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

European CLOs started the year with strong issuance volumes. But arbitrage dynamics with tight excess spreads are unfavourable to equity-tranche investors and CLO managers. Based on a review of 2014-vintage CLOs, spread data and other transaction metrics have shown a recent deterioration in credit quality.

The European CLO market remains attractive for investors hunting for yield. The market is coming off its strongest post-crisis year and is close to outpacing the EUR 100bn mark in outstanding volume. Trends from 2018 have continued into this year: liability spreads are at their widest in almost three years while asset spreads have largely remained constant, creating a challenging spread arbitrage environment for CLO managers.

Investors, particularly at the lower end of the capital structure, face tough questions. The latest CLO structures are weaker, due to higher leverage coupled with lower credit enhancement levels; and lower collateral quality.

The leveraged loan market has also been unfavourable to managers. While corporate default rates are at a historical low, the credit risk of European leveraged loans has worsened with an increased share of B rated loans. Modest primary issuance – down 30% year-on-year – has exacerbated these conditions, triggering a supply-demand mismatch that has prevented a substantial widening in spreads.

We expect the tight spread arbitrage to last if loan issuance does not pick up. For now, consequences remain workable as managers are using alternative transaction features to foster demand. This trend is unsustainable in the mid to long term, however, as further deteriorating structural metrics are forcing investors to request even higher yields.

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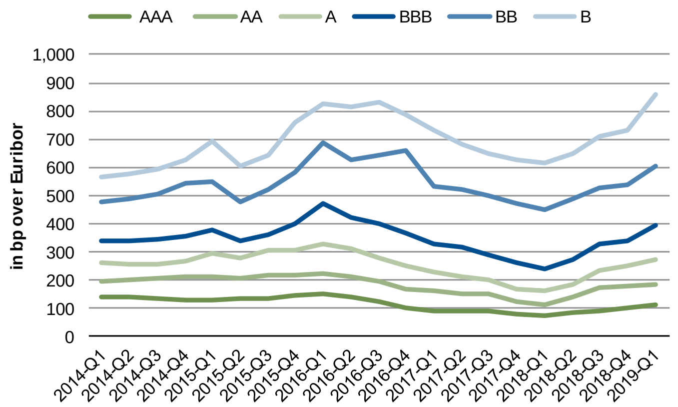
A challenging spread arbitrage environment…

As a result of a rise in the cost of liabilities

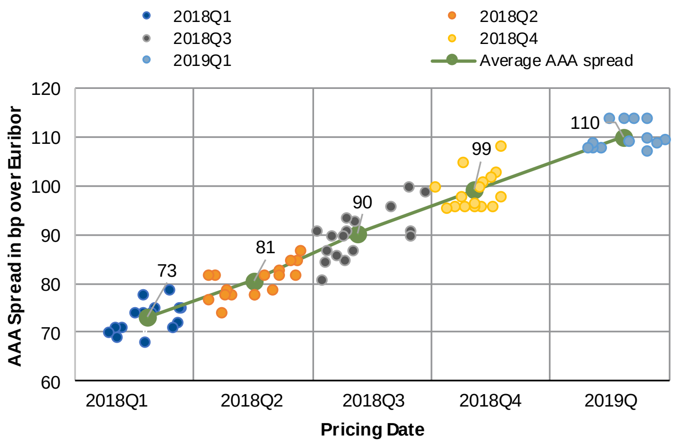
For CLO managers, spread arbitrage is the difference between the income generated by underlying leveraged loans and the cost of borrowing. The higher the spread arbitrage, the more excess spread flows into the structure. This measure is also an indicator of market sentiment. Recent arbitrage tightening comes as European CLO primary spreads are at their widest in almost three years –even at the lower end of the capital structure spreads now are higher than levels on new CLOs issued post-crisis. AAA margins, typically the largest contributor to overall funding costs, have also widened uninterrupted since Q1 2018, with an average increase of 37bp (+51%).

Figure 1: Evolution of EUR CLO primary spreads



Source: Scope Ratings

Figure 2: Recent evolution of EUR CLO AAA primary spreads

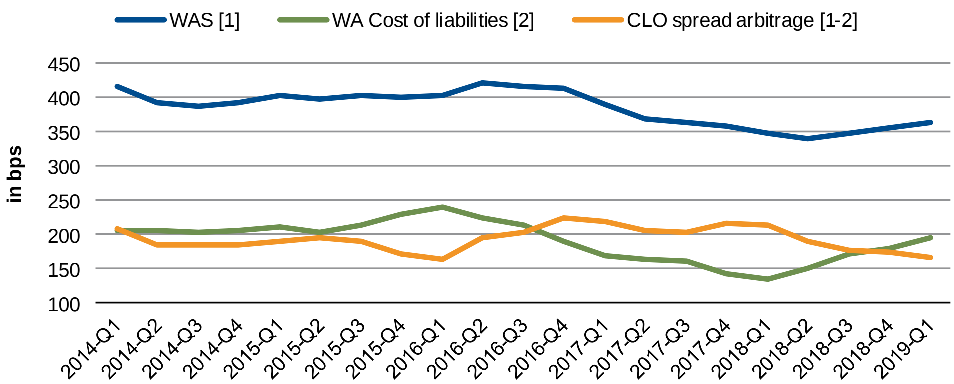


Source: Scope Ratings

Not matched by loan spreads

On the other hand, asset spreads have not widened as much, driven by a supply shortage. Consequently, spread arbitrage is at its lowest since the crisis, resulting in less protection for debt investors and lower expected equity returns. This will eventually weigh on the appetite of equity investors. Figure 3 highlights the tightening spread arbitrage, defined as the difference between weighted average spread (WAS) at inception and weighted average cost of debt liabilities.

