European CLO market stays strong but potential risks beckon

European CLO issuance was strong in 2019, with volumes up c. 10% year-on-year. However, signals in the leveraged loan market have been mixed, with lower supply and deteriorating credit quality. Entering 2020, we expect CLO issuance to remain solid as interest rates will stay low.

European CLOs remain popular among investors, providing a high-yield alternative in a low-spread environment. Over EUR 40bn was deployed in 2019, a mixture of new deals (72%) and refinancings (28%). This was despite a clear slowdown in leveraged loan activity due to fewer corporate acquisitions and buyouts.

While we expect the asset class to stay strong in 2020, a number of risks could materialise, including deteriorating credit quality among sub-investment-grade corporates and tighter spread arbitrage.

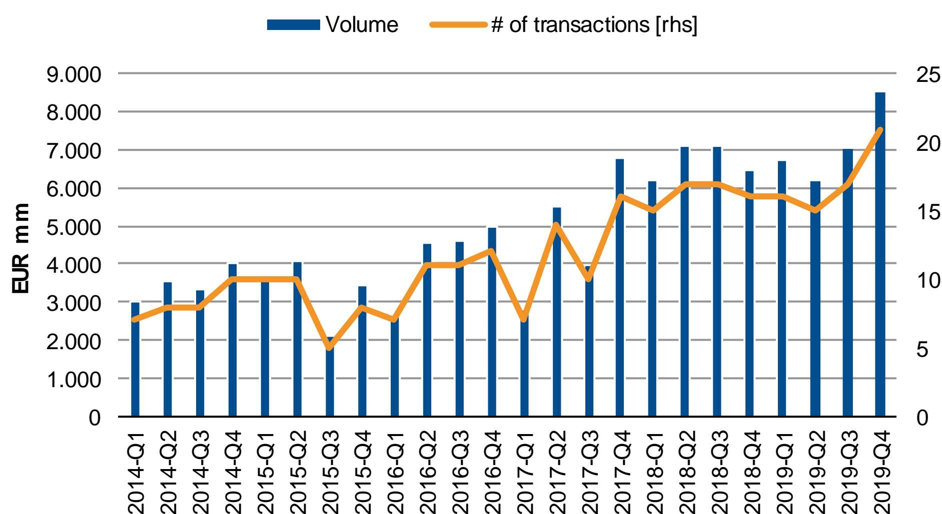
CLO managers keep bringing new deals, with an emphasis on the alignment of interests necessary to attract investors at the lower end of the capital structure. As new managers continue to enter the market, we expect a broader mix of investors and less reliance on anchor investors.

CLOs: Increasing volumes despite tightening in spread arbitrage

Issuance volumes continued to rise in 2019, following the trend of recent years. This was driven by a strong fourth quarter, topping EUR 30bn across more than 70 deals, a 10% increase from 2018. Eight new managers entered the market, the highest level since the financial crisis.

In 2020, we expect European CLO volumes to reach the levels of over the past two years as investor demand will remain solid, with ECB monetary policy set to remain accommodative. This will support the yield-enhancing nature of CLOs relative to other asset-backed segments.

Figure 1: EUR CLO new issuance to-date



Source: Scope Ratings

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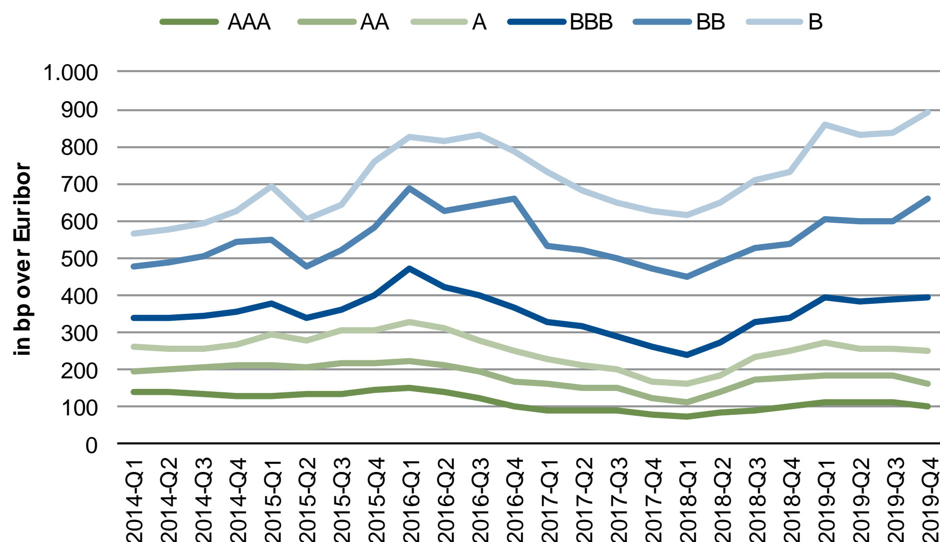
Higher liability spreads in 2019

