PILFOR
LENDING SOUNDNESS

3rd Quarter 2020

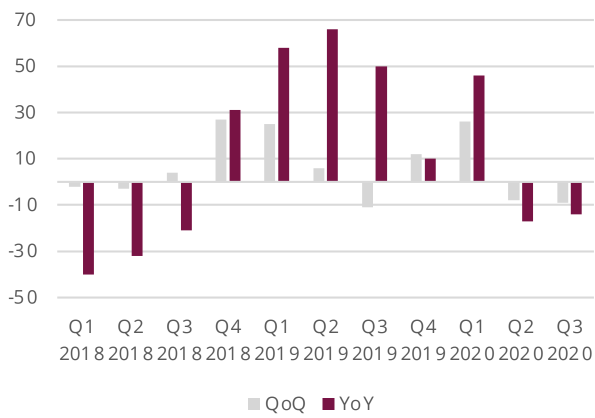
Quarterly Market Insights

30.10.2020

EMEA Financing Environment

The unprecedented actions taken by the central banks combined with large-scale government programs to stabilize the economy, markets, investors and above all companies continued to lend comfort and offered an ideal environment for issuers in Q3 2020 with spreads tightening further on the back of yield-hungry investors. With supply falling short from European new loan issue in the wake of high demand from CLOs in Q3, secondary loan spreads continued their recovery from Q2 levels, with the Euro Leveraged Loan Index (ELLI) nearly reaching 95% by the end of Q3, just four points shy of the highest mark in 2020 posted in late January. The continued market recovery in Q3 was further reflected in the strengthening bid base, helping nearly 90% of loans to trade above 90% by the end of Q3 vs. not even 30% of loans in mid-March. Even more hope was taken from a small number of ELLI loans trading above par in September, last seen in February 2020.

Leveraged Loan Pricing Changes EMEA (bps)

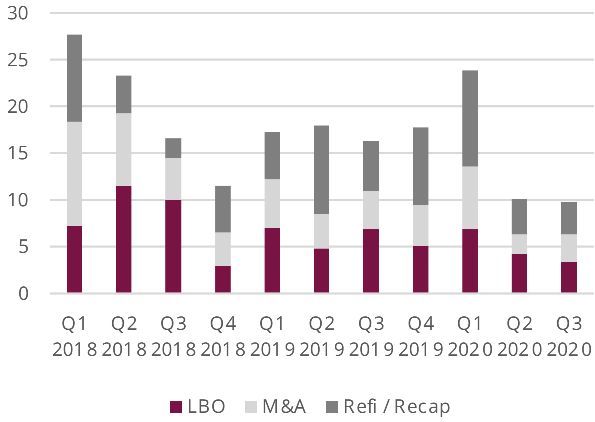


Source: afme

Leveraged Loan Market Insights

Despite August tending to be a quiet vacation month, the loan market in Q3 remained relatively solid. The increasing demand from new CLO formation helped overall issuance in Q3 to reach EUR 9.8 bn, only slightly below the EUR 10.1bn in Q2, but well below Q1 levels with EUR 22.9bn. The quarter under review was impacted by 1) a lower level of sponsor buyouts amounting to only EUR 3.4bn, down 19% vs. Q2 and down 51% vs. Q1 levels, and 2) lower refinancing / recapitalization activity of EUR 3.5bn, down roughly 8% vs. Q2 and down 66% vs. Q1. The stabilization and ongoing recovery witnessed during Q3 enabled a number of LBO and M&A related deals to be successfully financed exiting several banks loan books where they had been stuck since the outbreak of the pandemic. Despite average sizes still being below former levels, they clearly helped to pave the way for larger deal-related issues requiring sufficient investor demand to be able to successfully be placed in the market.

Leveraged Loan Issuance EMEA (EUR bn)

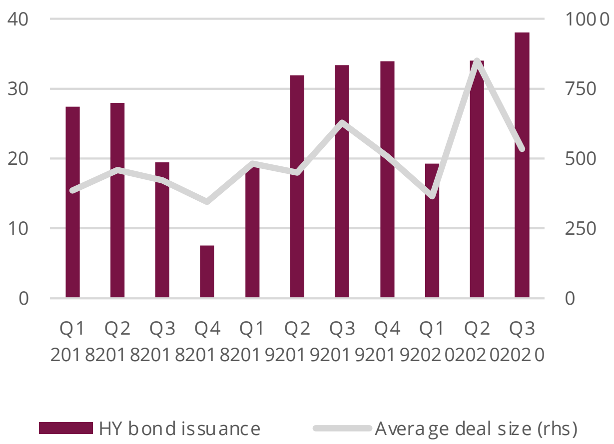


Source: afme, Xtract

Debt Capital Market Insights

Following a record setting issue quarter in Q2 with EUR 306bn, Q3 recorded a marked decline totalling EUR 150bn across 258 deals. Following a relatively quiet August with EUR 20bn, September witnessed a strong rebound amounting to EUR 79bn across 140 deals. Contrary to IG issuance activity that declined strongly from Q2 to Q3, high-yield issuance increased from Q2 with EUR 34bn to EUR 38bn. However, average deal size declined markedly from EUR 850m to around EUR 535m. The continued activity in high-yield issuance is based on investors' unabating thirst for yield and near-zero interest environments and the delayed re-opening of the European high-yield market post March 2020. Yields have remained fairly low, partly due to central bank stimulus interventions and government support countries have provided for companies to access liquidity. While these measures clearly helped issuers, they are also shifting the balance towards issuers once again. The mix of looser covenants, varying debt layers and economic challenges is set to cause havoc and record low recovery rates in a growing number of cases.

