European senior secured loans ("SSL"): 2015 review and 2016 outlook

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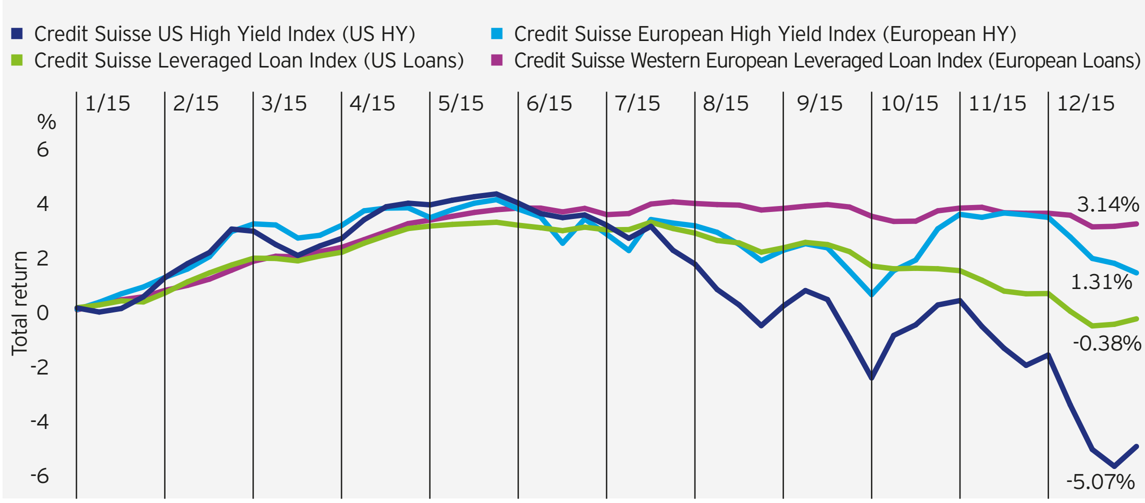
2015 SSL market review

The Credit Suisse Western European Leveraged Loan Index (CS WELLI) returned 3.14% in 2015. There was a marked dichotomy between the first and second half of the year for the asset class. The year started strongly, driven by a confluence of improving fundamentals, including better economic data and company earnings, along with technical support from both steady Collateralized Loan Obligation (CLO) formation and institutional demand. During the second half of the year, sentiment stuttered as Greece's future in the European Union came into question. In addition, slowing Chinese GDP growth, uncertainty on European Central Bank (ECB) action and falling commodity prices, particularly oil, further weighed down risk assets through the remainder of the year.

While price volatility reappeared and absolute returns suffered, European senior secured loans (SSLs) outperformed other risk asset classes.

Performance



Source: Credit Suisse Leveraged Finance Monthly Strategy as at Dec. 31, 2015. Credit Suisse Western Europe leveraged loan Index (EUR-HDG). Credit Suisse Western European HY Index (EUR-HDG). Past performance is not a guarantee of future results.

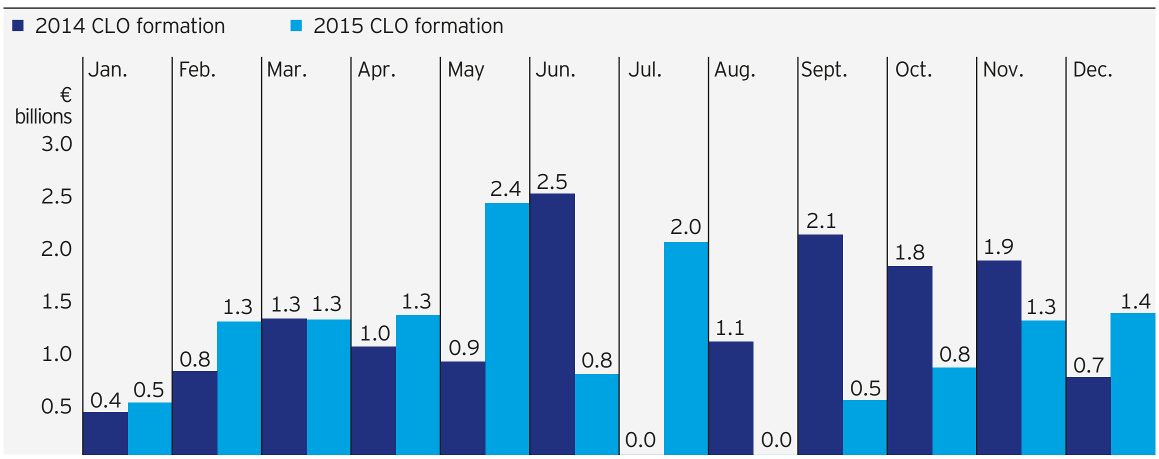
The key attributes of SSLs – senior position in the capital structure, secured status, and low duration (interest rate sensitivity) – position it defensively on the risk spectrum which helps minimise volatility in periods of instability. In addition to these defensive attributes, other factors also contributed to European SSL outperformance relative to other risk asset classes during 2015:

- **Benign macroeconomic environment/low default rate:** A combination of ECB stimulus, improving economic climate and limited idiosyncratic risks anchored the SSL default rate. The trailing 12 month default rate of the CS WELLI at the end of December was 0.60%, well below 2014 level of 3.41% and average of 6.33% (CS WELLI Jan. 30, 1998 through Nov. 30, 2015). In fact, there is currently only one issuer in default in the CS WELLI.
- **Limited commodity exposure and no mineral/mining exposure:** As shown in the table below, the CS WELLI had minimal exposure to the two most volatile sectors in 2015; Energy and Mining/Minerals.

	Energy sector		Mining/minerals sector	
Index total return	**% Index**	**2015 return**	**% Index**	**2015 return**
Credit Suisse Western European Leveraged Loan Index (European Loans)	2.32	-22.94	0	NA
Credit Suisse Leveraged Loan Index (US Loans)	2.87	-27.14	1.48	-23.20
Credit Suisse European High Yield Index (European HY)	3.03	-18.07	3.44	-11.63
Credit Suisse US High Yield Index (US HY)	12.09	-23.77	4.34	-23.85

Source: Credit Suisse Leveraged Finance Monthly Strategy as at Dec. 31, 2015. Credit Suisse Western Europe leveraged loan Index (EUR-HDG). Credit Suisse Western European HY Index (EUR-HDG). Past performance is not a guarantee of future results.

- **Steady institutional and CLO demand:** As the chart below shows, apart from a few months, CLO formation was metronomic providing an undercurrent of support for loan prices. For example CLO demand reached €13.6 billion in 2015 only slightly down as compared to last year's level of €14.5 billion - mainly due to the widening of the cost of liabilities (in sympathy with the US CLO market) eroding the equity arbitrage. In addition to CLO formation, demand from Institutional investors remained strong, in fact, by the end of 2015 these investors made up 41% of the demand for new loans, the highest level on record.



Source: The Credit Suisse Leverage Finance Strategy Monthly as at Dec. 31, 2015.

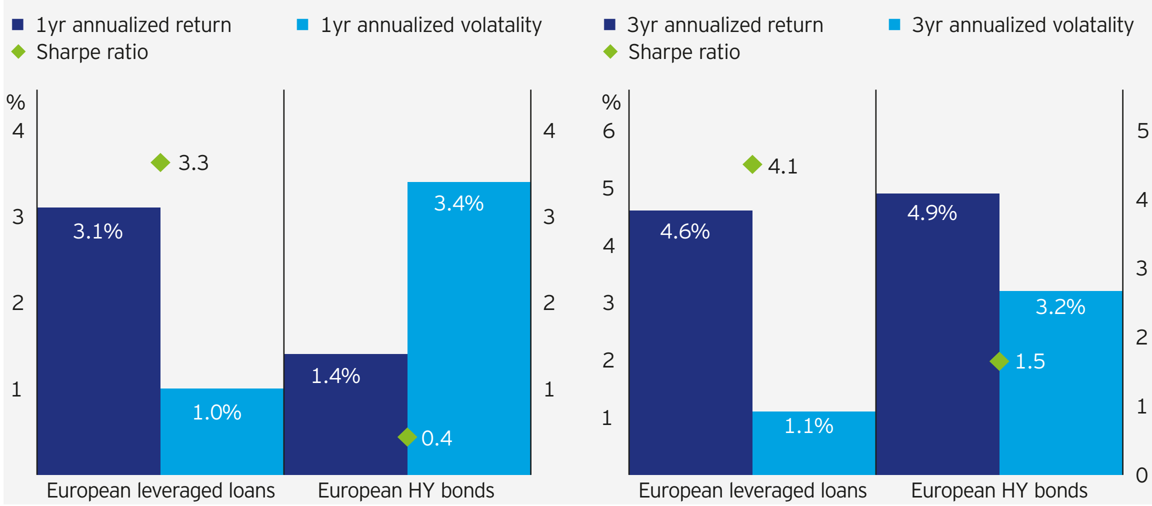
- **Active and attractive primary loan market:** Despite the broad negative headlines outlined above, the European loan market remained receptive to new deals throughout the year – providing investors with good opportunities to gain exposure to SSLs. However, deal flow was somewhat constrained, as private equity originated transactions were curtailed as these players lost auctions to very aggressive strategic bidders who were flush with cash and, at times, favourable IPO conditions which cannibalised recapitalisations. Full year, 2015 supply reached €40.1 billion, which was 18% lower than last year according to S&P LCD. Importantly, the deals that did come to market were attractively priced and structured, as investors benefited from general pullback in risk assets – see relative value table.

