The European CLO market continued to grow at a record pace in Q2 2019, with €7.8 billion of transactions pricing across 19 deals and 19 managers. With the steady supply of new issuance, we also saw an influx of debut managers. Sound Point Capital, Fair Oaks Capital, Napier Park and MeDirect all priced deals recently, bringing the manager count for the European 2.0 era to 51.

Looking forward, the European CLO pipeline does not show any signs of a slowdown, with 12 deals pricing in July. The persistent supply has not helped liability pricing, with junior liabilities widening in Q2 to pricing levels of early Q1. On the other hand, the AAAs are tightening in for more seasoned managers. The most notable change in the quarter was the bifurcation of the buyer base of the AAA tranche. Up until late May, the key Japanese anchor of AAAs was buying at c.108bps. However, greater publicity on the CLO asset class in Japan and increased scrutiny from the Japanese regulator, led to them increasing the spread they would need to buy the AAAs to 113bps. This has resulted in managers syndicating their AAAs, which was much needed in the European AAA CLO market. This has given buyers comfort that there is decent demand outside the key Japanese buyer and deals where AAAs were broadly syndicated started pricing at tighter levels than 113bps. Interestingly, this Japanese investor has now been seen back in the US market and speculation is that they will return to Europe by Q4.

The European loan issuance picture remains quite similar to Q1, with decent supply of €16.8bn in the quarter, but still lower than last year which was €23.5bn in Q2 2018. The supply this quarter was driven by more opportunistic deals rather than acquisition-related. For example Vue International returned to the market (after failing in December) with an improved structure that delevered the first-lien through a second lien loan taken by the sponsor OMERS.

The demand for European loans remained high, driven by the continued strong pace of CLO new issuance but also managed accounts, which have been pushing the spreads of mainstream credits tighter. This resulted in some deals pricing at the tight end of talk, such as Sector Alarm which tightened pricing on its debut syndication to E+350 with a 0% floor offered at 100 and a B/B1 rating. The market has shown strong appetite for higher rated deals. The tightest print in June was Befesa (provider of environmental-regulated services to the steel and aluminium industries), which closed its €526 million seven-year refinancing at E+250 at par, and was rated at BB/Ba2. However, the market is differentiating for credits that are more cyclical. For example, the c.€1.5 billion cross-border loan backing Advent’s buyout of Evonik’s metacrlylates business (Madrid) priced at the wide end of talk at E+500 and a price of 95. Other examples of deals that experienced some pricing pressure were Rodenstock (German manufacturer of lenses), Euroports (operator of a network of deep-sea terminals across Europe and China) and Multi-Colour (global label provider).
Given the pace of loan issuance has not kept up with CLO issuance, the arbitrage continues to be challenged. However, whether CLO new issue supply slows down is yet to be seen. Those managers that have captive equity investors may price more deals this year, but the newer managers or managers who need to syndicate most of their equity, are unlikely to issue again. This could result in second half of 2019 seeing less supply than the first half.

There are many dynamics to consider in the CLO space, which makes it an extremely interesting market. For those investors who are deploying in IG corporates, European AAA CLOs could look compelling from a risk return perspective. For those investors in the BB/B rated CLOs, who have less liquid capital, can form a view on some of the newer managers which are pricing at decent premiums to seasoned managers. Or for equity investors, one could consider the value of backing deals where the documentation gives more flexibility to the manager, especially at the end of the re-investment period.