Fitch Ratings 2020 Outlook: U.S. Leveraged Finance

Higher Default Rates and Mounting Downgrade Pressure

Outlook: Default Rates Expected to Rise Next Year

Fitch Ratings expects the U.S. institutional leveraged loan default rate to climb to 3.0% in 2020, versus 1.8% TTM as of December 2019. We forecast the 2020 high yield default rate to reach 3.5%, compared with 2.9% on a TTM basis. Ongoing weakness and lack of market access in the lowest rated-tier of the energy sector is expected to remain a theme in 2020, leading to 13% and 7% sector default rates on loans and bonds, respectively. Frontier Communications Corp. alone could account for 40% of the total 2020 high yield default volume. No individual loan issuers are expected to drive the default rate, but energy represents some of the larger exposures within our forecast, paced by Seadrill and California Resources Corp.

Weakening Rating Mix

Years of robust loan demand helped fund a wave of debt-funded M&A, LBOs and dividend recapitalizations that increased leverage and gradually weakened the rating mix of speculative-grade issuers. Weaker documentation presents additional risk and is likely lead to a greater divergence in recovery outcomes when the cycle turns. Most of the rating migration is the result of sponsored transactions with highly levered capital structures at inception that often rely on aggressive EBITDA assumptions given this point in the cycle.

Macro Picture Weakening but U.S. Remains Favorable

Mounting macro risks and slower global growth have prompted central banks to reverse course on raising interest rates. While this has implications for certain sectors with higher international and commodity exposure, lower rates do little to alter the fundamental reach for yield dynamic that has characterized the past decade and that has underpinned strong demand for senior corporate debt by CLOs and other institutional investors.

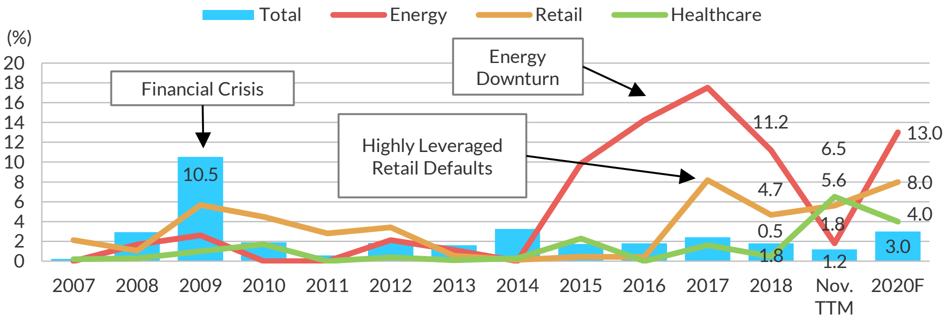
What to Watch

- Growing lists of *Loans* and *Bonds of Concern*: Fitch's bottom-up process forms the basis for our default forecasts. A recent surge in both *Loans* and *Bonds* total volume point to greater default volume next year.
- Flight to Quality: Investors are showing a notable preference for 'BB' rated loans over 'B' and lower issues, as sponsored transactions generate more push-back and CLO managers seek to limit potential exposure to 'CCC' credits in the event of further downgrades, creating pressure on secondary market trading levels.
- Interest Rates Lower for Longer: Lower interest rates reduce demand for floating-rate loans, but are broadly supportive to the speculative-grade credit market. U.S. debt is likely to remain attractive on a relative basis, absent an economic shock.
- Sectors of Concern: Retail and energy remain at forefront; lower-rated pockets of healthcare/pharmaceuticals and technology present growing risks.

