Global markets witnessed one of the sharpest price actions from late February throughout most of March when the world realised that the virus outbreak had started to spread exponentially. In the past 8 to 10 weeks, governments, central banks and regulators have been scrambling to find the right balance between saving lives and supporting businesses and these actions have reduced the systemic risk to a large extent. Although US equity markets have rebounded closer to where they started in 2020 (with S&P 500 at -9.32% YTD as of 11 May 2020) driven by positive sentiment, European credit and equity markets have not recovered with quite the same magnitude (EURO STOXX 50 down 22.66% and generic Markit iTraxx Crossover 5Y spreads still 143.72% wider YTD)[1]. Whilst there are still many unknowns surrounding growth and default expectations, our specialist investment teams believe that with the right expertise, relative value approach and sourcing capabilities, investment opportunities in European credit are attractive from a fundamental, relative value and technical perspective, and can compare favourably to their US counterparts.

Executive Summary

- HY Corporates
  - On a fundamental basis, European High Yield corporates have experienced lower defaults over the last 15 years[2] with 5-year HY default rates trending lower and stable at 12% (vs 18% and trending up in the US) and trailing 12-month default rates stable at 1.5% in February (vs 4.5% in the US). The three rating agencies also expect higher US HY defaults in this cycle[3] ranging from 8.5% from Fitch to 11% from Moody's for the trailing 12-month corporate default rates (vs 7.5% to 8% in Europe).
  - On a relative value basis, European HY corporates also pay a higher spread per turn of leverage and European corporates are generally less leveraged than their US counterparts (of 4x vs 6x)[4].

- Leveraged Loans and CLOs
  - On a fundamental basis, European CLOs have higher credit quality judging by, amongst others, a smaller percentage of Caa/CCC assets, lower default rates, higher OC cushion and less/no exposure to the Energy sector.
  - On a relative value basis, our team has seen some European CLO tranches (especially lower mezzanine tranches) trading wider than their US equivalent.

- In European Financials, European AT1s have been trading wider yield-to-worst than their US counterparts (US Bank Preferred Shares)[5] by an average of around 150 bps.

- Lastly, the size of the European credit markets (such as CLOs, leverage loans, HY bonds) are a fraction of the US market and although they have all grown in size in this cycle, the increase in competition from hedge fund/alternative competitors is still limited. For example, the European CLO market is €125bn vs. $612bn in the US[6]. Many global investors tend to underweight Europe or access European credit through global managers with a European office but may not have the full scale and scope with on-the-ground knowledge, sourcing, pricing and language capabilities.

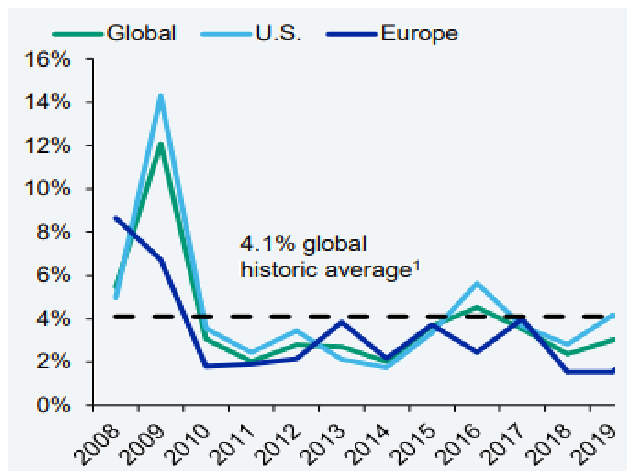
In the following pages, we provide our team's perspectives in greater detail.

[1] Source: Bloomberg, as of 11 May 2020
[2] Source: Moody's, Investor Report, as of 6 April 2020
[3] Source: Moody's, S&P & Fitch, Press Releases, as of 24 April 2020, 31 March and 30 March 2020
[4] Source: Credit Suisse & BoAML research as of April 2020
[5] Source: Bloomberg, as of 24 April 2020
[6] Source: Barclays Credit Research, CLO & Leveraged Loan Monthly Update, 6 April 2020

