COVID-19 and corporate credit valuations

April 1, 2020

The global spread of the Coronavirus Disease 2019 ("COVID-19") is having a significant impact on the global economy and financial markets. At the same time, geopolitical forces have driven oil prices to lows not seen since 1999.

One area strongly impacted by these two developments has been the corporate credit market. Throughout the credit spectrum and across industries, primary issuances have declined, typically liquid loan and bond prices have seen large declines, and market credit spreads have spiked.

These market movements present valuation challenges to market participants who invest in illiquid and private loans. As investors look to fair value their positions during these volatile times, KPMG LLP is here to help and provide market insights.

Market developments

Primary market

The spread of COVID-19 has brought businesses, cities, and almost whole countries to a standstill. The corporate credit market has been no exception. Primary issuances have slowed to a crawl in March. Refinitiv LPC data shows that in March, there are only 25 institutional term loans in market with 8 being middle market, which is a huge drop from the 123 institutional deals (16 middle market) that were completed in February.[1] Data tracked by Standard & Poor's shows a significant pull back in primary issuances in March. Investment grade borrowers who re-entered the market after March 16 discovered the world had changed.

To illustrate the significant changes and the volatility during the quarter, we focus on household names outside of the directly affected industries, to highlight the broad market effects. The following table shows three recent issuers after March 16, the credit spreads of their recent issuances, the credit spread for those issuances as of March 31, and the credit spreads of similar maturity instruments as of year-end 2019.[2]

Issuer	Rating	2019 Year-End spread	March issuance spread	March 31 Traded spread
Coca-Cola	A+/A1	50 bps	270 bps	136 bps
JP Morgan	A-/A2	68 bps	340 bps	107 bps
Intel	A+/A1	65 bps	295 bps	177 bps

The increases show investment grade spreads more than doubling during the first quarter of 2020, before recovering slightly by quarter end as a result in part of unprecedented action by the Federal Reserve. To put this in context according to data compiled by Bank of America, after Lehman Brothers' bankruptcy in 2008, it took around 45 days for investment grade spreads to double. This year, it has taken just 19 days.

[1] Source: Refinitiv LPC, Loan Connector website, March 31, 2020.

[2] Source: S&P Capital IQ database and S&P LCD database, data for both accessed on March 31, 2020.

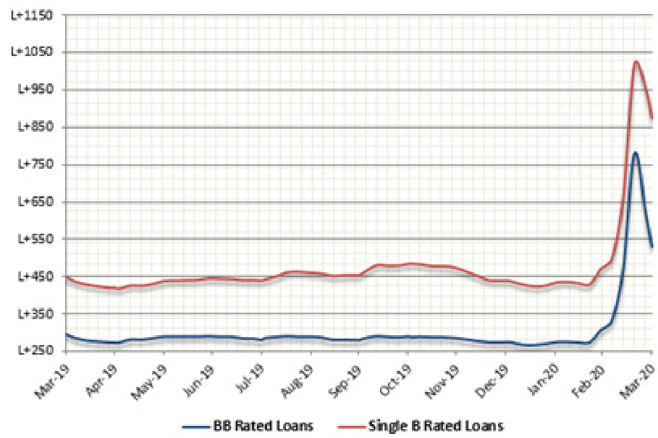
In addition, there was a single non-investment grade bond issuance after March 4, when on March 30 Yum Brands issued $600 million of 5-year notes. The notes were rated B+ by Standard & Poor's and B1 by Moody's Investor Services, and were issued at par with a coupon rate of 7.75 percent. On March 31, the bonds broke for trading at a significant premium, trading during the day between 104.50 and 105.50, or an average yield during the day of 6.56 percent.

