European senior secured loan market: 2016 review and 2017 outlook

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2016 SSL market review

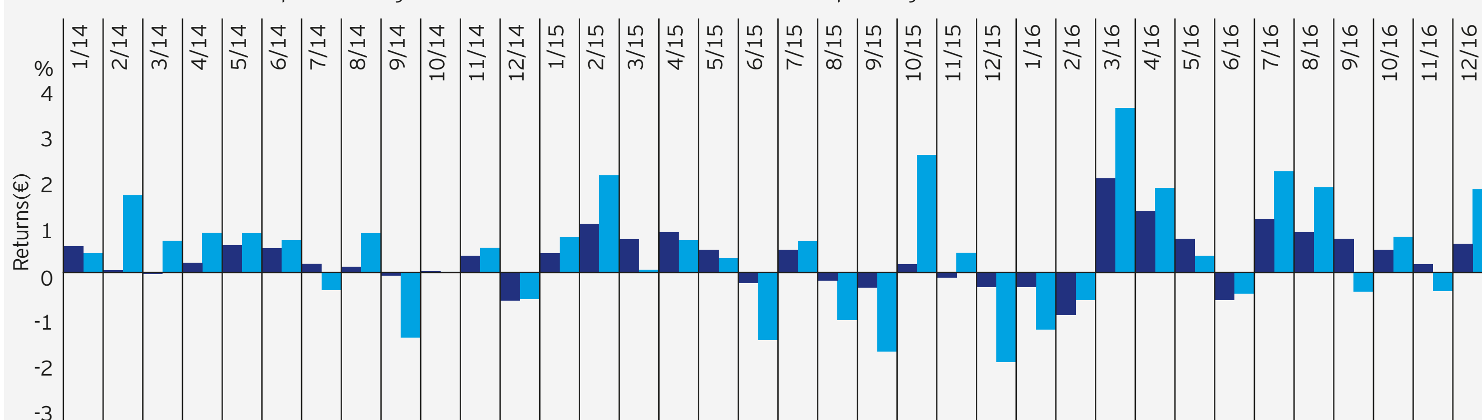
Fundamentals and technicals are likely to be favourable for European senior secured loans in 2017 thanks to modest Eurozone GDP growth (low default environment) as well as a healthy, supply and demand balance in the underlying loan market.

Furthermore, two dominant macro-themes should bolster investor appetite for the asset class. Firstly, we expect to see a softening in the market's belief in the European Central Bank's (ECB) perennial stimulus efforts as investors firmly focus on inflation data. Over the last few years, long-duration asset classes have benefited tremendously from central bank policies as the "Draghi Put" meant the question has simply been "when" not "if" the ECB will provide incremental stimulus. We believe this theme is closer to the end of its current trajectory. We contend that the question that will increasingly be asked will be "when" the ECB will start weaning the market off accommodative monetary policy. On balance, this should lead to more demand for short-duration asset classes such as senior secured loans. Loans provide a relatively high level of floating rate income comprising of Euribor + Margin, with most loans structured with a zero Euribor floor (as at Dec. 30, 2016, 3 month Euribor was -0.319%). Therefore, loans are insulated from Euribor's current negative rate and can pass on to investors any Euribor increase (above zero Euribor floor). In a steeping yield curve environment, the asset class has the potential to outperform long-duration assets.

Secondly, we see a repeat of the heightened sensitivity over political events. The lack of reliable predictive tools for election results has led to increased market volatility before and after these events. Against this backdrop, we believe European senior secured loans present a compelling allocation opportunity for investors given their defensive position in the capital structure (high recovery rate) and historically lower volatility than other fixed rate alternatives such as high yield bonds. As the chart on the following page shows:

Monthly returns: European leveraged loans vs. European high yield bonds

■ Credit Suisse Western European Leveraged Loan Index ■ Credit Suisse Western European High Yield Bond Index



Source: Credit Suisse as at Dec. 31, 2016, Credit Suisse Western European Leveraged Loan Index (EUR-HDG). Credit Suisse Western European HY Index (EUR-HDG). Returns stated are total returns. Past performance does not guarantee future results.

