GSO
CAPITAL PARTNERS

MAY 2020

Impact of Loan Downgrades on CLOs

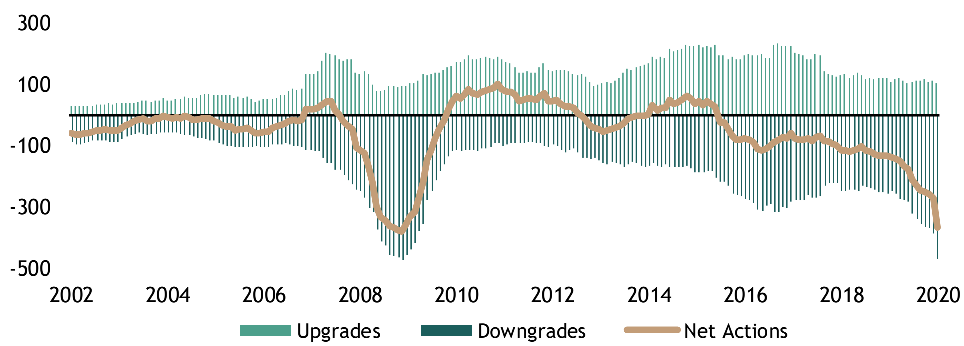
Overview

The effects of recent loan downgrades and defaults are beginning to ripple through CLO portfolios, and several rating agencies have recently announced a wave of potential rating actions on CLO tranches. We provide here a review of what has driven this activity and the implications for the loan market and CLOs.

Sweeping Downgrades Weigh on CLO Collateral

In the wake of deteriorating fundamentals, driven primarily by significant decreases in revenue growth, rating agencies began downgrading US loan and high yield issuers in earnest beginning in early March. As expected, the majority of the rating actions were in COVID-19-affected sectors. The Travel, Autos, and Transportation sectors accounted for the largest share of downgrades, followed by Metals and Retail.[1]

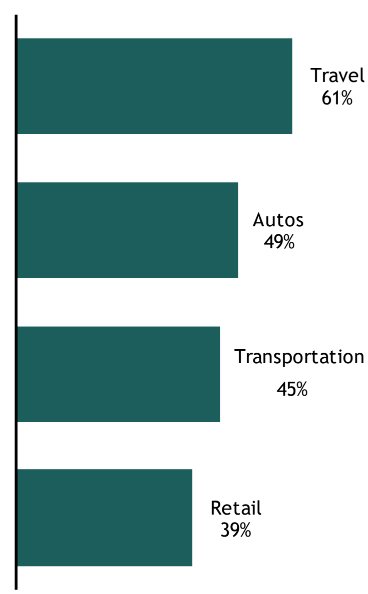
Rolling Last-Twelve Months US Loan Ratings Actions by Number of Loans[2]



In the US, the downgrade/upgrade ratio for the S&P/LSTA Leveraged Loan Index hit an unprecedented 11:1 at the end of March, as the portion of the Index rated B- and lower by S&P rose to 28%, a record high. Likewise, the number of US companies rated B3 and below by Moody's surged 52% quarter-over-quarter. A total of 19% of the US loan universe is now composed of loans rated B3 and below, representing \$270 billion in par value outstanding.[3] In Europe, the trend has been similar. S&P, Moody's and Fitch have collectively downgraded approximately 17% of the number of rated European loans outstanding.[4]

A majority of loan rating actions were in COVID-19-affected sectors

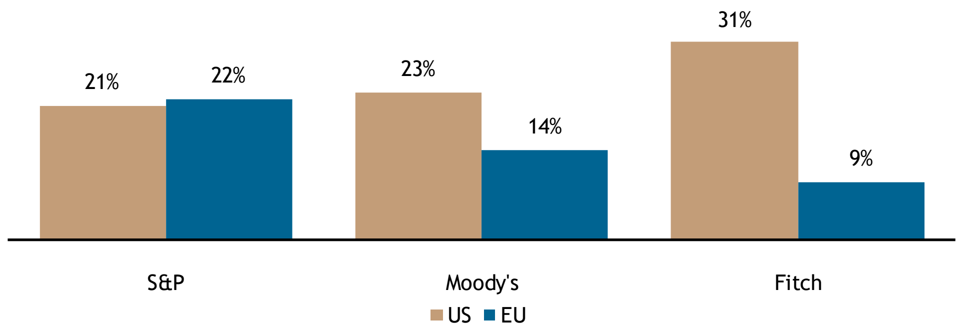
Percentage of Loans Downgraded Since March 2020



