Loans Ready for Pickup

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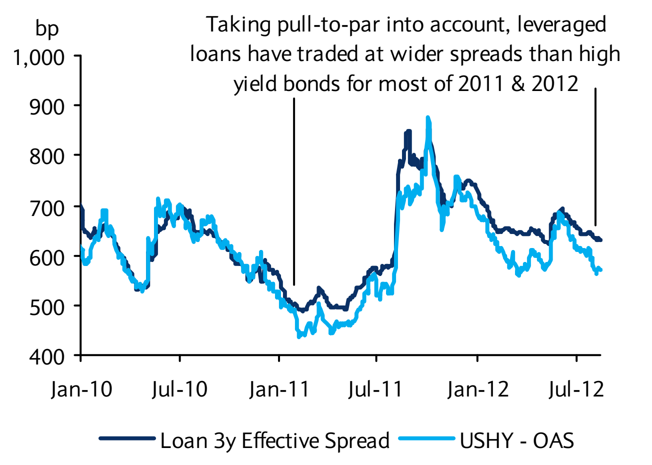
After a brief lull in the early part of summer, CLO creation has once again accelerated. Three deals priced in the early days of this week, including TICC CLO 2012-1, HighBridge Loan Management 2012-1, and Lafayette CLO 2012-1, a balance sheet transaction from Credit Industriel et Commercial (CIC). Also this week, new CLOs from Columbia Management Investment Advisors and BlackRock were announced. All told, 59 CLOs have priced thus far in 2012, for $24.1bn in total proceeds, bringing us fairly close to the amount required to fully offset this year's amortization of legacy structures (see *CLO Demand – Net Neutral for Now* for further details regarding CLO issuance, legacy amortization, and cash loan demand). The bid from CLOs, coupled with a continuous trickle of new retail money (mutual fund inflows have averaged ~$150mn per week since late June), has helped to offset a fairly busy new issue calendar following earnings, keeping cash loan prices steady. The Barclays Performing Loan Index settled at $95.75 as of Wednesday's close, up $0.05 on the week and up 1.75pts since risk assets turned upward in early June.

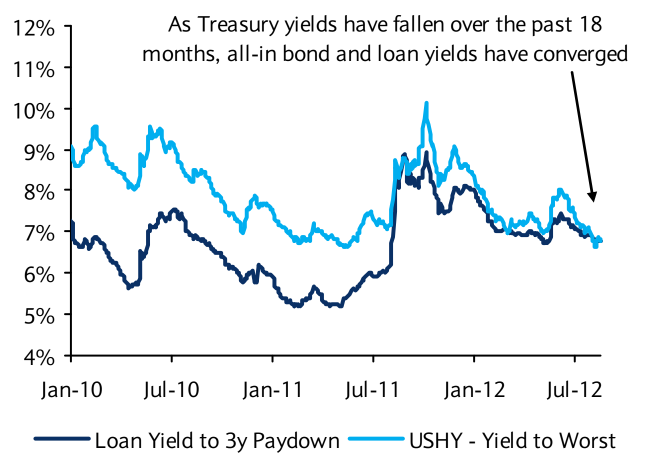
While the loan market's 1.75pt gain during the past two months is significant, it is less than half of the 4pt gain registered by the high yield bond market over the same period. The sharp rally in high yield bonds has pushed the bond market's average OAS to 569bp, well inside of the 631bp loan market average spread, using a 3y paydown assumption. (While this is an arbitrary timeframe, it roughly matches historical average loan paydown rates, and the underlying trend holds under alternate assumptions as well.) As Figure 1 shows, today's loan/bond spread relationship is fairly typical of the past 18 months, with bond spreads trading an average of 40bp inside of loan spreads since the beginning of 2011. What has changed during that period is the effect of Treasuries on the relationship between loan and bond all-in yields. Even after the recent backup, 5y Treasury yields are more than 1% lower today than they were at the beginning of 2011 (~0.8% now versus ~2.0% then). As the Treasury yields have fallen, bond and loan index yields have converged (Figure 2), closing virtually on top of each other at 6.8% on Wednesday. Given the greater security inherent in the loan product (only 20% of the bond index is secured), the loan market appears to offer compelling relative value, at least in aggregate.

