Press Release

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A member of MUFG, a global financial group

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Selective Investors Drive Wedge Between Leveraged Loan Pricing and Credit Ratings, MUFG Says

Greater scrutiny results in higher interest rates on certain loans despite favorable credit ratings and active market

New York, January 28, 2020 – Discriminating investors are driving the interest rates on certain leveraged loans higher than what their issuers' credit ratings appear to warrant, according to **Grant Moyer**, Head of Leveraged Capital Markets at MUFG.

Mr. Moyer delivered his remarks at an MUFG media roundtable in December 2019 to discuss the outlook for leveraged finance in 2020 alongside **Jeffrey Knowles**, Co-Head of Debt Capital Markets, and **Art de Peña**, Head of Loan Syndications and Distribution.

The effect of selective investors on leveraged loan pricing

Investors in leveraged loans, which typically carry a higher risk of default than their investment-grade counterparts, are "definitely doing more homework these days," said Mr. Moyer, pointing out that a number of loan financing deals have "struggled despite the fact that the market was relatively open." The reason, he said, was the growing number of "discerning" investors who are conducting thorough and more critical evaluations of lenders to better understand a their business models and path to profitability—regardless of how high their credit ratings may be.

Mr. Moyer expects a healthy appetite for highly rated issuers of leveraged loans in 2020, and he believes tightening credit spreads among such issuers will reflect this trend. However, he still believes "investors are going to differentiate between assets" and added that such careful discrimination has already resulted in higher interest rates for certain leveraged loans that are not reflective of their issuers' relatively high credit ratings.

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Key themes to watch in 2020

In the short term, MUFG's Leveraged Capital Markets team believes that low interest rates in the United States will promote attractive debt-funding costs for issuers and do little to diminish investors' pursuit of higher yields that has fueled demand for corporate debt by institutional investors. Yet the team notes a number of looming risks this year—including the prospect of sputtering global economic growth and the U.S. elections—that could spur market volatility and affect leveraged loans.

Other themes to watch include the following:

1. ***Supply***: The team expects leveraged-loan supply to decline by roughly 11% from last year—with an estimated issuance of $275 million—on the back of lower merger-and-acquisition (M&A) volume due to high valuations.

2. ***Bifurcation***: Last year saw a performance divide between high and low rated issuers of leveraged loans. The team believes this divide will continue, with investors showing a preference for B3-rated issuance or higher, especially as collateralized loan obligations (CLOs) seek to limit their exposure to lower-rated issuers to protect themselves from potential downgrades.

3. ***The CLO market***: CLOs represent the largest source of demand for leveraged loans, having purchased more than 70% of new issuances in 2019. The majority of CLOs have a 7.5% limit on holdings rated below Caa1/CCC+, prompting increased scrutiny by CLO managers for buying B-rated issuances. With slightly more than half of the Leveraged Loan Index rated B or lower, CLO managers are likely to remain cautious in 2020.

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4. ***M&A and "dry powder" for private equity***: According to Refinitiv LPC, fundraising for corporate acquisitions (buyouts) in the United States surpassed $250 billion during the first three quarters of 2019, outpacing that of every full year since 2007. Sponsor-backed loan issuance (i.e., loans issued by private-equity sponsors of such buyouts) constitutes roughly 60% of the leveraged loan market, and the substantial amount of cash on hand for deployment by private-equity funds may drive M&A volume in 2020, especially if the U.S. economy performs better than expected.

5. ***Borrowing terms***: Over the past few years, large private-equity sponsors have pushed the limits of traditional credit protections, resulting in significant flexibility to incur additional debt, make adjustments to EBITDA (or earnings before interest, taxes, depreciation and amortization), and make restricted payments, among other provisions. If economic growth slows, corporate borrowers and private-equity sponsors who choose to take advantage of these favorable terms may find that larger equity contributions may not be sufficient to ensure recovery in an event of a loan default.

The evolution of MUFG's Capital Markets group

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[1] As of September 30, 2019, and according to the exchange rate of 1 USD=¥107.9 (JPY) as of that date

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