M&G INVESTMENTS

February 2020

European loan market – review and outlook

For Investment Professionals only

Past performance is not a guide to future performance.

The value of investments will fluctuate, which will cause prices to fall as well as rise and you may not get back the original amount you invested.

Overview

- European leveraged loan returns delivered nearly 150bps above our medium-term, absolute-return target for the asset class, of 400bps over the risk-free rate, in 2019.
- Though duration was the friend of fixed income in 2019 and, married with some spread compression, created some pretty spectacular returns for bonds, the lack of duration in the floating-rate loan did not detract from its appeal and the market again exhibited fewer wild swings than other asset classes.
- European loans clocked up their best performance since 2016, matching the US loan market, while retaining their c.60bps long-term outperformance.
- The European market's expansion continued, the index growing in size by 18%; new issuance totalled €81 billion and the repayment rate fell for the second consecutive year (to 13%). While supply was 15% below 2018 levels, thanks to somewhat subdued M&A in Europe, it was still one of the more active post-crisis years for deal-making, including public-to-private takeovers, a trend that we expect to persist in 2020.
- Supply was met with strong demand: new CLO issuance rose to €29.8 billion from €27.3 billion – a post-crisis record – while inflows from institutional investors, both in Europe and Asia, continued steadily, attracted by the high running income and stability of the asset class. Our base case for 2020 sees CLO issuance remaining strong, albeit moderating from recent highs, while modest net fund inflows are also foreseen.
- New-issue loan spreads fell slightly over the year, but remained in their post-crisis range of +350-450bps – remarkable resilience in the context of public credit, indicating a yield to maturity, in euro terms, of c.4%. This relative stability should also prove valuable during any bouts of political or macro volatility in 2020.
- Leverage levels were broadly similar to last year, though EBITDA adjustments can flatter the picture, meaning that investor vigilance remains crucial. While loan defaults may rise from here, towards historical norms, this should happen only slowly, given the liquidity position and performance of most issuers, not to mention that valuation multiples and interest coverage ratios are at all-time highs nor is there any near-term maturity pressure. Furthermore, sponsors are maintaining sizeable (40-50%) equity levels – important ballast.
- We can expect greater regulatory scrutiny of the leveraged loan market and its participants, especially banks and CLOs – this is to be welcomed.
- ESG integration and lobbying for greater risk disclosure, including the impact of climate-change, is expected to become a feature of growing importance to lenders in 2020.
- The transition from Libor – particularly for sterling and dollars – will gather pace in 2020, requiring operational systems and documentation overhaul.

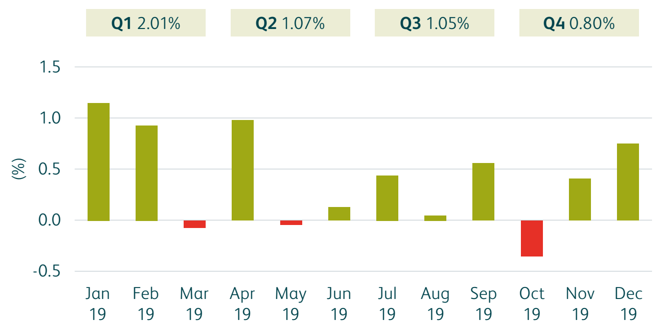
Review of 2019

Loan market performance

European loans returned 5.0% in euro terms (6.25% in sterling; 8.2% in US dollars) in 2019, marking another strong year and the asset class's best performance since 2016. In tandem with wider markets, the year was not without its wobbles, most markedly in October, but all quarters delivered positive returns and loans found their footing in the fourth quarter, as economic and political concerns dissipated and as progress towards a US-China trade deal was made, just as a decisive result in the UK elections inspired confidence in a clearer position on Brexit. Although loan returns in 2019 were less remarkable than other asset classes, it should be remembered that, unlike the negative performance of nearly every other asset class, European loans had produced a positive return in 2018.

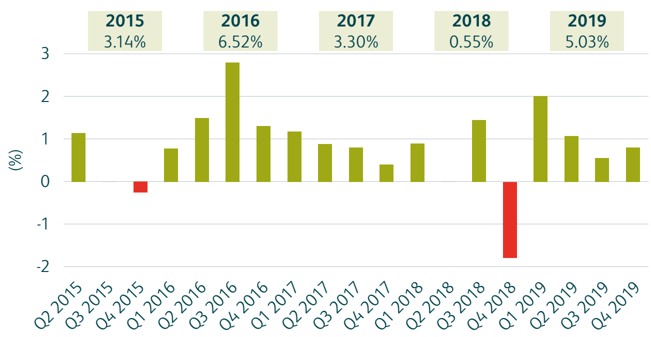
This resilience is also demonstrated over longer periods, with quarterly returns of European loans having been negative only twice in the last five years. The high-yielding and defensive nature of floating-rate, secured loans, including their minimal interest rate duration and long-term investor base, means that they tend to underperform on a relative basis in risk-on periods but exhibit resilience when markets sell off. Although loan prices are correlated with wider markets, particularly high yield and, to a lesser extent, equities, the defensive features insulate them better from precipitous falls. Therefore, despite adverse price movements taking returns into the red in Q4-18 and Q4-15, positive annual returns have been delivered in the last five years. Indeed, the European loan market has experienced only three years of negative returns since 1998 (inception of the oldest index).