Figure 1: Barclays Performing Loan and U.S. High Yield Bond Index Spreads



Note: Loan index spread assumes a 3y paydown period.
Source: Barclays Research

Figure 2: Barclays Performing Loan and U.S. High Yield Bond Index Yields

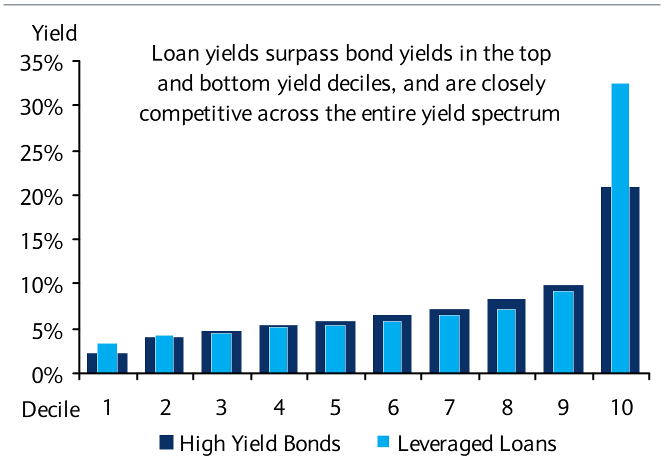


Note: Loan index yield assumes a 3y paydown period.
Source: Barclays Research

However, as most investors are aware, index averages in isolation can be misleading, particularly when the underlying distribution of yields is different. While it is true that the loan market is somewhat more skewed in this regard (more heavily clustered around par, but with a thicker downside tail), some simple cross-sections illustrate that loan yields are now competitive across the entire market spectrum. Figure 3 divides the loan and bond markets into deciles based on yield. As expected, the fatter downside tail causes loan yields to be much higher in the tenth (highest yielding) decile, while the extremely call-constrained nature of the bond market also results in higher loan yields in the first and second (lowest yielding) deciles. But more important, loan yields are virtually equivalent or, at a minimum, highly competitive across all deciles. Figure 4 provides a breakdown by credit rating and tells a similar tale, as loan yields equal or exceed bond yields at all but the highest quality levels and are competitive even there.

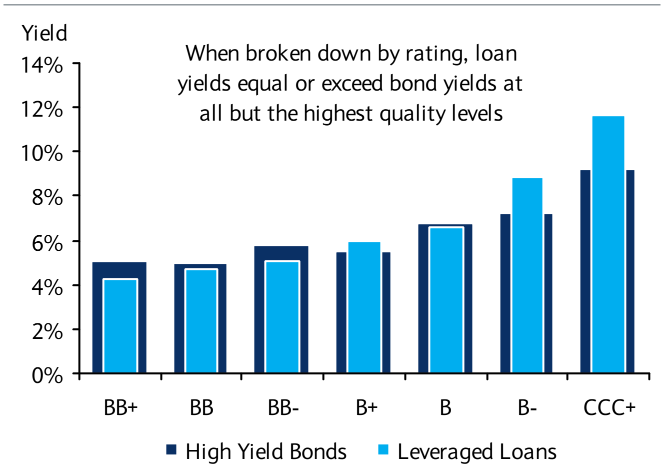
Given the much higher average recovery in the loan market historically, today's yield relationship across bonds and loans is difficult to justify from the standpoint of fundamental credit risk. Technical factors have favored the bond market and should continue to do so until the 2014 loan maturity wall is fully addressed (see *Over the Wall, Just Under the Wire* for an update), and the market has greater confidence that CLOs will not become large net sellers of loans as legacy structures amortize. While we do not expect dramatic outperformance in the near term, the loan market does appear to offer more compelling risk/reward for investors with longer time horizons. In particular, we believe there are opportunities for investors to swap out of highly call-constrained bonds offering minimal yield and into loans from the same capital structure that offer greater upside, better security, and lower dollar price exposure. As a starting point, we believe investors should consider the following credits in Figure 5 (next page), keeping in mind that early takeouts could cause the bond yields that are ultimately realized to be higher than current yield-to-worst calculations may indicate.

