Bank Loans

Secondary Loans Shrug Off Large Deals

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Bank loans delivered positive returns with secondary loan discount margins tightening over the quarter.

Between 2000 and 2016, the primary loan market would typically price about 25 new money transactions annually of $2.5 billion or larger. Those numbers rose to 54 transactions in 2017 and 43 transactions so far in 2018. We view this trend with a skeptical eye. Such large transactions are a result of large leveraged buyouts (LBO), which have priced at the highest multiples on record. Those multiples, excluding fees and expenses, averaged more than 10x in 2017 and 2018, compared to 8–9x in 2006 and 2007 (see chart, top right).

Notwithstanding some large notable transactions, there has been a general lack of supply and increased loan demand this summer. Institutional loan volume totaled only $89 billion in the third quarter, the lowest since the first quarter of 2016. Year-to-date institutional issuance of $362 billion is down 8 percent year over year. Meanwhile, CLO issuance is on pace to set an annual record. This speaks to why the market has absorbed large transactions with such ease: The technical imbalance has kept secondary spreads from widening over the summer and in early fall. The Credit Suisse Leveraged Loan index gained 1.9 percent in the third quarter, making it the 11th consecutive quarter of positive returns. During the quarter, three-year discount margins tightened to 381 basis points and set a new post-crisis low of 379 basis points, though spreads remain wide of the historical low of 230 basis points (see chart, bottom right).

The negative impact of general risk-off sentiment came late in the loan market. U.S. equity market volatility spilled into high-yield corporate bonds in October before it spilled into loans. By the end of October, bank loan secondary discount margins had widened by only 15-20 basis points, compared to a more pronounced effect in similarly-rated corporate bonds. Absent a major credit shock, we think CLO demand for loans will continue as investors pencil in another Fed rate hike in December. In light of still tight spreads and high leverage and price multiples, we remain highly selective in how we identify value in the loan market.

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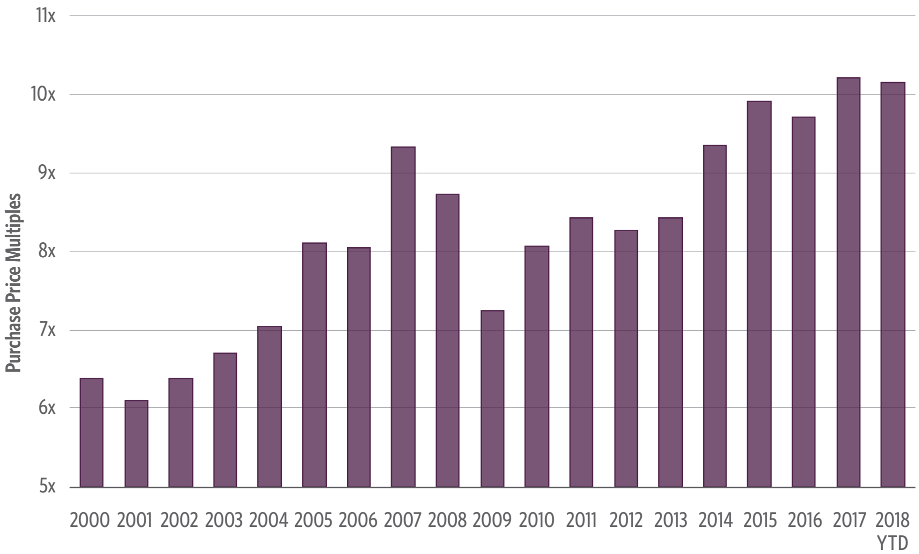
LBO Purchase Price Multiples Set Record Highs

Average Purchase Price / EBITDA Multiples of LBO Transactions

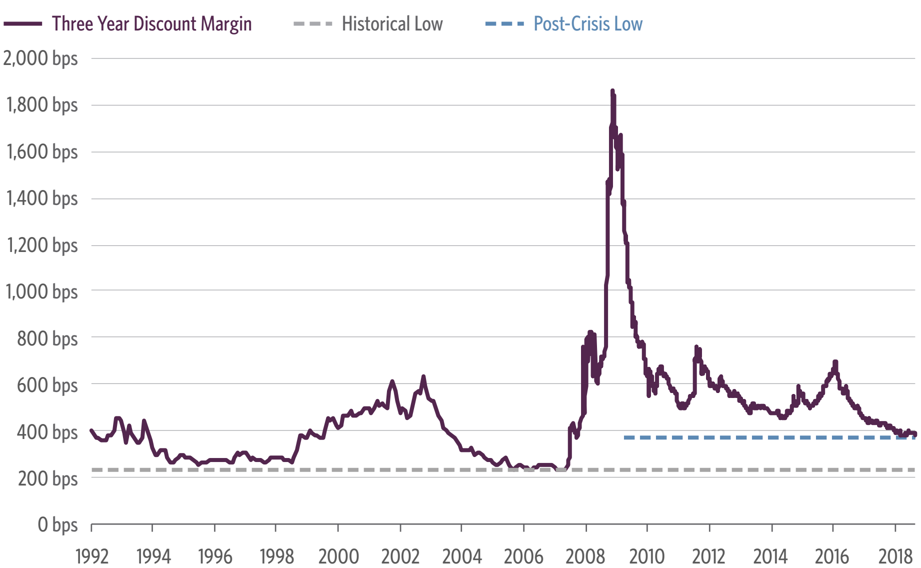


Source: S&P LCD, Guggenheim Investments. Data as of 9.30.2018.

Large leveraged buyouts have priced at the highest multiples on record. Those multiples, excluding fees and expenses, averaged more than 10x in 2017 and 2018, compared to 8–9x in 2006 and 2007.

Discount Margins Set New Post-Crisis Low, But Are Wide of Historical Tights

Three-Year Discount Margins, in Basis Points



Source: Credit Suisse, Guggenheim Investments. Data as of 9.30.2018.

During the third quarter, three-year discount margins tightened to 381 basis points and set a new post-crisis low of 379 basis points. Following some spread widening at the end of October, spreads remain near post-crisis low, but wide of the historical low of 230 basis points.