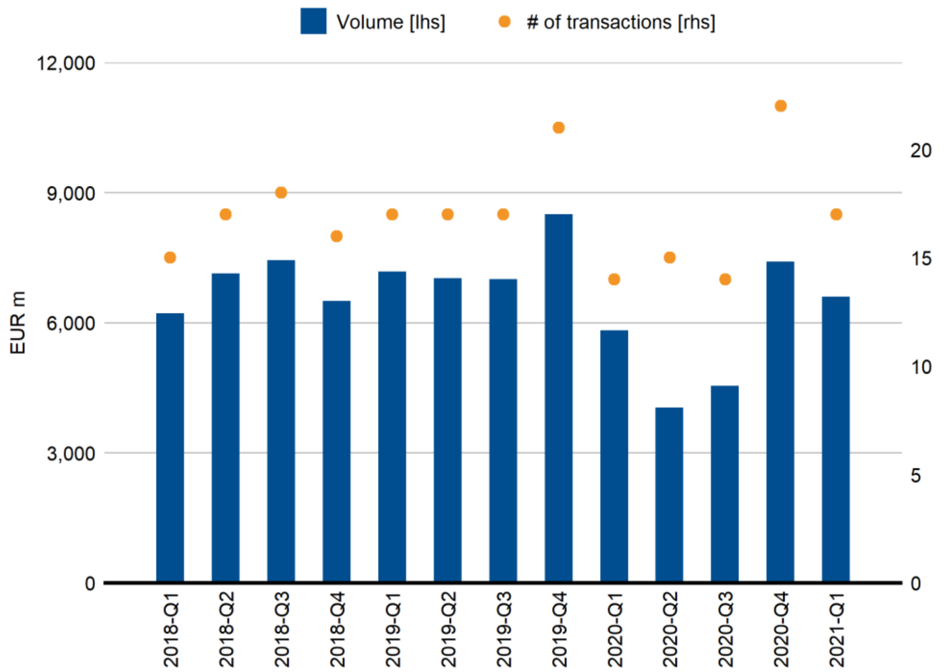
European CLOs: energetic start to 2021 but asset-quality concerns remain

The European CLO market has roared back to life following a pandemic-induced slump, as favourable market conditions support some of the busiest monthly activity in a decade. With new-issue volumes returning to levels seen in normal times, we ask whether equilibrium will soon be found regarding tightening tranche spreads. As well as ESG developments, we also assess the situation where CLO managers are facing tightening leveraged loan spreads in a business environment still impacted by the pandemic, high levels of competition, and potential disruptions caused by the emergence of SPACs in Europe.

Figure 1 below captures just part of the Q1 2021 backdrop for European CLOs. The new-issue market has been active, with EUR 6.6bn in 17 new transactions. Notably, EUR 4.7bn for 15 refinancings and EUR 5.6bn for 13 resets priced in the first two months of the year, making February one of the busiest months since the re-opening of the European CLO market in 2013.

Positive sentiment as well as progressive spread tightening have offered economic incentives to equity noteholders and CLO managers to pursue refinancing and reset activity. This trend is likely to continue as transactions issued in 2020, priced at much higher spreads and with short non-call periods in anticipation of a short-to-medium-term recovery, will likely go through the same process. However, concerns over asset quality remain in a context where governments and central banks are possibly delaying what could be a spike in corporate bankruptcies.

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



Source: Scope Ratings, Bloomberg

[1] Up to March 26th 2021

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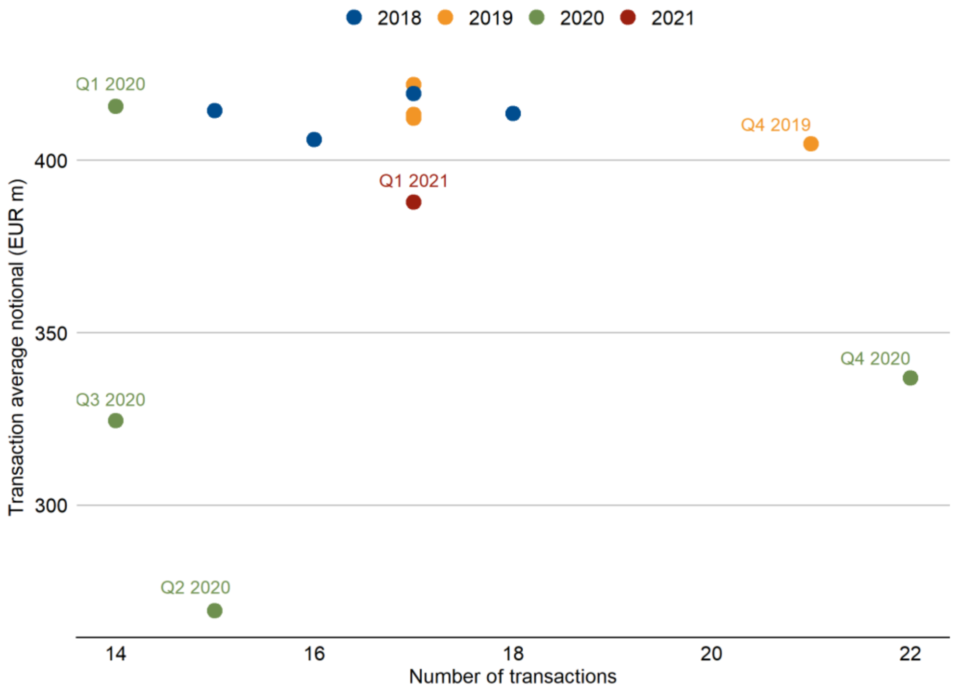
EUR CLO market continues to rejuvenate in Q1 2021