Michael Paladino, Managing Director, Head of U.S. Leveraged Finance

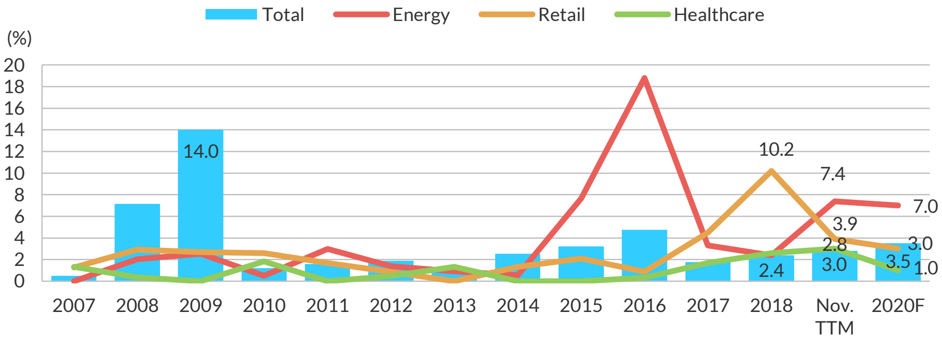
"Growing outstanding amounts on our lists of Concern, net downgrade pressure and increased investor skepticism toward lower-rated and aggressive sponsor deals defined second-half 2019, and these themes are likely to shape 2020 trends. While growing pockets of concern led us to revise our default rate forecasts higher, economic fundamentals and market access remain modestly constructive for leveraged U.S. corporates."

U.S. Institutional Leveraged Loan TTM Default Rates[a]



[a]Calculated based on loan volume outstanding, not number of issuers. F – Forecast
Source Fitch Ratings U.S. Leveraged Loan Default Index, Refinitiv LPC, Bloomberg LP.

U.S. High Yield TTM Default Rates[a]



[a]Calculated based on bond volume outstanding, not number of issuers. F – Forecast
Source: Fitch Ratings U.S. High Yield Default Index, Bloomberg LP.

Growing Lists of Concern Signals Rising Stress

Fitch's *Loans of Concern* total rose to $110 billion as of December 2019, up 53% YTD. The increase reflects our view that pockets of the market are likely to face headwinds next year, underpinning the higher default rate forecasts. While Fitch is not forecasting a recession in 2020, these companies will need to address over-levered capital structures just as growth weakens and market access wanes for lower-rated issuers. The *Bonds of Concern* is up a more modest 7% to $78 billion. Both lists now represent 7%–8% of their respective markets.

Downgrades Outpace Upgrades, but Ample Cushion for CLOs

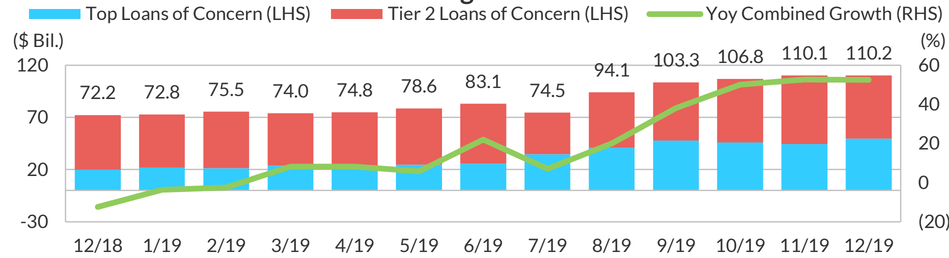
In 2019 Fitch downgrades surpassed upgrades by the widest margin since 2009, with the pace accelerating in the second half. Paired with high levels of 'B' issuance to support a surge in private-equity deals in recent years, this resulted in average loan ratings shifting lower throughout 2019. While the amount of first-lien loans outstanding with a composite average rating at 'CCC' or below has not changed dramatically over the past several years, the amount rated just above, at 'B–', ballooned to 15% from 9% since year-end 2017. Further downgrade pressure would naturally lead to a sharp increase in 'CCC' credits. However, we believe that the majority of CLOs have significant headroom to weather this. Our analysis shows that Fitch-rated CLOs can absorb downgrades to 'CCC' totaling an additional 10% on average before tripping their junior overcollateralization or interest diversion tests. The headroom is even higher for more recent vintages.

