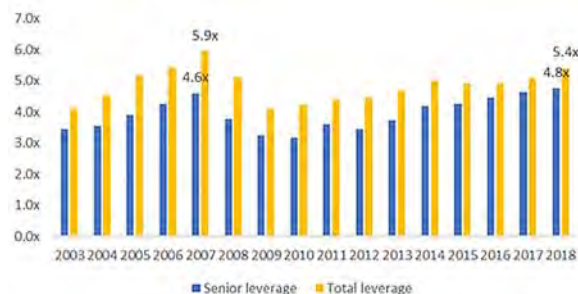
Leverage in the European Loan Market

European loan market leverage has crept steadily higher in recent years, which the financial press sees as a sign that the market is becoming overheated. From 2009 to 2018, leverage multiples on European leveraged buyouts rose from 4.0x to 5.4x, as can be seen below. While the aggregate measure remains well below its 2007 highs of 5.9x, first lien senior leverage has exceeded that year's peak of 4.6x. This largely stems from a post-crisis propensity for more simplified structures involving limited use of second lien tranches and minimal junior debt issuance.

European LBO Leverage Levels



Source: LCD, an offering of S&P Global Market Intelligence

Various factors have contributed to the growing use of leverage. For one thing, healthy corporate balance sheets and the proliferation of cheap financing have spurred increased competition for corporate assets, with strategic buyers vying strongly with private equity and other financial institutions. Bolstered by their ability to extract synergies from corporate combinations, the former group has been willing to pay higher multiples for acquisition targets, boosting enterprise valuations overall. In the recent public-to-private buyout of RPC, for instance, these factors afforded Berry Global Group, Inc. the wherewithal to outbid Apollo.

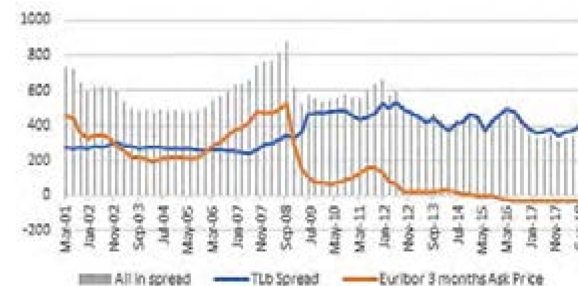
Against this backdrop, private equity buyers have been forced to bid aggressively to remain in the game. Ironically, while the equity component of recent deals is higher than the 40-50% share that prevailed before the global financial crisis struck, the uptick in enterprise values amid continued strong lender interest has facilitated a corresponding rise in leverage.

Indeed, demand from CLOs, managed accounts, pension funds and insurance companies for floating-rate loans, stemming from solid performance and the search for yield amid a persistent low-rate environment, has meant that deals are oversubscribed despite the increasingly aggressive structures being financed. Lending further weight, many investors view floating-rate securities as a natural hedge against rising rates.

There has been some discrimination, however. Contrary to 2006-2007, the lender base has been somewhat disciplined; conditions have not returned to a time when all deals were heavily oversubscribed regardless of quality. In transactions where concerns have been raised regarding structure, terms or business quality, lenders have pressed for wider spreads, deeper discounts and improved credit agreements. In some cases, deals have been pulled altogether following negative lender feedback. Given that, the quality of many loan portfolios appears to have remained strong, and weaker credits have had to accept more appropriate terms.

Regardless, while leverage has been increasing, the prolonged low-rate environment in Europe means that interest coverage remains comfortably above historical averages. As a point of reference, three-month EURIBOR, which was over 5% in 2007, has been below zero since 2015. Even allowing for the fact that the vast majority of European deals include a 0% EURIBOR floor, the all-in cost of a loan – EURIBOR plus margin – has fallen from more than 800 basis points in 2008 to 350-400 basis points currently, as illustrated below. This has led to a marked reduction in interest expense – and an accompanying improvement in coverage ratios – despite the higher leverage.

EURIBOR (3 mnths) Impact on European Senior Spreads



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The current state of affairs should support the ability of leveraged businesses to remain cash-generative through an economic cycle, in contrast to what transpired a decade or so ago. Prior to the financial crisis, LBOs were predicated on the assumption that the business in question would "grow into" its capital structure. Consequently, earnings shortfalls quickly led to negative cashflow. When things unraveled, financially-stretched companies had little room to maneuver. They were quick to face cashflow issues

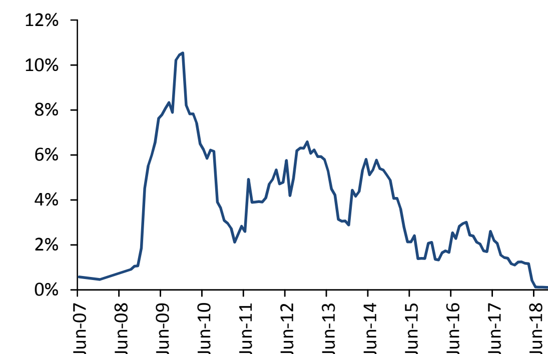
and covenant breaches, causing default rates to balloon above 10% during 2009. Today, low rates and the healthy cash flow foundations baked into transaction structures have helped mitigate that threat.

With many now expecting interest rates to remain lower for longer, default rates should remain subdued despite a deteriorating macroeconomic backdrop. Amid weaker-than-expected economic reports and other evidence of slowing European – and global – growth, the ECB at its March Governing Council meeting announced a new series of targeted longer-term refinancing operations (TLTRO III) to provide additional support for banks. It also announced a short extension to its forward guidance on rates, vowing to keep them where they were "through the end of 2019," which pushed out prospects for any increase by four-six months to early 2020. This has effectively put the ECB's normalization plan on hold, removing the threat of a potential "cliff effect" stemming from the withdrawal of current accommodation.

Thus far, the reaction has been enthusiastic: yields on 10-year German bunds briefly turned negative on March 22 for the first time in three years. That said, it is ironic that weaker economic data is being viewed as a positive, especially given earlier fears about the slowing pace of activity in the region. As with Pavlov's dog, it appears that markets can't help but respond positively to the prospect of a more supportive central bank and a further extension of monetary accommodation.

Taken together, these various factors bolster the notion that default and loss rates are unlikely to spike in the near-to-medium term, despite higher levels of leverage, even though conditions are about as benign as they can be. As illustrated in the chart below, the S&P ELLI trailing twelve-month default rate recently fell to zero after registering a record low reading of 0.11% in December. Should defaults eventually rise to the 2-3% level that many commentators, including rating agencies and research analysts, expect, this would still leave them below their long run averages.

ELLI Trailing 12-month Default Rate



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Overall, then, we believe that defaults will likely stem from idiosyncratic situations rather than a broad-based systemic failure. With this in mind, bottom-up credit picking will be the key to successfully navigating the European leveraged loan market in the period ahead.

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