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Hunger Games: risk and reward in leveraged finance - the buyside view

On 7 September 2016, **Chris Porter (S&P Global Ratings), Fiona Hagdrup (M&G Investments), Aly Hirji (BlackRock), Madelaine Jones (Oaktree Capital Management)** and **Craig Scordellis (CQS)** discussed developments in leveraged finance from a buyside perspective.

The current state of the leveraged market

The first half of 2016 has seen the volume of leveraged loan issuance fall by over 20% from €38bn to €30bn. Of the transactions that came to market, 75% were originated in France and Germany, with UK issuance noticeably subdued prior to and after the Brexit referendum. Nevertheless, despite the suppressed levels of activity, loan pricing has remained relatively stable.

Influential investor types

From a fundamentals standpoint, CLOs are assets of exceptional relative value, with cumulative defaults in CLO liabilities being less than 0.1%. Despite this, due inter alia to macroeconomic issues, geopolitical risk and increased regulation, CLO issuance has been relatively restrained. However, predictions for the final quarter of 2016 are positive, with hope for a robust pipeline before the end of the year.

When asked which type of investor would be the most influential in leveraged loans in three years time, 37% of conference delegates voted in favour of CLOs, 45% voted in favour of non-CLO funds and 18% voted in favour of banks.

The rise of non-CLOs funds in the aftermath of the financial crisis saw a much needed injection of liquidity into the market. From open and closed-ended credit funds to managed accounts, these type of funds focus on creating value via fundamental credit analysis, leading arguably to loans being priced more appropriately for the level of risk undertaken.

However, with the rise of non-CLO funds will there always be a space for CLOs in the market? The panel agreed that diversification is key to promoting a stable and healthy market and with increasing asset specialisation of investors, there is likely to be space in the leveraged loan market for all knowledgeable players.

Predictions for the economic cycle

When asked to vote where the leveraged loan market currently sits in the economic cycle, 57% of conference delegates were of the opinion that it will take 3 years to see an increase in defaults, 28% believed it will take 5 years and 15% less than 1 year. With company balance sheets and loan portfolios currently in good health and EBITDA growing at a steady pace, speakers on the panel generally agreed with the majority vote.

However, the position of defaults in the US and Europe differ considerably. In the US, defaults are occurring across a variety of markets including oil, gas and mining, as well as media and retail. In Europe the default cycle remains 1-2 years behind, although obviously industries such as chemicals, software and technology are highly cyclical, and thus more exposed to shorter term volatility. From a documentation perspective, terms are becoming looser and broader in their interpretation.

The future of the leveraged loan market

On the whole, the market has come a long way. It is no longer a bank driven market, with alternative forms of finance available from a variety of credit funds and asset managers. Loans are more commonly being seen as less of an opportunistic asset class and more of a core asset class and it is clear that this trend will continue, with the market continuing to diversify, promising a bright future for the leveraged loan market.