European loan market returns in 2019 on a monthly and quarterly basis



Source: M&G, Credit Suisse Western European Leveraged Loan Index (hedged to euros), as at 31 December 2019.

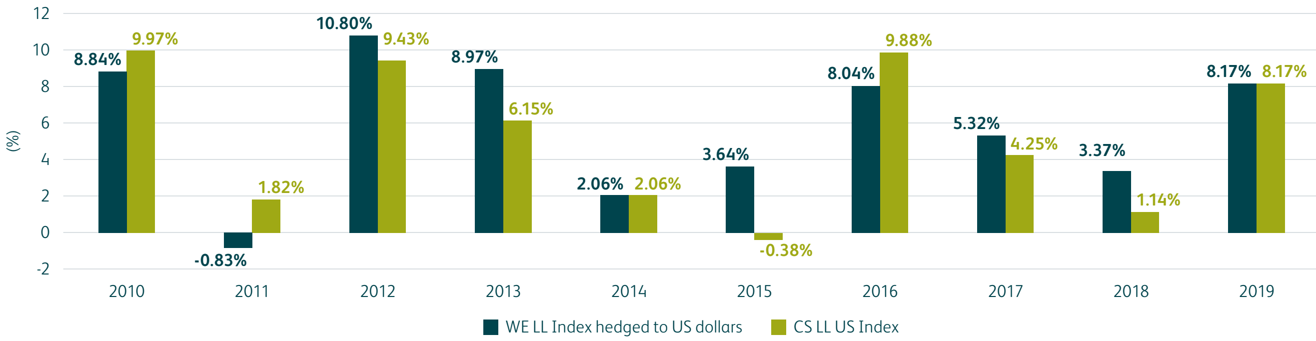
European loan market returns over the last five years on a quarterly and annual basis



Source: M&G, Credit Suisse Western European Leveraged Loan Index (hedged to euros), as at 31 December 2019.

If we look at how European loans have performed against the US, there was identical performance in 2019, unlike in 2018, when they outperformed by more than two percentage points. European loan returns continue to exceed those of the US over longer periods of time, having delivered an extra 60bps over the last decade.

US and European loan market annual returns over the last 10 years

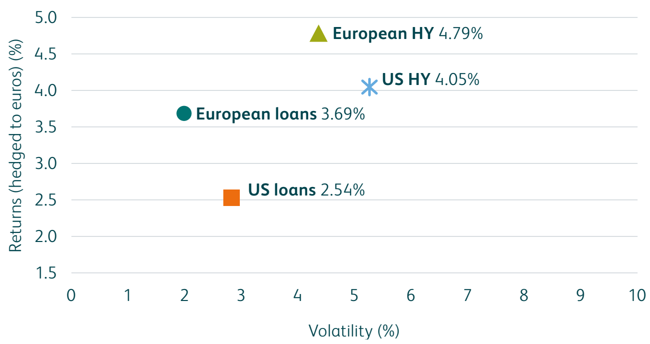


	WE LL index*	CS US LL index	Differential
Last 1 year Total Return	8.17%	8.17%	0.00%
Last 3 years Total Return (annualised)	5.60%	4.48%	1.12%
Last 5 years Total Return (annualised)	5.69%	4.54%	1.15%
Last 10 years Total Return (annualised)	5.78%	5.18%	0.60%

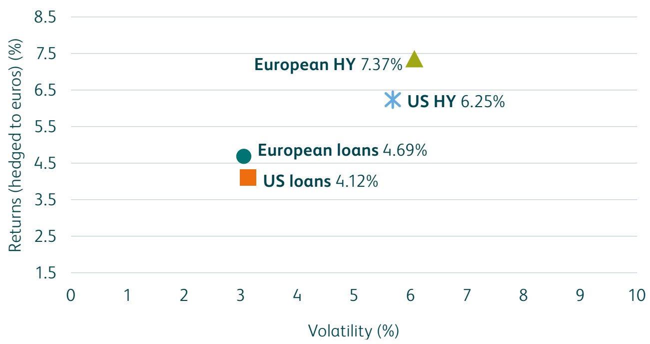
Source: Credit Suisse Western European Leveraged Loan Index (WELLI) and Credit Suisse Leveraged Loan Index (LLI), as at 31 December 2019. * hedged to US dollars.

Moreover, these additional returns have been generated while exhibiting lower volatility. Putting European loans into the context of all major sub-investment-grade markets reveals this:

Reward for risk (five years annualised) hedged to euros



Reward for risk (10 years annualised) hedged to euros

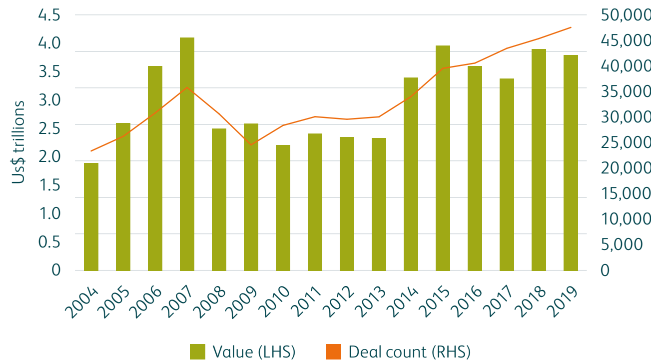


Source: M&G, Bloomberg, HPIC, H0A0, Credit Suisse WELLI and Credit Suisse US Index returns all hedged to euros, as at 31 December 2019.

