European CLOs: low lev-loan supply, asset quality concerns offset reassuring issuance

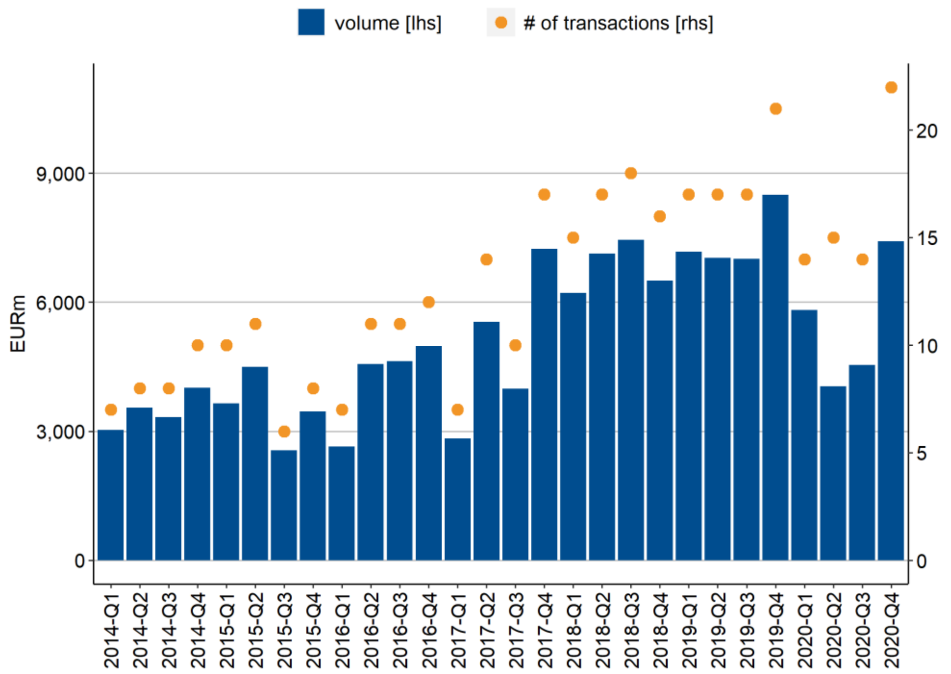
The pandemic has impacted new European CLOs as well as existing transactions. Despite increasing pressure from higher market volatility and decreasing asset quality, CLO managers successfully adapted as they continued bringing deals to market throughout Q3 and Q4 2020. Looking forward to this year, we expect the current challenges to persist, at least for some time, along with more non-vanilla structures and advanced selection criteria for loan portfolios.

The past year was challenging for the European CLO market and its participants. The level of uncertainty was exemplified by the span of 45 days over March and April without issuance[1], one of the longest shutdown periods since the market reopened in 2013. The market eventually recovered and saw c. EUR 21bn in issuance, albeit that was down 31% year-on-year. Q4 issuance was noteworthy as it was in line with volumes observed in 2019, despite a significantly lower average notional per transaction.

The decrease in the notional of single transactions is one of many changes observed in CLO structures since the start of the pandemic, as fluctuating investor demand and the relative scarcity of adequate collateral forced CLO managers to issue shorter and less levered transactions. This trend should continue as long as global uncertainties persist.

Entering 2021, the outlook is mixed. On one hand, recent months have been reassuring in terms of issuance, as managers have successfully met the prevailing demand for CLOs while still offering attractive relative value compared to most other credit markets. On the other hand, we observe rising pressure on the asset side of the equation as leveraged loan issuance continues to be sluggish while asset quality has deteriorated. The unwinding of government support packages could trigger a spike in corporate defaults, particularly at the bottom end of the rating scale.

Figure 1: EUR CLO new issuance to-date



Source: Scope Ratings, Bloomberg

[1] No transaction was priced between 12 March and 27 April.

