Leveraged Loans

Reprice If the Price Is Right

| CORE

Repricings have represented a majority of loan supply so far this year, as more than half the index is trading above par. Breaking down these repricings, we find that the average spread cut from a repricing has declined over time and, as a result, should not be a significant drag on the index, even as volumes pick up.

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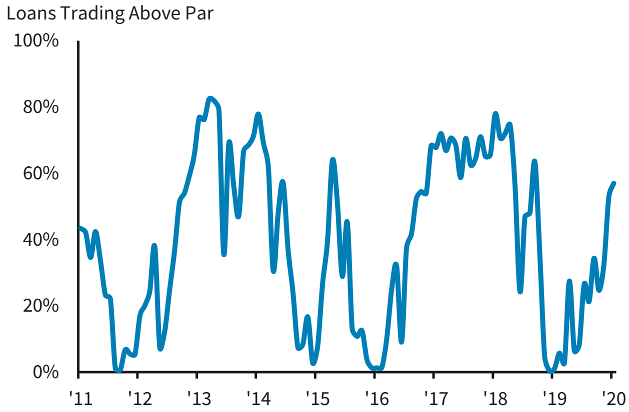
The leveraged loan market is coming off its best month since April of last year, as the December rally and beta compression were led by CCCs, with a total return of 3.2% on the month, outpacing the broader index return of 1.6%. The rally has continued into the new year, as the S&P/LSTA Leveraged Loan Index (LLI) has not had a negative daily return since November 20. Lower-rated loans have continued to outperform in 2020, with CCCs already capturing 1.65% of total return in the first 22 days, compared with 0.52% for BBs and 0.95% for single-Bs. This suggests that investors are a bit more constructive on loans as they search for ways to generate alpha in 2020.

As a result of the rally, 53% of the loan index was trading above par at year-end (Figure 1). The continued rally so far this year has increased that level to 57% as of January 21. This compares with just 8% at the midway point of last year. Breaking down the loans trading above par, the majority are rated BB, which is not surprising considering that BB loans outpaced CCC loans by almost 6% in 2019. However, there is a wide range of dispersion in the single-B rating, as 68% of B+ loans trade above par, compared with only 26% of B- loans (Figure 2).

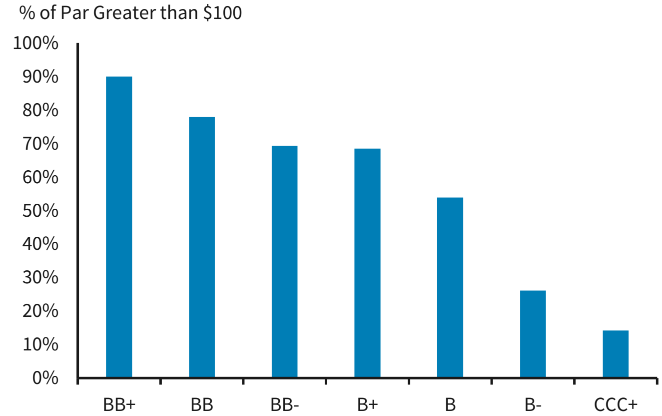
So far this year, repricings have accounted for 68% of total supply of $24bn, which is almost double the long-term average for repricings as a percentage of total supply since 2003. This also represents a material increase from this time last year; loan repricings totaled $1.8bn in the first half of 2019. With the recent rally driving the number of loans trading above par up quickly in the past month, we expect repricing volumes to increase.

FIGURE 1. More Loans Are Currently Trading above Par



Source: Bloomberg, S&P LCD, Barclays Research

FIGURE 2. A Vast Majority of BBs Trade over Par



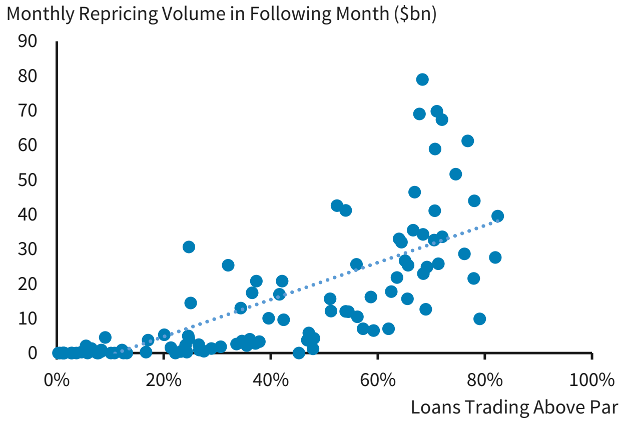
Note: Based on S&P rating.
Source: Bloomberg, S&P LCD, Barclays Research

