



**FIXED INCOME**

**A Bloomberg Professional Service Offering**

# **SYNDICATED LOANS**

**Present Landscape & Future Drivers in 2014**

# **Bloomberg**

*"We feel fundamentally very good about the prospects of our market here in the U.S."*

– Oliver Wriedt,  
Head of Capital Markets  
& Distribution at CIBC  
Asset Management

2013 was a strong year for loan markets in the U.S. and Europe. Three experts discuss the realities of 2013, the impact of new regulations and the outlook for 2014.

This article is based on a December 12, 2013 webinar entitled *"Syndicated Loans: Present Landscape and Future Drivers,"* moderated by Bloomberg's Spencer Cutter.

**Featured speakers were:**

- » Oliver Wriedt – Head of Capital Markets & Distribution, CIBC Asset Management
- » Michael C.J. Marsh – Head of EMEA HY & Leveraged Loan Capital Markets, Goldman Sachs
- » Tess Virmani – Assistant General Counsel, Loan Syndications and Trading Association

## **INTRODUCTION**

### **Spencer Cutter**

2013 has been a big year for the leveraged-loan market in the United States. Including refinancing deals, total issuing volume was over \$750 billion through October 2013—far above the full-year new issue volume in 2012 of around \$570 billion.

One of the primary factors is the resurgent CLO [collateralized loan obligation] market, which has heated up after years of near ice-age demand. We are now back to pre-crisis levels, with around \$75 billion of CLO new-issue volume in 2013.

While the trend for LBO and acquisition activity in the United States has been relatively flat, activity in Europe actually declined over the last year—from about \$2.5 billion per quarter in 2012 to around \$1.5 billion per quarter in 2013.

Meanwhile, an increasing number of European-based borrowers have crossed the pond to satisfy their capital-raising needs in the United States. The volume of European deals in the U.S. market was \$10 to \$12 billion per quarter in 2013, compared with essentially zero at the end of 2011.

## **A TALE OF TWO MARKETS**

### **Michael Marsh**

Europe has taken a longer time to recover from the effects of the post-2008 credit crisis than the U.S. has. Capital flows, whether bond or loan, are weaker.

European risk-retention rules have also made CLO issuance or CLO formation more difficult than it is in the U.S. We think that is changing, as structures that work with the current regulations in Europe start to stimulate CLO activity. In November 2013, for example, CLO volumes were almost a quarter of the entire year. While European loan volume in 2013 looks modest in size compared with the U.S., it is still more than twice the level of 2012.

### **Oliver Wriedt**

The European market tends to principally be a bank-loan market. In the U.S., the institutional investor plays a much more significant role and banks are generally limited to origination and syndication. While there is some retention, the U.S. institutional investor is the principal investor in the underlying loan asset.

In the U.S., CLOs have had a record year in 2013, following a very strong 2012. Mutual fund inflows have been continuous throughout the year and are multiples of what we saw in 2012. There has also been a massive inflow of capital from public and corporate pension funds in the U.S. Mostly made through the use of separately managed accounts, this flow has led to a continuous and very strong bid for U.S. denominated loans.

*"In July, the LSTA conducted a survey of 35 CLO managers who collectively manage \$228 billion of loan assets in over 500 CLOs. So that represents more than 70% of the U.S. CLO market."*

– Tess Virmani  
Assistant General Counsel  
at Loan Syndications and  
Trading Association

## **RISK RETENTION**

### **Tess Virmani**

The post-Dodd-Frank regulatory landscape is starting to come into focus, hopefully lifting the regulatory uncertainty that has clouded the market over the last three years.

We now have the final Volcker rule and significant movement on risk retention, which have been the two main sets to the CLO market. On August 28th, the OCC, Fed, FDIC and SEC released a re-proposal of the Credit Risk Retention rules, intended to solve the problems seen in the financial crisis with originate-to-distribute asset-backed securitization. Unfortunately, the proposed rules also capture CLOs.