Software and Healthcare in Focus; Energy, Retail Continue to Struggle

The increased 'B–' exposure is widespread across sectors, but technology, services and healthcare/pharmaceuticals stand out among the largest increases. These segments have attracted a large amount of capital and currently make up a combined 36% of all outstanding institutional loans as a result. The percent of first-lien technology loans rated 'B–' has increased 13pp since the start of 2018, while services and healthcare/ pharmaceuticals have each seen a 10-point rise.

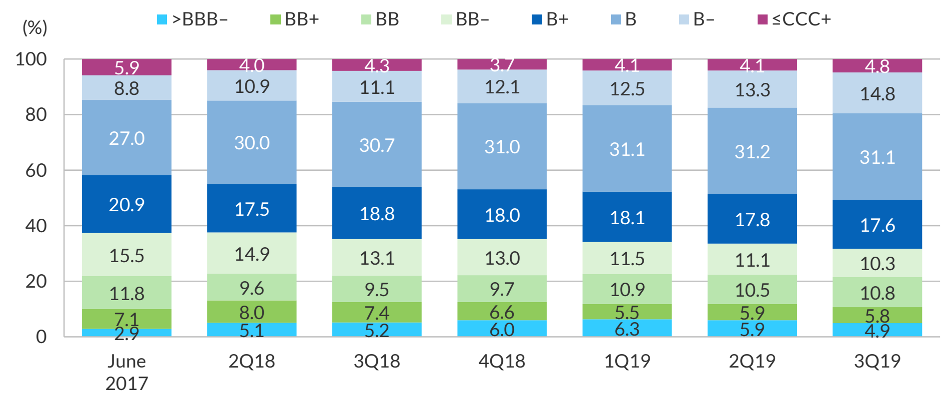
- Technology: 23% of first-lien loans are currently rated 'B–' or below. This jumps to 31% for the software subsector. These companies tend to have relatively asset-light business models, which could challenge recovery prospects in the event of default and may put additional pressure on managers to reduce exposure as ratings deteriorate.
- Healthcare/Pharmaceuticals: 22% of loans are rated 'B–' or below. Litigation related to opioid prescriptions affect a handful of issuers and the industry overall faces pricing pressure and reduced volumes as a result of increased regulatory and political scrutiny.
- Retail: 37% of the sector is rated 'B–' or worse as has been the case for several years. Robust consumer spending and stabilizing market shares are supportive but some issuers remain challenged due to overleveraged capital structures and under-investment in omni-channel distribution.
- Energy: 22% of sector is still 'B–' or worse, but the amount rated in the 'CCC' to 'C' category has fallen considerably due primarily to issuers defaulting. Refinancing risk is high for lower-rated issuers, as market access is extremely limited.

Loans of Concern Amount Outstanding



Source: Fitch U.S. Leveraged Loan Default Index.

Historical Rating Distribution of First-Lien Institutional Loans

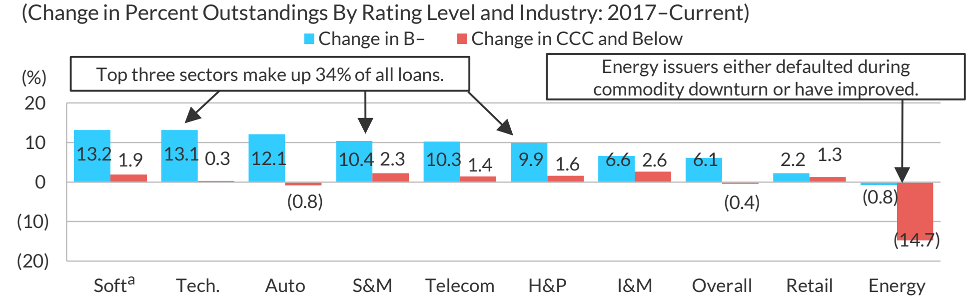


(%)	June 2017	2Q18	3Q18	4Q18	1Q19	2Q19	3Q19
≤CCC+	5.9	4.0	4.3	3.7	4.1	4.1	4.8
B–	8.8	10.9	11.1	12.1	12.5	13.3	14.8
B	27.0	30.0	30.7	31.0	31.1	31.2	31.1
B+	20.9	17.5	18.8	18.0	18.1	17.8	17.6
BB–	15.5	14.9	13.1	13.0	11.5	11.1	10.3
BB	11.8	9.6	9.5	9.7	10.9	10.5	10.8
BB+	7.1	8.0	7.4	6.6	5.5	5.9	5.8
>BBB–	2.9	5.1	5.2	6.0	6.3	5.9	4.9

Note: The breakdown is based on issuer ratings by at least one of the agencies. After June 2017, data are quarterly.
Source: Fitch Ratings.