Unsurprisingly, as a higher percentage of loans in the index begin to trade above par, repricing activity has become more prominent (Figure 3). Given the current rate of loans trading above par, the regression in Figure 3 would imply roughly $25bn in repricing supply for the month, which will likely be surpassed. The outsized volumes are not surprising, as the variability in Figure 3 is clearly quite high when the majority of the market is trading above par.

Given the recent rise in repricings, we look at historical trends to discern the characteristics of loans that reprice and the effect on the market. In terms of ratings, the majority of repricing supply has historically come from the single-B cohort, accounting for more than two-thirds of all repricing supply since 2011. Last year was the only year since 2011 when a higher percentage of repricings came from BBs than Bs, which makes sense given the percentage of BBs trading above par and the higher-quality outperformance in 2019. We expect that the distribution of repricings will be more evenly split between BBs and Bs in 2020, but not return to the historical single-B heavy skew, as repricings remain unlikely for most of the lower-rated Bs.

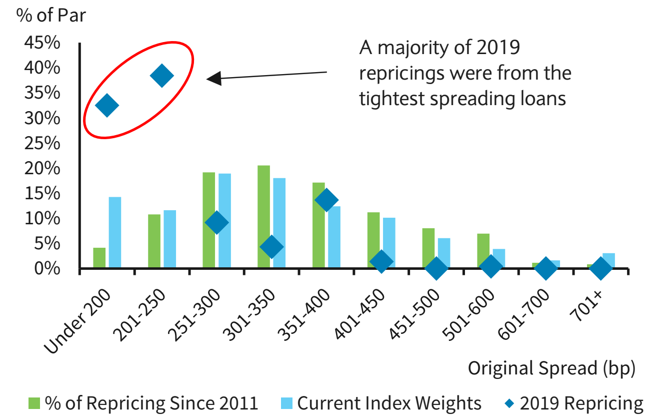
Another important characteristic when attempting to identify repricings is the level of starting spread. Figure 4 shows the percentage of repricing supply since 2011 that has come from each spread bucket, as well as the current breakdown of the index. Comparing these, repricing supply as a whole tends roughly to mirror the breakdown of the index, as expected. However, adding the breakdown from 2019 shows that a majority of repricings last year came from the tightest spread loans. This corresponds with the higher-than-average percentage of BBs that repriced last year.

FIGURE 3. Repricings Pick up When the Percentage of Loans Trading above Par Is Higher



Source: Bloomberg, S&P LCD, Barclays Research

FIGURE 4. The Majority of 2019 Repricings Were from Low Initial Spreads

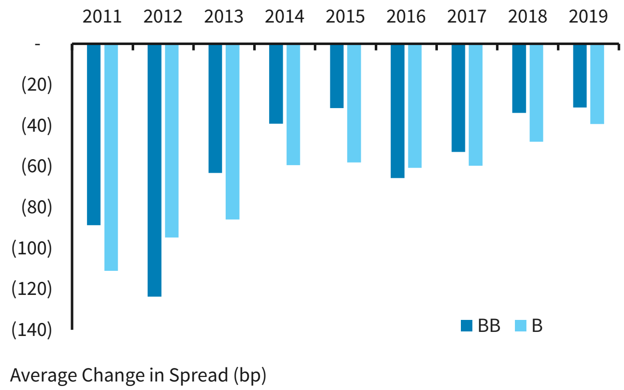


Source: Bloomberg, S&P LCD, Barclays Research

Although repricing volumes have been variable over the past decade, the spread change as a result has followed a consistent trajectory for both BB and B-rated loans (Figure 5). In 2011, the average spread declines from repricings were 89bp and 111bp for BBs and Bs, respectively. This compares with just 31bp and 39bp last year. A major driver of this decline was lower overall index spreads, with the LLI spread to maturity declining from over 600bp at the end of 2011 to 423bp at the end of 2019. The average coupon declined less than spread to maturity, but has still drifted lower, falling from 422bp to 352bp over the past eight years. Obviously, this diminishes the ability of companies to reprice and meaningfully lower interest payments.