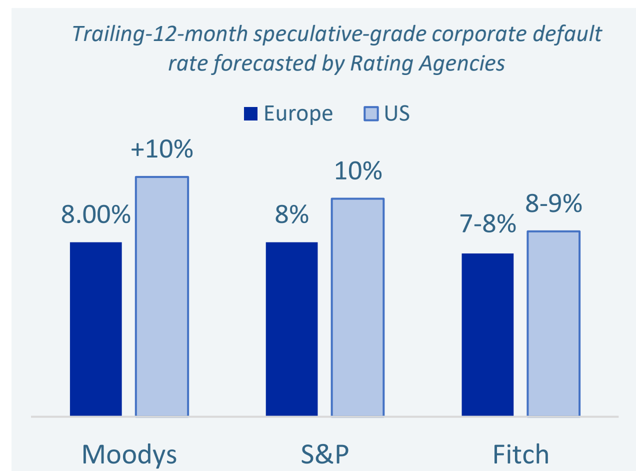
High Yield Corporates

- European HY corporates have experienced lower defaults over the last 15 years[7] with 5-year default rates trending lower and stable at 12% (vs 18% and trending up in the US). European corporates have faced a more subdued economic cycle and in most years since 2008, have deleveraged. European corporates are generally less leveraged than their US counterparts (of 4x vs 6x)[8].
- The US HY default rate closed at 4.5% for the 12 months ended in February, up slightly from the trailing 12-month rate of 4.4% in the prior month. In Europe, the comparable rate held steady at 1.5%.
- The rating agencies on average also forecast higher defaults in US credits in this cycle.

Speculative-Grade Corporate Default Rates[9]

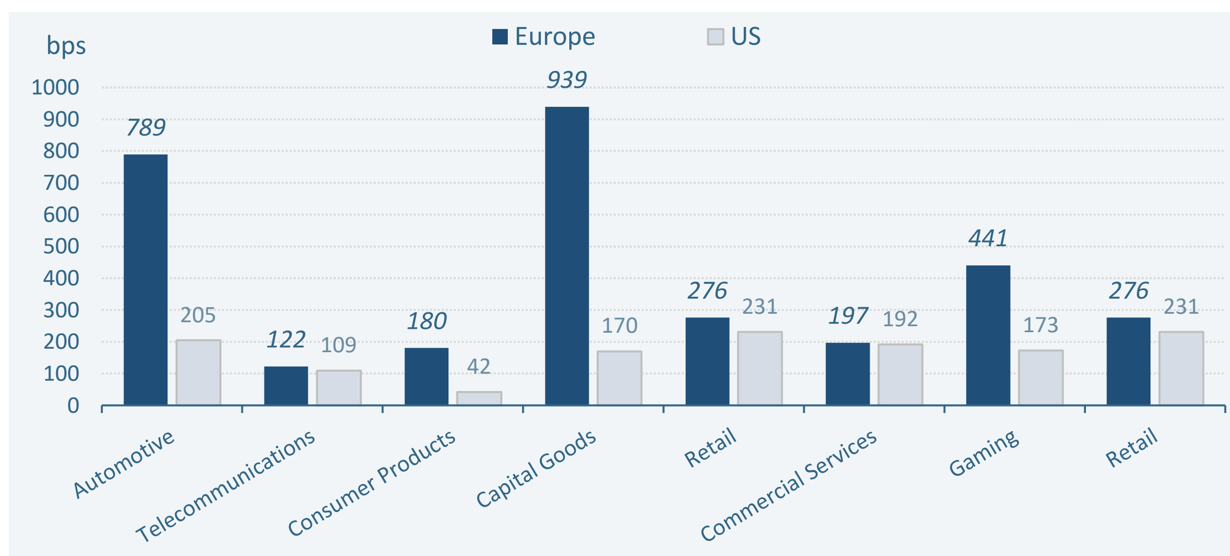


Rating Agencies Forecast 2020/2021[10]



- On a relative value basis, European HY corporates also pay a higher spread per turn of leverage and such differential was only 20bps at the end of 2014[11].

