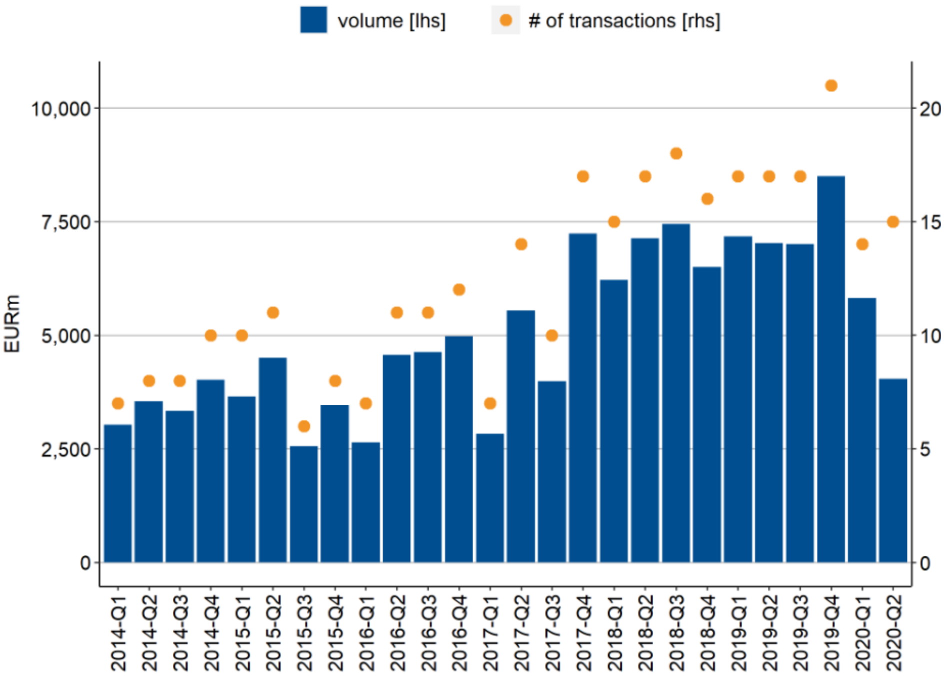
European CLOs: slowly but surely restarting despite pressure on asset quality

After a slowdown in March and April, the European CLO market has actively restarted since the end of lockdowns. About EUR 13bn have been issued so far in 2020 and investor appetite has remained relatively robust despite deteriorating collateral performance.

The volume of newly-issued European CLOs in 2020 is approximately EUR 7.5bn down year-on-year, equivalent to a 39% decline. This is primarily the result of the pandemic, as the two-month lockdown period from March put a halt on new issuance. Since markets re-opened late in April, the number of newly syndicated CLO transactions is very close to 2019 volumes.

Figure 1: EUR CLO new issuance to-date[1]



Source: Scope Ratings, Bloomberg

[1] 10 transactions have been issued so far in Q3 2020 for a total volume of c. EUR 3bn.

Analysts

Benoit Vasseur
+49 69 6677389 40
b.vasseur@scoperatings.com

Cyrus Mohadjer
+49 69 6677389 59
c.mohadjer@scoperatings.com

Media

Keith Mullin
k.mullin@scopegroup.com

Related Research

European corporate defaults & Covid-19: Pressure points show uneven crisis impact – August 2020

Covid-19: short and medium-term consequences for the European CLO market – April 2020

European CLO market stays strong but potential risks beckon – January 2020

Tight spread arbitrage leaves investors and European CLO managers with tougher decisions – May 2019