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 CLOs: slowly but surely restarting despite pressure on asset quality – September 2020

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

info@scoperatings.com
www.scoperatings.com

Bloomberg: RESP SCOP

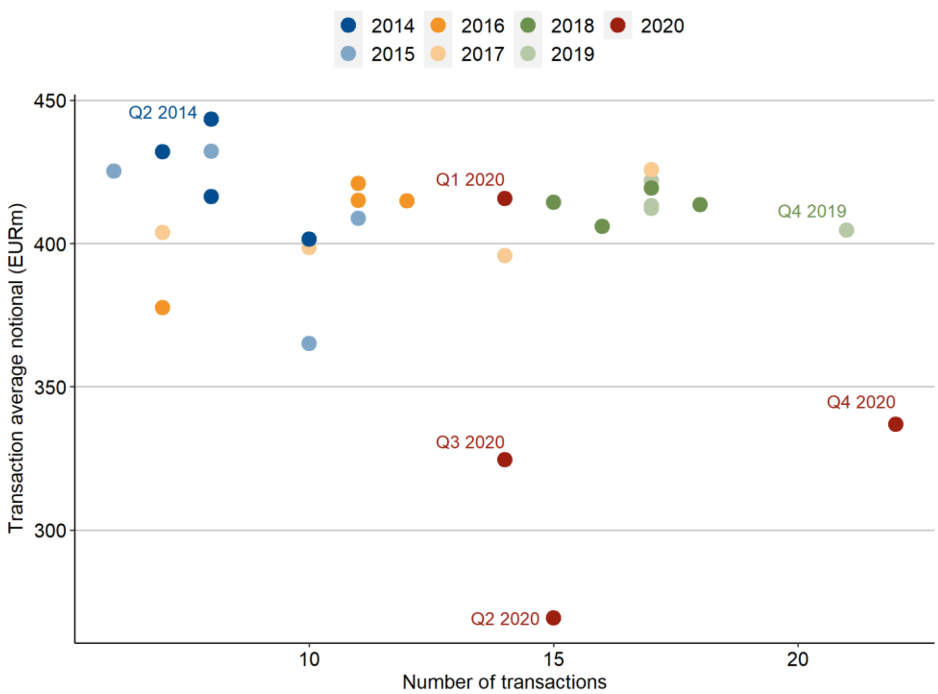
Back to pre-Covid?

Increasing number of transactions and notionals

The trend in terms of European CLO activity is positive, as the fourth quarter saw the highest number of single transactions come to the market since the Global Financial Crisis. This was in spite of restrictions in most European countries. The recovery in volume was certainly not foreseen a few months back and was made possible by the various adjustments managers made to meet investor requirements in the prevailing environment.

This includes alternative features that had occasionally been explored in certain pre-Covid transactions, such as the removal of the single B rated tranche leading to managers retaining more equity; shorter reinvestment periods; and one-year non-call periods. The average notional per transaction is still relatively low, even though we observed a slight increase compared to Q2 and Q3 2020. We consider this supportive entering 2021.