Figure 3: Evolution of EUR CLO spread arbitrage[1]



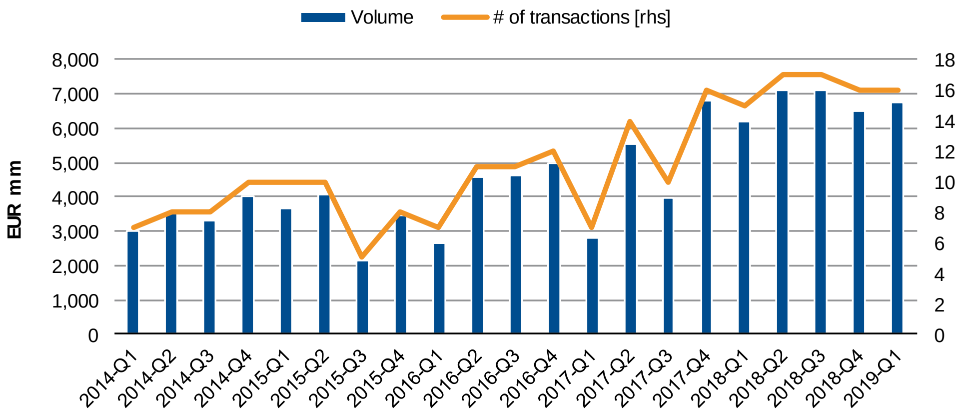
Source: Scope Ratings

[1] Spread arbitrage for a quarter is hereby computed as average of the spread arbitrage for each new EUR CLO transaction issued in the quarter in question. For a particular transaction, WAS is taken from data at inception from Moody's, S&P or Fitch and weighted average cost of debt liabilities is computed using rated notes' contractual spreads (for fixed rate notes, we use the spread of the pari passu floating rate note, when available).

No impact on issuance yet

Transactional volumes continue to follow last year's upward trend, reaching EUR 6.8bn in the first quarter of 2019, with a healthy deal pipeline expected in Q2. This outpaces issuance in Q1 2018, and anchor investors such as Japanese banks have been continuously active in new transactions. However, the high backlog of CLO warehouse facilities is a sign that keeping new issuance viable is increasingly difficult.

Figure 4: EUR CLO new issuance to date



Source: Scope Ratings

Eventual deterioration in transaction credit quality

Deteriorating collateral quality

Collateral quality is deteriorating, highlighted by the increase in the average pool rating factor for recent transactions[2]. This results from i) the need among CLO managers to keep excess spread high enough to attract equity investors; and ii) the worsening credit quality of the leveraged loan market, portrayed by the higher share of B -rated loans, to the detriment of those rated BB. Another sign is the share of loans trading below 90% in EUR CLO collateral, reaching the highest level since the market re-opened in 2013, at 6% in Q1 2019[3].

The deterioration in loan quality exposes transactions not only to more defaults but also to collateral downgrades. This directly impacts collateral quality and coverage tests, therefore potentially restricting the portfolio manager's ability to perform its role.

Weaker structural fundamentals

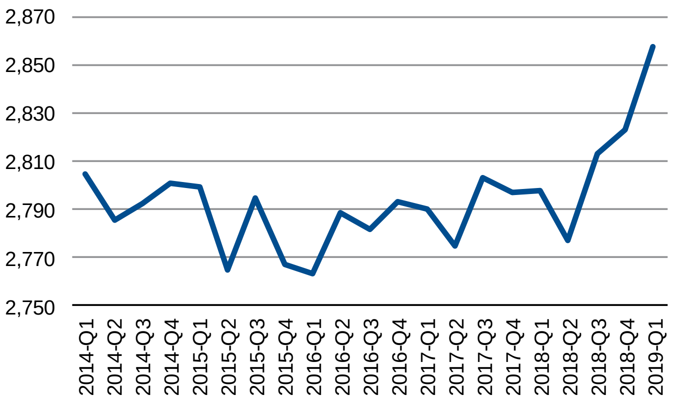
The fundamental quality of structures has also worsened. Transaction leverage has risen significantly since the start of 2018, exceeding the post-crisis average of 9.7x, and credit enhancement levels have reduced steadily. This has put more pressure on the initial ratings for recent deals, particularly for Class D notes, where more tranches are rated at the lower bound, i.e. BBB- or equivalent. This may put off CLO investors, if premiums are insufficient to compensate for the higher risks.