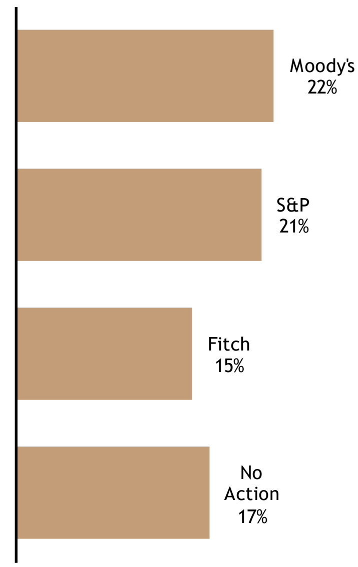
[1] BofA Global Research, S&P LCD, April 24, 2020. Represents percentage of par downgraded since March 2020.
[2] Last-twelve-months loan index rating actions. Morgan Stanley Research, S&P/LCD, March 31, 2020.
[3] JP Morgan US High Yield and Leveraged Loan Strategy, April 23, 2020.
[4] Barclays Research, Bloomberg, April 27, 2020. Broad loan universe represented by the S&P European Leveraged Loan Index.

It is worth noting that the deterioration in ratings began in 2015 and has exhibited a progressive decline that has accelerated with the onset of COVID-19. This pattern is notably different than the one preceeding the 2008-2009 GFC, in which the detioration in ratings did not start until the crisis began to unfold and the entire deterioration occurred over approximately six quarters.

Percentage of Rated Loans Downgraded or Placed on Negative Outlook in 2020[5]



Percentage of Loans Downgraded within US CLO Portfolios under Rating Agency Review[9]

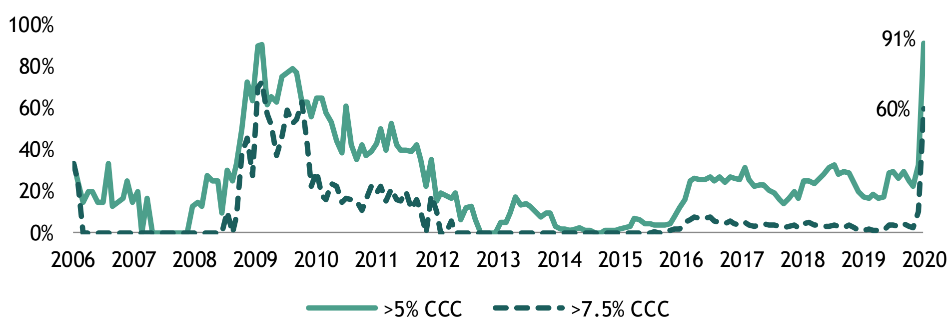


The loan downgrade wave has led to a degradation of the ratings profile for the below-investment grade loan universe. Notably, the amount of CCC-rated US loans has increased by almost 2%, or $37 billion this year. US loans rated CCC and below now represent 8.0% of the broad US loan market.[6]

Impact to CLOs

Looking at loans held only in CLOs, the percentage of US CLO portfolios invested in assets rated CCC and below nearly doubled to 8.4% as of April 28 from 4.3% as of March 31. In Europe, 4.9% of CLO portfolio holdings are rated CCC and below, up from 3.3% as of March 31. Morgan Stanley estimates that CCC-rated assets in US CLO portfolios may rise as high as 14%, implying additional rating downgrades ahead.[7]

Percentage of CLOs with CCC Baskets in Excess of 5% and 7.5%[8]

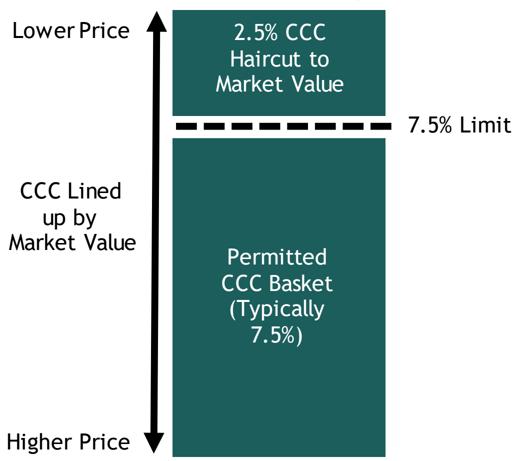


60% of US CLO CCC baskets exceed 7.5%[8]

[5] Barclays, S&P/LCD, April 28, 2020. Represents the estimated percentage of rated loans by agency that have been downgraded or placed on negative watch.
[6] S&P/LSTA Leveraged Loan Index, April 28, 2020.
[7] Morgan Stanley Research, Leveraged Finance and CLO Strategy, April 28, 2020.
[8] Wells Fargo Research, April 28, 2020.
[9] Nomura, S&P, Moody's, April 22, 2020.