Scope Ratings GmbH

Neue Mainzer Straße 66-68
D-60311 Frankfurt am Main

Phone +49 69 66 77 389 0

Headquarters

Lennéstraße 5
10785 Berlin

Phone +49 30 27891 0
Fax +49 30 27891 100

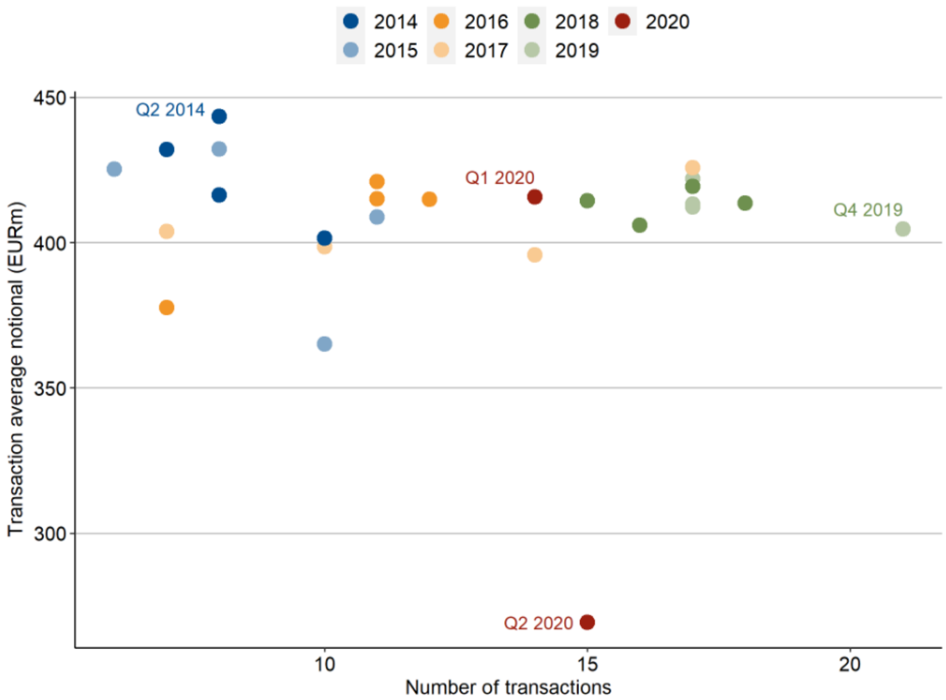
info@scoperatings.com
www.scoperatings.com

Successful adaptation to the global market conditions

More deals, smaller tickets

CLO managers have successfully adapted to the current context, adjusting both the terms and size of transactions to facilitate access to post-Covid markets. The average ticket has significantly decreased compared to the levels observed since 2014, allowing managers to target a narrower investor base and maintain higher credit quality. As described in Figure 2, more transactions closed in Q2 2020 than January and February combined, despite an associated volume that is c. 50% lower.

