Ares Global Liquid Credit: Market Views

A Tale of "Haves" and "Have Nots"

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INTRODUCTION

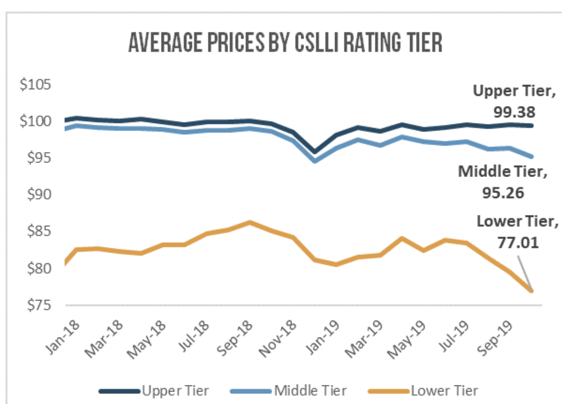
As the impact of late-cycle sentiment and lower interest rates heightens across global capital markets, the subsequent effects have reverberated within the leveraged loan market. In this tenuous environment where an earnings miss can cause loan prices to instantly drop 10-50 points, we find ourselves asking how to best navigate these choppy waters. As we assess the underlying fundamental quality of the market, we have taken a closer look at the B3 rating category, which has been the largest detractor to index performance this year alongside CCC-rated loans. We speculate whether the market might be failing to discern the distinction between the technical and fundamental pressure that has resulted in the broad-based punishment of lower quality loans amidst the headlines of idiosyncratic events. This has especially manifested itself in the confusion surrounding the loan facility rating vs. corporate family rating ("CFR") as it relates to CLO appetite for this paper. As such, we believe B3 CFR rated loans with a B1/B2 facility rating offer attractive value amidst what we view to be an overexaggerated "buyer's strike." **In the following thought piece, we investigate the "haves" and "have nots" in today's below investment-grade market and reveal how discerning credit selection can mitigate both technical and fundamental trends alike.**

BACKGROUND

U.S. bank loans have recently received more attention and scrutiny than usual as dispersion amongst credits is at recent highs. The bifurcation in the loan market that first began at the end of the 2Q'19 has since resulted in the underperformance of lower tiered credits relative to the broader market. This trend is most clearly demonstrated by the dispersion in loan prices across ratings tiers in the Credit Suisse Leveraged Loan Index ("CSLLI"), as seen in the following chart[1].

As fears of a global slowdown grew over the summer, investor tolerance for more storied credits evaporated as certain loans gapped down on the heels of earnings misses, reduced guidance, and liquidity concerns, while performing loans continue to be bid close to par. This year, the market has seen 23 out of 1,960 names in the CSLLI fall by more than 10 points in one day, while 107 names have fallen by 10 points for the year-to-date period ending September 30, 2019. Due to our focus on credit fundamentals, Ares did not own any of the loans that fell during the single session and only a single digit percentage of the 107 for the year-to-date period[2,3]. Though the increased volatility in single issuers has generated broad-based headlines in the media, these dramatic price moves have been driven by idiosyncratic issues. Conversely, we believe the broader downward trend of B3-rated loans presents an opportunity that is largely technical in nature.

The market bifurcation has been particularly apparent within the B3/B- segment as retail capital, which once comprised as much as 20% of the leveraged loan holder base, has steadily left the market since late 2018 to comprise less than 9% of the market today[4]. Meanwhile CLOs, which have grown from 43% of the market in 2013 to a majority of the leveraged loan holder base today, are limited in their enthusiasm to take on lower-rated credits. This shift in holders, combined with growth in the single-B segment (approximately 40% in 2007 to 62% as of October 31, 2019[5]) has resulted in the lower segment of the market struggling to find a natural buyer, which has been clearly evidenced over the past few months by the aforementioned dispersion across average prices by rating tier.



As the single-B portion of the market has grown, investors have become increasingly concerned with the market's ability to digest this lower-tier supply and the underlying fundamental quality of this segment. While we do agree that lower quality loans warrant further scrutiny, we also believe that the market does not fully comprehend the composition of this ratings cohort.

SO WHAT IS THE MARKET MISSING?

One key nuance to the B3 narrative that we believe both the market and media outlets are misunderstanding is the distinct difference between B3 *corporate family* rating and the loan *facility* rating. While B3 corporate family rated issuers represent approximately 30% of the loan market, B3 facility-rated loans represent just 8% of the loan market. Importantly, the facility level is a primary driver of CLO performance, as there are limits on facility-level CCC-rated exposure within a CLO, typically set at 7.5%. However, it should be noted that CLOs are *not* forced sellers if these limits are breached; rather, managers are unable to add additional CCC-rated exposure and are required to mark-to-market this excess exposure.

While much has been said about the potential downgrade impact to CLOs, we ultimately believe that the following thought experiment is instructive in dispelling the myths surrounding this risk. The median overcollateralization ("OC") cushion for CLOs today stands at 4.28%, while median CCC-exposure is 3.30%[6]. In the unlikely event in which all B3 facility-rated loans are downgraded, sending median CCC-exposure to approximately 12% in the median CLO, market prices on these loans would need to be less than 20 cents—a truly apocalyptic scenario—to trigger deleveraging in the median CLO.

