Viewpoint

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European Secured Bank Loan Market Offers Higher Return Potential Than U.S.

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Executive Summary

Alcentra Chief Investment Officer Paul Hatfield argues that market developments in Europe have made the risk-adjusted return outlook for European secured bank loans significantly more attractive than that in the U.S. Owing to a combination of the challenging current market conditions and outlook facing Europe and the structure of the European secured bank loan market, he believes there is strong evidence to support allocating to Europe rather than to the United States. He argues that the current circumstances present significant opportunities to generate higher risk-adjusted returns in the European bank loan market, predicated on the following observations:

- Higher expected returns in Europe
- Capital shortfall in the European market
- Effect of retail flows on the U.S. market
- Weaker covenant structures in the U.S.
- Quality of information in Europe compared with that in the U.S.

Higher Expected Returns

The sovereign debt crisis in Europe caused prices in the European bank loan market to fall despite reasonable corporate performance. We believe there is better relative value in European assets due to the average bids of the S&P European Leveraged Loan Index (ELLI) falling below those of the S&P/LSTA Leveraged Loan Index (LLI).[2] This has had a significant impact on yields attainable in the two markets. The average yield to maturity (YTM) of the ELLI at the end of December was 9.94% and the corresponding YTM for the LLI was 6.70%.[3] Europe's peripheral countries do not form a significant proportion of the European secured bank loan market. By focusing on investing in the more stable Northern European jurisdictions, we believe there is still a greater opportunity to achieve higher returns and, more importantly, higher risk-adjusted returns in Europe than in the U.S.

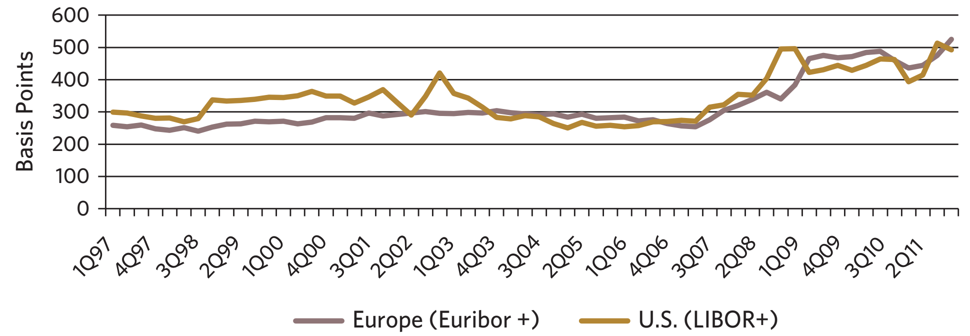
1 BNY Mellon holds over 90% of the parent holding company of The Alcentra Group. The Group refers to these affiliated companies: Alcentra, Ltd and Alcentra NY, LLC. Only Alcentra NY, LLC offers services in the U.S.

2 S&P LCD Global Leveraged Lending Report Q4 2011.

3 S&P ELLI and S&P/LSTA LLI, Excel Data, as at December 31, 2011.

Equity contributions are falling in the U.S. and the level of debt in capital structures is generally higher.

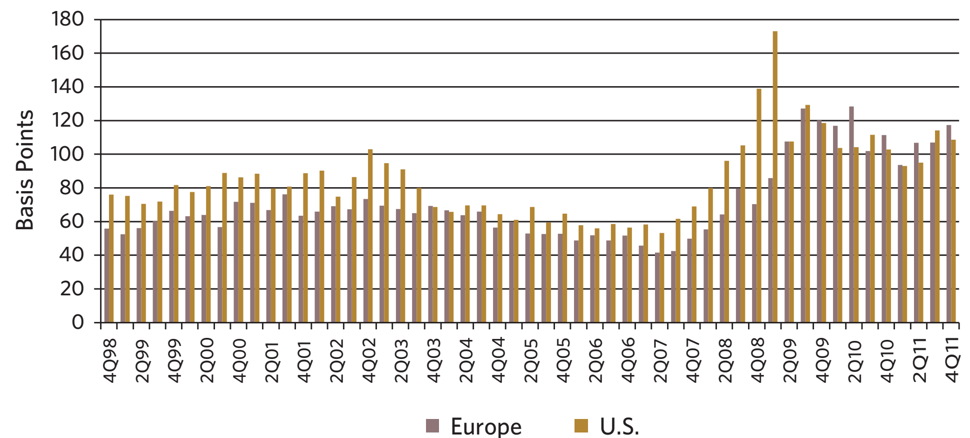
Exhibit 1 – Weighted Average New Issue Institutional Spreads



Source: S&P LCD Global Leveraged Lending Report Q4 2011.

