ISSUANCE ON THE RISE

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Alcentra

Paul Hatfield, chief investment officer at Alcentra believes 2014 is an attractive year for senior secured loans with a backdrop of high rates of recovery and low defaults in both the US and Europe.

I still take a very positive view on the loan asset class in both Europe and the US, although there is certainly capacity for more issuance, especially in the European market. However, I think the amount of dry powder private-equity has to its name, combined with the recent uptick in M&A activity, means 2014 will be a better year for new issuance. Economic recovery in both markets, though still in its early stages, will also help in this respect.

We've seen declining default rates and I expect 2014 will remain a year with few defaults. Outside of the loans we already know are headed that way, there should be no surprises in that area.

Inflation does not seem to be exactly racing ahead and with recent events in Washington pointing to continued low interest rates, the backdrop for borrowers remains favourable. I think interest rates will stay lower for longer in Europe until the problems with peripheral countries are sorted.

LOAN DEMAND SET TO CONTINUE

Through most of 2013 there was $481bn of issuance in the US market, compared to €61bn in Europe (a large jump from €23bn in 2012).[1] This disparity is reflected in the number of issues in each market: 1,450 in the US versus 517 in Europe.[2] It is worth bearing in mind the US loan market is much larger than its European counterpart with a total notional value outstanding of US $726bn, versus €144bn in Europe.

We (Alcentra) expect continued demand for loan assets in Europe. However, a number of factors, including a fledgling return of the European CLO market, limited scope for retail investors and the smaller size of the LBO market, is likely to contain any moves toward parity with the US in terms of size.

Liquidity is undoubtedly greater in the US than in Europe. In the US, on average more than US$400bn of principal value in loans has been traded each year since 2007,[3] clearly outstripping

1 Credit Suisse, Leveraged Finance Strategy Update, October 2013.
2 Credit Suisse, Leveraged Loan Index and Western European Leveraged Loan Index, Monthly Excel data, September 2013.
3 S&P/LSTA, 2013.

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the market size of European loans in total. In Europe the private nature of many financings – often numbering a handful of lenders in a ‘club’ deal – tends to limit the volumes traded, with many participants buying to hold until maturity. Though liquidity is lower in Europe, for institutional investors this may be seen as presenting less pressure on prices (both upward and downward), meaning greater price discipline can be maintained and volatility minimised.

Covenants are common in the European market but increasingly rare in the US. In the first three quarters of 2013 the US loan issuance was on average 52% ‘covenant-lite’ versus 21% ‘cov-lite’ in Europe, with the majority of the latter being in ‘cross-border’ deals.[4]

We believe covenants will remain an important part of the European market this year, with the greater discipline we see in evidence from the mainly institutional investor base important in maintaining lender-friendly terms and deal structures.

FALLING DEFAULT RATES

Default rates in the US and European loan markets have started to converge, after a long period of higher European numbers inflated by directories’ businesses and Spanish issuers. In the US, the lagging 12-month default rate by volume increased to 2.41% at the end of September 2013 from 1.37% at the end of June 2013. In Europe this rate has fallen from 5.29% to 3.14% over the same period (starting at more than 6% at the beginning of 2013).[5]

We believe European default rates will be benign throughout 2014, with rates falling further than their current level. Should TXU, a US issuer, default on its US$20bn of outstanding debt, which we believe is likely; this would lift the default rate for the US to more than 6%. However, we expect by the end of 2014, rates will have normalised below the mean of 2.5%–3.0%. As a senior secured asset class, we continue to believe that high rates of recovery, and therefore low default loss rates, will continue throughout this year in both the US and Europe.

Average annual total returns for US loans have been 6.90% versus 5.49% in Europe[6] from 2003 to 2012. In 2013, Credit Suisse estimated a total return for US loans of 5.5% versus 7.5% for European loans. As such we would expect a total return for a diversified portfolio of US loans to achieve approximately 5%-6% in 2014, relatively unchanged on 2013. For European loans we expect returns of 6.5%-7.5%, slightly lower than last year.

OUTLOOK

Economic recovery in US and European markets will help to keep default rates low

Interest rates will stay lower for longer in Europe until the problems with peripheral countries are sorted out

Inflation doesn’t seem to be exactly racing ahead and with recent events in Washington pointing to continued low interest rates, the backdrop for borrowers is still very favorable

4 S&P LCD European Leveraged Lending Review, Q3 2013 & S&P LCD LoanStats Weekly, 10th October 2013. “Cov-lite” loans only have a financial incurrance covenant (akin to a bond), rather than the traditional maintenance covenants that are normally guaranteed by a loan agreement.
5 Standard and Poor’s, Weekly Topicals, ELLI Default Rate, 10th October 2013.
6 Credit Suisse, Leveraged Loan Index and Western European Leveraged Loan Index, Monthly Excel data, September 2013.