High Yield Bond Issuance EMEA (EUR bn)

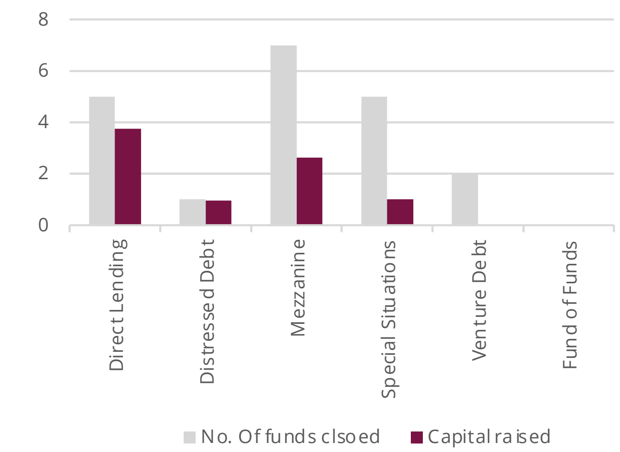


Source: afme, LCD

Private Debt Market Insight

During Q3 2020 some 20 private debt funds closed, raising USD 8.4bn, down from Q2 when 60 funds closed raising USD 38bn. However, historically Q1 and Q3 have been lower than the other two quarters as these typically reach a final close then. 75% of funds closed in Q3 focus on North America, with total capital raised focused on this market reaching 97%. The other 5 funds closed focus on Asia. Direct lending and mezzanine funds secured USD 3.8bn and USD 2.6bn, respectively. The dislocation the pandemic is causing is likely to create a growing number of distressed and special situations opportunities, for which USD 1bn capital was raised in Q3. In line with trends underway across other asset classes, the largest fund managers are leveraging their position and have launched large-scale funds, attracting significant commitments. Investors are increasingly aiming to commit to just a single fund to gain exposure to the asset class, leading to increasing dominance by those firms with the most established relationships. Capital consolidation is continuing, triggered by the pandemic.

Private Debt raised by fund type (USD bn)

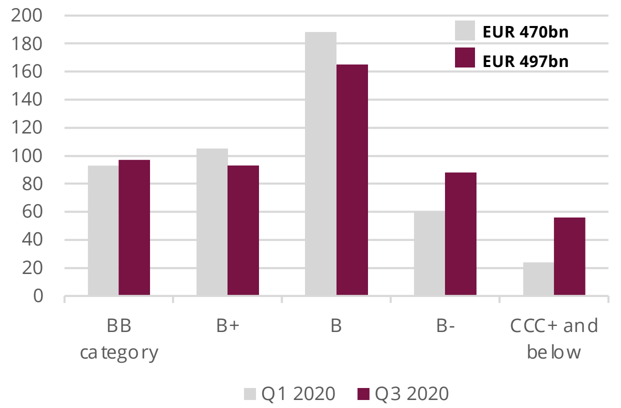


Source: Preqin

Rating Market Insight

Following what can clearly be regarded as unprecedented negative rating actions in both Q1 and Q2, Q3 recorded a much lower pace with most adjustments occurring in the airline, aircraft and components sectors. Due to the aforementioned central bank and government interventions, the default rate remained low during Q2, but picked up during Q3, thereby doubling QoQ. As the economy is far from visibly recovering due to the pick-up of second pandemic waves, companies will set their focus on solvency and being able to maintain adequate capital structures. "BB" rated debt increased due to a considerable rise in "Fallen Angels", more than offsetting debt downgraded into the "B" category. "B" rated debt declined to a 1/3 of overall, while secured debt spiked to nearly 20% of sub-IG rated secured debt. The "CCC" category witnessed a marked increase of issuers and debt doubling. According to S&P, a third of this debt is set to face a restructuring over the next 12 months.

Deteriorating Rating of Sen. Sec. Debt – Europe (EUR bn)

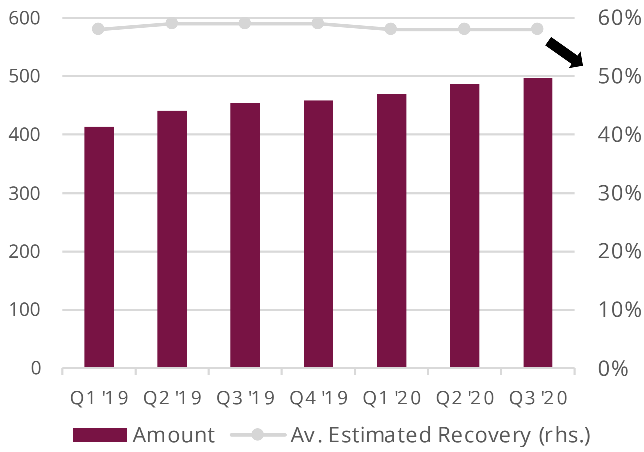


Source: S&P

This time is different

Historical first-lien recovery levels in Europe moved within ranges of 60% to 85% on average. Even in 2008 and 2009, when a considerable number of debt instruments faced default recovery levels were north of 60%. The continued supply of cheap debt fuelled the rise in all-senior transactions, boosting average leverage levels for new transactions past levels last seen in 2007. Despite hopes of seeing recovery rates on first-lien debt in the speculative area reaching historical levels of 60% or just shy thereof, this might well turn out to prove different this time around. Documentation loopholes have ignited sky-high leverage levels translating into highly vulnerable structures. The thirst for yield has led to very generous / risky documentations such as transferability of assets, redesignation to unrestricted group and reallocation of debt, are just some clauses looming to be utilized in restructurings. Relating recovery levels will likely offer "cold showers" to investors.

Rated European Spec.-Grade First-Lien Debt (EUR bn)



Source: Moody's, S&P

Sources used in this report include afme, Dealogic, Fitch, Moody's, Pitchbook, S&P

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