This opportunity is derived from two sources: higher spreads and lower leverage. New issue spreads in the U.S. are around 490 basis points (bps), compared with 525 bps in Europe, as illustrated in Exhibit 1. Equity contributions are falling in the U.S. and the level of debt in capital structures is generally higher. In Europe, however, equity contributions are closer to historically high levels and debt levels are typically lower.[4] The result is a higher spread per unit of leverage in Europe than in the U.S. (Exhibit 2).

Exhibit 2 – Spread Per Unit of Leverage



Source: S&P LCD Global Leveraged Lending Report Q4 2011.

4 S&P LCD Global Leveraged Lending Report Q4 2011.

Capital Shortfall in Europe

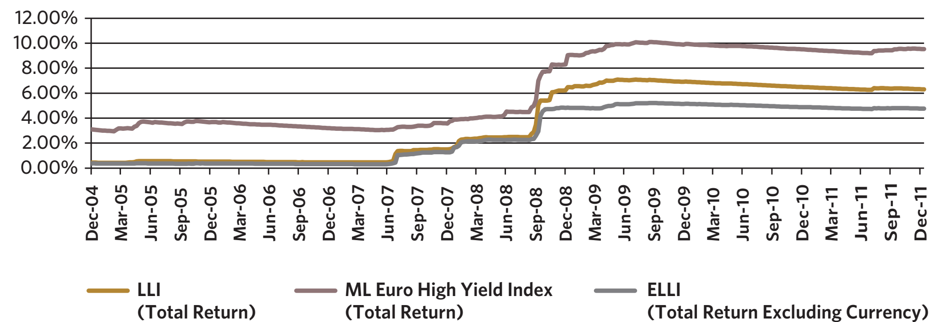
A further contributor to higher risk-adjusted returns is the capital shortfall in Europe. The combination of the impending "maturity wall," a lack of new issuance of collateralised loan obligation (CLO) funding vehicles and the regulatory pressures on banks to reduce capital consuming activities has led to a funding shortfall in the European secured bank loan market. With the highest concentration of future refinancing needs occurring between 2014 and 2016, and with some of the key investors (i.e., banks and hedge funds) stepping back from the market, investors in Europe are well placed to benefit from this shortfall in our view. Stronger issuers refinancing debt are paying higher spreads, which generally creates higher risk-adjusted returns. As a result of the central position of institutional investors in the European secured bank loan market, the capital shortfall has allowed them to demand robust capital structures together with higher margins. This is generally not the case in the U.S. due to the impact of retail investor flows.

The combination of the impending "maturity wall," a lack of new issuance of collateralised loan obligation (CLO) funding vehicles and the regulatory pressures on banks to reduce capital consuming activities has led to a funding shortfall in the European secured bank loan market.

Retail Investor Flows

The U.S. loan market has not seen the same capital shortfall as in Europe, due to the inflow of retail funding through mutual fund investments. Although this has increased liquidity, the greater retail element of these inflows has increased price volatility (Exhibit 3). The price volatility level of loans in the U.S., while lower than that for bonds, is significantly higher than for European loans.

Exhibit 3 – High Yield, U.S. Loan and European Loan Volatility

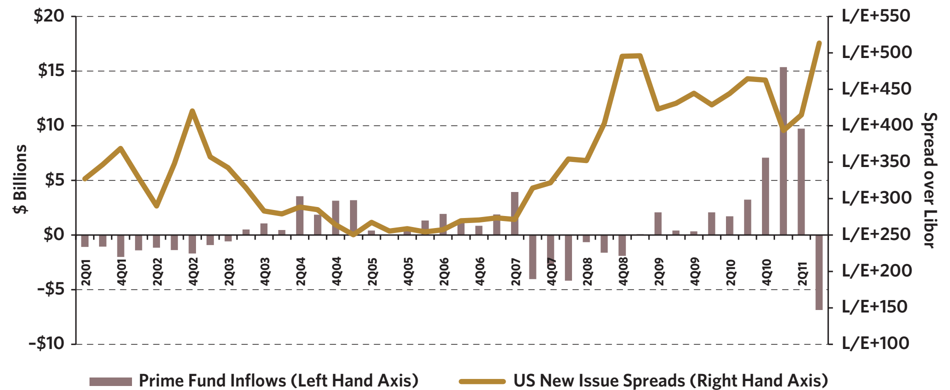


Source: S&P LCD Euro Secondary Report, February 23, 2012.

The increase in liquidity from retail inflows in the U.S. market has led to greater demand for assets in the short term. This increase in competition has led to tighter spreads and smaller original issue discounts (OIDs) for new issues. In fact since 2009, the relationship between prime fund inflows and U.S. new issue spreads has displayed a strong negative correlation (Exhibit 4).

With the increased inflows in the U.S. market, investors are under pressure to invest so as to avoid the drag of the comparatively low yield currently available from cash deposited on account.