Loan supply

At big picture level, while it was another active year for global M&A activity ($3.8 trillion versus $3.9 trillion), there were some clear regional differences, with the US up 6% from a year ago, while Europe was down some 25%.

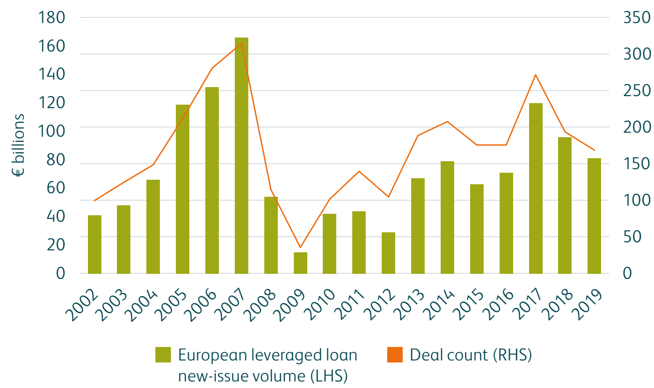
Global M&A annual volumes and number of transactions



Source: Bloomberg, as at 31 December 2019.

In the subset of deal-making that is sponsor-led, there were pleasingly a number of 'megadeals' (those greater than $10 billion in size), like Galderma, the skin-health unit of Nestlé, helping to boost leveraged loan volume. Indeed, new European loans raised over the year amounted to €81 billion (2018 total: €96 billion), down 15%, but a respectable number nevertheless and the third-most significant tally since the global financial crisis.

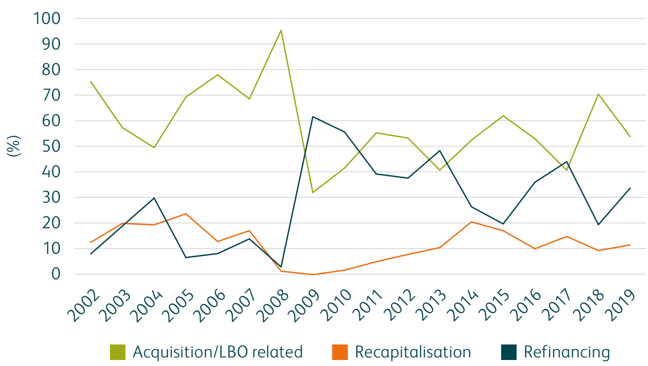
Annual European leveraged loan new volume



Source: S&P LCD, as at 31 December 2019.

While more than half of new loan supply arose from M&A-related activity, refinancing made up a higher percentage of issuance than the year before, accounting for 34%, compared to 20% in 2018 (though far from the refinancing frenzy year that was 2017, when almost half of all issuance was a rehashing of existing stock). There was a modest increase in recapitalisations too in 2019, but this remained a small proportion of total issuance, a sign of relative equilibrium of supply and demand.

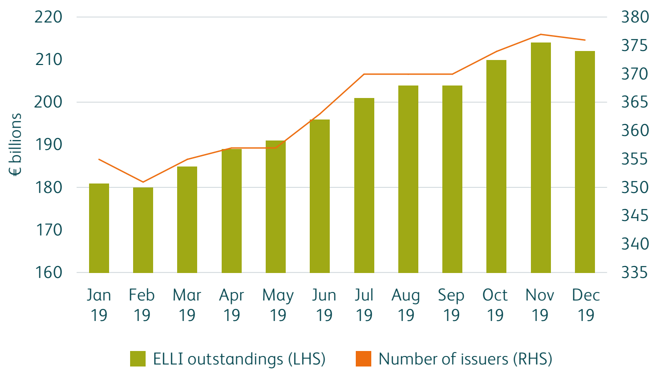
Use of proceeds



Source: S&P LCD, as at 31 December 2019. Deal purpose diversification (based on volume).

The demand for loans was alleviated by a lower-than-average prepayment rate of 13% in 2019 versus the norm of 25%. As a result, the loan market grew, with the S&P European Leveraged Loan Index (ELLI) exceeding the €200 billion mark by year-end, an increase of 18%, year on year.

S&P European Leveraged Loan Index ('ELLI') size and number of issuers



Source: S&P LCD, as at 31 December 2019.

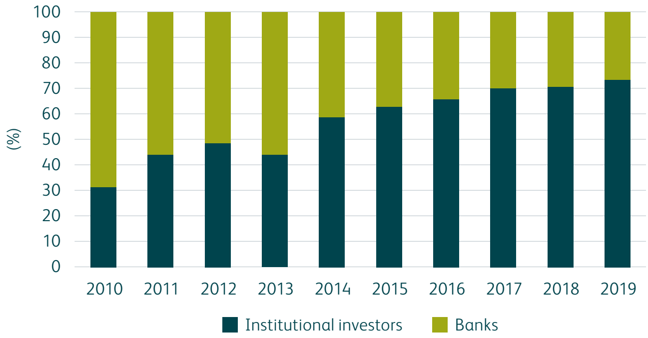
Loan demand

Demand remained high and stable for European loans over the course of the year. Inflows from pension funds and insurance companies, both in Europe and Asia, were anecdotally (there being no reported or verifiable data on this) positive again, while collateralised loan obligations (CLOs) continued to be an important demand-driver.