Secondary market

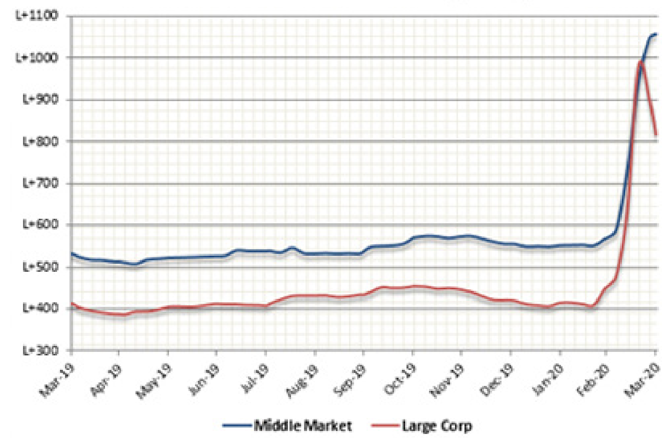
The secondary loan and bond markets have been similarly impacted. The average bid of non-investment grade secondary market loans tracked by Standard & Poor's LCD, excluding oil and gas, has declined from 96.5 at year-end to 83.1 as of March 31.[3] For oil and gas loans, already in a challenged environment, the decline has been from 87.3 at year-end to 59.3. On the bond side, the average price for the ICE BoA US High Yield Index declined from 100.7 at year-end to 85.47 as of March 31.[4]

The resulting price movements have led to correspondingly significant movements in observed spreads across credit ratings. To illustrate the observed movements, the graphs on the right chart the spreads to maturity ("STM") for non-investment grade loans, using data from S&P LCD.[5] In particular, the market has experienced significant increases across the non-investment grade space, with spreads increasing for both middle market and large corporate borrowers, which recovered slightly to quarter end for large corporate borrowers.

STM—BB vs Single B rated loans



STM—Middle market vs large corp



Valuation considerations

The large movements and extreme volatility in the corporate credit market produces unique valuation challenges. On March 20, Reuters reported that "Composite bond pricing services run by trading and data platforms such as Bloomberg, MarketAxess and Tradeweb are struggling to put an accurate value on large sections of credit markets."[6] In the non-investment grade space, traders say there are examples of bonds trading five price points—not basis points—lower than the price at which they are being quoted.

Given these market dynamics, there are a few key points that market participants should consider when fair valuing their illiquid loans.

— **Bid-Ask Spreads and Fair Value Ranges**
Private and illiquid loans generally have a range of fair values, reflecting the range of market participant assumptions of unobservable inputs. Given the current market uncertainty, the range of such market inputs has widened, as observed by widening in bid-ask spreads. This is shown in the

[3] Source: S&P LCD database, data accessed on March 31, 2020.
[4] Source: ICE BoA database, data accessed on March 31, 2020.
[5] Source: S&P LCD database, data accessed on March 31, 2020
[6] Source: Reuters, "Concerns grow over mismarked bond positions", March 20, 2020.

bottom chart, using data tracked by Refinitiv LPC.[7] During the fourth quarter of 2019, a typical quarter, liquid loans had an average bid-ask spread of 0.59 points, while the market overall had an average bid-ask spread of 1.04 points; indicating that illiquid loans had a roughly 2x as wide a range. However, as of March 31, the bid-ask spread for liquid loans spiked to 3.04 points, and the overall market average bid-ask spread spiked to 3.48 points. Not only did the overall market range increase nearly 3x, but the liquid market and overall market converged—indicating limited liquidity even for the most liquid loans.

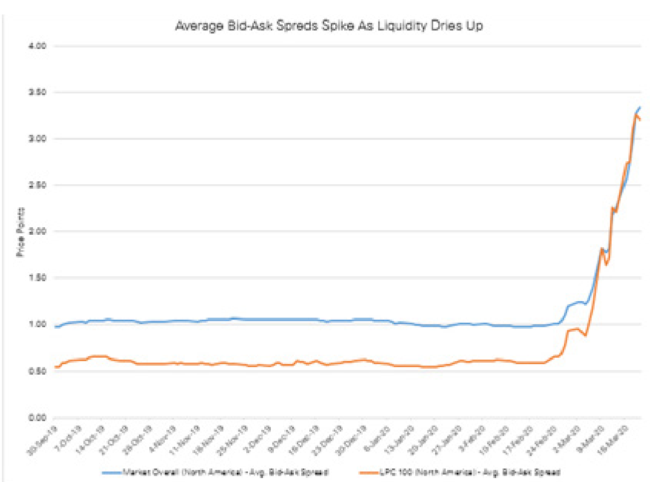
— **Illiquidity**
Private loans are generally priced at a higher spread relative to more liquid observations, to account for the higher required return for illiquid loans. Given the lower liquidity observed in the primary and secondary markets, as discussed above, observed spreads may already embed a higher amount of illiquidity than under more typical market conditions. As a result, careful consideration should be given to the level of adjustments from observed spreads.

