Minding the Gap

THE LEAD | May 24, 2016

A major consequence of regulatory reform since the credit crisis has been the reduction of future demand for leveraged loans. As one example, risk retention rules have dramatically impacted the formation of new CLOs. These securitized vehicles currently comprise roughly 60% of the broader US loan market.

Banks, of course, have seen their capacity curtailed as well. Just how much demand has been removed from the bank system is hard to quantify. Large cap issuers are working to structure loans with sufficient amortization and lower leverage to still appeal to regulated entities. But many transactions just won't fit leveraged lending guidance.

Metrics on diminished CLO capacity are easier to come by. JP Morgan recently issued a report that examined loan securitization vehicles by reinvestment period. It found that about $320 billion are coming out of their reinvestment period after this year, with the balance ($122 billion) exiting by the end of 2016.

As we show in our *Chart of the Week*, the bulk of CLOs that will no longer be able to reinvest in loans comes in the 2017-2019 time frame. This corresponds with the class of 2012-2014 vehicles than came on line during the peak of CLO issuance before risk retention rules were adopted. In fact, the 2014 vintage accounts for 30% of all outstanding CLOs.

The report also highlights that loan demand from CLOs will be about $160 billion for this year and next, estimating loan supply of $200 billion this year. As exiting vehicles peak in 2018, JPM predicts a shortfall in CLO capacity. This imbalance is accentuated by the slow lift-off of new CLO formation this year ($40 billion), with a similar volume projected for 2017 as well.

It's tough to see how the shortfall will be plugged. While CLO formation has crept up this year, the drag created by managers required to hold at least 5% equity in each of their vehicles will keep volume well short of its 2014 peak.

A similar supply/demand imbalance exists in the middle market. Thomson Reuters LPC projects over $600 billion of middle market loans maturing over the next five years. As with CLOs, this refinancing cliff represents post-crisis issuance of 2012-14; in the case of banks, before the full weight of leveraged lending guidance was felt.

Unlike CLOs, however, the source of refinancing for mid cap deals is clear. Non-bank lenders have been raising considerable funds in preparation for this looming wave.

Of course, there will likely be different structures and higher costs associated with the take-outs. And some companies will be sold to strategics, or taken public, even liquidated. But the rest there will likely be capital available.

For CLOs, the gap between future loan demand and supply remains substantial. For larger asset managers of any stripe, that could present real opportunities.