In 2019, the two ends of the capital structure saw spread behaviour diverge. On the one hand, spreads on mezzanine and junior tranches continued to rise, with coupon rates on recently issued transactions nearing 10%; a result of more financial pressure on high-yield corporate issuers. On the other hand, AAA spreads stabilised at around 100bp, as tranches were generally unaffected by the lower collateral quality and benefited from strong investor demand.

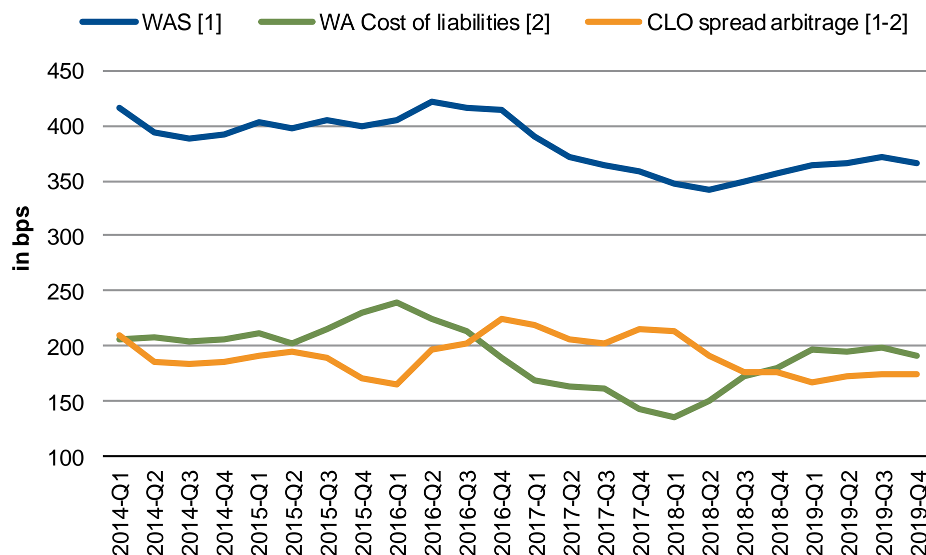
Figure 2: Evolution of EUR CLO primary spreads



Source: Scope Ratings

As we noted in a previous research report *("Tight arbitrage spread leaves investors and European CLO managers with tougher decisions" – May 2019)*, spread arbitrage continues to be under pressure and is at its lowest level since the financial crisis. CLO managers are increasingly challenged when structuring new transactions and may have to accept lower equity returns as deal leverage is not being increased.

Figure 3: Evolution of EUR CLO spread arbitrage



Source: Scope Ratings

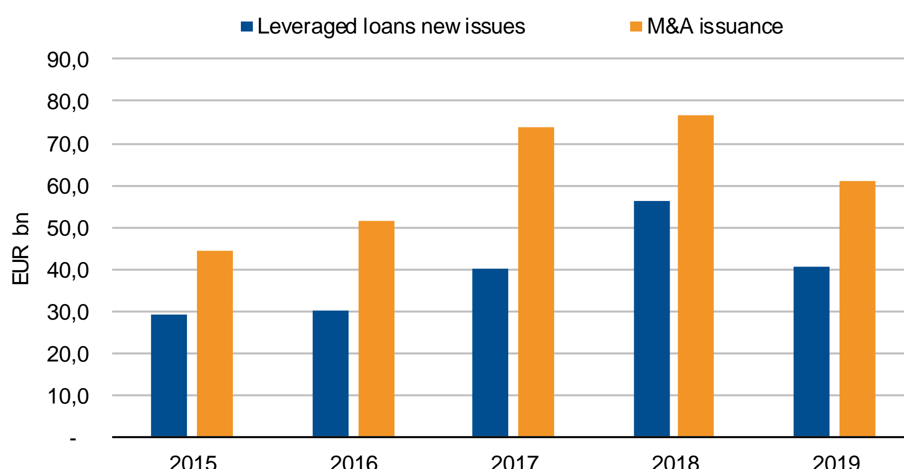
Leveraged loans: dry supply and lower credit quality

Supply-demand mismatch

In Europe, investor appetite for leveraged loans was robust throughout 2019, aided by record-low default rates among high-yield issuers. Demand was led by banks and notably by CLOs, as the pace of new CLO issues accelerated in 2019. However, supply still fell short of demand: 2019 was the first year since 2013 where both primary and secondary activity decreased year-on-year.