How big is this problem? The vast majority of the institutional loan market is held by non-banks and CLOs represent approximately half of that non-bank constituency. In July, the LSTA conducted a survey of 35 CLO managers who collectively manage \$228 billion of loan assets in over 500 CLOs, representing more than 70% of the U.S. CLO market. Respondents said that risk retention would reduce their CLOs under management from more than 500 to less than 70; 85% of the respondents said that the risk retention rules would reduce CLO formation by 75% or more.

Perhaps in response to this survey, the re-proposal attempts to create an option whereby the loan arranger, rather than the CLO, can satisfy the risk retention requirements. This option would require the arranger to hold 5% of the term loan B tranche from origination for the life of the loan or until default, without the ability to hedge or sell. That is just not workable from the banks' perspective, particularly not in light of the Leveraged Lending Guidance.

Clearly, most CLO managers think that 5% retention as proposed is not feasible. That's why the LSTA is still engaging with the regulators and hoping to craft something that would have more broad-based support and adaptation. Given that implementation of risk retention will not be until two years after the final rules are released, the concern about this rule may be fueling some of the issuance today as people rush to get CLOs done before the risk retention rules are effective.

## **PRICE VOLATILITY**

### **Oliver Wriedt**

There is no question that price volatility in our market is picking up, due to the amount of retail money flowing in and the advent of ETFs. We saw a glimpse of it back in June when the 10-year sold off and the fixed-income markets declined meaningfully. We also saw some bank loans selling out of bond funds and crossover funds.

The few defaults we have had in the marketplace over the last several years have been limited to collateral that was created or originated before the financial crisis. We have seen stellar performance in floating-rate corporate loans here in the U.S. that were originated or created subsequent to the financial crisis.

That's why we are not overly concerned about the effects of expected TXU bankruptcy or restructuring. Although it is the largest LBO ever done, TXU is clearly regarded as a pre-financial crisis product that obviously has been struggling for some time.

## **TRADE SETTLEMENT**

### **Tess Virmani**

The LSTA has focused on developing a full suite of trading documents, because the more standardized the documents are the more streamlined and the more facilitated trades can be. However, some realities of the loan market—including privacy concerns and amendments—make it very difficult to get settlement to the level of the bond market: The agent's role and the nature of the loan product raise a lot of issues for settlement that are not easily solved.

I think the U.S. has been able to make more progress largely because we don't have the same confidentiality concerns that Europe has, or the transfer restrictions under domestic laws that can raise additional hurdles for settlement in Europe.

*"We would expect greater growth in Europe than in the U.S. during 2014."*

– Michael Marsh  
Head of EMEA HY &  
Leveraged Loan Capital  
Markets at Goldman Sachs

### **Oliver Wriedt**

Trade settlement is a wonderful barrier to entry and is part of the reason why the U.S. market is so attractively priced. You might argue that we would all be better off if we could trade loans T+3. Yet the relative cheapness and absolute cheapness of our market is partly a function of the complexity of settlement. So we are not overly anxious to see literally everyone enter our market. It already feels like everybody has come in, but if the last of the stragglers stay absent for some time, I don't think they will be missed.

### **Michael Marsh**

In Europe, we welcome those stragglers, because we would like to have greater liquidity. The settlement issue is an active one at the LMA [Loan Market Association] and it is being debated by a number of interested European parties.

## **SECOND-LIEN LOANS**

### **Michael Marsh**

The second-lien loan market in Europe is a small, developing market compared with the U.S. We would feel comfortable raising second-lien loans in Euros, but the bond market has been so strong that it has generally taken the place of a second-lien Euro-loan market.

### **Oliver Wriedt**

The situation is the exact opposite in the U.S., where the second-lien market has seen tremendous growth. This is an instrument that on average may incorporate an extra turn to turn-and-a-half of leverage. You are still secured, albeit as a second-lien. You are able to earn almost twice the spread of a traditional first-lien loan. The OID [original issue discount] and call protection are more compelling; the LIBOR floor is largely identical.

So this is an instrument that looks very cheap compared to the first lien, with lower recoveries as you would expect, but risk-adjusted we think it is very compelling. It also looks incredibly attractive versus the high-yield bond alternative. So in the U.S., second liens are increasingly being used in lieu of bonds.

