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THE RISE OF THE LEVERAGED LOAN

Leveraged Finance's Structural Change

In Conversation with Mathew Cestar, Managing Director, Head of Leveraged Finance EMEA, Credit Suisse

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LEVERAGED FINANCE'S STRUCTURAL CHANGE

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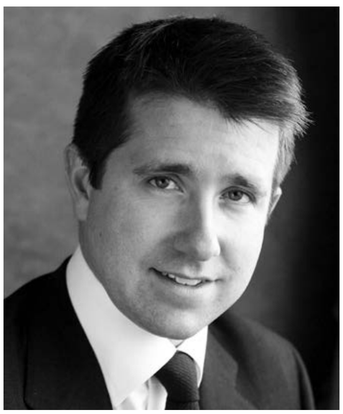

In conversation with Mathew Cestar, Managing Director, Head of Leveraged Finance EMEA, Credit Suisse

Mathew Cestar explores how industry regulations are forcing a structural shift in the way European companies finance themselves: away from relationship-led commercial-bank lending to an increasing reliance on the public capital markets. This has spurred a significant increase in the issuance of institutional leveraged loans which, combined with growing secondary market liquidity, has attracted an increasingly global investor base lured partly by the returns available on loans issued in the region.

FROM BANK TO INSTITUTION

"There's a shift in financing models that's happening in Europe, away from bank-led financing-type models to institutional capital markets," Mathew notes. "The first expression of this has been in the high yield market where we've had record volumes since 2010. In 2013, however, we saw very impressive growth in loan issuance and now that all the right conditions are in place, we think 2014 will be another strong year for loans."

Global regulations have increased the cost of capital for banks, forcing them to restrict their bilateral lending to corporates, who have now turned to the public capital markets for financing, some of them for the first time. This resulted in record issuance volumes during 2013 in high yield bonds and a resurgence of the leveraged loans market.

Last year institutional leveraged loan issuance in Europe reached EUR70.8 billion while European high yield bond issuance came at EUR96.5 billion—both types of instrument showing tremendous increases on the previous year. Mathew identifies some of the key leveraged loan transactions that have contributed to that (see table at the back), with heavy institutional involvement and broad secondary market liquidity.

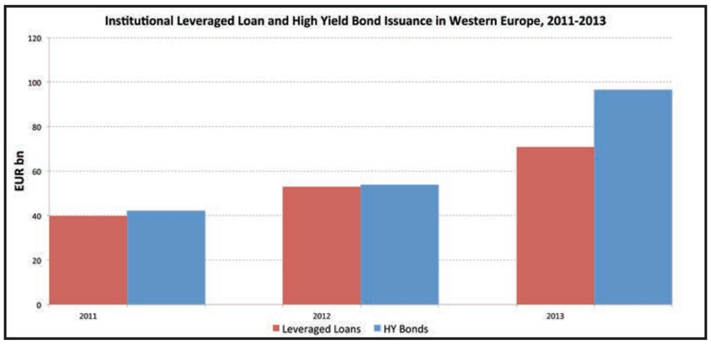

Figure 1 – Leveraged loan and HY bond issuance is growing in Europe. (Source: Bloomberg)

The bulk of loan issuance came from borrowers having to refinance maturing loans from their relationship banks and it's this refinancing need that is expected to continue underpinning supply over the next few years. Credit Suisse estimates issuers in Europe will need to refinance EUR330 billion of outstanding loans and high yield bonds over the next four years.

"If you look at the last four to five years, the lion's share of activity has been refinancing because there's been a substantial amount of debt that needs to be extended and refinanced, and that trend is going to continue," says Mathew.

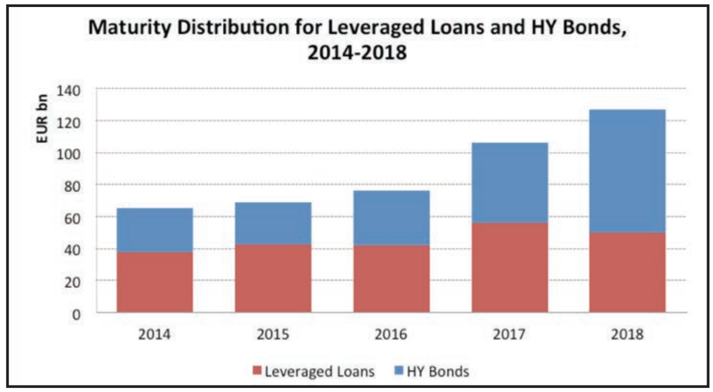

Figure 2 – Upcoming maturities for leveraged loans and HY bonds in Europe. (Source: Bloomberg)

"Borrowers in the loan market want to have flexible, low-cost loans in their capital structure–instruments that are pre-payable at par so they can be repaid easily," Mathew says. And investors are increasingly interested in gaining exposure to the secure part of a company's capital structure in floating-rate format–and the way they're doing that is through loans.