The lack of jumbo deals was a key reason for the decline in leveraged loan issuance. This is closely linked to M&A activity, which fell 25% year-on-year in Europe in 2019, according to preliminary data from Refinitiv. Corporates have been particularly cautious, fearing threats of recession and ongoing uncertainties about Brexit, while facing continuous pressure on their operating performance. Cash holdings for both corporations and funds have increased as a result and could be used in financing leveraged buyouts if markets become more stable in 2020. This could help improve the net supply of leveraged loans, which recovered in the last few months of 2019 following more opportunistic deals across Europe.

Figure 4: EUR leveraged loans and M&A issuance



Source: Scope Ratings, Bloomberg

Deteriorating credit quality

The credit quality of the broader leveraged loans universe has worsened, however. Loans trading at below a EUR 80 cash price now account for 4.5%[1] of all European leveraged loans, the highest level since 2016. Additionally, issuers have seen their financial leverage increase, with the share of underlying debt-to-EBITDA ratios of above 6x now exceeding 35% of the outstanding universe, compared to c. 20% in 2015[2]. The main contributors were healthcare and telecommunications companies, two sectors with a prevalence of buyouts and acquisitions, accounting for around 40% of leveraged loan volumes in Europe. Pharmaceuticals (e.g. Zentiva) and cable operators (e.g. Ziggo, Altice) show particularly high leverage.

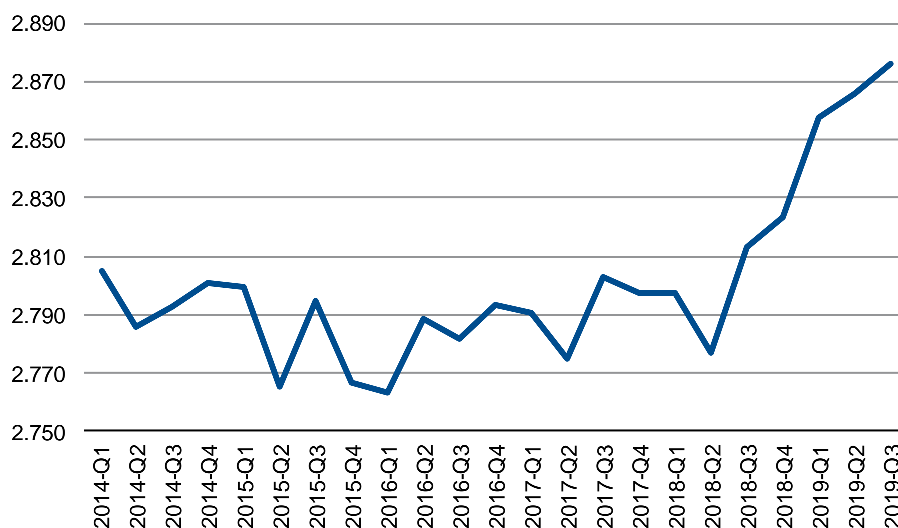
[1] Morgan Stanley (November 2019)
[2] BIS (September 2019)

The relatively high share of B- loans in the European universe will remain a threat for CLOs, as potential downgrades to CCC expose structures to market risk. A persistence in these difficult conditions could prompt some dislocation in manager performance. Decreasing credit quality has been accompanied by deteriorating underwriting standards at the lending level, with an increased share of cov-lite issuance. Moreover, weaker fundamentals have not been compensated for by higher premiums, as leveraged loan spreads remain within the 300bp-450bp range, similar to in 2018.

Adverse consequences on CLOs

For CLO managers and investors, these dynamics have three over-riding adverse effects: i) a significant overlap in loan collateral; ii) tight spread arbitrage; and iii) decreasing collateral quality, shown in the sharp rise in the average pool rating factor in the past few quarters.

Figure 5: Evolution of average pool rating factor[3]



Source: Scope Ratings

[3] As measured using Moody's WARF metric and data

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