## **2014 OUTLOOK FOR U.S.**

### **Oliver Wriedt**

We feel very good about prospects for the U.S. market, which is a huge beneficiary of an increasingly steep yield curve. The short-term view is for more of the same. Policy makers have been very vocal, very transparent; their guidance has been a big positive for our market.

A low-growth economy works just fine for the leveraged-loan market. The debt-service coverage ratio, based on current rates, is fantastic and our companies are generally very healthy. Notwithstanding some of the challenges around finding AAA investors, we expect similar volumes to what we have seen in 2013. (Goldman Sachs reported this morning that there are 180 CLOs issued globally, with a combined volume of \$87 billion.)

We also expect that the retail bid will continue to remain strong as long as the yield curve retains its current shape, with an extremely low front end. Underwriting has gotten increasingly frothy, so credit selection is ever-more important. But we are not facing a 2007/2008-type cliff here at all. Spreads are also likely to tighten across the board.

We expect that all the pressures we have experienced this year will remain. Covenant light is here to stay; we are not going to be able to change that. There may be moments of weakness, of price volatility, where we can push back, but we believe those opportunities will be limited.

In 2014, loan growth may again outpace the growth in high-yield bonds. The leveraged-loan market is increasingly becoming a traditional fixed-income asset class as opposed to an alternative fixed-income asset class, which bodes very well. As far as the potential size cap for a new LBO in 2014, certainly a \$20 billion or \$25 billion transaction can't be ruled out.

*"We are now back to pre-crisis levels with around \$75 billion of CLO new-issue volume expected for 2013."*

– Spencer Cutter  
Bloomberg Industries Credit  
Analyst at Bloomberg L.P.

## **2014 OUTLOOK FOR EUROPE**

### **Michael Marsh**

We expect greater leveraged-loan growth in Europe than in the U.S. during 2014, given the year you had and the year we had in 2013. On the supply side of the equation, we also anticipate more refinancing.

Our pipeline of business has never been higher post-crisis, so we feel confident that merger activity will drive the supply side. In terms of the demand side, of the 180 global CLOs that Oliver mentioned, less than 15 have come from Europe. Given the current pipeline, this number should increase in 2014.

Capital formation in various forms, from CLOs to loans, feels very strong right now. The demand side is certainly going to drive that equation to be more balanced, so we expect to see growth in loan issuance next year. We're very bullish on that. Although spreads are attractive now, we expect spread compression next year, given the strong expectations for rates rising in dollars and perhaps in Euros as well.

It is conceivable that you could see a jumbo buyout in the right rating category with \$15-plus billion in financing, including \$10 billion of leveraged loans as well as bonds. Covenant light has also become a feature of the market. While it is unusual to see all-European or all-Euro-denominated covenant-light loans, we expect that to happen early in 2014.

Default rates, clearly a focus for any credit manager, are a big question. Right now the portfolio of companies that we see in the leveraged-finance space are performing well. As Oliver said, we are looking at a flat, rather than growth scenario. This is generally good for highly levered companies, so right now we feel very constructive looking at 2014.

### **CONCLUSION**

If you have questions or comments, please contact Sunny Gupta at +1 212 617 1339 or at [sgupta96@bloomberg.net](mailto:sgupta96@bloomberg.net).

# ABOUT THE BLOOMBERG PROFESSIONAL SERVICE

The founding vision in 1982 was to create an information services, news and media company that provides business and financial professionals with the tools and data they need on a single, all-inclusive platform. The success of Bloomberg is due to the constant innovation of our products, unrivalled dedication to customer service and the unique way in which we constantly adapt to an ever-changing marketplace. The Bloomberg Professional service is a powerful and flexible tool for financial professionals—whatever their needs—in cash and derivatives markets as diverse as equities, currencies, commodities, money markets, government and municipal securities, mortgages, indices, insurance and legal information. The Bloomberg Professional service seamlessly integrates the very best in real-time data, news and analytics.

In addition, Bloomberg users benefit from on-demand multimedia content, extensive electronic trading capabilities and a superior communications platform. Bloomberg customers include influential decision makers in finance, business and government. Business and financial professionals recognize the Bloomberg Professional service as the definitive tool for achieving their goals because it offers unparalleled assistance and functionality on a single platform for a single price.