CLO structures are sensitive to ratings, which – if eroded beyond set limitations – can lead to trading restrictions as well as to cashflow diversion away from equity and subordinated noteholders. These features are designed to limit adverse portfolio asset migration and deleverage the structure through retaining excess interest to either purchase additional collateral or repay liabilities. One such limitation is on CCC-rated assets, which are typically limited to 7.5%. While CLOs are never forced sellers, once the 7.5% limit is breached, the structure then marks to market the overage, beginning with the lowest-priced loans, which reduces the value of the collateral for purposes of calculating the interest diversion and overcollateralization ("OC") tests.

10% CCC Example

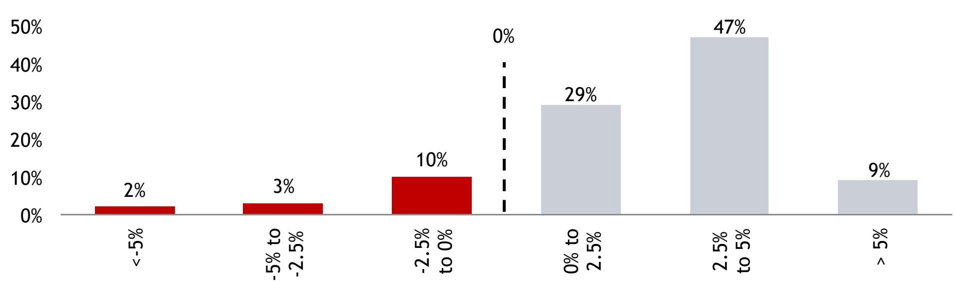


Additional haircuts may also be applied to reduce the value of any defaulted assets in a CLO portfolio or assets purchased at deep discounts. Morgan Stanley estimates that default rates in US CLOs could increase to 10% in the next year.[10]

The reduction in value of the collateral caused by CCC excesses and higher defaults has eroded CLO asset coverage ratios such that, according to our estimates[11], 21% of all US CLOs are now failing their interest diversion test and 15% are also failing an OC test. At their peaks during the GFC, those numbers reached 77% and 55%, respectively.[12] In Europe, no CLOs are currently failing either of these tests.

We estimate that 21% of US CLOs are failing their interest diversion test

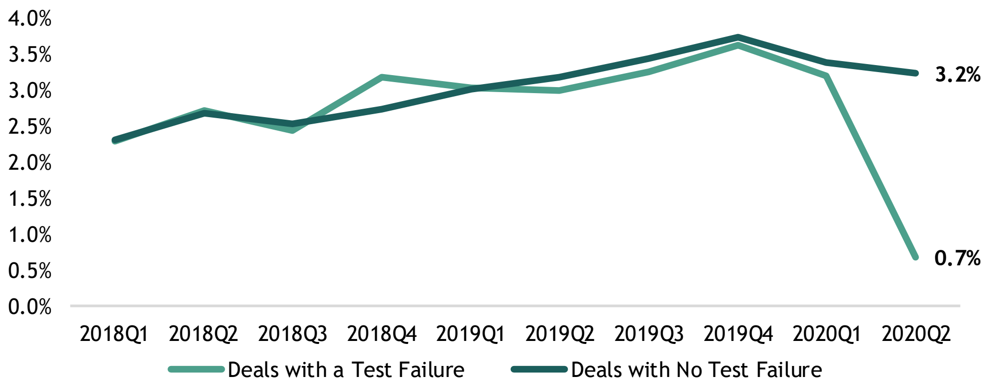
April Reported Junior OC Test Cushion for US CLOs[13]



[10] Morgan Stanley Research, Leveraged Finance and CLO Strategy, April 28, 2020.
[11] Per data from Intex, April 28, 2020.
[12] Wells Fargo Research, April 28, 2020.
[13] Citi Research, April 17, 2020.

