The European CLO market posted its busiest quarter of the year despite the weighted average cost of capital remaining broadly flat quarter-on-quarter. We saw increased demand at the top of the capital structure with tightening AAA spreads but significant widening of junior mezzanine tranches.

The surge in AAA demand was mainly driven by the negative interest rate environment in Europe. CLO liabilities are typically structured with a 0% Euribor floor, thereby protecting against negative rates and adding significant value to the CLO AAA returns. In Q3 2019, the floor added 30-50bps of return, making European CLO AAAs compelling compared with other similar rated assets. This contributed to European new issue AAA CLO spreads tightening significantly from over 110bps in Q2 to the recent print of 91bps for Cairn’s latest new issue. This also resulted in a pickup of reset and refinancing activity, where it was possible to refinance a European CLO AAA tranche in the mid-60s in late Q3. However, in early Q4 the floor value decreased on the back of rate moves and the short-dated AAA buyers seemed unwilling to increase their exposure at spreads below 70bps, which has halted refinancing activity for the moment.

In contrast, the bottom of the capital structure continued to widen driven by large amounts of new issue CLO supply. Single Bs recently priced at yields over 10% and spreads are 65bps wider than the lows experienced in December 2018.

On the asset side, activity picked up in September with €9.08 billion of issuance launching during the month which helped offset a slow start to loan issuance in Q3 2019. Of the €16.4bn European institutional loan volume issued in Q3, €9.16 billion came from buyout or acquisition-related deal flow and the remainder from other issuance including refinancings and recaps. Notable deals that priced in the quarter included Domidep, an elderly care provider, and Salt, a mobile phone operator, both at E+350bps. Even though loan issuance picked up towards the end of the quarter, the loan market supply was not able to keep up with the growth in CLO issuance, which was a key driver of tightening asset spreads. The yield to maturity for euro-denominated loans rated B fell to 3.98% at the end of Q3 compared versus 4.15% in the previous quarter.

Despite the spread compression in the loan market, distress ratios are rising and there is a steady increase in the percentage of assets in European CLOs that are trading at a discount to par. However, Europe is still considerably lower than the US. According to Barclays research, 5.4% of assets in European CLOs are trading below 90 vs. 12.1% in US CLOs.
During Q3, three debut managers priced their first European CLOs: CIFC, MacKay Shields and Angelo Gordon. Looking forward, the new-issue pipeline has slowed as the lower mezzanine tranches become more difficult to place and since loan asset spreads do not show signs of widening, the arbitrage is still proving difficult for equity investors.

How are CLO managers reacting to this backdrop of increasing volatility and increasing stress ratios?

• Some managers seem to be actively selling risk assets where possible.

• Given lower growth, there is a bias towards buying bigger and more liquid capital structures and a preference to lend to companies that have been through a previous cycle versus new LBOs with less historic performance to prove downside resilience.

• There seems to be a greater focus on the private equity sponsors and how well these sponsors have treated debt investors in the past, but also how deal teams have changed recently. CLO managers seem to be more critical of a business owned by a less favored sponsor.

As an investor, one has to be prudent; it can be increasingly important to underwrite at least junior mezz and equity investments using fundamental credit analysis. With spreads where they are, CLOs could provide a compelling way to allocate capital across the risk-return spectrum for those investors with a long-term approach and a tolerance for complexity.