Leveraged Loans

Libor Floor Love

Libor levels continue to decline, putting increased focus on Libor floors for loans. We look at the implications of lower rates and find that investors have already placed a premium on loans with greater protection from low Libor levels.

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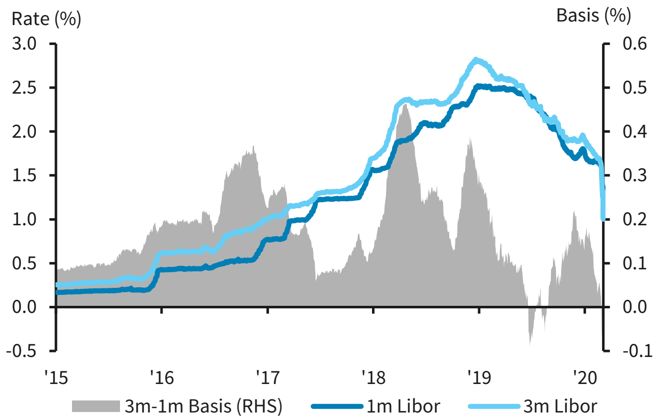
As macro concerns continue to spread, keeping volatility elevated across markets, the Federal Reserve cut interest rates by 50bp two weeks prior to its next scheduled meeting. This sent front-end rates lower, with Libor experiencing its largest drop since the recession and returning to levels last seen at the beginning of 2017.

Rates markets had begun pricing in central bank stimulus before the cut, sending both Treasuries and Libor sharply lower. While Libor rates have been trending down since December 2018, when the Fed reversed course and began cutting interest rates, the recent market turmoil has exacerbated the move lower (Figure 1). Beyond the current levels, three-month Libor futures curves remain inverted, but absolute rates have steadily declined (Figure 2). As a result, loan valuations have been pressured not only by current Libor levels, but also by the implied forward curve.

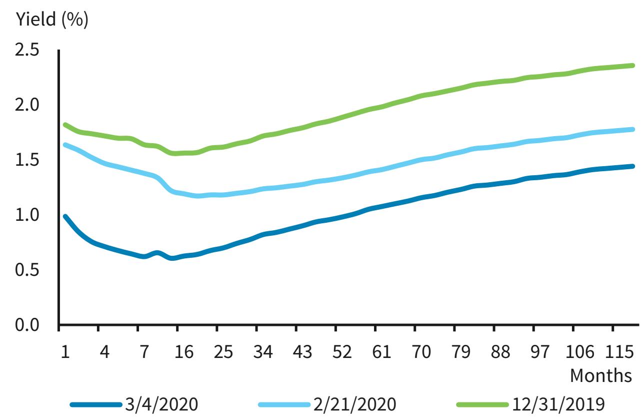
As we have noted in the past (*Rates Take Their Toll on Yields*), incorporation of the Libor forward curve is a better approximation of the returns investors can expect to receive than simply looking at the spot rate. While investors may conservatively choose to look at the spot level as opposed to the forward curve when it is upward sloping, using the forward curve in an inverted Libor curve environment is even more important for relative value, even if it is not fully realized.

FIGURE 1. The Decline in Libor Accelerated Recently



Source: Bloomberg, Barclays Research

FIGURE 2. The Libor Forward Curve Has Shifted Down in 2020



Source: Bloomberg, Barclays Research

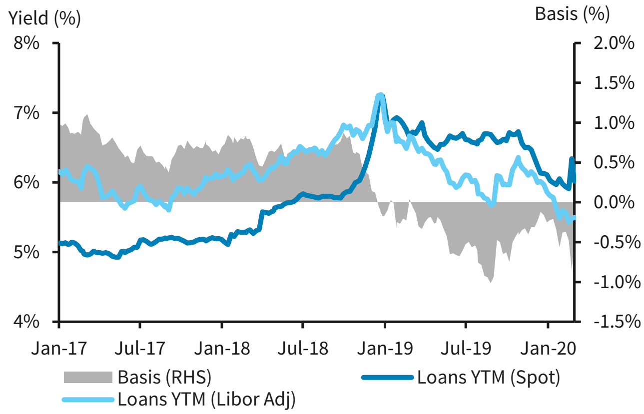
While the recent sell-off has sent loan yields higher on a spot basis, the decline in Libor expectations has offset this change. As seen in Figure 3, the yield to maturity of the loan index has continued to decline this year when the Libor forward curve is taken into account. In fact, the current level of 5.5% is the lowest in our analysis, which dates back to the start of 2017.

For reference, the loan index yield to maturity is currently about 40bp higher than the yield to worst of the high yield bond index based on spot Libor. When adjusting for the Libor forward curve, though, loans have a yield roughly 15bp lower than high yield bonds. In fact, the two markets have had very similar yields until recently (Figure 4). While bond yields widened in the recent sell-off, loan yields adjusted for the Libor forward curve did not. This will likely make it difficult to garner interest in the loan market from non-dedicated buyers unless prices decline further.

In the past, when Libor was below 1%, demand was boosted by the presence of Libor floors. As Libor rates have trended lower, Libor floors have been a growing topic of conversation for investors again. As we noted in *Leveraged Loans: Lessons from January's Large Supply*, the vast majority of loans issued so far this year and throughout 2019 have come with a Libor floor set at 0bp – continuing a trend seen over the past few years.

