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State of the Loan Market (Third of a Series)

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Besides the Annual LSTA Conference, the other recent industry gathering of note was the Creditflux CLO Conference in NY. The focus here was trends in structured finance, from both issuer and investor perspectives.

Collateral loan obligations, as we've covered in a special series [link], represent the majority of loan buyers in the broadly syndicated market. Assuming almost $950 billion in the leverage loan universe, roughly half is in the hands of CLO vehicles. That's close to $500 billion of loan demand.

As our *Chart of the Week* shows, other funds, including separate managed accounts, are a fast growing category of institutional investors for leveraged loans. Sources estimate that SMAs are now around $140 billion of demand for floating-rate assets.

The advent of risk retention rules almost one year ago meant that CLO managers must own 5% of the vehicle capital in the form of equity. This "skin in the game" would incent managers to be as careful with their investors' money as they would be with their own. At least, that was one of the assumptions behind the regulators' thinking.

It was also predicted that only deep-pocketed asset managers could afford the significant capital it would take to issue multiple CLOs over time. Expectations of lower future annual issuance were widespread among market observers.

This has not proved to be the case. Total CLO activity so far this year, at $95 billion, is well ahead of 2016's full-year volume. This is driven in part by the compelling economics that afford both CLO investors and issuers.

For one thing, CLO liability costs, largely driven by Libor spreads of the triple-A debt tranches, have shown "surprising spread compression" this year. The cost today is 117 bps, 25 bps below the level recorded in October 2016. That's also the case for middle market CLOs, where volumes are up smartly this year.

On the asset side large liquid loan spreads have continued to erode. Refinancings have been one of the hallmarks of 2017. That's made it especially challenging for managers to keep their vehicles full. Cash is not an investor's (or issuer's) friend.

Institutional issuers at the Creditflux conference also remarked on the complexity of managing vehicles governed by so many intertwined metrics related to asset pricing, ratings, size, industry, and terms. As asset spreads compress, there's also a race to refinance CLO debt tranches to keep the equity arbitrage economics in line.

The allergic reaction by managers to being underinvested is understandable. Their investors aren't paying management fees to earn passbook savings rates. On the other hand, in a market where good structures and decent yielding assets are scarce, loading up on dicey stuff is a questionable long-term strategy.

It does demonstrate in bright lights one of the major drivers in leverage lending this year. Even for experienced asset managers, it’s ABC – Anything But Cash.