Figure 3: High Yield Bond and Leverage Loan Yield Deciles



Note: Loan index yield assumes a 3y paydown period and includes the effect of a Libor swap.
Source: Barclays Research

Figure 4: High Yield Bond and Leverage Loan Index Yields by Credit Rating



Note: Loan index yield assumes a 3y paydown period and includes the effect of a Libor swap.
Source: S&P LCD, Barclays Research

Figure 5: Loans Offering Yield Pickup and Lower Dollar Price Exposure Relative to Bonds in the Same Capital Structure

	Loan				Bond				Difference	
Issuer	Facility	Mat Year	Price	Yield	Coupon	Mat Year	Price	YTW	Price	YTW
NXP Semiconductors	Term Loan A-2	2017	100.25	5.65%	9.750	2018	114.25	4.48%	-14.00	+1.17%
CB Richard Ellis Services	Term Loan B	2016	100.25	3.75%	11.625	2017	112.88	2.79%	-12.63	+1.04%
Geo Group	Term Loan B	2016	99.50	5.14%	7.750	2017	107.75	4.14%	-8.25	+1.00%
Sinclair Television Group	Term Loan B	2016	100.00	4.24%	9.250	2017	111.25	3.44%	-11.25	+0.80%
Manitowoc Company	Term Loan A	2016	100.00	4.49%	7.125	2013	100.25	3.71%	-0.25	+0.78%
Universal Health Services	Term Loan B	2016	100.00	3.99%	7.125	2016	114.00	3.25%	-14.00	+0.74%
NGPL PipeCo	Term Loan	2017	100.00	6.99%	7.119	2017	103.25	6.39%	-3.25	+0.60%
Wesco Aircraft Hardware	Term Loan B	2017	100.00	4.50%	7.500	2017	101.75	4.27%	-1.78	+0.24%
Health Management Associates	Term Loan A	2016	98.50	3.90%	6.125	2016	107.75	3.84%	-9.25	+0.06%
Davita	Term Loan B	2016	100.00	4.74%	6.375	2018	106.25	4.72%	-6.25	+0.03%

Note: Loan yields assume a 3y paydown and include the effect of a Libor swap. Source: Barclays Research

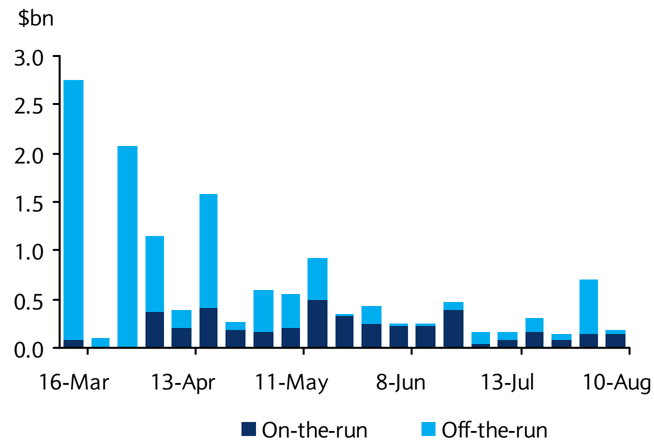
New Issue Volume

Institutional Leveraged Loans	No. of Deals	Amt ($bn)
Trailing 1m Launches	48	20.3
Forward Calendar	25	16.2
Year-to-Date Priced (ex-repricings)	350	127.2

CLOs (BSL and MM)	No. of Deals	Amt ($bn)
Forward Calendar	8	3.1
Year-to-Date	59	24.1

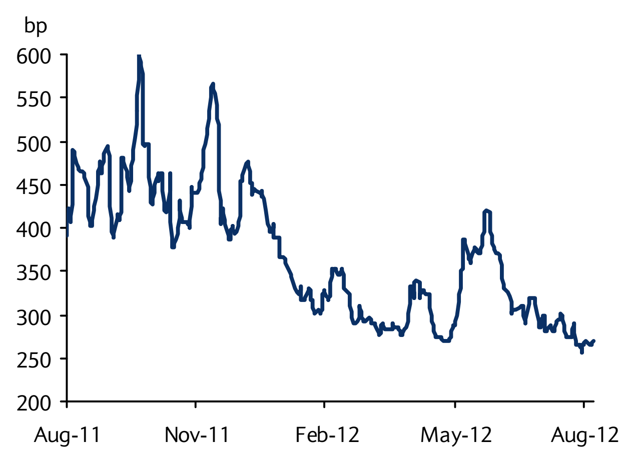
Source: Creditflux, Bloomberg, Total Securitization, S&P LCD, Barclays Research