With projections for downgrades and defaults on the rise, it seems likely that more CLOs may breach these limitation tests that, by design, will lead to interest diversion away from equity holders. As stated above, diversion amounts are applied to fortify or delever the structure.

Equity Cash-on-Cash for Deals with and without Test Failure[14]



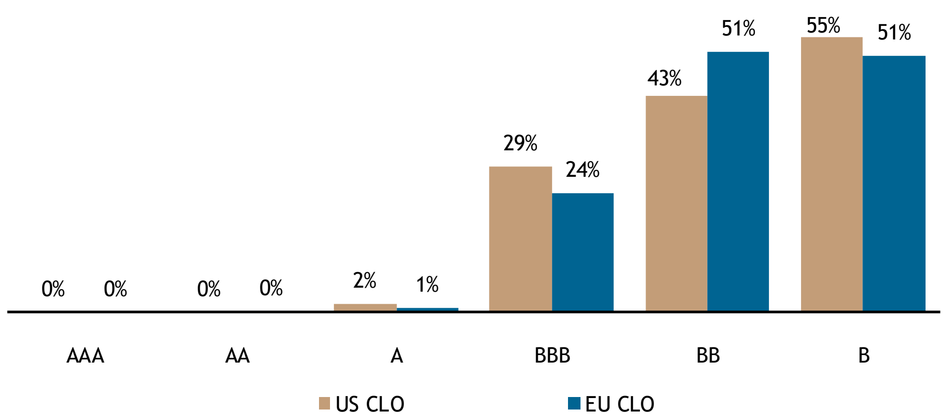
Rating Agencies Take Action on CLO Tranches

As a result of the underlying rating pressure on CLO collateral, as well as expected future fundamental borrower stress, Moody's and S&P have respectively placed 857 and 356 broadly syndicated loan ("BSL") US CLO tranches on negative watch or outlook just since March. In Europe, Fitch and Moody's have placed 304 and 117 CLO tranches, respectively, on negative watch or outlook view. S&P has only taken action on 18 European CLO tranches this year and these were largely placed on negative watch, with a smaller number placed on negative outlook.

1,600

CLO Tranches Impacted by Ratings Actions

Percentage of US and EU CLO Tranches on Negative Watch / Outlook by Original Rating[15]



CLO rating activity was largely in tranches rated BBB and below

[14] BofA Global Research, Bloomberg, Moody's, S&P, Fitch, Intex, April 27, 2020.
[15] Source: Kanerai, Intex, Bloomberg, Moody's, S&P, Fitch, Barclays Research, April 28, 2020.

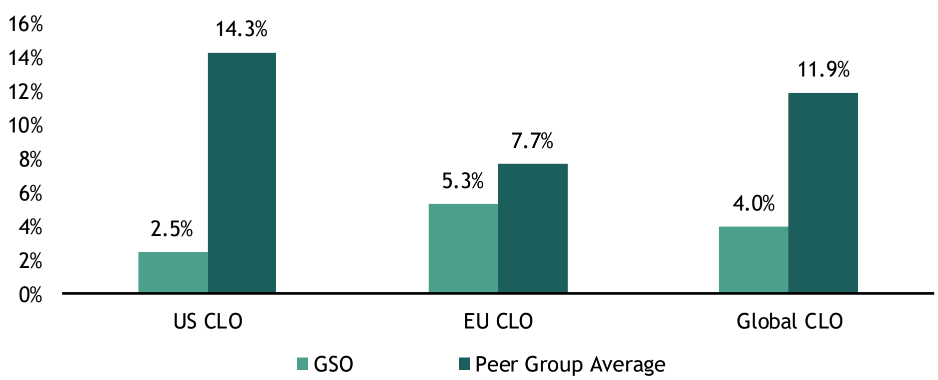
Moody's and S&P emphasized the factors that informed their actions:

	Moody's	S&P
Overall portfolio credit quality / COVID-19 sector exposure	✓	✓
Overcollateralization ratios	✓	✓
Indicative preliminary cash flow results / possible diversion	✓	✓
Exposure to industries with a large share of recent negative rating actions		✓
Exposure to CCC loans		✓
WARF migration	✓	
Par erosion	✓	
Exposure to obligors whose ratings were recently downgraded or negative watch/outlook	✓	

GSO CLO Tranche Ratings Remain Resilient

Over 80% of US BSL CLO managers with at least two deals outstanding had at least one tranche placed on negative watch by the rating agencies as a result of the actions taken year to date. Of the 15 largest global BSL CLO managers, GSO has one of the lowest percentages of rated CLO tranches placed on negative watch by Moody's, S&P, and Fitch, at just 4% of global tranches in total versus an average of 12% for the top 15 managers by CLO assets under management.