Growing Portion of U.S. Leveraged Loan Market Rated Just Above CCC+

(Change in Percent Outstandings By Rating Level and Industry: 2017–Current)



	Soft[a]	Tech.	Auto	S&M	Telecom	H&P	I&M	Overall	Retail	Energy
Change in B–	13.2	13.1	12.1	10.4	10.3	9.9	6.6	6.1	2.2	(0.8)
Change in CCC and Below	1.9	0.3	(0.8)	2.3	1.4	1.6	2.6	(0.4)	1.3	(14.7)

[a]Subsector designation that includes companies with "software" in the business descriptions as provided by Refinitiv LPC and Bloomberg LP, in addition to manual Fitch designations. It mostly falls within Technology, but also Telecom, Healthcare, Services & Misc. and others. Soft- Software. S&M – Services and Miscellaneous. H&P – Healthcare/ Pharmaceuticals. I&M – Industrial and Manufacturing. Note: Ratings based on average of the three rating agencies. Only first-lien facilities included. Data as of Sept. 30, 2019.
Source: Fitch U.S. Leveraged Loan Default Index.

Likely Lower but Stable Loan Issuance in 2020

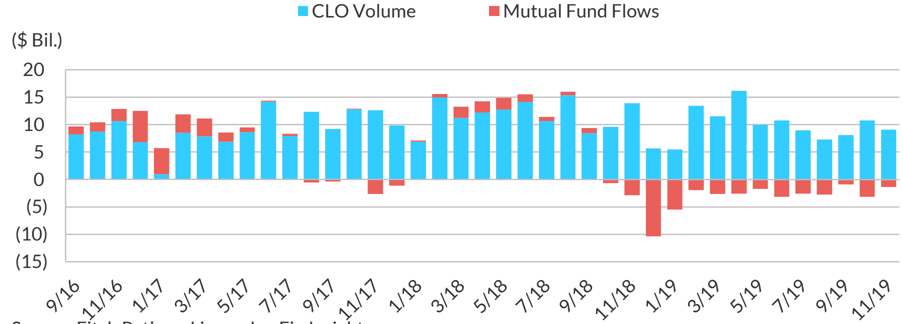
YTD institutional leveraged term loan issuance tallied approximately $350 billion at Nov. 30, according to LevFin Insights. This comes in well behind $712 billion for fiscal 2018. Much of the drop in gross issuance can be seen as a reversion off a surge in 2017 and 2018 that was driven by high repricing and refinancing activity ahead of what the market then expected to be a prolonged rate-hike cycle. However, growth in Fitch's U.S. leveraged loan index slowed as well, which captures repayments and migration out of the index. Yoy as of November, total outstandings grew by 6.3%, compared with 17% in 2018 and 19% in 2017. We are watching several factors affecting loan issuance in 2020:

- CLO Formation: These investors represent the largest source of demand, purchasing 70% of new issuance in 2019 by some estimates. Fitch's CLO team forecasts primary new CLO issuance for 2020 to end down from 2019's volume at between $75 billion and $90 billion, supplemented by limited refinancing and reset activity.
- Interest Rate Expectations: The Federal Reserve held rates steady through first-half 2019 but implemented three cuts in the second half. With less incentive to own floating-rate debt, loan funds experienced outflows every month from October 2018, totaling over $40 billion. Fitch expects this source of demand to continue to track interest rate expectations. It's possible the worst is over and loan funds may serve as a tailwind to demand in 2020, but this group has traditionally held 10%–20% of institutional loans outstanding.
- Private Equity Economics: U.S. buyout fundraising surpassed $250 billion during the first three quarters of 2019, outpacing every full year since 2007 (per Refinitiv LPC). On the other hand, high valuations and stretched first-lien leverage put pressure on LBO deal economics, which may weigh on sponsored issuance going forward. This segment makes up approximately two-thirds of the leveraged loan market, and accounts for 44% of YTD new money issuance through October. While PE firms have turned to direct lenders for smaller deals, any sustained pullback by CLOs is likely a net negative on issuance.
- High-yield bond issuance through November stands at $222 million, compared to a low $144 million for full-year 2018. Issuance this year benefited from the sharp shift in interest rate expectations, but we expect next year's tally to moderate in 2020.

Documentation Still a Key Concern in Downturn

The negotiation power issuers and sponsors have enjoyed in the past few years resulted in the erosion of traditional credit protections in debt documentation. Borrowers have significant flexibility to incur additional debt, divert value away from secured lenders, and prevent lenders from engaging as performance deteriorates. With the market pull-back in late 2018 and 2019, lenders had more success with pushing back on terms across each of these categories, as evidenced by an improvement in Covenant Review's documentation scores. As growth slows, borrowers who choose to take advantage of generous debt baskets and looser EBITDA definitions may find that larger equity contributions are insufficient to ensure robust recoveries in the event of default.

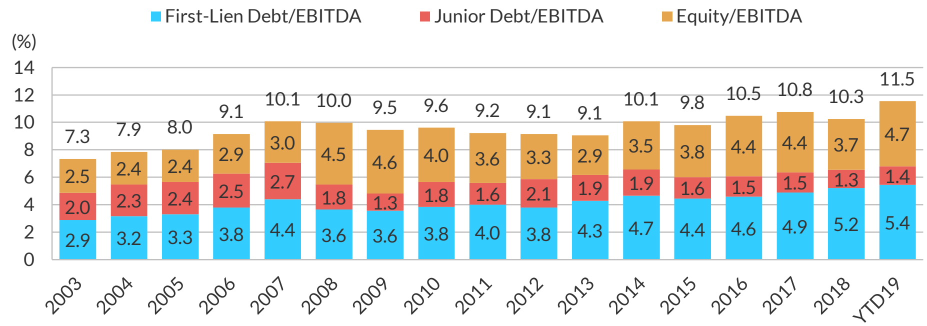
Visible Investor Base Flows



Source: Fitch Ratings, Lipper, LevFin Insights.

Large LBO 1L Leverage Continues to Climb; Sponsors Put Up More Equity

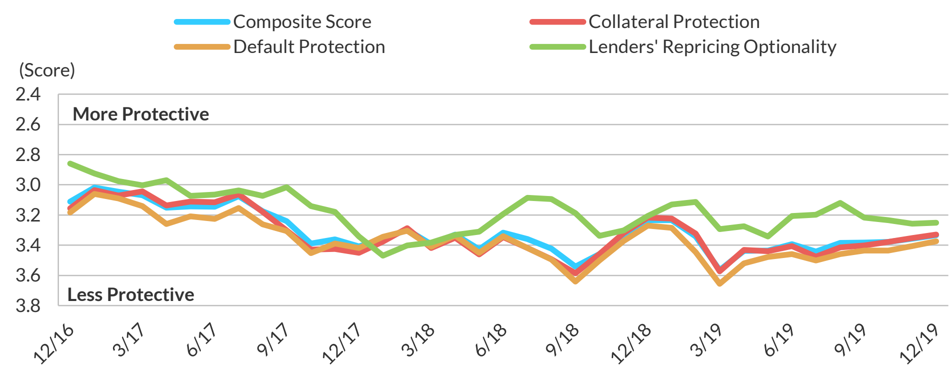
(Average Broadly Syndicated LBO Debt and Equity Multiples)



Source: Refinitiv LPC.