Figure 2: Average notional and number of transactions per quarter



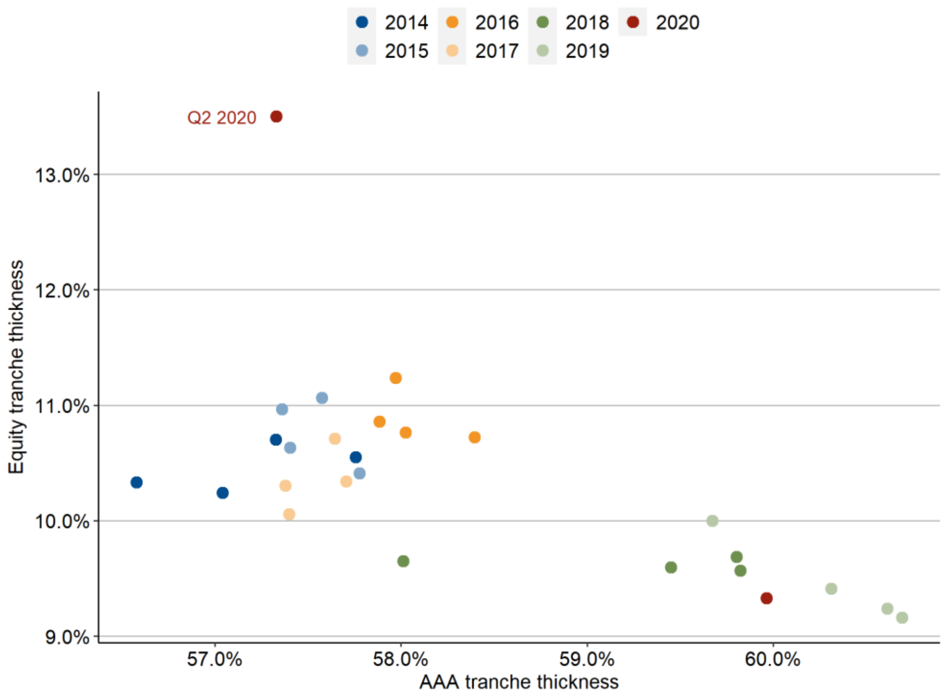
Source: Scope Ratings, Bloomberg

Increased structural management

Given the pressure on the rating of the underlying loans and general market sentiment, the first transactions to emerge showed increased credit enhancement for senior investors and thicker equity tranches, resulting in lower deal leverage. Figure 3 highlights how Q2 2020 is an outlier. Reinvestment periods are also getting shorter, and the first European transaction with a static pool was issued recently[2], as already observed in the US CLO market.

[2] Palmer Square European Loan Funding 2020-1 DAC

Figure 3: AAA vs. Equity tranche thickness

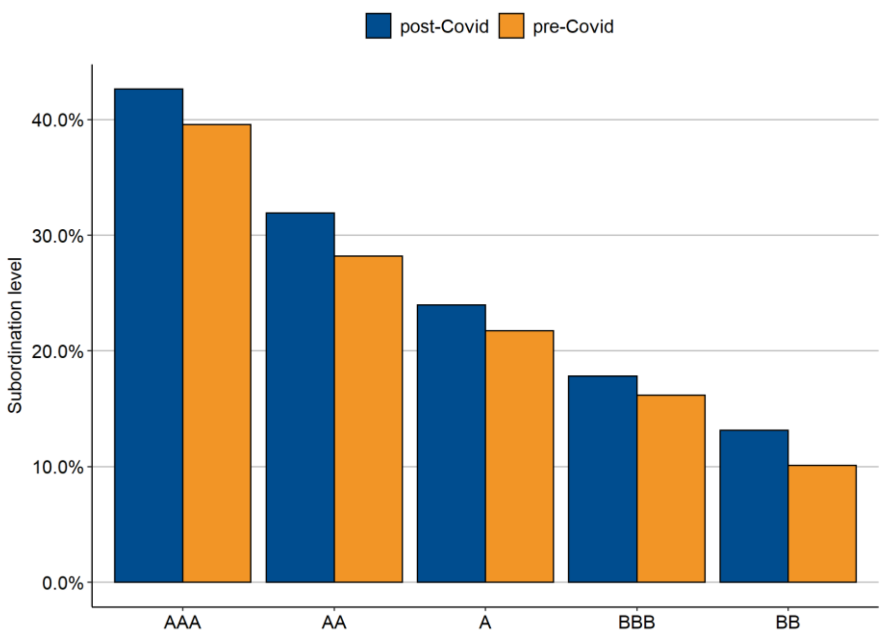


Source: Scope Ratings, Bloomberg

Extra subordination for rated tranches

Figure 4 illustrates how rated tranches have benefited from an extra 2% to 4% subordination on average since May 2020.