Looking at the composition of the European primary loan market by investor type, institutional investors made up broadly the same proportion (the lion's share) of the buying-base as 2018. Of the 73% of the market that is institutional, the mix is broadly split between CLOs and institutional funds or separately-managed accounts. This is a much more balanced composition than the US loan market, where CLOs have a more dominant role (two-thirds of the non-bank buying-base). Furthermore, in the US, unlike Europe, daily-dealing retail funds are present (c.13% share)[1].

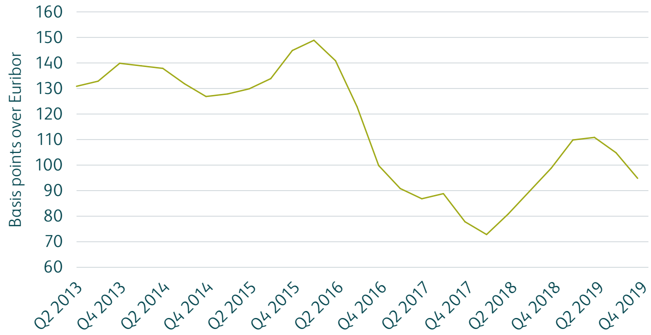
[1] Source: Barclays, "Global CLO Primer January 2020".

Investor demand for primary loan issuance



Source: S&P LCD, as at 31 December 2019.

European AAA CLO pricing



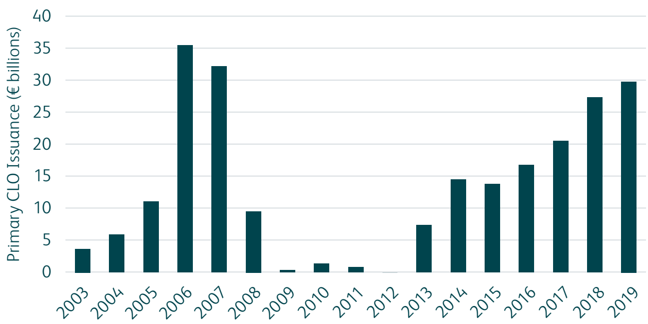
Source: S&P LCD, as at 31 December 2019.

CLO primary market volume hit another post-crisis high in 2019, up almost 10% year on year, with €29 billion (2018: €27 billion) being raised from 72 vehicles. The proliferation of 'originator vehicles', the externally-raised permanent capital vehicles that help a manager comply with EU risk retention rules, was also likely to be a factor in CLO supply in 2019. 82% of CLOs raised had their equity held by originator funds in 2019, up from 52% a year earlier[2]. There were also eight new CLO managers active in fund-raising, taking the total number of managers to 50 (a post-crisis high).

The pricing demands of AAA-note buyers moderated in the second half of the year too, trending lower and reverting back to end-2018 levels. This is an important metric to monitor because the total financing cost of a CLO influences the pricing of loan issuance.

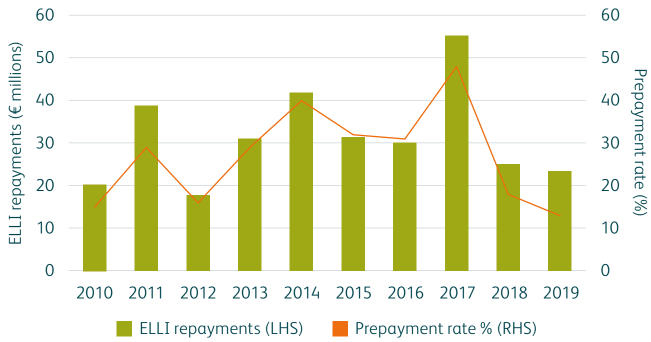
Though the major Japanese buyer that had reportedly anchored so many of the 2018 CLOs paused its buying in 2019, it would appear that new buyers of AAA notes (the largest part of a CLO's capital stack) emerged, including Bank Treasury departments, permitting both a healthy pace of issuance and tighter cost of liability-pricing.

European CLO issuance per annum



Source: S&P LCD, as at 31 December 2019.

European loan repayments



Source: S&P LCD, as at 31 December 2019.

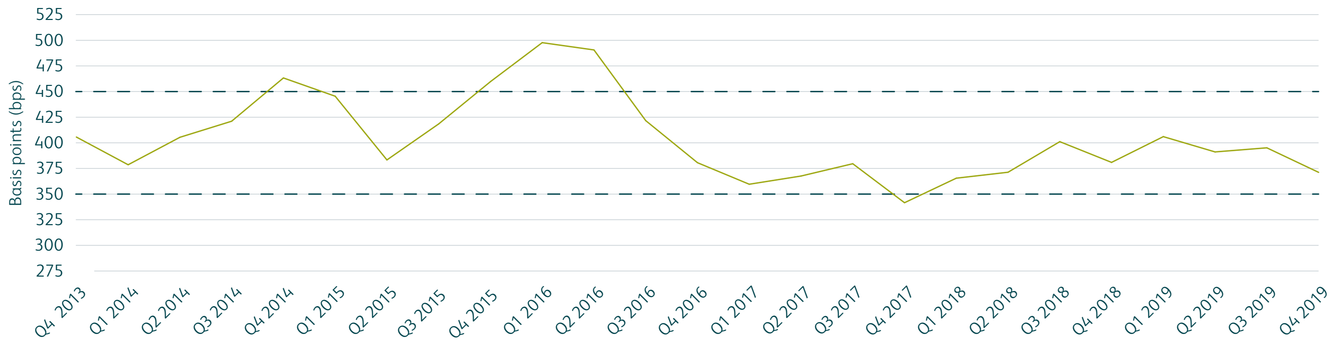
[2] Source: Barclays, "Global CLO Primer January 2020".