LCDX Weekly New Contract Volume



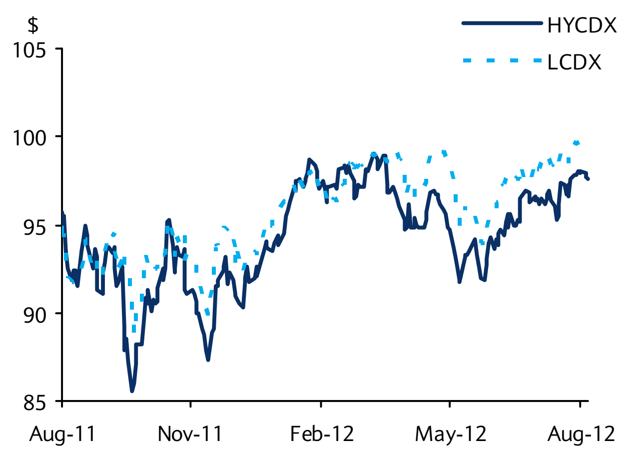
Source: DTCC

LCDX Historical On-the-Run Spreads



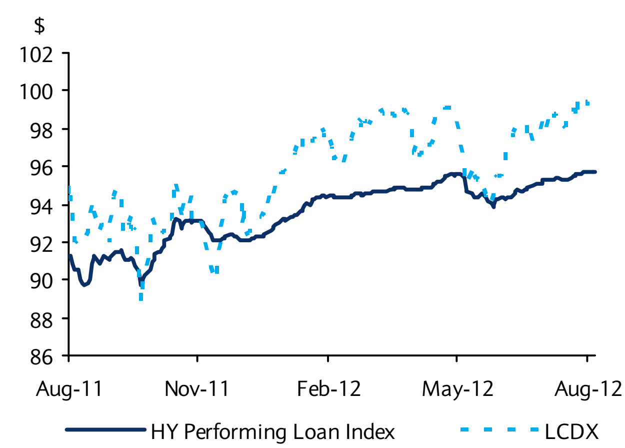
Note: Current market assumes 70% recovery on LCDX.
Source: Barclays Research