Figure 4: Subordination level pre- and post-Covid per rating category



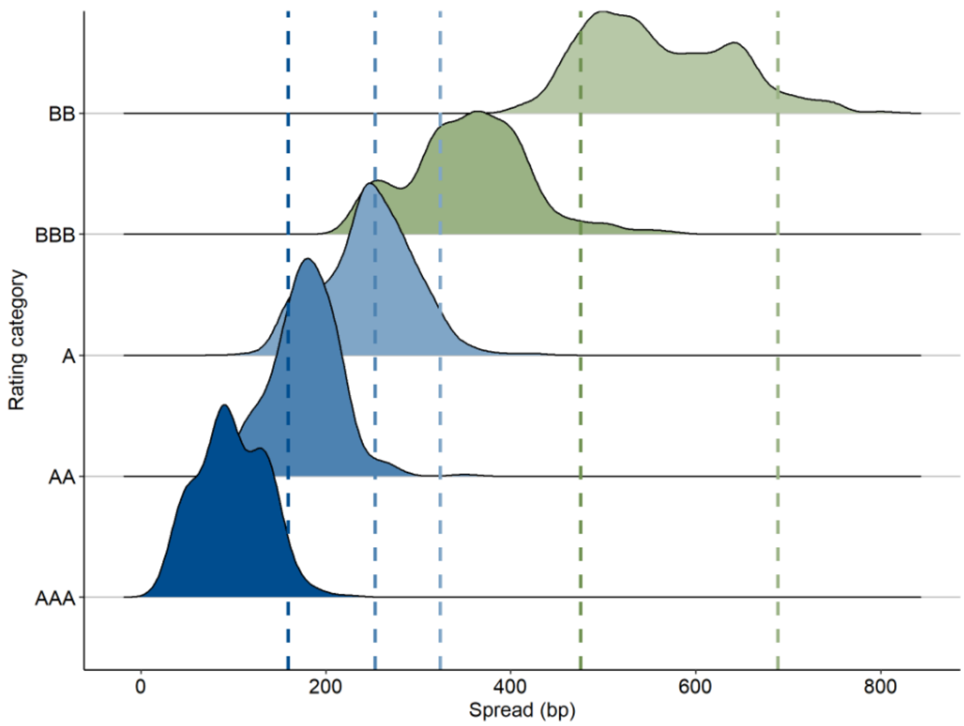
Source: Scope Ratings, Bloomberg

European CLOs: Slowly but surely restarting despite pressure on asset quality

Natural liability-spread widening in post-Covid CLOs

European CLO tranche spreads have widened despite the increased credit enhancement, in line with global credit spreads. Figure 5 shows the spread distribution[3] per rating category for European CLOs issued between 2014 and Q2 2020. The vertical dashed lines correspond to the average level of transactions issued in Q2 2020. It clearly shows how large the price correction has been post-Covid. We note, however, that transactions issued in Q3 2020 have tighter spreads. AAA spreads for transactions priced late July 2020 are around 145bp, about 50bp lower than in May 2020 but 50bp higher than in February 2020. Q3 2020 transactions have seen their leverage gradually increase with the reintroduction of B rating category tranches.

Figure 5: Spread distribution per rating category



Source: Scope Ratings, Bloomberg

Asset quality: inescapable deterioration

Wave of high-yield corporate downgrades…

As expected, high-yield corporate downgrades have reduced junior over-collateralisation cushions and the reported proportion of CCC rated loans in European CLOs pools has almost tripled on average, reaching levels as high as 12% for some transactions[4]. According to Morgan Stanley[5], 43% of outstanding EU CLO deals have already breached the typical 7.5% CCC bucket limit. Leveraged loan issuance has been relatively fragile, particularly in the BB space where bonds have been the preferred instrument, mostly used to refinance existing debt. Compared to Q1, overall volumes of sub-investment-grade loans brought to the market have decreased by c.30%[6].

[3] The spread represented corresponds to the contractual spread over Euribor paid by the CLO tranches, as opposed to the discount margin, which is usually higher for lower-rated tranches as they are issued at a price discount.
[4] CCC CLOuds (#3) – July 2020 – Morgan Stanley Research
[5] CCC CLOuds (#3) – July 2020 – Morgan Stanley Research
[6] High Yield and Leveraged Loan Data Report – Q2 2020 - AFME

… yet not resulting in a wave of defaults

While corporate borrower risks have increased in most industries, forbearance measures implemented by various governing bodies are delaying the conversion of those risks into defaults. CLO tranches have thus been relatively resilient, facing a relatively small number of downgrades, while placements under negative watch have mainly occurred in the BBB and sub-investment-grade segments.