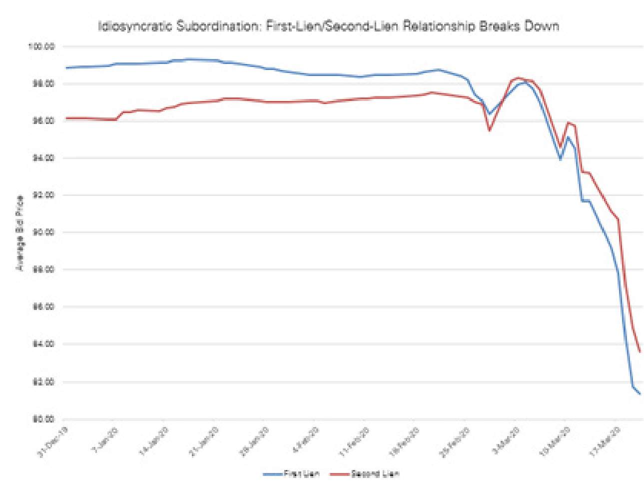
— **Recoveries**
The economic impact of COVID-19 is expected to cause a spike in defaults, with Standard & Poor's projecting default rates could rise to 10 percent in North America in the next twelve months. As the defaults are expected to be concentrated in certain industries, such as oil and gas, such a spike can lead to a significant reduction in recoveries, as assets are all liquidated at once. In measuring non-performing or distressed loans, consider adjusting historical recovery expectations, or examining recoveries in prior sector-specific downturns.

— **Credit Ratings**
Standard & Poor's and Moody's have announced an anticipated wave of credit rating downgrades in the near term. As most illiquid and private loans are unrated, it is important to consider any potential changes in credit risk, or estimated synthetic credit ratings. In fair valuing illiquid and private loans, investors should consider any downgrades of publically rated peers in the industry.

— **Industry**
The impact of COVID-19 and the oil price decline has not affected all industries equally. While there has been an impact across all sectors, industries more directly impacted (such as hospitality, oil and gas, airlines, etc.) have seen greater changes in credit spread and pricing. In measuring the fair value of illiquid loans, consider using narrower, or more focused, industry observations to best match the specific risks of each investments.

— **Subordination**
In times of increased market stress, a loan's position in the capital structure becomes increasingly important. Additional consideration should be given in fair valuing second lien loans, or other subordinated positions, to determine their coverage and level of risk. In particular, the additional spread required for a specific subordinated position should be considered in the context of both the particulars of that capital structure and the market's current risk appetite. This is illustrated in the bottom chart, using data tracked by S&P LCD, showing that for the first time since 2014 the average bid price of second lien loans is above the average price of first lien loans—the result of idiosyncratic subordination considerations.[8]





[7] Source: Refintiv LPC, Loan Connector database, data accessed on March 31, 2020.

[8] Source: S&P LCD database, data accessed on March 31, 2020.

KPMG is here to help

In these volatile times, choosing an adviser requires a firm that has the technical skills and market experience to provide sound, and objective advice. KPMG professionals have experience in dealing with the challenges faced by market participants in such volatile times and can help you think through complex valuation topics and the associated financial reporting implications. KPMG prides itself on a practical valuation framework that recognizes the importance of investment-specific nuances and stresses the facts and circumstances of each instrument in this market environment.

Contact us

Brian Bouchard
T: 212-954-4871
E: bbouchard@kpmg.com

Thomas D'Arminio
T: 212-872-5545
E: tdarminio@kpmg.com

Yosef Lugashi
T: 212-954-3648
E: ylugashi@kpmg.com

Nanki Singh
T: 212-954-8010
E: nankisingh@kpmg.com

Some or all of the services described herein may not be permissible for KPMG audit clients and their affiliates or related entities.

kpmg.com/socialmedia

The following information is not intended to be "written advice concerning one or more Federal tax matters" subject to the requirements of section 10.37(a)(2) of Treasury Department Circular 230.

The information contained herein is of a general nature and based on authorities that are subject to change. Applicability of the information to specific situations should be determined through consultation with your tax adviser.