On-the-Run HYCDX versus LCDX



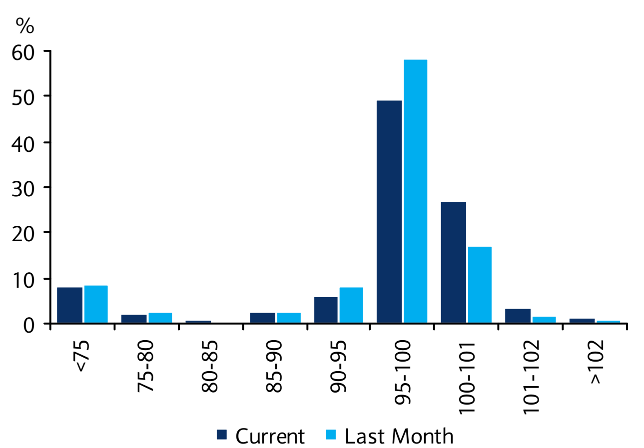
Source: Barclays Research

On-the-Run LCDX versus Loan Index Price History



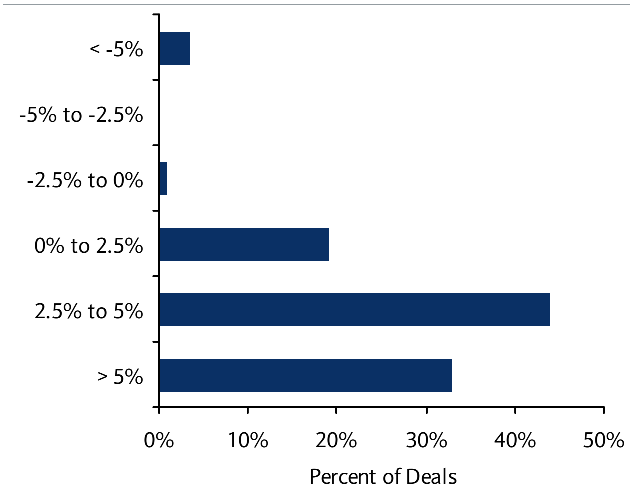
Source: Barclays Research

Loan Index Price Distribution by Par

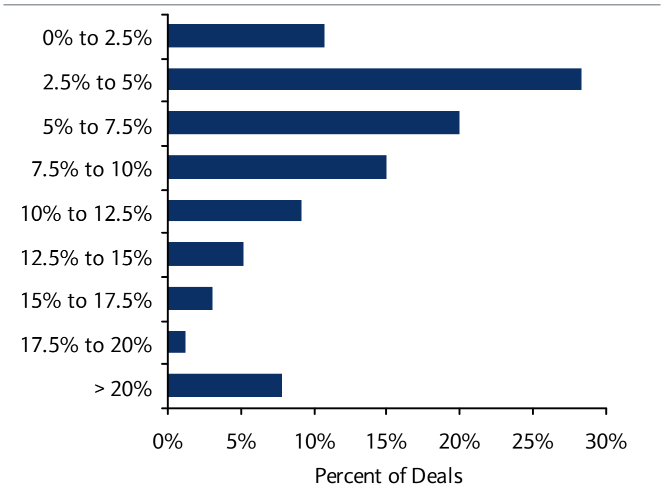


Source: Barclays Research

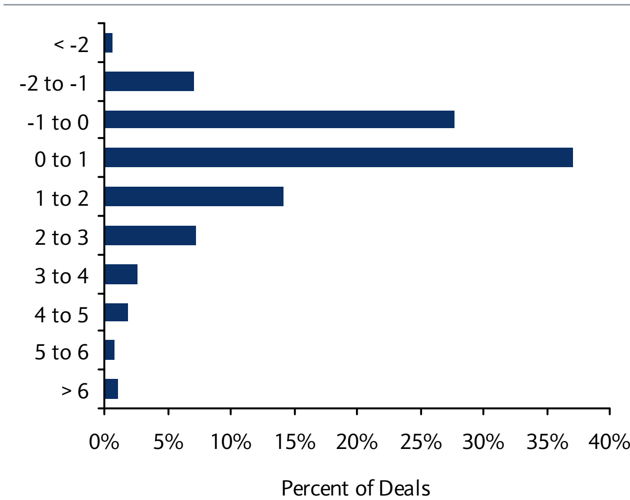
Junior OC Test Cushions for U.S. CLOs



CCC Bucket Size for U.S. CLOs



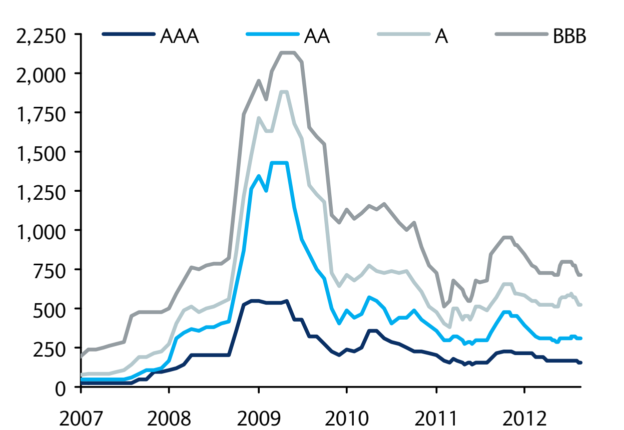
Weighted Average Life (WAL) Test Cushion for U.S. CLOs



U.S. CLO Moody's Ratings Upgrades

Rating as of April 23rd	Rating as of May 23rd: Aaa	Aa	A	Baa	Ba	B	Caa	Ca/C	WR	Total
Aaa	**954**	-	-	-	-	-	-	-	13	967
Aa	14	**551**	-	-	-	-	-	-	4	569
A	3	13	**355**	-	-	-	-	-	3	374
Baa	-	1	12	**363**	-	-	-	-	3	379
Ba	-	-	1	11	**578**	-	-	-	-	590
B	-	-	-	-	4	**132**	-	-	-	136
Caa	-	-	-	-	-	1	**28**	-	-	29
Ca/C	-	-	-	-	-	-	-	**19**	2	21
Total	971	565	368	374	582	133	28	19	25	3,065

U.S. CLO Spread Performance by Rating (bp)[1]



Cash Amount for U.S. CLOs

	Reinvestment Period: In	Reinvestment Period: Post	Total
U.S.			
Cash ($bn)	5.2	2.7	7.9
Total Par ($bn)	171.6	71.5	243.2
Cash Percent	3.04%	3.77%	3.26%

Note: [1] Spread data from BWIC levels.
Source: Moody's Investor Services, Intex, Barclays Research

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