Figure 2: Average notional and number of transactions per quarter

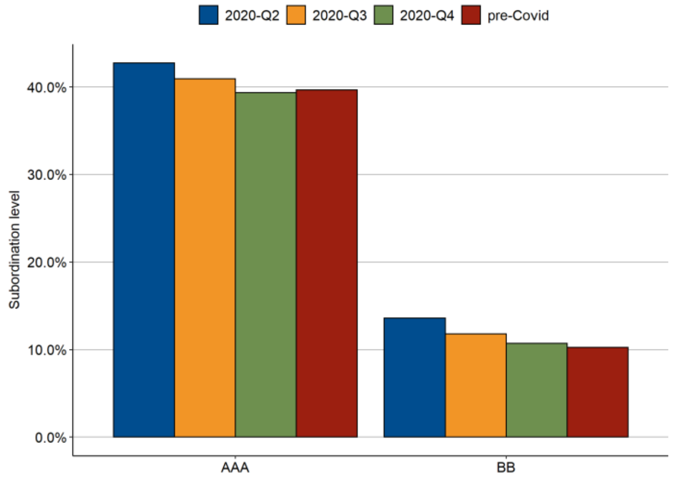


Source: Scope Ratings, Bloomberg

Spreads and subordination back to more standard levels

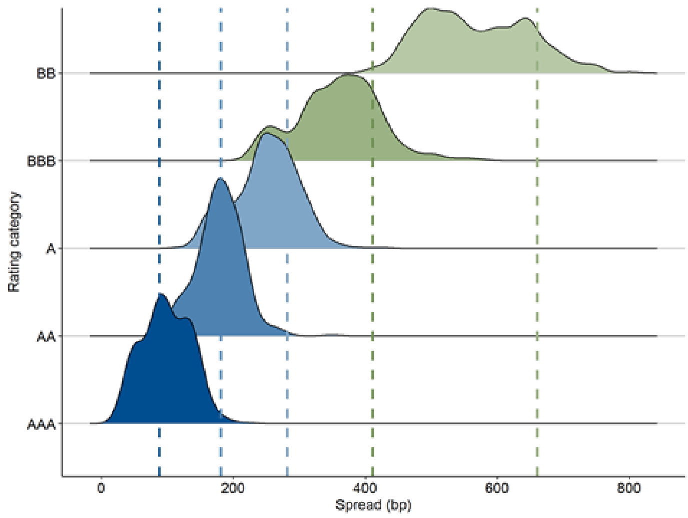
In addition to primary issuance volumes, other indicators are trending back towards pre-Covid levels in the transactions issued recently, such as credit support and primary spreads, especially at the AAA level. Sub-investment-grade tranches continue to be impacted, as the risk premium requested by investors is among the highest since 2014. This suggests a resurgence of idiosyncratic risk over the systemic risk we have witnessed since March, when CLO spreads significantly widened for all rating categories and especially for senior tranches on a relative basis.

Figure 3: Subordination level pre- and post-Covid-19



Source: Scope Ratings, Bloomberg

Figure 4: Spread distribution per rating category[2]



Source: Scope Ratings, Bloomberg

Themes for 2021

From systemic to idiosyncratic risk for high-yield corporates

Scope expects an asynchronous recovery in corporate performance in 2021, which will require a highly discriminating assessment of credit risk as the aftermath of the pandemic separates strong companies from weak, even within sectors; particularly among sub-investment-grade companies and small and medium-sized enterprises. The next months are likely to continue being a transition period. Only after the virus is controlled will we be able to tell whether pandemic-related damage to credit quality is temporary or permanent – and whether ratings need to be adjusted accordingly[3].

The median CCC bucket across outstanding European CLO transactions now stands at 6.4%, compared to c. 2.1% before the pandemic.[4] A further weakening of asset quality appears inevitable, especially in light of the unwinding of forbearance measures for European corporates, which should occur in 2021.

Loan supply is drier than ever

The availability of collateral continues to be limited as leveraged loan supply has gradually dried up over the past two years. Primary leveraged loan issuance has decreased since Q2 2020 while the opposite trend has been observed for newly issued CLOs, intensifying the existing overlap in loan collateral.

High sector concentration among leveraged loan CLO issuers could also eventually impact industry diversification in future CLOs. For instance, 41.5% of leveraged loans issued in the last quarter came from the telecommunications sector, which remains one of the only active industries in terms of LBO and M&A activity. We expect this supply-demand mismatch to last in the first half of 2021 as uncertainties should persist (threats of extended lockdowns, Brexit, etc.), while residual demand from existing and newly formed CLO warehouses will continuously increase.

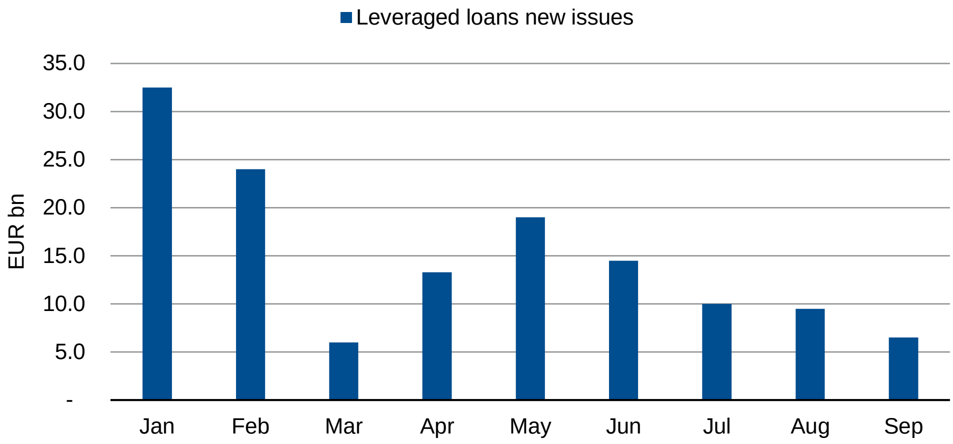
---

[2] The dashed line is the average spread observed for transactions issued in Q4 2020. The associated range includes all CLO issued since 2014. 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.