Exhibit 4 – U.S. Prime Fund Inflows and New Issue Spreads



Source: S&P LCD Topical Monthly Technicals, November 10, 2011; and S&P LCD USD Global Leveraged Loan Review — U.S./Europe, Q32011.

With the increased inflows in the U.S. market, investors are under pressure to invest so as to avoid the drag of the comparatively low yield currently available from cash deposited on account. At the same time in the U.S. market, pressure from investors to provide higher returns has led to a flurry of "undisciplined" deals — typically they will have more aggressive capital structures, higher leverage and be more "covenant-light" than those currently issued in Europe. There have been examples in recent months of European borrowers accessing the U.S. market to issue debt because of the more favourable terms offered to borrowers, or because European institutional investors had pushed back on what were seen as more aggressively structured deals. For example, Taminco, a Belgian chemical producer, decided to issue debt in the U.S. market as it was allowed to do so more cheaply and without covenants — a significantly more aggressive request than had been accepted in Europe.[5] Another example is Kabel Deutschland, the German cable operator, which also decided to issue a new term loan in the U.S. to gain access to lower new issue spreads.[6]

5 Standard & Poor's LCD News, January 27, 2012. While Alcentra may not own or invest in securities of these companies on behalf of clients, the references to these companies or strategies should not be considered a recommendation to purchase or sell any particular security.

6 *Ibid.,* January 19, 2012.

The availability of more frequent and detailed information allows European investors to maintain a tighter control on the investment.

Weaker Covenant Structures

Loan agreements have various covenants within the debt agreements, including maximum debt-to-EBITDA ratio and minimum level of interest coverage. Typically, bond documents will only include incurrence covenants, i.e. restrictions on the borrower issuing additional debt to that already in existence as it gives loans better protection than bonds.

Continued inflows into the U.S. loan market have seen weaker covenants, and in particular deals with no covenants at all, or so called "covenant-light" deals, have become commonplace. The opposite is true of the European market where lower funding supply allows investors to push back on weak covenant structures. In 2011, there were no new "covenant-light" issues in Europe, while in the U.S., 22% of new issues had "covenant-light" structures.[7]

Since a breach in covenants can (but does not necessarily have to) lead to lenders enforcing their security, borrowers believe that stricter covenants can increase the likelihood of default. However, covenants allow investors to take action sooner in stressed conditions, potentially preventing default, and increasing recovery values. Generally, if an issuer is due to breach a covenant, a waiver request must be circulated to reset or waive the breach. This needs to be approved by the syndicate, which usually requires a fee and an increase in the margin for providing consent.

Private Versus Public

Many loan deals in Europe are private transactions, while in the U.S. they are mostly public. Investors in private transactions have access to monthly management reporting that provides detailed financial information as well as trading updates. Investors also have better access to the company's management and their projections of future trading.

On public deals, information is only available on a quarterly basis and, in general, the detail of this information is more restricted. The availability of more frequent and detailed information allows European investors to maintain a tighter control on the investment. Therefore, European investors will tend to have better insight, including earlier warning signals, on impending stress in a company's performance.

7 Credit Suisse, *2012 Leveraged Finance Outlook and 2011 Annual Review,* January 26, 2012.

Conclusion

Uncertainty over the outcome of the European sovereign debt crisis is likely to continue for the immediate future. While this is likely to create a more volatile backdrop for all markets, in the bank loan market, we also believe that it should result in yields staying at attractive levels and in capital structures and loan documentation remaining investor-friendly and less aggressive than is currently the case in the U.S. loan market.

This lender-favourable environment is likely to be exacerbated by a continuing lack of supply of capital in Europe, as banks retrench from corporate lending and the dearth in the supply of CLOs is not replaced by other sources of funding.

For all these reasons, we believe the European bank loan market represents better relative value than the U.S. loan market, especially on a risk-return basis.

Index Definitions

The S&P European Leveraged Loan Index (ELLI) is a multi-currency index that covers the European leveraged loan market back to 2003 and currently calculates on a weekly basis.

The LLI is a daily total return index that uses LSTA/LPC Mark-to-Market Pricing to calculate market value change. On a real-time basis, the LLI tracks the current outstanding balance and spread over LIBOR for fully funded term loans. The facilities included in the LLI represent a broad cross section of leveraged loans syndicated in the United States, including dollar-denominated loans to overseas issuers.

The BofA Merrill Lynch Euro High Yield Index tracks the performance of EUR denominated below investment grade corporate debt publicly issued in the euro domestic or eurobond markets. Qualifying securities must have a below investment grade rating (based on an average of Moody's, S&P and Fitch) and an investment grade rated country of risk (based on an average of Moody's, S&P and Fitch foreign currency long term sovereign debt ratings). Issuer exposure is capped at 3%.

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