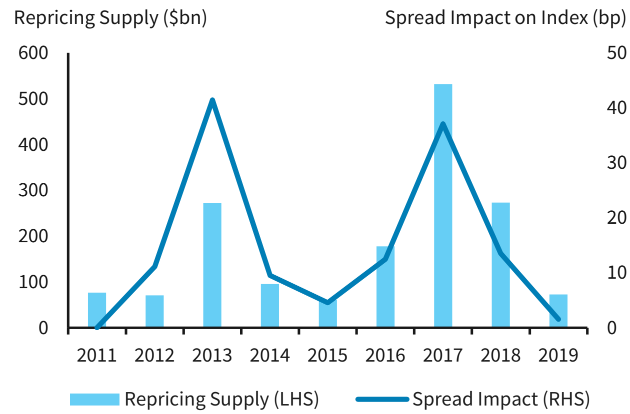
Given the lower average spread decline from repricings, as well as the fairly low level of repricing supply in 2019, the resulting drag on the index was negligible last year (Figure 6). Notably, in periods where repricing activity was higher, such as 2017, the drag on performance was much more meaningful, eclipsing 40bp, even though coupons had already been declining for several years. There was also a 40bp drag from repricings in 2013, even though repricing volumes were roughly half those of 2017. Because of the recent pickup in loans trading above par and subsequent repricing activity, we expect the drag on the index to trend higher in 2020 than in 2019, although the lower level of spread declines as a result of a repricing transactions should limit the overall drag on the index. As noted in our 2020 Loan Outlook (see *Enthusiasm curbed by tail risks*), we expect repricings' effect on the index to be less than 10bp this year and do not see much more downside than that even with the elevated repricing supply to start the year. As long as the average coupon decline remains at 30-40bp, we would have to see $300bn+ in repricings before the effects really start to mount.

FIGURE 5. **Par-Weighted Average Repricing Spread Change Has Declined**



Source: Bloomberg, S&P LCD, Barclays Research

FIGURE 6. **Drag from Repricings Was Minimal in 2019**



Source: Bloomberg, S&P LCD, Barclays Research

Effects on CLOs

US CLOs, which we estimate own 62-66% of the US loan market (see *CLOs Take More of the Demand Pie*) are directly affected by declining nominal loan spreads, especially in an environment of heightened loan downgrades. As outlined in our recent *Global CLO Primer*, CLOs have collateral quality tests to ensure that a portfolio's ratio of risk (ie, asset ratings) to reward (ie, asset coupons) is in balance. These tests include weighted average spread (WAS), weighted average rating factor (WARF), and diversity scores (DS), and test failures generally mean that managers must maintain or improve the failing tests to continue trading.

The limits for such tests operate off a matrix, with the maximum WARF typically based on current minimum WAS and DS levels. As asset spreads decline due to repricings, CLO managers will have to lower minimum WAS thresholds to ensure that WAS tests are not failed. Assuming that DS is constant, maximum WARF levels will also decline, requiring managers to de-risk their portfolios in order to keep trading. While this de-risking should be a more gradual process and not cause forced selling, managers may still have difficulty replacing repriced loans with assets of a similar spread-to-rating ratio, especially for managers that employ a "barbell" allocation to high spread/low-rated and low spread/high-rated assets.

This surge in repricings, if it continues, could also put pressure on new issue CLO supply if CLO liability costs do not decrease in line with asset spreads to help the equity arb (ie, the difference between CLO asset spreads and debt cost). However, we do not think it is worth lowering our issuance forecasts since the effect on CLO assets should be capped at the 10bp we mentioned above in our base-case scenario. CLOs are significantly underweight BBs and overweight Bs, so even if the average spread cut is slightly higher in repricings for Bs, if the amount of repricings is fairly evenly split between the two categories, it should mitigate the effect on CLOs.

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