Percentage of Rated CLO Tranches on Negative Watch[16]



We believe our portfolios have benefited from active management: over the previous 24 months when the markets were strong, we decided to prune risk given the advanced stages of the economic cycle. As a result, our portfolios are conservatively positioned and have relatively limited exposure to COVID-affected sectors, as well as upstream oil and gas. We expect CLO downgrades to continue, and we believe our advantageous positioning and thorough monitoring of Weighted Average Rating Factor (WARF) and CCC basket levels will contribute to the resilience of our CLO portfolios.

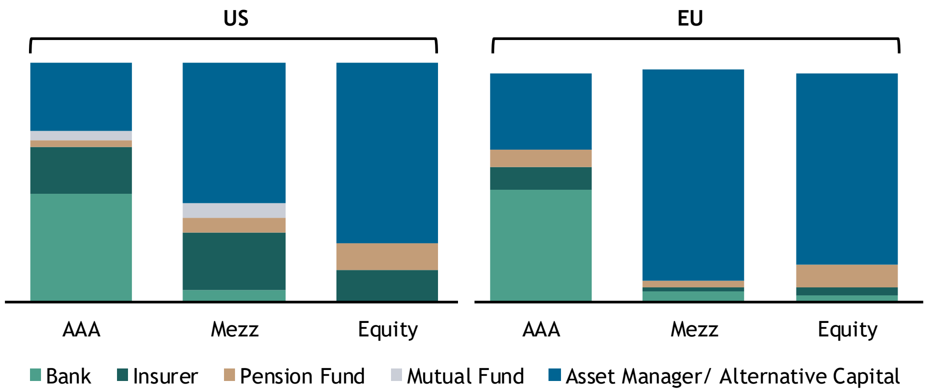
Of the 5 largest global BSL CLO managers, GSO has the lowest % of CLO tranches placed on negative watch

[16] Source: GSO and Creditflux, March 31, 2020. Represents the total amount of CLO tranches (by count) on negative watch across Moody's, S&P and Fitch. Excludes AAA-rated tranches. US CLO peer group represents the top 15 largest US BSL CLO managers, EU CLO peer group represents the top 10 largest EU BSL CLO manager and Global CLO peer group represents the top 15 largest Global BSL CLO managers, all according to Creditflux AUM, as of March 31, 2020.

How Do CLO Tranche Downgrades Impact Investors?

The CLO investor base is diverse, and we believe the majority would not be forced sellers in the event of tranche downgrades. There may be a small percentage of tranches held by inexperienced investors or in investment grade funds or insurance company portfolios that may be required to sell, creating unique buying opportunities in a dislocated market.

CLO Investor Base by Type[17]



Banks and insurers are the largest holders of CLOs

While banks represent the largest portion of the CLO AAA tranche investor base, in mid-March, a handful of large money managers caused movement in AAA spreads. These holders reportedly sold sizable blocks of AAA tranches in a scramble for liquidity. However, CLO AAA spreads soon recovered to more reasonable levels. Given the relative immunity of AAAs to principal impairment, and the fact that primary issuance has been subdued, we do not anticipate widespread near-term selling of this most senior tranche as a result of recent rating agency action.

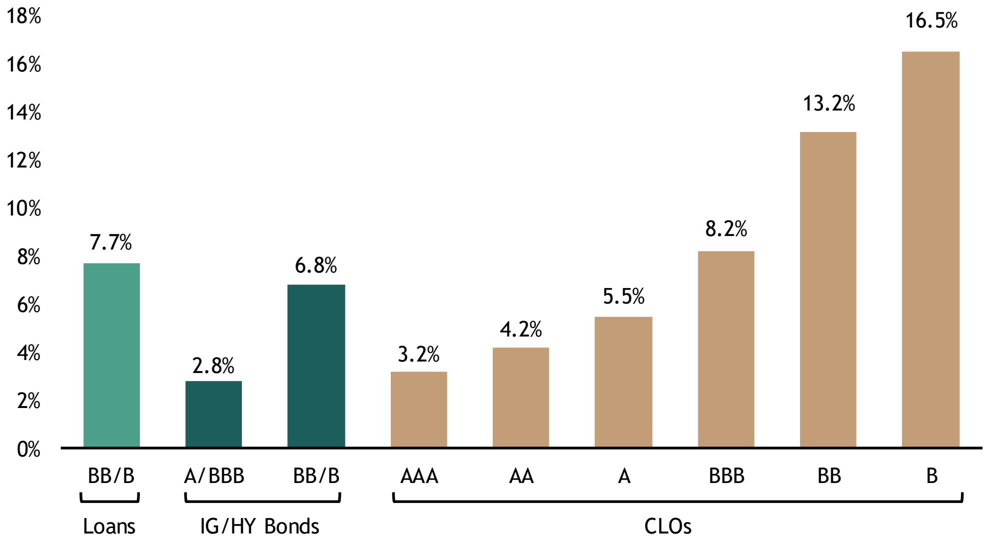
Insurers represent a large portion of the CLO investor base, with exposure across the capital stack, and life insurers in particular have been increasing their exposure to CLOs in the past several years. For the lower-rated tranches they hold, selling activity may increase as insurers work through their reserve requirements and capital allocation plans.

