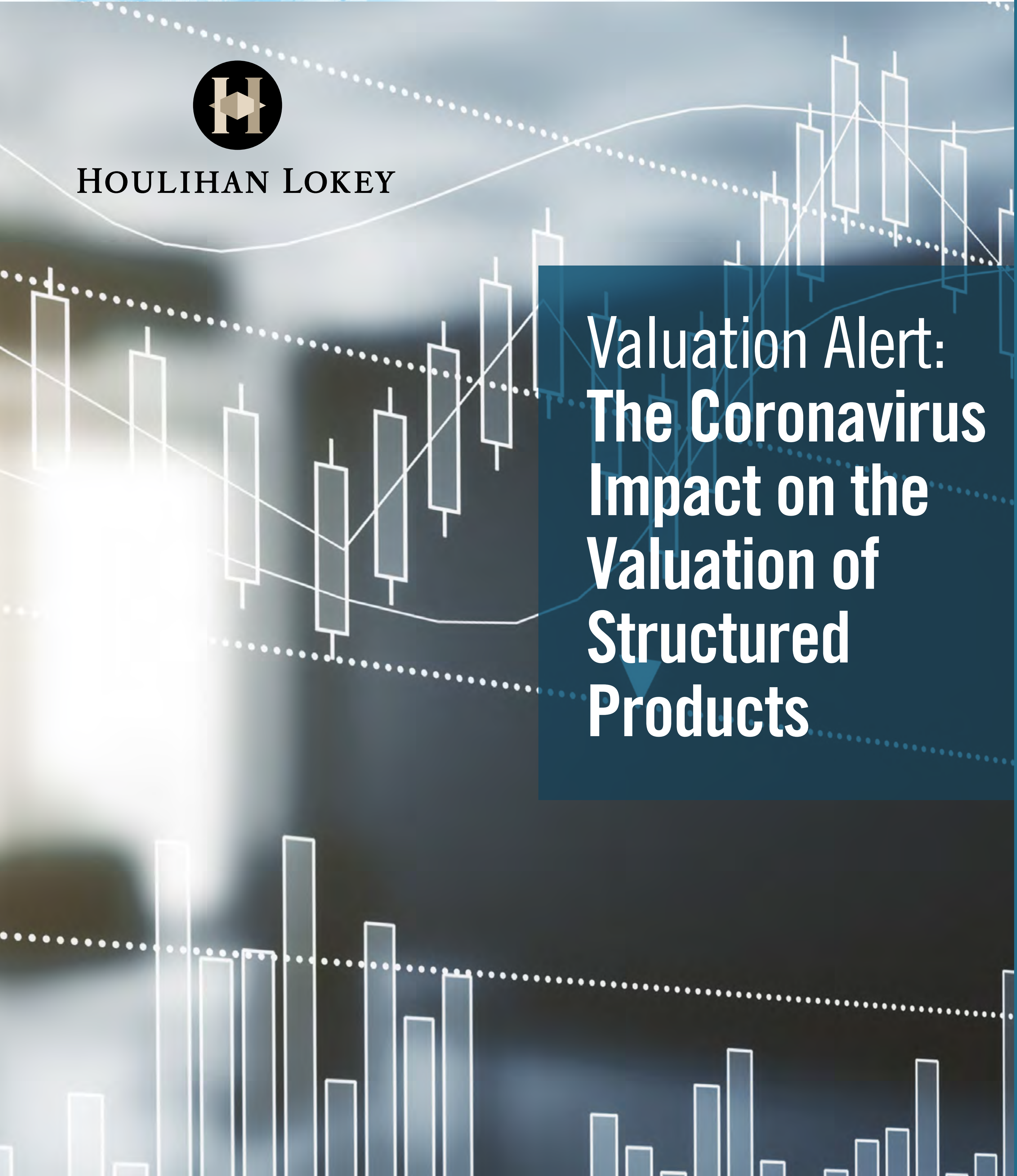
March 16, 2020

SPOTLIGHT ON **COVID-19**



HOULIHAN LOKEY

Valuation Alert: **The Coronavirus Impact on the Valuation of Structured Products**

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COVID-19, better known as coronavirus, has had a significant effect on the equity and fixed income markets. The spread of the virus has impacted virtually all asset classes, including structured products. Although we anticipate bid wanted in competition (BWIC) volumes to increase, to date, non-market factors have limited list frequency. We continue to monitor dealer commentary for additional price discovery.