Covenant Review's Documentation Score

(Three-Month Rolling Average)



Source: *Covenant Review.*

Appendix

Top Loans of Concern

Issuer	Amount Outstanding ($ Mil.)	Industry	Issuer	Amount Outstanding ($ Mil.)	Industry
Ligado Networks LLC	4,638.0	Telecommunications	Montreign Resort Casino	450.0	Gaming, Lodging & Restaurants
McDermott International	2,776.0	Industrial/Manufacturing	ASP MCS Acquisition Corp.	440.1	Services & Miscellaneous
Seadrill Partners LLC	2,621.8	Energy	Bowie Resources	435.0	Metals & Mining
Serta Simmons Bedding LLC	2,400.0	Retail	KCA Deutag US Finance LLC	412.0	Energy
California Resources Corp.	2,300.0	Energy	Flavors Holdings Inc.	400.0	Food, Beverage & Tobacco
Skillsoft Corp.	2,035.0	Services & Miscellaneous	Phillips Pet Food & Supplies	390.0	Services & Miscellaneous
Mallinckrodt plc	1,909.6	Healthcare & Pharmaceutical	Exela Technologies Inc.	388.0	Technology
Revlon Consumer Products Co.	1,746.0	Consumer Products	Jamul Indian Village Development Corp.	340.0	Gaming, Lodging & Restaurants
Frontier Communications Corp.	1,703.0	Telecommunications	Chief Power Finance LLC	339.8	Utilities, Power & Gas
Lumileds Holdings Ltd.	1,683.0	Industrial/Manufacturing	Contextmedia Health LLC	325.0	Healthcare & Pharmaceutical
JC Penney Corp. Inc.	1,561.0	Retail	CPI Card Group Inc.	312.5	Services & Miscellaneous
Ascena Retail Group Inc.	1,371.5	Retail	Lago Resorts & Casino	310.0	Gaming, Lodging & Restaurants
J Crew Group Inc.	1,352.8	Retail	Caelus Energy Alaska O3 LLC	300.0	Energy
Constellis Holdings LLC	1,087.5	Services & Miscellaneous	Permian Production Partners	300.0	Energy
Ultra Resources Inc.	971.2	Energy	TOMS Shoes LLC	299.0	Retail
Commercial Barge Line Co.	949.0	Transportation	Mood Media Corp.	296.7	Leisure & Entertainment
Healogics Inc.	795.0	Healthcare & Pharmaceutical	Longview Power Inc.	289.0	Utilities, Power & Gas
Quorum Health Corp.	777.7	Healthcare & Pharmaceutical	Alorica Inc.	281.0	Technology
IPC Systems Inc.	760.0	Telecommunications	Checkers Drive-In Restaurants Inc.	280.0	Gaming, Lodging & Restaurants
Doncasters Group USA Finance	745.0	Industrial/Manufacturing	Engine Group	224.0	Services & Miscellaneous
Foresight Energy LLC	743.3	Metals & Mining	Express Energy Services	220.0	Energy
Moran Foods LLC	740.0	Supermarkets & Drug Stores	VIP Cinemas Holdings Inc.	210.0	Leisure & Entertainment
4L Technologies Inc.	693.0	Services & Miscellaneous	Dayton Superior Corp.	209.5	Building & Materials
RentPath Inc.	662.4	Broadcasting & Media	Pier 1 Imports Inc.	190.0	Retail
TNT Crane & Rigging Inc.	655.0	Banking & Finance	Steak N Shake Operations Inc.	185.9	Gaming, Lodging & Restaurants
Systems Maintenance Services Holding Inc.	645.0	Services & Miscellaneous	Pioneer Energy Services	175.0	Energy
NPC International Inc.	605.0	Food, Beverage & Tobacco	Fairway Group Acquisition Co.	172.5	Supermarkets & Drug Stores
Millennium Health LLC	600.0	Healthcare & Pharmaceutical	Iconix Brand Group Inc.	171.6	Retail
Global Eagle Entertainment	507.4	Services & Miscellaneous	NYDJ Apparel LLC	100.0	Retail
Imagine! Print Solutions LLC	475.0	Broadcasting & Media	Gold Standard Baking Inc.	90.4	Food, Beverage & Tobacco
Gavilan Resources LLC	450.0	Energy	**Total**	**49,496.2**	