European leveraged buy out (LBO) metrics							
	Peak		Trough		Normal		
	2006	2007	2011	2012	2013	2014	2015
Senior leverage	4.6x	4.6x	3.9x	3.6x	3.9x	4.3x	4.3x
Total leverage	5.7x	6.1x	4.5x	4.6x	4.7x	5.1x	5.1x
Interest coverage	2.8x	2.4x	3.6x	3.7x	4.2x	3.9x	3.8x
Equity contribution	34%	34%	47%	52%	42%	43%	43%
Purchase multiple	8.8x	9.7x	8.8x	9.3x	8.7x	9.7x	9.15
Spread	E+2.67%	E+2.62%	E+4.58%	E+5.05%	E+4.41%	E+4.21%	E+4.29%

Source: S&P LCD European Weekly Topical as at Dec. 31, 2015

- **Long-term minded investor base:** Unlike other risk asset classes which have been buffeted by high velocity retail in-and-outflows on positive and negative macro news over 2015, SSLs, largely institutional, investor base has proven to be more resilient. We note that SSL are not readily accessible by retail investors. If we look over a long period of time, we see that loan sharp ratio's compare favourably to European high yield bonds. Note that SSLs are not "Eligible Securities" for the purposes of UCITs funds.

Annualized returns, volatility, and sharpe ratio



Source: S&P LCD as at Dec. 31, 2015. European leveraged loans as represented by the Credit Suisse Western European Leveraged Loan Index; European HY bonds as represented by the Credit Suisse European High Yield Index. Credit Suisse Western Europe leveraged loan Index (EUR-HDG). Credit Suisse Western European HY Index (EUR-HDG). Past performance is not a guarantee of future results.

2016 Technical outlook

In our view, there is no catalyst for a sea-change in the technical dynamics of the European SSL market in 2016. We are expecting demand for assets to modestly outstrip supply, once again resulting in support for the underlying price of loans.

From a supply perspective, the pipeline is already looking strong for the beginning of the year as a number of 2015 deals have been pushed into early 2016. For the remainder of 2015, we see three potential tailwinds driving volumes into 2016: (1) high yield bond markets continuing to be volatile, driving sponsors to utilize the SSL market for certainty of execution instead of the high yield bond market. (2) private equity dry powder has almost reached €300 billion, up from €250 billion at the end of last year according to S&P LCD. We expect sponsors to come under increasing pressure to use this capital even in the face of higher purchase multiples. (3) A few outsized transactions in active M&A sectors. Therefore, we are conservatively optimistic on new deal flow and our base case is for 2016 volumes to be in line with 2015 levels.

From a demand perspective, we expect to see the CLO market to be roughly in line with the volume seen in 2015. This view is based on two competing trends in the market which we expect to continue into 2016. The first trend is growth driven by new managers entering into the CLO market, we expect these new CLO managers to bring much needed diversification to a very concentrated market. In 2015 according to S&P LCD, 9 of the CLOs priced were brought by first time CLO 2.0 managers. The second trend is a drag on growth caused by existing CLO managers either lacking the necessary capital (retention piece – required by CLO regulation) to issue a second or third CLO or manager fatigue from the concentrated end-investor base. We estimate that there are 17 open CLO warehouses in Europe providing anecdotal evidence to support the view of steady CLO demand in 2016. In addition to our expectation for steady support from new CLOs, we also expect to see continued inflows from Institutional investors following the strong relative performance in 2015, further supporting loan prices (please see table on page 1).