In this alert—the second in a series of alerts—we discuss specific valuation issues to consider for CLOs, mortgages, consumer lending, and aircraft leasing.

CLOs

Although actual executed trades for collateralized loan obligation (CLO) equity have been scarce, bid/ask ranges have widened and leveraged loan prices—generally a leading indicator for CLOs—have seen sharp declines since the coronavirus-induced sell-off in the broader risk markets began. The S&P/LSTA Leveraged Loan 100 Index declined 9.3 points from February 20 to March 12, 2020. This has resulted in a precipitous decline in CLO equity net asset values (NAVs) by more than 50 points. According to JP Morgan, secondary spreads in the CLO market have widened across the capital stack, rising 85 to 130 bps at the AAA to AA tranches and by as much as 185 to 385 bps in A to BB tranches over the course of the week ending March 12, 2020. Additional widening may continue as the markets work through knock-on effects such as the rapid fall in energy prices and decline in travel. Given the increased volatility and wider spreads, new issuances of CLOs have also slowed with some deals being postponed as wider liability spreads squeeze CLO arbitrage.

Mortgages

Mortgage credit has generally lagged the sell-off seen in broader credit markets. As concerns intensify that the coronavirus will have an outsized effect on the global economy and following the recent interest rate cuts by the Federal Reserve, mortgage rates tumbled to 3.36% as of March 12 and could fall further. The lower mortgage rates are likely to drive mortgage refinancings higher and may lead to an increase in home purchases. According to data from the Mortgage Bankers Association, the Market Composite Index—a measure of total loan application volume—increased 55.4% in the week of March 2, 2020. The Refinance Index jumped 79%, while the Purchase Index rose 6%. The S&P U.S. Mortgage-Backed Securities Index had an OAS increase from 61 on February 21 to 115 on March 13, while YTM decreased from 2.20% to 2.19%. If the coronavirus continues to spread, there could be a slowdown in consumer spending, which could eventually lead to job losses and lower incomes. Increased delinquencies and defaults would result; however, there would be a lag to the coronavirus impact in the collateral performance.

Consumer Lending

Originators of consumer credit are less sensitive to the Fed's interest rate cut and tend to act slowly when cutting their lending rates. U.S. job growth increased in February with 273,000 jobs added; however, this was before the effects of coronavirus were expected to be felt in the broader U.S. economy. If there is a continued economic slowdown, it could lead to reduced corporate profits and subsequent workforce reductions. Higher delinquency and default rates in the unsecured consumer lending space would likely follow. Originators could potentially offer modifications and deferments to work with borrowers who have difficulty making payments. Although these loss mitigation techniques would delay delinquencies and defaults, performance would be affected. According to J.P. Morgan, spreads of AAA, A, and BBB tranches of credit card portfolios have widened by 21–27 bps and auto spreads have widened by 21–22 bps in the week of March 9. From February 20 to March 12, 2020, credit card spread widened by 45–52 bps and auto spread widened by 45 bps. The spread widening reflects the concern over the impact of the coronavirus on the economy and spreads could adjust further to reflect additional credit risk.

Aircraft Leasing

The airline industry is expected to be significantly affected by the spread of the coronavirus. As of March 5, according to the International Air Transportation Association (IATA), revenue passenger kilometers (RPKs)—a measure of passenger demand—could see a 4.7% global decrease and a 13% decrease for Asia-Pacific airlines. Aircraft lessees typically are responsible for continuing to make rent payments regardless of aircraft use or any outside circumstances; however, deals should be reviewed individually to determine the potential impact on cash flows. We expect discount rates on pools of aircraft leases and securitizations to increase in order to reflect additional credit risk. We have seen tranches in some aircraft leasing securitizations trade significantly lower, in one case by more than 20 points from early February through the week ending March 13, 2020.

The uncertainty caused by the coronavirus adds to the complexities involved in valuing structured products. Houlihan Lokey has assisted its clients through times of extreme market volatility and we are ready to assist you today. Please reach out to one of the team members below for more information.

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