Note: Names reflect our view of the most concerning issuers in the institutional leveraged loan market. Sorted by amount outstanding based on SEC filings or available market information. Key components for inclusion in this table are low ratings, discounted secondary market bid levels relative to par, adverse market information/events (e.g. hiring restructuring attorney, issuer considering bankruptcy, etc.) and/or fundamental coverage analysts' input.
Source: Fitch U.S. Leveraged Loan Default Index.

Top Bonds of Concern

Issuer	Amount Outstanding ($ Mil.)	Industry	Issuer	Amount Outstanding ($ Mil.)	Industry
Frontier Communications Inc.	15,436.0	Telecommunications	Unit Corp.	650.0	Energy
Chesapeake Energy Corp.	5,761.0	Energy	Jonah Energy Inc.	600.0	Energy
JC Penney Corp. Inc.	2,210.7	Retail	Mallinckrodt International Finance	600.0	Healthcare & Pharmaceutical
California Resources Corp.	2,181.9	Energy	J Crew Group Inc.	544.7	Retail
Denbury Resources Inc.	1,882.2	Energy	McClatchy Co.	536.5	Broadcasting & Media
Ferrellgas Partners LP	1,832.0	Energy	Quorum Health Corp.	400.0	Healthcare & Pharmaceutical
Hovnanian Enterprises Inc.	1,372.6	Building & Materials	Chaparral Energy Inc.	300.0	Energy
Exela Technologies Inc.	1,000.0	Technology	Flexi-Van Leasing Inc.	300.0	Banking & Finance
Ultra Resources Inc.	954.0	Energy	Pioneer Energy Services	300.0	Energy
Revlon Consumer Products Co.	950.0	Consumer Products	Carrington Holding Co.	263.0	Real Estate
Vine Oil & Gas LP	910.0	Energy	MAI Holdings Inc.	135.0	Services & Miscellaneous
Fresh Market Inc.	800.0	Supermarkets & Drug Stores	Goodman Networks Inc.	106.9	Telecommunications
Hornbeck Offshore Services Inc.	674.3	Transportation	**Total**	**41,350.7**	
Calfrac Holdings LP	650.0	Energy			

Note: Names reflect our view of the most concerning U.S. issuers in the high yield market. The list includes bond outstandings greater than $100 million. Sorted by amount outstanding based on end of month-end figures. Key components for inclusion in this table are low ratings, discounted secondary market bid levels relative to par, adverse market information/events (e.g. hiring restructuring attorney, issuer considering bankruptcy, etc.) and/or fundamental coverage analysts' input.
Source: Fitch U.S. High Yield Default Index.

Outlooks and Related Research

2020 Outlooks
Global Economic Outlook
Fitch U.S. Leveraged Loan Default Insight (November 2019)
Fitch U.S. High Yield Default Insight (November 2019)
What Investors Want to Know: Middle Market Supply and Demand Forces (Views on U.S. Middle Market Loans, CLOs and BDCs) (October 2019)
Structure Series: Unitranche Versus Syndicated Loans (Unitranche Borrowers Eye Simple Execution Despite Variety of Risks) (October 2019)
Ultimate Recovery Rate Study (Solid First-Lien Term-Loan Recovery Rates) (October 2019)
Evolving Liquidity Dynamics in the U.S. Leveraged Loan Market (Transformation of Lending Space Brings Advantages, but Risks Remain) (September 2019)
CCCs in U.S. CLOs (Indenture-Specifics Provide Flexibility, Blur Comparisons) (May 2019)

Analysts

Brendan Hoelmer
+1 646 582-4781
brendan.hoelmer@fitchratings.com

Lyuba Petrova
+1 646 582-4885
lyuba.petrova@fitchratings.com

Michael Paladino
+1 212 908-9113
michael.paladino@fitchratings.com