Summary 2016

European senior secured loans delivered a respectable 6.52%[1] in 2016. While the initial period following the Brexit vote was an anxious time for the leveraged loan market, loan prices stabilised quickly given outflows were muted - demonstrating the stability of the loan buyer base - and loan new issuance continued unabated.

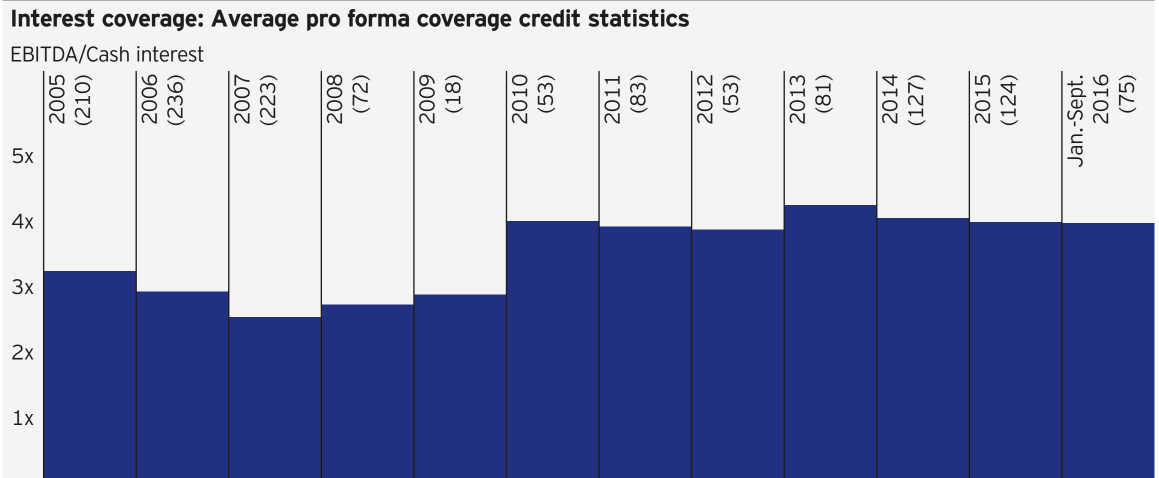
Return expectation

Going into 2017, we have lower return expectations as compared to 2016, given the significant price appreciation already experienced – with the average loan price at 97.58[2] and most of the market currently bid above par. Overall, we forecast a slight coupon-plus year with a 4.5%-5.0% total return.[3]

Fundamentals

- Credit fundamentals remain stable heading into 2017, with no clear catalyst for a spike in default rates. The macro-economic environment is likely to be supportive of risk assets with the Eurozone benefiting from the same trends seen in 2016; private sector demand and supportive government spending.
- Drilling down to the borrower level, credit metrics also look robust – particularly in terms of interest coverage, a measure of a company's ability to meet its interest obligations when they become due. This has been evidenced by a wave of refinancing seen in the second half of 2016, with most borrowers also able to lower cost of debt and/or extend maturities. Furthermore, there is very little systemic risk in the loan market given the minimal exposure to Energy. We expect a default rate of around 2% by principal amount - which remains well below the 5% historical average between 2009 and 2015.[4]
- However, pockets of credit weakness should remain in the loan market. Oil & Gas businesses, retailers and food manufacturers exposed to softer demand (channel shift, macro-uncertainty and / change in consumer habits) and dollar-denominated sourcing costs (cotton and food commodities) remain the most vulnerable.