Normalisation trend continues

The large aggregate volumes of new issues, refinancings, and resets seen in Q1 2021 demonstrate how the European CLO market has recovered since the start of the pandemic. Around this time last year, no European CLO transaction priced for a month and a half. When the market reopened in Q2 2020, the average transaction size was below EUR 300m and spreads were near the highest seen since 2014. Figure 2 show the normalisation in terms of volume and average transaction size in Q1 2021 for new issues. We are much closer now to the levels observed in the months before the pandemic.

Figure 2: Average notional and number of transactions per quarter



Source: Scope Ratings, Bloomberg

CLO spreads tightening especially in senior tranches

Positive market sentiment and large volumes have driven CLO spreads down across the capital structure, mirroring the tightening in leveraged loan spreads. Figure 3 shows the gradual decrease in spreads in the last year. Spread compression is more pronounced in the AAA and AA rating categories, reflecting the attractive relative value of CLOs compared to other asset classes in the context of historically low yields in Europe. The latest transactions priced in March saw margins for the most senior tranches in the high 70s to low 80s basis points, relatively close to the tightest levels of high 60s bp seen in early 2018.

Such compression has been key in improving spread arbitrage for managers, enabling them to consistently issue new transactions over the past few months. The market has been buoyed by solid demand from financial institutions willing to deploy liquidities in AAA CLO tranches providing attractive value compared to other asset classes. We therefore see the current spread tightening as being predominantly driven by technical factors, rather than by positive changes in fundamentals.

Figure 3: Mean spreads per rating category[2]

Rating category	2014 - Q1 2020	Q2 2020	Q3 2020	Q4 2020	Q1 2021
AAA	114	175	138	110	84
AA	183	255	202	182	137
A	251	324	288	281	221
BBB	352	475	402	412	321
BB	552	689	631	657	555

Source: Scope Ratings, Bloomberg

Spreads in the lower parts of the capital structure have also compressed since Q2 2020 and are in line with the average seen pre-pandemic. This suggests that idiosyncratic risk remains high in the market´s perception compared to systemic risk, which currently seems less of a concern to CLO investors.

Where to from here?

Leveraged loan issuance has picked up in Q1 2021

In our previous research piece, we highlighted the deteriorating asset quality and relatively dry leveraged loan markets in 2020 as potential obstacles to a full normalisation of the European CLO market. So far in 2021, leveraged loan activity has been supportive, on the back of increased M&A and buyout activity and with borrowers seeking to refinance at tighter spreads to take advantage of favourable market conditions. These conditions are likely to persist in Q2 but the pace of new issuance should slow as spreads stabilise.

Asset quality continues to be a concern

Asset quality continues to be an important theme, especially in the context of refinancings and resets. The median CCC/Caa bucket for the EU CLO universe remains elevated at c.6.3%, compared to 2.5% pre-pandemic[3] with a few transactions failing their interest diversion test or with thin junior OC test cushions. Further spread tightening in leveraged loans may lead managers to focus further on borrowers at the lower end of the B rating category, leaving transactions vulnerable to a worsening economic situation.

ESG CLOs: positive selection in the spotlight

A few recent changes in the European CLO markets also point towards trends that are likely there to stay. Neuberger Berman issued its first European CLO in Q1 2021, with assets that are objectively ESG-positive, including borrowers that have covenants referencing the UN's Sustainable Development Goals[4]. In the case of this particular transaction, we note that the ESG compliance is determined by the collateral manager in its sole discretion rather than by a third party. A third-party certification would constitute a further step towards a positive selection of assets with regards to ESG criteria going forward and would benefit market participants. This focus is also encouraged by the growing amount of ESG-labelled high-yield debt (c. EUR 4.5m YTD), as illustrated by VodafoneZiggo´s green bond in December 2020, as well as the more recent issuances of Novelis and Faurecia.

