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ABS Research

Weakened Loan Documents Leave Non-Investment-Grade CLO Debt on Potentially Shaky Ground in 2019

Analysts:

Stephanie K. Mah | Vice President | stephanie.mah@morningstar.com | +1 646 560-4571
John Nagykery | Vice President | john.nagykery@morningstar.com | +1 646 560-4537

Analytical Manager:

Rohit Bharill | Managing Director | rohit.bharill@morningstar.com | +1 646 560-4543

Morningstar Perspective

As supply and demand imbalances have tipped the scales in the leveraged loan market, with covenant-lite loans, EBITDA add-backs, and other issuer-friendly terms becoming the norm, Morningstar Credit Ratings, LLC believes that the collateralized loan obligation market is vulnerable to credit shocks should the economy start to deteriorate. Non-investment-grade and equity tranches are especially susceptible to an economic downturn because of weakening loan terms and highly leveraged portfolios where subordination or excess spread may not be enough to absorb potential losses down the road. Investment-grade CLOs, particularly notes rated AAA, are less vulnerable to a deterioration in the economy, considering existing subordination and credit enhancement levels. However, we are actively monitoring our rated CLOs by running sensitivity tests to determine how susceptible the rated notes are to lower recoveries and the corresponding effect to the break-even conditional default rate. Morningstar's U.S. CLO Ratings Methodology covers increased default probability during a recession by typically applying a constant conditional default rate, or flat CDR curve, for the life of the transaction that is based on the historical leveraged loan performance across various sectors and industries. The peak observed default experience is assumed to correspond to an A rating stress. However, Morningstar may analyze different front or back loaded curves as appropriate.

How We Test Recovery Sensitivities

As described in our U.S. CLO Ratings Methodology (October 2018), we conduct a sensitivity analysis to determine how sensitive our ratings on CLOs are to lower leveraged loan recoveries. We lower our recovery-rate assumptions to account for possible deterioration in the leveraged loan market. We use Intex Calc for this analysis for both new issue and on-going surveillance transactions. We start with the base-case recovery-rate assumption for the tranche based on the rating stress and then test the sensitivity by reducing the recovery rate generally by 1% until the portfolio's break-even conditional default rate no longer passes the adjusted target break-even conditional default rate. We discuss the results of these sensitivities internally and compare the structural features of each transaction.

Borrower-Friendly Terms Dot Record Issuance Landscape

CLO new issuance in 2018 reached the highest level on record, totaling $128.1 billion, besting the previous record of $123.6 billion in 2014, according to LPC, a global provider of information on the syndicated loan and high yield bond markets. The increase in leveraged loan issuance has remained in lockstep with this growth, with the sector exceeding $1.24 trillion last year. With this issuance boom, however, we have seen the continuing trend of more borrower-friendly terms being offered, resulting in less restrictive documentation. Portfolio compositions have completely reversed, as the covenant-lite share of U.S. new issue institutional loan volume accounted for roughly 80% in 2018, eclipsing the 1.5% reported in 2009, according to LPC.

Moreover, the scope of the covenant-lite loan has also changed over the past decade. Historically, if a loan was characterized as covenant-lite, it meant that the loan agreement included fewer financial maintenance covenants, such as an interest coverage ratio, a leverage ratio, and a cash flow ratio, to name a few. After the crisis, we have seen more loan agreements characterized as covenant-lite even though they may require fewer maintenance tests than pre-crisis or even no maintenance covenants altogether. In the absence of maintenance covenants, lenders may have diminished abilities to step in with required remedies should credit deteriorate.

Borrower-friendly terms may also include flexible agreements whereby the borrower can issue more debt or even shift collateral. For example, the absence of "no sale of assets" or restricted payment covenants in the credit agreements limits the protections to the lenders on asset transfers or on borrowers selling collateral without first paying down the loans. While the probability of defaulting may not change, there is less advance notice of credit deterioration for investors, and recoveries will very likely be lower than previously seen.

In addition, EBITDA add-backs have also proliferated, as lending volume has escalated. In a leveraged buyout, a company may seek to more accurately reflect the profitability of its operation by adding back one-time or specific owner-incurred expenses or expected future cost savings to earnings. EBITDA add-backs are subjective, with the increased usage favoring the company being evaluated because it facilitates higher leverage. Incremental facility, another borrower-friendly feature, has also been showing up more frequently in loan agreements. This option enables the borrower to either increase the size of the loan or add a new tranche without the approval of the current lender(s).

While back-door provisions are not necessarily the norm, concerns have increased since J. Crew used this mechanism in 2017 to transfer a portion of its intellectual property assets to an unrestricted subsidiary to help facilitate borrowing against the transferred assets. The proceeds were subsequently used to pay off subordinated debt at a discount. The publicity of the J. Crew case by its lenders has subsequently prompted some secured lenders to include language which would prevent this type of transfer to unrestricted subsidiaries in their facilities as investors were made aware of the impact of having loose asset transfer provisions.

CLO Issuers Negotiate More Flexible Terms

Likewise, 2018 saw more concessions offered that can have a negative effect on the CLO side. With demand for CLOs remaining strong, issuers have more flexibility with the terms and have included features that investors should take note of, including more aggressive concentration limits and excess par flush with a refinancing of only the Class A or most senior class of notes. Higher concentration limits can increase the risk in a transaction because the portfolio of underlying loans may be more exposed to a downturn in a sector. Cyclical sectors, such as energy and metals and mining, which experienced high default rates during the financial crisis, may come under pressure in another recession. In addition, an excess par flush arrangement can also potentially increase the risk to junior bondholders; the feature enables the issuer to pass trading gains through to the equity notes before paying off the more senior notes. For more information, please see Push for Higher Equity Returns Leads to Weaker Structural Features in CLOs.

The loosening of loan documentation, more borrower-friendly terms, and additional concessions on the debt side are the result of the strong demand for leveraged loans, which investors have found attractive in a rising-interest-rate environment because of their floating interest rate. With the Federal Reserve becoming more cautious and market expectations for fewer interest-rate increases this year, we may see lenders become less accommodating to borrowers as demand pulls back. In 2018, there were more new borrowers on the lower end of the credit scale, or in the B/B- or below range, not leaving much cushion in an economic downturn. This increase in B/B- issuance raises concerns for CLOs tripping their CCC buckets in the next market downturn.

Recoveries Likely to Decline Amid a Weakening Economy

So far, the loosening of loan documents and increase in borrower-friendly terms have not had any repercussions for investors. However, once the economic cycle shifts, we will likely see recoveries take a hit because of the absence of such maintenance provisions or the inclusion of more disciplined borrower terms. Morningstar will continue to monitor the underlying loan portfolios by running recovery sensitivity tests and other stresses to be proactive in identifying credit deterioration.

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