[3] Scope Ratings – Creditors, taxpayers ride to rescue in 2020. Will shareholders provide credit relief in 2021? (December 2020)

[4] Morgan Stanley – 2021 European ABS and CLO Outlook (November 2020)

Figure 5: European leveraged loan issuance



Source: Scope Ratings, AFME, Bloomberg

Structural tweaks to last as long as uncertainties persist

We do not necessarily expect spread arbitrage to become tighter for managers, as the projected increase in corporate downgrades and defaults could result in a larger widening of leveraged loan spreads compared to CLO margins. The increased portion of CCC rated loans in the universe and the short supply could force market participants to increase the allowance for such loans in CLO pools, and we could see more 'enhanced structures', as already observed in the US.

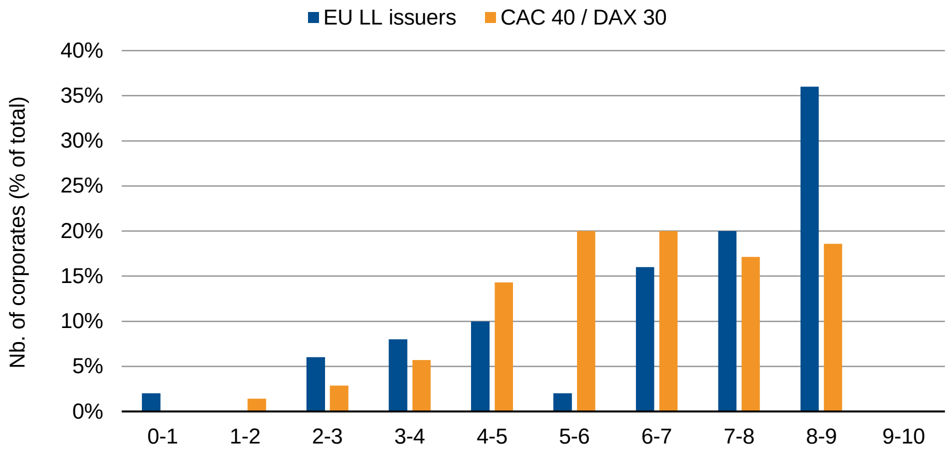
This could give selected managers the opportunity to buy downgraded loans at steep discounts, assuming that such structures would also provide more credit enhancement to senior investors. Changes recently observed in CLO structures and style of management should remain at the forefront as long as macro uncertainties are high, securing a reasonable floor in terms of volumes issued.

ESG CLOs: from negative exclusion to positive selection

Since the first fully ESG compliant transaction brought by NIBC Bank in November 2019, managers have been exploring further forms of incorporating ESG elements into their decision-making when constructing leveraged loan pools, both in the US and in Europe. While an increase in the issuance of such transactions will be closely tied to the macroeconomic environment and the availability of loan collateral, we could see more positive selection going forward. Currently, selection criteria observed to-date in European CLOs are mostly preventing a levelling down in sustainability by excluding credit products issued by corporates not meeting relevant ESG factors, rather than exclusively including ESG debt.

Scope has applied its approach to measuring ESG impacts of a corporate's fundamental externalities and global value chain (described in Appendix I) to a sample of 50 leveraged loan issuers, frequently present in European CLO pools. As described on Figure 6, we observe that these corporates perform slightly better in terms of ESG impact score, compared to the 70 firms forming the CAC 40 and DAX 30 indexes, with an average score of 6.47 compared to 6.17 on average for the two indexes.

Figure 6: ESG impact score distribution – 50 European leveraged loan issuers versus CAC 40 & DAC 30 indexes



Appendix I: Scope's ESG approach applied to leveraged loans issuers

We measure the ESG impacts of a corporate's fundamental externalities and global value chain based on its industry and location. Our ESG impact review is quantitative and objective and provides a score based on a macroeconomic model. The score ranges from 0 (worst) to 10 (best) and captures the cost of externalities per euro of revenue. This macroeconomic approach offers i) independence from the self-disclosed and non-standardised data provided by corporates; and ii) the possibility to capture the entire supply chain from raw materials to products.

The ESG impact analysis facilitates the integration of certain securities into portfolios in the context of future European regulations on sustainable finance disclosure (SFDR). It also reduces the risk of transition or the reputation risk for the most polluting companies – environmentally or socially.

CLO outlook mixed: low lev-loan supply, asset quality concerns offset reassuring issuance

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

Oslo
Karenslyst allé 53
N-0279 Oslo

Phone +47 21 62 31 42

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

Scope Ratings UK Limited

111 Buckingham Palace Road
UK-London SW1W 0SR

info@scoperatings.com
www.scoperatings.com

Disclaimer