The rate of repayment was 13% in 2019, down from the 18% seen in the previous year, and moving further below its medium-term average of 25% per annum. Although, in volume terms, total repayments in 2019 matched those seen in the previous year, based on the ELLI.

Loan pricing

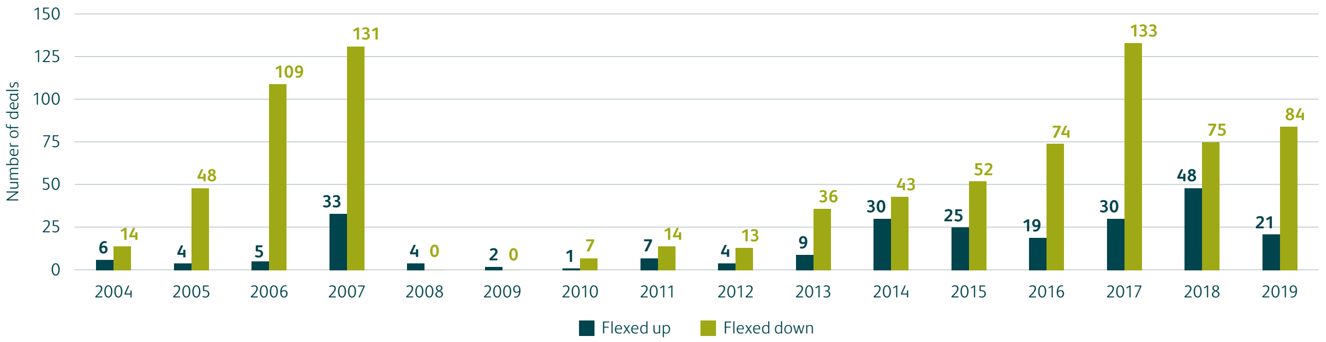
With strong demand and given an inherent level of repayments, sizeable new supply is vital to keep new loan spreads at acceptable levels. While margins tightened in the second half of the year, they remained within their medium-term, +350-450bps range. The zero-minimum Euribor floors were near universally preserved, a hidden source of extra value for yields, their being worth some c. 40bps or so in the face of negative euro rates.

European primary loans: new-issue margins



Source: S&P LCD, as at 31 December 2019.

Incidence of a change to initial terms: New-issue spreads

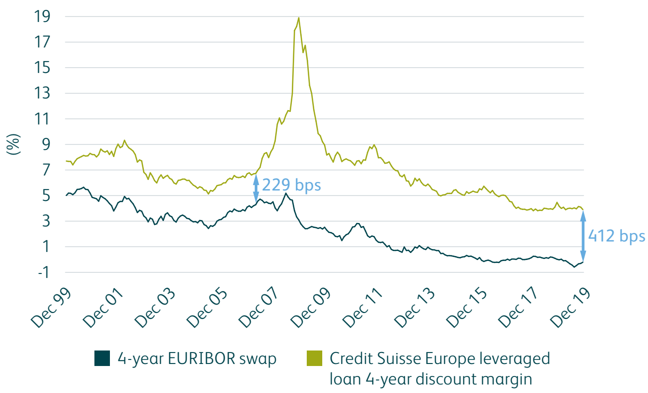


Source: S&P LCD, as at 31 December 2019. Based on number of deals but first and second liens are counted separately.

The incidence of loan spreads being 'flexed down' (ie reduced part-way through a syndication process) far outweighed the number of times where spreads were 'flexed up', high demand fostering issuer-friendly conditions. This dilution of documentation was not universal though and lenders successfully resisted some of the more aggressive or unrealistic ambitions of sponsors. That said, there is no denying the greater flexibility inherent in today's structures and terms, making scrutiny and discernment important.

Loan spreads in the secondary market tightened by 50bps towards the end of the year, but the tightening seen in high yield bond spreads was far greater. With euro swap rates still in negative territory, this means that the market is projecting a yield to assumed maturity, in euro terms, of approximately 4%.

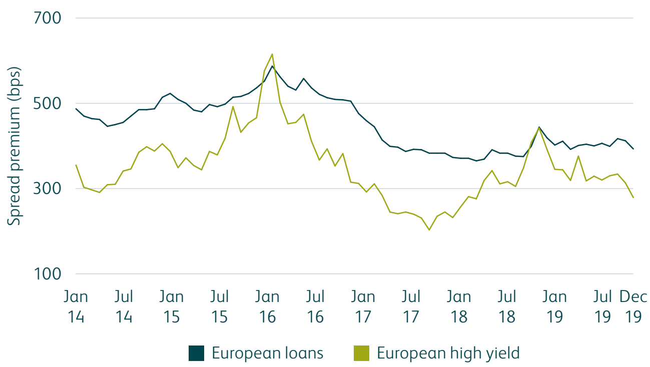
European loan yield and spread to swaps



Source: Bloomberg, Credit Suisse and M&G, as at 31 December 2019. CS yield to maturity is 4-year Euribor swap plus discount margin to a 4-year take out. Forward 4-year swap curve.