Though we note that CLOs do have tests that measure exposure to corporate family ratings, the impact of failing these tests results in limitations on a manager's ability to buy *additional* B3 or lower corporate family rated debt. In today's market environment, we have observed a pickup in downgrades. When combined with recent heavy B3 CFR issuance, these tests have consequently been pressured, leading to a "buyers' strike" as each new B3 primary loan issuance potentially triggers a further repricing of the secondary B3 loan market. **In short, we believe the technical pressure of the "buyer's strike" on B3-rated loans and the loan market's subsequent lag in identifying this trend has led to an interesting opportunity for discerning institutional loan investors.**

NOT ALL B3-FACILITY RATED LOANS ARE CREATED EQUAL

As alluded to above, while corporate family ratings are regularly tested by CLOs, we note that CFR downgrades alone do not lead to deleveraging or a CLO "blow up." However, B3 corporate family ratings can be less efficient for CLOs, and possibly ineligible in certain funds failing the tests described above. Within the B3 CFR segment of the market, we are directing our attention to relative value differences between loan-only capital structures and more traditional capital structures (with junior debt beneath the first lien) and what we believe are mispriced risks between the two. The basis for this mispricing is driven by the presence of this junior capital – while improving the risk profile of the first lien, it often results in a lower corporate family rating, potentially subjecting the loan to the impacts of the technical pressures described above. **Drilling down into the single-B subset of the market, we find that not only do loan-only structures offer less absolute yield but also carry significantly more leverage through the security, making them even less compelling on a spread per turn of leverage basis in general.**

	Single-B Loan-Only Issuers[7]	Single-B Loan Issuers with Subordination[7]
Average Leverage	5.06x	4.75x
Spread per Turn of Leverage	86	104

Furthermore, loan-only issuers have historically demonstrated lower recovery rates than loan issuers with subordination, as evidenced by a historical average recovery rate of 56% compared to an average recovery rate of 71% for those loans with subordination[8]. We find that by assuming a 2.1% historical average default rate for single-B risk and implied loss rates, expected returns on loan-only names are only 6.2% compared to 6.7% for loans with subordinated debt, suggesting that loans with subordination are the better buy for investors focused on identifying lower risk, well-performing loans[9].

The B3 CFR segment also further presents an attractive relative value opportunity in comparison to B1/B2 bonds when looking at the most liquid segment of the market (loan tranche sizes > $1 billion). As of October 31, 2019, the average B1/B2 facility-rated loan with a B3 CFR is yielding approximately +200 bps more relative to comparably-rated high yield bonds. In comparison, this relationship in less-technically dislocated environments has historically seen loans trade 75 bps *tighter* than high yield bonds as a result of their secured position in the capital structure[10].

CONCLUSION: WHERE DO WE GO FROM HERE?

From a fundamental perspective, there have certainly been credits with idiosyncratic issues, such as Deluxe Entertainment, 4L/Clover Technologies, and McDermott International, amongst others; however, we feel that a very attractive technical opportunity has developed in the lower-rated bank loan market that is distinct from credit-specific concerns. The diminished demand for leveraged loans from retail accounts, coupled with the growing supply of lower-rated B3 corporate family rating debt, has led the CLO community to either oversell or outright abandon the lower-rated segment of the market. As highlighted above, many of these B3 CFR secured loans are rated B1 / B2 at the facility level, which are currently trading at the 95th percentile on a spread basis compared to similarly-rated high yield bonds. We eventually expect to see that the relationship between bonds and loans will normalize. **Ultimately, we find that the current disconnect provides an attractive risk-adjusted return opportunity for investors with sector knowledge and industry insights such as Ares whom are positioned to take advantage of this technical dislocation.**

For any further information, please contact ***credit@aresmgmt.com***.

ENDNOTES

(1) Source: Credit Suisse. As of October 31, 2019. Note: Upper Tier includes Split BBB and BB; Middle Tier includes Split BB, B, and Split B; Lower Tier includes Split CCC and Default.
(2) Note: Excludes Ares Managed CLOs.
(3) Note: Ares owned 8 out of 107 loans that fell by 10 points for the year-to-date period ending September 30, 2019. Past performance is not indicative of future results.
(4) Source: JP Morgan Market Intelligence. Post-crisis historical average recovery rate calculated based on annual recovery rates from January 1, 2010 through YTD 2019. As of September 2019.
(5) Source: Credit Suisse Leveraged Loan Index. As of October 31, 2019.
(6) Source: Wells Fargo CLO Market Update. As of September 10, 2019.
(7) Source: Credit Suisse Leveraged Loan Index, Ares QR². As of June 30, 2019.
(8) Source: JP Morgan Market Intelligence. As of June 19, 2019.
(9) Source: Credit Suisse Leveraged Loan Index, Ares QR². As of October 31, 2019.
(10) Source: Credit Suisse Leveraged Loan Index, ICE BofAML Single-B U.S. High Yield Index. As of October 31, 2019.

INDEX DEFINITIONS

The Credit Suisse Leveraged Loan Index ("CSLLI") is designed to mirror the investable universe of the $US-denominated leveraged loan market. The index inception is January 1992. The index frequency is daily, weekly and monthly. New loans are added to the index on their effective date if they qualify according to the following criteria: 1) Loan facilities must be rated "5B" or lower. That is, the highest Moody's/S&P ratings are Baa1/BB+ or Ba1/BBB+. If unrated, the initial spread level must be Libor plus 125 basis points or higher. 2) Only fully-funded term loan facilities are included. 3) The tenor must be at least one year. 4) Issuers must be domiciled in developed countries; issuers from developing countries are excluded.

The BofA Merrill Lynch Single-B US High Yield Index is a subset of The BofA Merrill Lynch US High Yield Index including all securities rated B1 through B3, inclusive.

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