Distinctive features present in transactions

We have also seen recent structures with different liability formats for the same rating category, longer reinvestment periods (up to five years), and documentation that allows managers more flexibility to take part in restructurings and rescue financings.

[2] The average spread computed 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.
[3] Morgan Stanley – CCC CLOuds (#5) (February 2021)
[4] Bloomberg - https://www.bloomberg.com/news/articles/2021-02-10/pioneering-clo-targeting-un-development-goals-launches-in-europe

These are signs of a mature market as CLO managers develop distinctive features in their transactions driven by the increasing levels of competition between CLO managers and the way they are perceived by CLO investors.

SPACs: can they disrupt the corporate debt environment?

SPACs are popular investment vehicles

Special purpose acquisition companies (SPACs) are increasingly seen as an attractive mechanism for both investors and companies looking to go public. These shell companies raise funds through an initial public offering (IPO) with the only business objective being the successful merger with an unlisted company, hence acting as an alternative vehicle in bringing companies public as a joint entity.

There is a limited timeframe to complete the merger, generally two years from the IPO. Failing to do so in time results in IPO proceeds, held in a low-interest trust account, being returned to SPAC shareholders. A particular highlight for SPAC investors is the right to redeem their shares shortly before the merger date for the corresponding trust value, plus interest accrued, if they do not wish to participate in the merger.

When finalising the merger, a SPAC will typically seek to expand its capabilities by approaching additional investors and including them in the transaction. This is done through private investment in public equity (PIPE) deals which not only serve to raise additional capital but also as a validation tool which promotes further market confidence in the merger.

SPACs provide investors and the target company with the means to circumvent the traditional IPO process while presenting a direct injection of capital without the usual red tape involved. There is a reduced need to take on expensive underwriters or commit time and resources into lengthy transition proceedings. SPACs often also come with experienced managers who play key roles in the transition and thereafter the running of the public company.

SPACs currently operating in Europe are in limited number

European markets have succumbed to the increasing popularity of SPACs, although when compared to the US there is a huge disparity in the number of SPACs being listed. Last year saw 244 SPACs listed in the US with USD 78.2bn of combined capital, while only three SPACs listed over the same period in Europe for slightly less than EUR 500m[5]. Importantly, European and other international companies can be potential targets for US SPACs.

The consensus is that European exchanges are currently less accommodating towards SPAC-like structures compared to their North American counterparts. The merger targets have also, of late, been increasingly made up of high-growth tech firms and Europe tends to have a reduced number of listed companies which are necessary to establish a suitable benchmark.

However, given the rapid rise and popular nature of SPACs in the US, they are bound to carve out significant territory in European markets. The question is not if, but what kind of reception they will experience in Europe and what form they will take compared to US SPACs.

What does this mean for leveraged loans and CLOs?

The expansion of this kind of M&A activity could have a significant effect on leveraged loan and CLO markets. Borrowers in CLO transactions could be attractive targets for SPACs. A few such transactions have already occurred in the US. An example would be Global Blue Group AG, which went public through a US SPAC in August 2020.

[5] Source: CNBC, Refinitiv

The company is headquartered in Switzerland and maintains a presence in both European and international markets, as a global provider of tax-free shopping and payment solutions. The company's EUR 630m term loan with a 300bp margin was present in various EU CLOs prior to the acquisition. This credit experienced large increases in price shortly before the planned merger as a result of market anticipation around the new public entity with the term-loan subsequently being refinanced[6].

An advantage for firms that choose to go public through a SPAC is greater flexibility when it comes to refinancing and restructuring debt with incoming capital. Incoming SPAC capital is predetermined and most likely accompanied by PIPE, which can influence the targeted company's current obligations. These occurrences, where firms represented in CLOs receive new capital and changing debt structures, can result in a flurry of market activity and volatility in their loan pricing, which further leans on and emphasises the capabilities of the CLO manager.

Ultimately, SPACs have made up significant ground in challenging traditional IPOs, and serve as vehicles revolving around successful and increased M&A activity. The knock-on effect on the financing, debt load, and loan issuance of these companies cannot be accurately determined and will be something to keep an eye on. What kind of disruptions these developments have on current and new leveraged loans will be a factor that CLO managers need to consider going further into 2021.

[6] Source: Bloomberg, Trepp

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