The relative value of loans to high yield bonds has become more attractive to investors. The rally in high yield in the final few months of the year effectively pushed the spread premium of secured European loans versus (largely unsecured) high yield bonds out to 114bps.

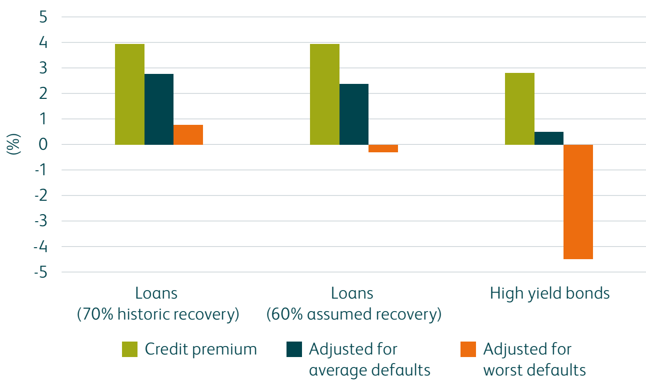
European loan and high yield bond spreads



Source: Credit Suisse, Bloomberg (Merrill Lynch European HPIC high yield index asset swap spread), as at 31 December 2019.

If we compare the loss-adjusted spreads of the two markets (which are based on stressing both asset classes for the average and worst defaults of the last decade making different assumptions about average recoveries to account for the weaker documentation that currently prevails), the superior risk-return case for loans over bonds remains compelling. Leveraged loans benefit from first-ranking security and have consistently demonstrated higher recovery rates than high yield bonds.

Default-adjusted European loan and bond spreads



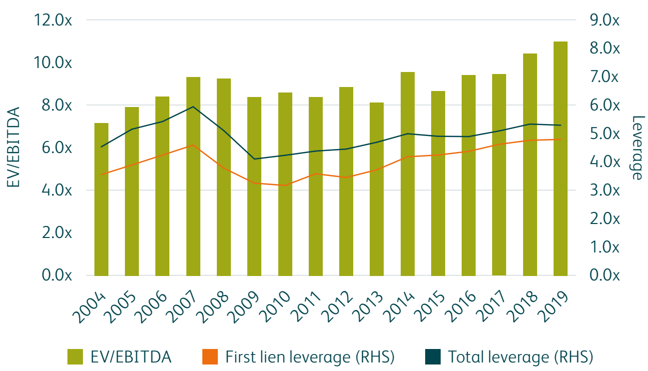
Source: Credit Suisse (WELLI four-year DM), Bloomberg (Merrill Lynch European HPIC high yield index asset swap spread), as at 31 December 2019. Estimated recovery rate 40% bonds, 70% and 60% loans based on data from S&P, Moody's and M&G.

Structures

Regulators have been routinely expressing their concerns about the state of the global leveraged loan market – particularly the potential risks posed by higher leverage and looser lending standards. On the face of it, there was not much change from 2018. Total (pro forma) leverage was 5.3x at the end of 2019, a touch below the 5.4x seen in 2018, but the second-highest level in Europe, post-crisis. First-lien leverage remained at 4.8x, the same as the previous year and narrowly above pre-crisis levels (2017: 4.6x). However, it is the flexibility to adjust EBITDA (eg for future synergies) that can belie the reliability of headline leverage statistics so there is no substitute for thorough rigorous analysis of the true earnings of a company.

Interest coverage ratios remained reassuringly strong, averaging 4.4x in 2019, up from 4.0x in 2018, while equity valuation multiples of leverage buyouts (LBOs) reached an all-time high, rising to 11x from 10.4x in 2018. Important then that the sponsor level of equity commitment was also high – 47% – preserving a sizeable buffer for senior lenders.

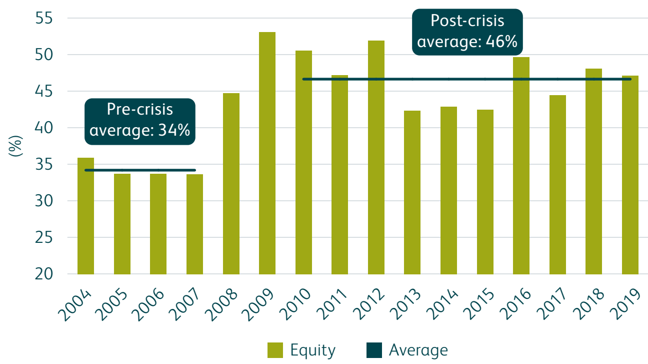
Total and first-lien leverage and valuation multiples



Source: S&P LCD, as at 31 December 2019.

A high level of equity commitment from sponsors is important given the limited incidence of junior debt in European structures. Higher equity cheques have been a pervasive feature of European buyouts since the financial crisis and offer important downside protection.

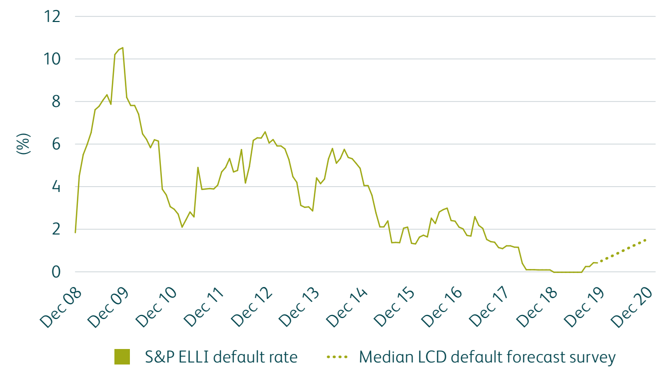
Average equity contributions to buyouts



Source: S&P LCD, as at 31 December 2019. Equity contributions from European LBOs, buyout multiples.