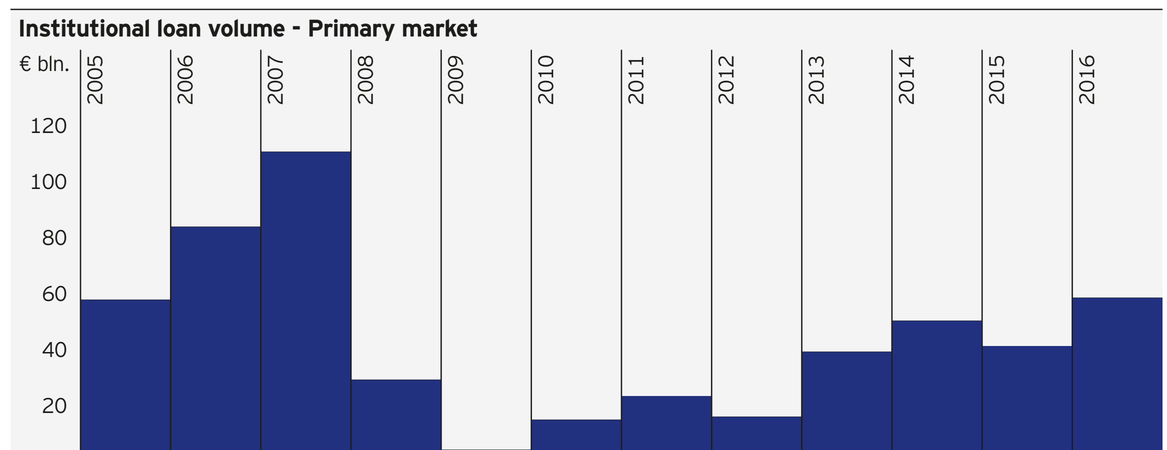
1 Credit Suisse Western European Leveraged Loan Index - (EUR-HDG) – year-to-date Total Return as of Dec. 31, 2016.
2 S&P Leveraged Commentary & Data (LCD) as of Dec. 28, 2016.
3 The anticipated return is not guaranteed.
4 Average historical default rate: Credit Suisse Western European Leveraged Loan Index covering the periods of Jan. 1, 2009 through Dec. 31, 2015.



Source: S&P Leveraged Commentary & Data (LCD) as of Sept. 30, 2016. Senior debt includes first lien, second lien and senior notes. Excludes Broadcasting, Cable & Telecom loans prior to 2002. Includes only transactions for which Pro Forma financials were made available. ( ) represents number of observations by borrower.

Technicals

- Technical conditions were a tailwind throughout most of 2016 and expectations are for them to stay supportive in 2017. This can be attributed to a combination of loans' priority ranking (seniority in the capital structure), floating rate returns and a longer term investor base (banks, CLOs and other institutions). For example, the high yield bond investor base tends to include a larger proportion of shorter term minded investors, which tend to repeatedly enter and exit the market creating heightened volatility.
- Private equity sponsors' coffers are rather well filled going into 2017 - un-invested dry powder hit record levels at the beginning of 2016 - and they seem to be in an acquisitive mode. Moreover, sponsors are expected to keep refinancing bonds with loans, given their preference for greater exit flexibility.
- We expect European senior secured loan new issue volume of €65-75 billion in 2017, ahead of 2016's €57 billion level.[4] While volume was modest in the first half of 2016, syndicate trading desks appear optimistic for a burst of activity in early 2017 due to a strong primary pipeline for the first quarter of 2017.
- The expectation for an active primary market in 2017 is also supported by Collateralized Loan Obligation (CLO) demand going into 2017. In 2016, 41 new CLOs were brought to market totalling €16.8 billion.[4] We expect approximately €15-20 billion of new CLO formation in 2017. Between these ramping CLOs, inflows into commingled funds, separately managed accounts and European banks in asset-gathering mode – all of which have been underwhelmed by net new supply in the market in 2016 – the technical demand for paper is set to continue to be strong in 2017.[4]



Source: S&P Leveraged Commentary & Data (LCD) Global Interactive Loan Volume Report as of Dec. 31, 2016.

4 S&P Leveraged Commentary & Data (LCD) as of Dec. 31, 2016.

Important Information

All data provided by Invesco unless otherwise noted. All data is US dollar and as of December 31, 2016, 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.

Compared to investment grade bonds, junk bonds involve a greater risk of default or price changes due to changes in the issuer's credit quality. Diversification does not guarantee a profit or eliminate the risk of loss.

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