The State of the Broadly Syndicated Loan Market

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"Investors Turn Sour on Risky Deal Debt.

So read a front page *WSJ* headline this past Monday. The thesis of the article was that slowing investor appetite was hurting "the corporate buyout boom." Three transactions were cited as evidence of this trend – one in the pharmaceutical sector, a specialty chemicals company, and a barge transportation business.

What the article failed to mention is that the tone of the leveraged loan market is not driven by investor appetite for a few issuers, or even specific sectors. Buyer behavior in the broadly syndicated market is reflective of three factors: fund flows, loan repayments and CLO formation.

First, on fund flows. As we've covered extensively in this space, fears of a sluggish global economy and the prospect of long-term near-zero interest rates have pushed investors out of loan funds and (until the last five weeks) out of high yield funds.

The net result of this investor flight is that $10 billion has been removed from the leveraged loan system year-to-date. Since retail funds historically represent about 20% of the overall demand for loans, that's a meaningful drain on the cash supply needed to keep private equity sponsors engaging in buyout activity.

At the same time, the creation of new collateralized loan obligations has demonstrated surprising strength, given the headwinds of risk retention rules. These rules, set to take effect at the end of next year, will force asset managers to put up 5% equity of the total value of each vehicle they launch. Nevertheless, 2015 CLO formation is expected to exceed last year's record total of $124 billion.

Finally, as S&P LCD reported last week, loan repayments shrank from a high of $27 billion in July to about $6 billion in September. While that rebounded to $13 billion last month, this puts less cash back in the hands of institutional and retail accounts.

On the supply side, loan issuance has been improving steadily this quarter. Per S&P the total outstandings of leveraged loans rose last month by over $10.4 billion to an all-time high of $855 billion. At the same time, the forward calendar of loans in the pipeline is up sharply from about $34 billion in July to $65 billion in October.

As our *Chart of the Week* highlights, this confluence of factors has resulted in a more balanced technical picture. Yes, some transactions for credit-specific reasons have received lukewarm reception from the buy-side. And yes, investor interest has cooled making it more challenging for aggressively leveraged, or "story", deals than earlier in the year.

The real story behind the headlines is not of an unhealthy market, but rather of a good old-fashioned supply-demand equation. Without the steady flow of funds from retail investors and repayments, and with CLOs facing long-term challenges, the broadly syndicated market is in the midst of a choppy phase.

But as one loan veteran put it, we’ve seen this movie before. “Every year we go through periods of buyer caution,” he said. “They never last long. And this won’t either.”