European loan market default rates may rise from here, towards the historical norms of 2% to 3% per annum over the next couple of years, albeit from an abnormally low base of 0.44% at 2019's year-end and having spent most of 2019 at zero. This rise is likely to be gradual with S&P LCD's latest default forecast survey predicting default rates of 1.5% by the end of 2020.

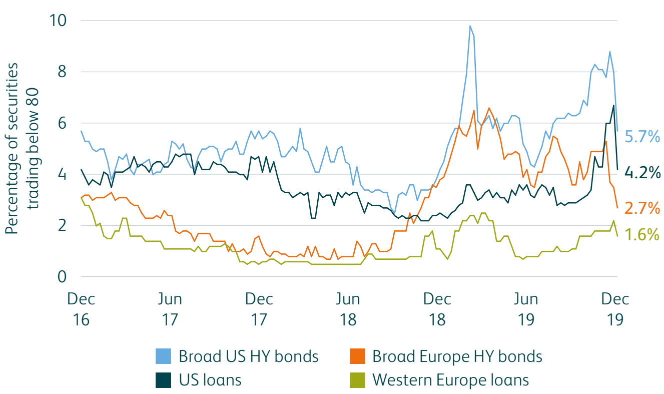
European loan market default outlook



Source: S&P LCD, LCD default survey 2019, as at 31 December 2019.

Although stress ratios in Europe have inched higher, with the percentage of loans trading below 80 close to 2% of the overall index, they remain much lower than the directly equivalent sub-investment grade markets – particularly US loans.

European distress ratios are steadily rising



Source: Credit Suisse, as at 31 December 2019. % of securities trading at a price below 80.

ESG

The first leveraged loan linked to sustainability targets was issued in 2019. There was a fanfare but, in essence, it amounted to little more than showmanship. While it may have been an admirable attempt to draw attention to a financing niche that could grow, regulatory support – via capital relief, for example – is likely to be a pre-requisite to wider support from the banking community.

What gained more significant traction in the year was the attempt by institutional investors to improve the integration of ESG risk assessment into their credit analysis, including greater engagement with borrowers and private equity owners. This is a welcome development that could contribute to enhanced disclosure even if it is acknowledged that privately-owned companies lag their large, listed peers.

Outlook

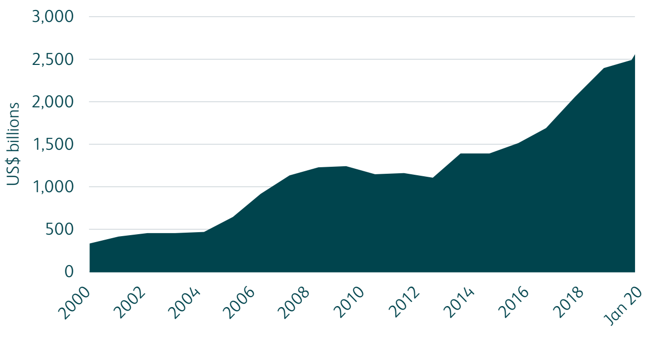
Macro backdrop

Political risks will continue to swirl, culminating perhaps in the US Presidential election in early November. This is against a backdrop of escalating tensions and souring relations between the West and the Middle East, which could spark volatility in markets in 2020 at short notice not to mention the unknowable consequences of the fast-spreading coronavirus.

While rates are likely to remain on hold for the foreseeable future, risks are tilted towards rate-cuts. Indeed, the global economy would need a considerable growth spurt for things to look bad for bonds and for yields to move up dramatically as we look at the markets today. Loans are linked to base-rates so move up in lock-step with rates. That said, as their fixing-rates cannot be negative, this has technically introduced an element of duration to the asset class, given that swap rates in euro are negative. However, even were rate expectations to rise, we would not expect the price of a zero-fixed loan to fall in reality, this floor benefit not being universally valued as part of the credit margin by investors.

The pace and volume of M&A activity in the year ahead will be important in determining supply. The private equity industry is sitting on a total of $2.5 trillion in dry powder, globally, it is estimated – the highest recorded amount raised and more than double that of five years ago, according to figures compiled by Preqin.

Global private equity dry powder levels



Source: Preqin, as at 31 December 2019.

Loan-specific factors

Quality

In this environment, careful lending practices, including a high level of selectivity over which loan assets make it into a portfolio, rigorous due diligence and ongoing vigilance and monitoring of existing loans will become ever more important for investors.

ESG

Green and sustainable-related issuance could become more of a feature of the loan market going forward, and even if it does not, we expect the emphasis from lenders to be on pushing for greater ESG risk disclosure, including the impact of climate-change and the state of cyber health, and wider integration of ESG factors into investment analysis and decision-making processes.

Baseline 2020 view

We expect new-issue loan pricing to remain in the medium-term range, +350-450bps over Euribor. There may be occasional wobbles in wider financial markets – that could filter through to the loan market and create short-lived secondary opportunities – but only a protracted period of macro-economic difficulty would materially affect issuance and primary pricing. High running income should continue to provide key support to loans.