"When this sort of supply and demand dynamic comes together you get substantial market growth," Mathew says. "When borrowers considered their financing options in the past, they looked at the European and U.S. high yield bond markets and the U.S. leveraged loan market but now, increasingly, they have a fourth option—the European loan market."

The development of a sizable public loan market in Europe has attracted a range of global investors willing to deploy large amounts of capital in European companies. While before the crisis many investors relied on private ratings and covenant protections, most are now increasingly undertaking their own extensive credit and business analysis of companies. Broadly half the new issue product in the U.S. has been what's known as covenant-lite. Cov-lite issuance in Europe is also growing dramatically, albeit from a much smaller starting point.

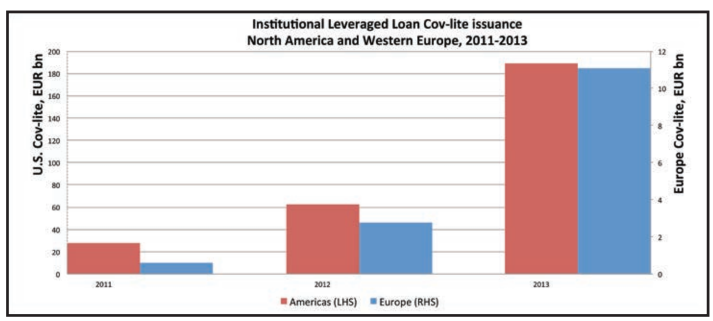

Figure 3 – Growing use of Cov-lite structures in the U.S. and Europe. (Source: Bloomberg)

"I think there's a movement in Europe to develop much more of a credit culture, so investors are making credit investment decisions, and that has really put the onus on the portfolio managers and research analysts to come up with strong credit analysis," says Mathew. "If investors are looking at a stable company with a steady business profile, they are less likely to require covenants on their deals; on smaller or more cyclical deals, covenants are appropriate."

EUROPEAN LOAN MARKET OUTPERFORMS

Investors will make investment decisions based on the relative attractiveness of the European market compared to the U.S., and with the eurozone sovereign debt crisis having stabilized during 2013 on the back of central bank support, returns significantly outperformed the U.S.

The European leveraged loan market returned 8.19% in 2013, outperforming both the U.S. high yield market at 7.44% and the U.S. leveraged loan market's 5.90% return. Credit Suisse estimates that European leveraged loans will return 6% in 2014, outperforming both U.S. markets again as well as the European high yield sector.

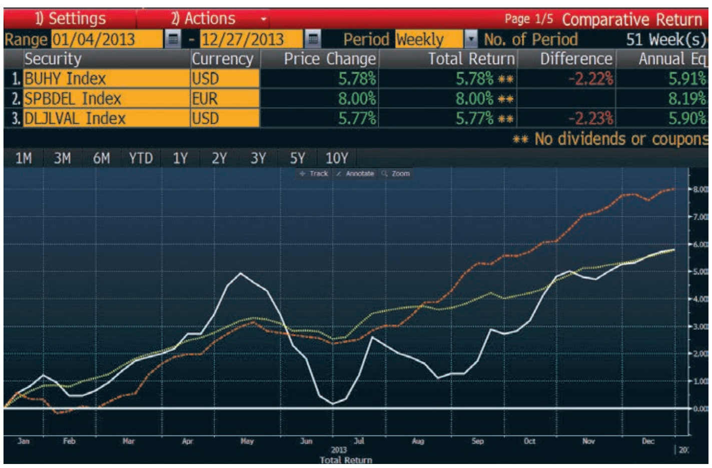

Figure 4 – European Leveraged Loans outperform U.S. Lev loans and, U.S. HY bonds. (Source: Bloomberg Comparative Returns COMP <GO>, using Credit Suisse U.S. Lev Loan Index, Bloomberg U.S. HY Corp Index, S&P European Lev Loan Index)

"Money finds value in this market and the yield pick-up on European leveraged loans relative to comparable U.S. transactions is attractive," says Mathew. "So if global investors are underinvested in European loan product they're underperforming."

