It was a sluggish start to 2019 for institutional loan issuance with only €20.4bn issued in the quarter, well below the €35.2bn that was issued in Q1 2018. This reflected a soft January, when loan issuance was only €1.5bn, offset by a strong March, where issuance was €9bn.

The weak issuance at the start of the year stemmed from the market uncertainty that followed the sell-off across most assets at the end of 2018. Failed auctions for deals such as Chubb Fire & Security and Kimberly Clarke’s European Tissues business, where buyers and sellers struggled to agree on valuations, resulted in a much smaller pipeline of loans early in the new year.

In contrast, CLO new issuance set a new record, with €6.9bn being issued across 16 deals and 16 managers. This was achieved despite a backdrop of more expensive liabilities, as AAA spreads continued to widen. The last primary deal to price in the quarter that did not feature a Japanese anchor investor was Pinebridge’s Euro-Galaxy VII, which priced its AAA tranche at 114bps. This compared with KKR’s Avoca XX, where a Japanese anchor investor took the AAA tranche at 108.5bps. The all-in weighted average cost of debt for new deals ended the quarter at 190-200bps. The increased liability costs continued to put pressure on the arbitrage, which resulted in managers giving up fees and arranging banks reducing their syndication fees in order to make the economics work for CLO equity investors. For some deals, the trading gains and some of the carry from the warehouse may have been transferred to the CLO to benefit equity investors. Some managers also opted to price shorter deals or to remove the single B tranche from the structure in order to reduce the cost of capital. Even with a number of levers to pull, it seems that most of the equity went to either the CLO manager, risk retention vehicles or CLO warehouse equity investors rolling into the equity.

Looking forward, there continues to be a healthy pipeline of new issue CLOs, with at least 13 deals coming to the market in the second quarter. Most of these deals are from newer European CLO managers, such as MeDirect, Napier Park, CIFC, Capital Four and Angelo Gordon. In 2018, 40 European CLO managers priced at least one CLO, and this year the number may be even higher.

Demand for assets remains high, driven by the strong pace of CLO new issuance. This resulted in some deals pricing at the tight-end of talk. For example, IVC, the EQT owned veterinary practice group, priced its €400m term loan B at E+400/99.5 and Praxiserve, the French energy services business, closed its €335m buyout term loan B at E+375bps.
Given the pressure on CLO arbitrage, there was hope that this would drive asset spreads wider. However, with new capital coming into the market from Asia, away from CLOs into separate managed accounts, and as prepayment rates pick up in existing CLOs where the cost of liabilities is cheaper relative to the current market, this may mean there continues to be some demand for assets pricing below E+4%. That said, the average yield of new issue was 4.22% in April 2019 vs. 3.97% in April 2018.

If there is no real catalyst for loan spreads to widen much more from here, CLO liabilities need to tighten. This could happen if CLO new issue supply slows down as managers, arrangers and equity investors struggle to find a pricing point that works.

If we look back at the quarter, there has been some tightening YTD across the CLO stack (though manager tiering is evident), with the exception of the AAA tranche. Maybe AAA investors, mostly being real money investors, need some conviction that away from a Japanese bid there is enough demand for the tranche and there is consistency in the clearing level. But they probably also want to see this for seasoned managers given it’s mostly the newer managers that have priced without the large Japanese anchor. However this is a classic “chicken and egg” where seasoned managers are seeking the Japanese bid because it gives them certainty of execution at a lower cost. The current 6-8bps spread differential, in a world where every basis point matters, may need to compress to motivate these seasoned managers back into the generally syndicated market. Just this week CSAM announced its second deal of the year, this time syndicating their AAAs away from the Japanese anchor. If these end up pricing closer to the Japanese bid of 108bps they received in their first deal of the year, this may pave the way for more managers to step back into the syndicated market.