CLO issuance seems to correlate to B Loan returns. This makes sense as mutual funds generally gravitate towards less risky investments while CLOs invest in single B rated assets on average. Chart 8 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 9 depicts monthly CLO issuance vs. monthly B Loan total returns.

Chart 8: BB performance vs Loan retail flows



Source: S&P LCD, EPFR Global

Chart 9: B performance vs CLO creation



Source: S&P LCD, EPFR Global

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