We anticipate loan issuance in the range of €80 to €100 billion (in gross terms) this year. The European loan pipeline started the year at over €15 billion, spread across more than a dozen names, including the €2 billion to support the public-to-private buyout of UK defence company, Cobham.

Indeed, there were a number of take-private deals last year, a trend that could well persist in 2020, such is the size of the dry powder of sponsors. KKR's proposal to take the $70 billion US drugstore chain, Walgreens Boots Alliance, private – if it goes through – would be a case in point. It would also be the largest LBO on record.

Demand should remain strong but not excessive. We expect issuance in the CLO market to be slightly lower than 2019, at €25 billion, as the arbitrage is somewhat stretched, with loan margins at the tighter end of their range and as due diligence requirements of investors mount. Institutional flows should remain steady, attracted by high running income yet moderated by the end-of-cycle credit environment.

Regulation

At the end of 2019, the Financial Stability Board (FSB) published a report, assessing the vulnerabilities of leveraged loans and market participants, including banks and CLOs. However, it acknowledged the difficulty of fully analysing the inherent risks. The Bank of England (BoE) also wrote about the risks associated with leveraged loans in its "Financial Stability Report December 2019", pointing to the increasing indebtedness of companies in the global leveraged loan market and noting that leverage can be understated. It is not entirely clear what implications these findings will have for the market at large, but regulatory scrutiny is unlikely to subside from here. In any case, this close attention from officialdom is welcome and aids transparency.

The EU Securitisation Regulation (EUSR) came into being in 2019, imposing heightened disclosure requirements to investors on European CLO managers, and, while it initially had a suppressant effect on CLO issuance, the dilution of its impact was soon evident. There may be clarifications in 2020 that could result in some current vehicles falling out of compliance, something that might interrupt the CLO buying fervour of EU investors at least.

Libor transition

With good progress made in 2019, we can expect the rhetoric and action on the global London Interbank Offered Rate (Libor) transition to ramp up in 2020, with more financial regulator-driven milestones being set. In sterling, there is a 2021 deadline for the cessation of Libor. UK and US regulators are calling for "significant and sustained efforts" to transition from the discredited fixing-rates. Libor underpins the pricing of as much as $400 trillion of products around the world, from loans to derivative products[3]. The focus for the UK loan market is to achieve the regulatory goal of no more new Libor-linked loans post Q3-2020. This may have a knock-on effect on liquidity and/or loan settlement times given the sheer administrative process of transitioning away from Libor. While Euro-denominated loans are less affected (Euribor being reformulated but not eradicated), most loans are multi-currency, meaning that there will be individual documentation amendments needed for thousands of contracts, in all likelihood.

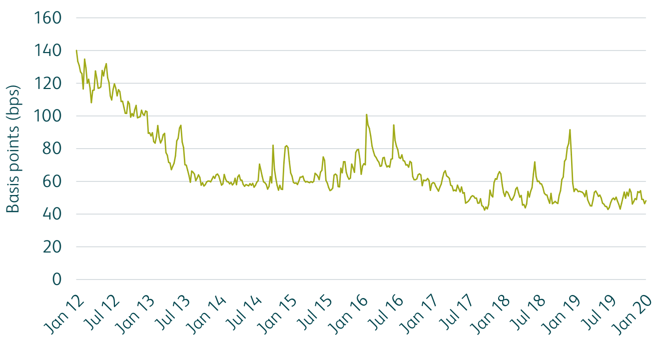
[3] Financial Times, "UK regulators launch fresh push to switch away from Libor", 16 January 2020.

Liquidity

For European regulators, liquidity risk will be high on the agenda for 2020. The European Securities and Markets Authority (ESMA), an independent EU authority that contributes to safeguarding the stability of the EU's financial markets, noted in a recent report that the Alternative Investment Funds (AIFs), with large leveraged loans and CLOs exposures, do not face a significant liquidity mismatch, with the exception of the few AIFs that are offering daily liquidity to investors. We anticipate sensible structuring of the redemption terms of funds that has largely characterised the European loan market to persist.

The European loan market has been reasonably liquid since the investor base began to diversify 15 years ago, now including plenty of non-CLO, long-term institutional capital though no retail funds. Open-ended funds are now relatively common in Europe, albeit that dealing frequencies will typically be monthly, rather than daily, given the – sometimes lengthy – periods for loans to settle, loans not being cleared via an exchange like bonds.

European liquid loans: Bid-ask spreads



Source: Refinitiv, as at 31 December 2019.

In terms of trading liquidity, bid-ask spreads for the most-liquid European loans display a high degree of stability, largely trading in a 20bps range since 2013, despite short-lived spikes.

Under the Alternative Investment Fund Managers Directive (AIFMD) regulations, funds have to report their liquidity profile, by reporting the share of their NAV that can be redeemed over a specified time period. As an example, in both normal and stressed scenarios, our estimate of scheduling would indicate that over half the typical portfolio could be realised over a quarter, even in difficult market conditions.

Illustrative liquidity ladder

Timeframe	Base case	Stressed
1 day	9.35%	9.35%
1 week	12.84%	11.09%
1 month	14.70%	14.70%
3 months	82.18%	53.92%
6 months	89.37%	89.37%
1 year	89.37%	89.37%

Source: M&G, as at 31 December 2019.

www.mandg.com