Opportunistic funds such as hedge funds and private equity funds form the majority investor base for below-investment-grade CLO debt and equity. We surmise, given the large amounts of capital these firms have raised to deploy into dislocation strategies coupled with the current wide spreads of junior CLO tranches, that these buyers will increase their allocation to these assets in the near-term. Attractive entry points exist for investors who can distinguish the tranches backed by higher-quality portfolios and managers from the rest of the pack.

[17] Citi Research, December 2019.

We see the most dislocation and potential for enticing entry points in CLO tranches rated BBB and below. However, for investors focused primarily on high levels of subordination, the senior-most tranches will remain attractive. Subordination and other positive structural features support the resilience of AAA, AA, and A-rated tranches, which can withstand relatively high asset defaults before registering principal losses.

US Yields by Rating[18]



CLO tranches rated BBB and below are trading at dislocated prices

Next Steps for Rating Agencies

So far, each of the three most active rating agencies have placed CLO liabilities on negative watch or outlook but have not yet downgraded any. S&P and Moody's indicated they aim to resolve the negative rating actions within the next 90 days but caveated it could take longer due to the large volume and high degree of market uncertainty. Fitch noted its negative ratings would be resolved following rating actions on the underlying issuers.

The rating agencies are projecting further deterioration in CLOs as loans are expected to face increasing downgrade pressure. More information will be available to the rating agencies as monthly CLO trustee reports are posted. These will likely show further erosion of collateral quality tests and failure of overcollateralization tests, which could prompt additional downgrades. This may continue until there are signs of improvement in corporate fundamentals for the underlying portfolio companies. Despite this negative outlook, the rating agencies have suggested that the ratings of AAA and AA-rated tranches may be spared, due to their higher levels of subordination and structural protections.

CLO Issuance Amid COVID-19

Recent rating actions have affected CLO collateral pools more broadly than any time since the Global Financial Crisis, and at an accelerated pace. CLO collateral pools have also shifted more rapidly over the past month and a half than during any other comparable period in the history of the CLO market.[19]

[18] BofA Global Research, Bloomberg Barclays U.S. Corporate Index, Bloomberg Barclays High Yield Index, S&P/LSTA Leveraged Loan Index, April 24, 2020.
[19] S&P Global, Structured Finance Ratings – CLO, April 27, 2020.

In this interim period, we've seen new-issue CLO structures adapt to the current fluid market situation. New CLOs that came to market in April had higher credit enhancement levels and shorter reinvestment periods, or no reinvestment period, in the case of static CLOs that were issued.

On April 2, GSO took advantage of market conditions to issue its first static CLO, which was also the first US BSL CLO to price since the market shut down due to the COVID-19 crisis.

The Path Forward

Managers will be increasingly focused on finding safe opportunities to build or rebuild lost par in existing CLOs. They will need to do this in an environment where additional selling pressure may build on CCC-rated loans as investors seek out higher-quality loans. In this uncertain environment, we believe CLO structures will remain resilient and continue to represent an attractive risk-reward proposition for experienced investors in what is proving to be a uniquely volatile period in the history of the leveraged loan market.

If you wish to discuss the opportunity set further with the GSO team, please reach out to our Investor Relations and Client Service team at the email address below.

CCSIRMS@blackstone.com

At GSO, our thoughts remain with everyone affected by the COVID-19 pandemic, and we hope you and your families are keeping safe and healthy.

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