STANDARD DOCUMENTATION AIDS GLOBALIZATION

To aid the development of a global investor base for European loans, Credit Suisse has been using standardized loan term documentation that is based on U.S. standards.

"Increased standardization of loan documentation will allow us to increase the amount of capital flowing into this marketplace," says Mathew. "Once you have standard documentation and you know the risks then you have the confidence to start focusing on the credit work and analysis of the borrower."

This growing global demand for European loan product has also increased liquidity in the secondary market which, in turn, makes borrowers more keen to issue into the primary market. A more liquid secondary market results in more efficient price discovery for new issuance.

Mathew notes: "Borrowers want liquid markets because they want to be able to finance in good times and bad—they want a market in which all assets can trade at a certain price rather than seizing up due to lack of depth."

MARKET SET FOR FURTHER GROWTH

The European leveraged loan market appears set for further strong growth, not just because there is a lot of refinancing of existing debt to be done. The improving global economic outlook, greater stability in Europe and improved liquidity in the loan market is expected to provide more comfort to companies wanting to finance M&A transactions through the loan markets.

Additionally, the return of the market for Collateralized Loan Obligations (CLOs) in Europe during 2013 is also expected to create further demand for the leveraged loans that underlie these transactions.

These powerful drivers of supply and demand are set to propel further growth of the European loan market which will make it more liquid and should help the market weather bouts of extreme volatility from factors such as eurozone political instability or concerns about rising sovereign debt levels.

As Mathew puts it: "From where we stand now, we think 2014 will be the year of the leveraged loan."

MATHEW'S PICKS – "DEALS FOR A GROWING GLOBAL MARKETPLACE"

Mathew identifies a number of deals that sum up the trend towards large deals that satisfy large global investors.

DEAL	TRANCHE	CURRENCY	MARGIN	AMOUNT	MATURITY	BLOOMBERG ID
Dell – Sponsored by MSD Capital, Silver Lake Partners. Total deal size USD equiv 10,750 M	T L B	USD	Libor+350	4,660 M	Apr 2020	BL0934234
	TL B	EUR	Euribor+375	700 M	Apr 2020	BL1124876
	TL C	USD	Libor+275	1,500 M	Oct 2018	BL0934242
Chesapeake – Sponsored by Carlyle. Total deal size GBP equiv 340 M	RCF	GBP	Libor+400	50 M	Sep 2019	BL1103334
	TL B	GBP	Libor+500	145 M	Sep 2020	BL1103318
	TL B	EUR	Euribor+450	172 M	Sep 2020	BL1103326
Virgin Media – Acquired by Liberty Global. Total deal size USD equiv 8,000 M	RCF	GBP	Libor+325	660 M	Jun 2019	BL0933475
	TL A	GBP	Libor+325	375 M	Jun 2019	BL0933459
	TL B	USD	Libor+275	2,755 M	Jun 2020	BL0933731
	TL C	GBP	Libor+375	600 M	Jun 2020	BL0933467
Dupont Coatings – Sponsored by Carlyle. Total deal size USD equiv 4,300 M	RCF	USD	Libor+350	400 M	Feb 2018	BL0909699
	TL B	EUR	Euribor+400	400 M	Feb 2020	BL0909715
	TL B2	USD	Libor+350	2,300 M	Feb 2020	BL0909707
Springer Science – Sponsored by BC Partners. Total deal size USD equiv 2,400 M	TL B1	EUR	Euribor+425	615 M	Aug 2020	BL1056961
	TL B2	USD	Libor+400	1,591 M	Aug 2020	BL1056946
BMC Software – Sponsored by consortium led by Bain Capital. Total deal size USD equiv 5,855 M	RCF	USD	Libor+400	170 M	Sep 2018	BL1020710
	RCF	USD	Libor+350	180 M	Sep 2018	BL1119462
	TL B	USD	Libor+400	2,880 M	Sep 2020	BL1020702
	TL B	USD	Libor+400	335 M	Sep 2020	BL1086125
	TL B	EUR	Euribor+450	500 M	Sep 2020	BL1073578
Ziggo – Acquired by Liberty Global—Total deal size EUR equiv 4,400 M	TL B 1/2/3/4	EUR	Euribor+300	2,000 M	Jan 2022	BL1227604
	TL B 1/2/3/4	USD	Libor+275	2,350 M	Jan 2022	BL1227612

Total deal sizes include HY bond financing portion (not on table).

If you're a Bloomberg Professional® service user, you can view these deals by typing the Bloomberg IDs above followed by <Corp> DES <GO>.

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