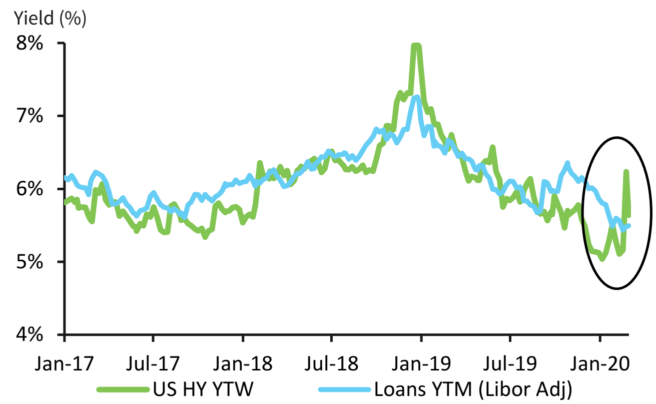
Although new issues have skewed toward loans with a Libor floor of 0bp, 37% of the loan market has a floor above 0bp. As rates approach levels where the Libor floors may provide a benefit to investors, we evaluate loans with different Libor floor levels. Given that 94% of the loan index has a floor of either 0bp or 100bp, we limit our analysis to loans with floors at either one of those levels.

FIGURE 3. **Loan Yields Did Not Increase in the Recent Sell-Off When Adjusted for the Libor Curve**



Source: S&P LCD, Bloomberg, Barclays Research

FIGURE 4. **Libor-Adjusted Loan Yields Have Not Increased Like Bond Yields**



Source: S&P LCD, Bloomberg, Barclays Research

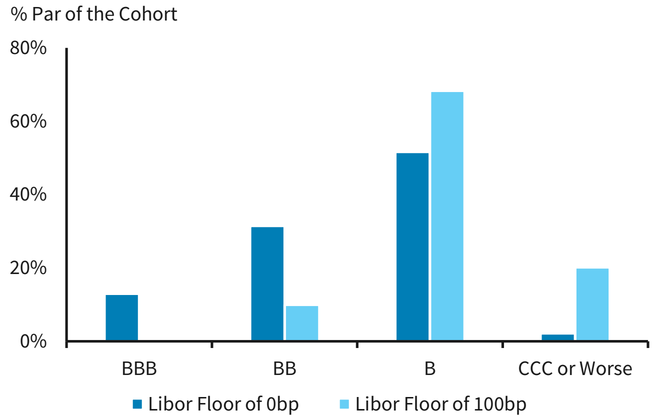
Understandably, the cohort of loans with Libor floors at 100bp tend to be lower quality, as investors have been able to push back on Libor protection further down the rating spectrum (Figure 5). On average, the S&P rating of the 100bp cohort is roughly two notches lower on a par-weighted basis than the cohort with a Libor floor of 0bp.

This rating skew between the two buckets is likely driving differences across other characteristics. For example, the cohort with a Libor floor of 0bp has a lower nominal spread and higher average price than the loans in the 100bp group. In addition, the 0bp cohort has a greater average issuance size, in line with what we would expect from higher quality loans.

CLO managers tend to be skewed toward loans with a Libor floor of 100bp compared with the market (Figure 6). While this may appear to point to a preference for better protection from low rates, the skew is in line with the level expected given the CLO ratings skew. Put simply, CLO managers are more exposed to single-B loans, which in turn are more likely to have a floor of 100bp. Regardless, if Libor drops materially below 1%, this could help cushion the blow for CLO equity, since liabilities do not have a similar floor. With 1m and 3m Libor currently on top of each other, there may also be some mismatch of cash flows for CLOs and loans, but this should be a short-term effect.

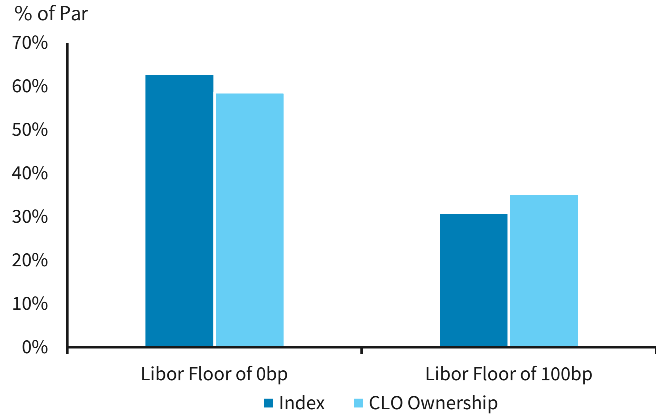
The year-to-date price change of the bucket with 100bp floors has been -$1.35, while the change for the bucket with 0bp floors has been -$1.57. To account for the ratings difference between the two, we adjust the 100bp bucket to have the same ratings weights as the 0bp bucket. As a result, the adjusted price change for the 100bp bucket is -$1.07 when applying the higher-quality ratings breakdown. By making the adjustment, we find that the 100bp bucket would have outperformed the 0bp floor bucket by $0.50 if the two had the same ratings makeup. This highlights the premium that investors have placed on loans with greater protection from low Libor levels. We would expect this premium to remain unless there is a major reversal in the stance of the Fed.

FIGURE 5. Loans with Libor Floors of 100bp Are of Higher Quality



Source: S&P LCD, Barclays Research

FIGURE 6. CLO Ownership Skews toward Loans with Libor Floors of 100bp



Source: S&P LCD, Kanerai, Bloomberg, Barclays Research

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