Alternative transactions features

The tight spread arbitrage has also forced arrangers and managers to explore alternative transaction features, particularly at the middle to low end of the capital structure. These include i) removing costly B rated tranches in some transactions; ii) the manager retaining more equity; iii) creating more tranches with step-up coupons; and iv) shortening the maturity and re-investment periods of some transactions.

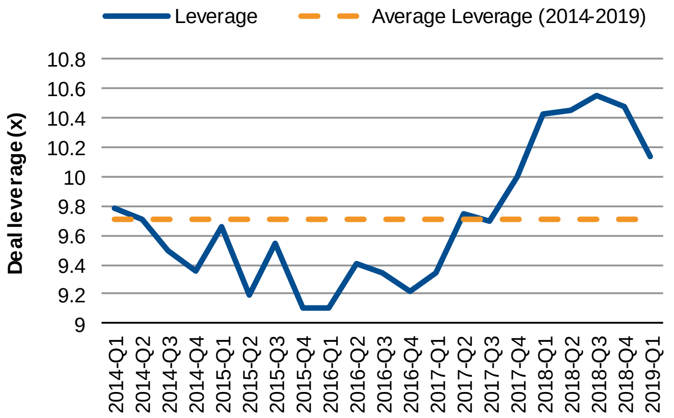
[2] As measured using Moody's WARF metric and data
[3] Morgan Stanley (April 2019)

Figure 5: Evolution of average pool rating factor[4]



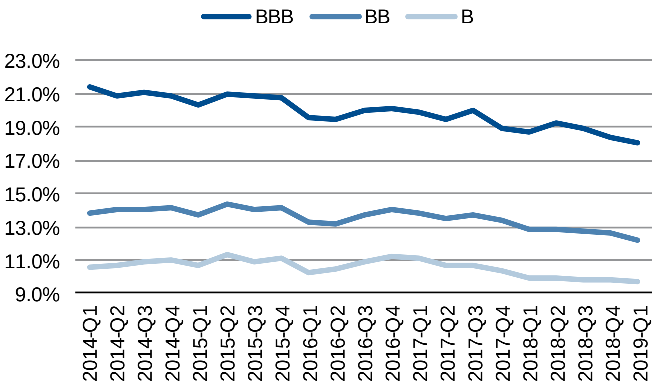
Source: Scope Ratings

Figure 6: Evolution of transactions' leverage



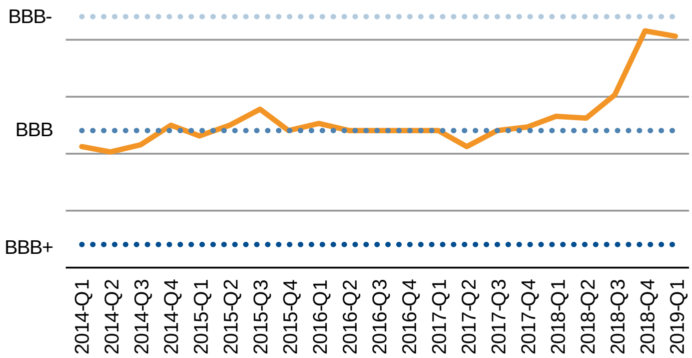
Source: Scope Ratings

Figure 7: Evolution of credit enhancement levels



Source: Scope Ratings

Figure 8: Evolution of Class D initial rating



Source: Scope Ratings

What is next?

High bargaining power for investors

A scenario of spread arbitrage widening from a lower cost of funding is unlikely. The CLO investor base lacks granularity, and anchor investors are likely to request additional premia for their increased exposure to the asset class and the extra risks from lower-quality loan collateral. Also, the levers being used to keep structures attractive cannot be used in the long term without spreads widening further. Once this tipping point is reached, the spread arbitrage could tighten further, triggering a vicious circle resulting in a slackening of new primary transactions.

Dry leveraged loan supply

Loan issuance will be essential to the recovery of spread arbitrage, and eventually of CLO collateral quality. The European leveraged finance market started the year slowly, with loan issuance down about 30% on the previous year and at its lowest quarterly volume since 2016. This is explained in part by the slump in M&A, with market sentiment suggesting over-valuation in most industries and by political uncertainties, which continue to pose a threat to financial markets.

[4] See footnote 2

A rebound in leveraged loan issuance, helped by the currently benign default environment, could relieve some pressure in loan spreads and offer managers better-yielding and diversified portfolios.

Volumes not expected to drop significantly in the short-term

We expect CLO issuance volumes to drop only slightly in the next two quarters, based on strong investor demand at the high end of the capital structure, and the strong performance and yields of CLOs compared to other European asset classes, especially with low interest rates persisting. Additionally, many warehouse facilities have been ramped up and need to close soon. This will lead to additional issuance, even at sub-optimal conditions. An extended stretch of tight spread arbitrage and weakening structures could, however, have an adverse effect on EUR CLO activity beyond this short-term horizon.

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