We outline two key risks to our base case scenario described above:

- **Contagion from other risk asset classes:** Despite the supportive technical elements in the European SSL market, we have seen that there is some degree of contagion from other risk asset classes. Both European and US high yield bond funds hold European loans, which they often sell to fund redemptions as their prices are more resilient. However, typically these types of sell-off's are contained to a handful of the largest, most liquid names rather than the broad market.
- **Considerable widening in US CLO liabilities impacting the European CLO market:** While this is a concern, we do believe that investors have differentiated the two CLO markets in terms of both vehicle structure (attachment points), economic environments (default cycles), the underlying collateral pools and the volatility of the market values of the loans (less volatility in Europe). We believe this has accounted for some of the spread differential between the two markets during 2015.

2016 Fundamental outlook

In our view, the tailwinds to the European economy are likely to extend into 2016 including (1) stimulative central bank policy, (2) currency depreciation and (3) low oil prices. In addition, we see continued domestic demand thanks to better consumer sentiment (tightening labour markets) and improving business confidence. Positively, the recovery has proven to be resilient to various shocks such as Greece, China and the auto emissions scandal providing support for our thesis of a continued recovery. Even a modest economic uplift in Europe should provide an attractive back drop for risk assets and keep default rates at historically low levels.

Current European themes:

- **Deceleration in economic data from emerging markets, particularly China:** China is a systemic factor that we cannot fully insulate from but only mitigate. As a matter of principle we tend to invest in cycle resistant / cash generative businesses with adequately sized capital structures not dependent on any particular geography which should carry well against this fundamental risk.
- **Diverging monetary policies:** From a fundamental stand point, the diverging monetary policy should provide significant tailwinds to European businesses (borrowers) as the impact of the ECB supports (continues to) flows through to the real economy and the interest rate differential results in a weaker Euro. We expect a continuation of the recent trend in Europe for more deals with Euribor floors to compensate for the low level of Euribor.
- **Lower oil prices:** We believe lower oil prices will generally be good for Eurozone growth as it is a net importer of the commodity. However, clearly the benefit will not be linear. Energy consumers will reap benefits at the expense of the oil producers and intermediaries. Generally, this should help drive stronger consumer sentiment, which could lead to higher demand for products and services.
- **Political risk:** Companies which have revenue or operational exposure to countries facing political uncertainty (sanctions) are likely to see some degree of negative performance. However, while European companies do have global exposure, their exposure to geopolitical hotspots (such as Russia) is usually limited, even to countries within the Eurozone such as Greece. The British European Union referendum will likely create some short term volatility in the market and may have a material impact on some business models. Like emerging market risk, we will endeavour to position our portfolios to limit exposure to such businesses.

Conclusion

We anticipate a return of 5.00-5.50% including EURIBOR for the SSL asset class in 2016.* In our view, this return will be heavily weighted towards running coupon which currently stands at EURIBOR + 3.97%. This margin will be augmented by some degree of price appreciation as SSL prices rebound from the decline in prices experienced at the end of 2015. Note that the Index's (CS WELLI) weighted average bid is still considerably below par (€0.9563).

Relative value	Price	Yield to worst	Spread to worst	Duration
Credit Suisse Western European Leveraged Loan Index (European Loans)	€0.9563	–	5.68%	45-60 days
Credit Suisse Leveraged Loan Index (US Loans)	$0.9143	–	6.43%	45-60 days
Credit Suisse European High Yield Index (European HY)	€0.9688	6.00%	5.60%	3.43 years
Credit Suisse US High Yield Index (US HY)	$0.8652	9.20%	7.47%	4.14 years

Source: The Credit Suisse Leverage Finance Strategy Monthly as of Dec. 31, 2015

*The anticipated return is not guaranteed

Important information

All data provided by Invesco unless otherwise noted. Data as of Dec. 31, 2015, unless otherwise noted.

Most senior loans are made to corporations with below investment-grade credit ratings and are subject to significant credit, valuation and liquidity risk. The value of the collateral securing a loan may not be sufficient to cover the amount owed, may be found invalid or may be used to pay other outstanding obligations of the borrower under applicable law. There is also the risk that the collateral may be difficult to liquidate, or that a majority of the collateral may be illiquid.