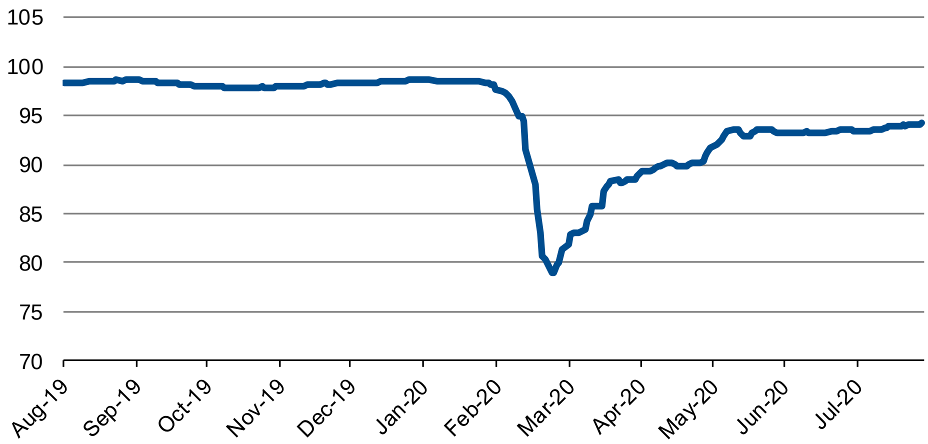
What next for the European CLO market?

In a unique context, the European CLO sector has maintained a certain level of performance since the various European lockdowns have been lifted. Volumes in the second quarter were sustained as pre-Covid warehouses needed to be converted, and the trend observed in Q3 points towards a return to normal with some managers slowly starting to increase deal size. More experienced managers have been able to contemplate structural changes or obtain warehouse financing, in a market where we have seen few new players enter since the pandemic.

The current trend is supportive for CLOs and their underlying assets.

The positive trend is also illustrated by the recovery of leveraged loan prices since the massive sell-off in March. While prices are not yet back to pre-Covid levels, such a readjustment, alongside improved liquidity, should provide managers with more options to deal with asset covenants.

Figure 6: European Leveraged Loan price index[7]



Source: Bloomberg

Yet, global macroeconomic uncertainties remain, and CLOs could weaken at any time if a delayed wave of defaults emerges once emergency measures are lifted. Smaller and more indebted companies are particularly vulnerable in a context where corporate leverage has continuously increased in recent years. But the relatively high level of industry diversification in CLOs could prove to be a natural hedge against potential waves of insolvencies at the sector level.

[7] S&P European Leveraged Loan Index (ELLI)

European CLOs: Slowly but surely restarting despite pressure on asset quality

Scope Ratings GmbH

Headquarters Berlin
Lennéstraße 5
D-10785 Berlin

Phone +49 30 27891 0

Frankfurt am Main
Neue Mainzer Straße 66-68
D-60311 Frankfurt am Main

Phone +49 69 66 77 389 0

Paris
23 Boulevard des Capucines
F-75002 Paris

Phone +33 1 8288 5557

London
3rd Floor
111 Buckingham Palace Road
London SW1W OSR

Phone +44 20 3457 0444

Madrid
Edificio Torre Europa
Paseo de la Castellana 95
E-28046 Madrid

Phone +34 914 186 973

Milan
Regus Porta Venezia
Via Nino Bixio, 31
20129 Milano MI

Phone +39 02 30315 814

Oslo
Haakon VII's gate 6
N-0161 Oslo

Phone +47 21 62 31 42

info@scoperatings.com
www.scoperatings.com

Disclaimer