Spread per Turn of Leverage[8]



[7] Source: Moody's, Investor Report, as of 6 April 2020
[8] Source: Credit Suisse for Europe & BoAML research for the US as of April 2020. Please note leverage for Europe excluded any individual credits with a YTW above 15% or leveraged above 10x
[9] Source: Moody's, Investor Report as of 6 April 2020
[10] Source: Moody's, S&P & Fitch, Press Releases, as of 24 April 2020, 31 March and 30 March 2020
[11] Source: BOAML, H0A0 Index (US HY) and HE00 (EU HY)

In addition, divergence of employment policy between the US and Europe could also lead to different economic recovery expectations. Europe tends to have stronger employment protection laws and it can take up to 3 months to implement redundancy programmes and some countries such as France and Italy require government approval or consultation. In the current crisis, European governments have also supported companies with wage replacement furlough schemes and a mixture of corporate loans, grants and tax deferrals. For example, in France, companies (such as Loxam) could borrow up to 25% of their revenues for less than 1% borrowing cost up to a 5-year term and with a state guarantee for up to 90% of the loan and an interest payment holiday of 1 year. All of these measures aim at avoiding shortage of liquidity, sustaining employment and supporting businesses. Eurozone unemployment rate is forecast to peak at 10%, in stark contrast to the 20% peak forecast for June 2020 in the US[12]. With skilled labour kept in employment, our team believes that the European approach would enable companies to resume production much more quickly than in the US, provided that the lock down is not protracted and there is a relatively swift return to economic recovery. Furthermore, not all industries will be affected the same way. Unlike the GFC which was a bank-led crisis, the COVID-19 shock has not impacted credit markets in the same way a typical corporate recession would, where cyclical businesses see a large downturn. Instead, it has impacted service sectors the most and they are also the most vulnerable to ongoing movement restrictions. For example, the hotel and casual dining sectors have seen up to 100% revenue losses, whereas many building sites (non-residential) have either remained fully or partially open.

As a consequence, credit dispersion has increased within the European HY sector and can potentially be a good target for long/short investment opportunities when the macro and idiosyncratic picture becomes clearer in the coming quarters. Deep dive fundamental analysis is key to assess EBITDA contraction, free cashflows and any second order effect (such as a lasting drop in demand arising from a collapse in consumer confidence) of COVID-19 on corporates.

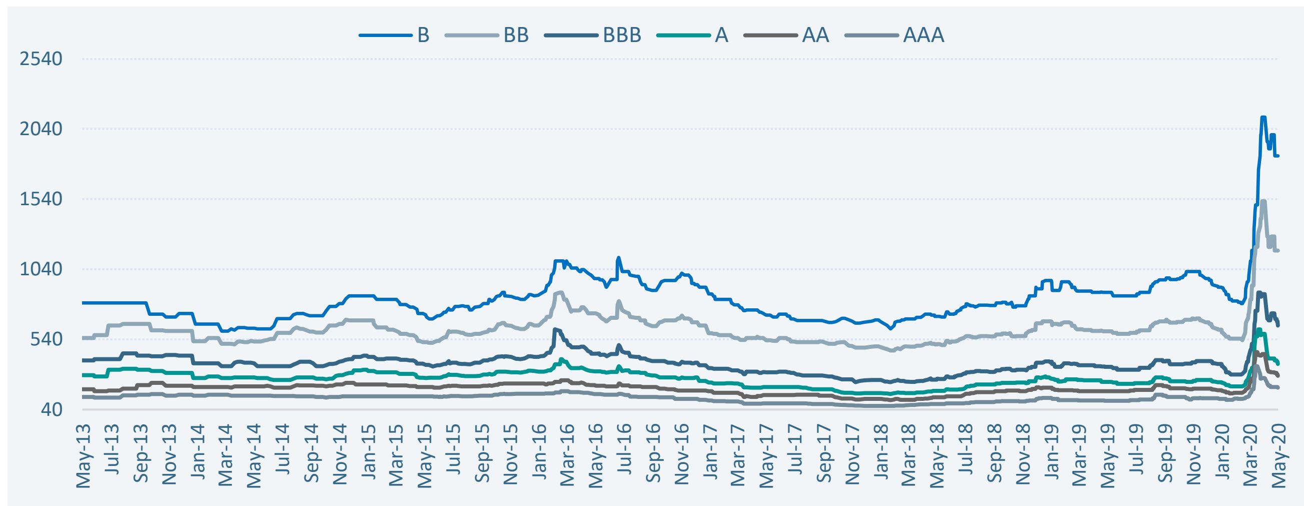
Credit Spread Dispersion (HY € Corp BB-)[13]

[12] Source: Bloomberg Forecast, ECUPEU 20 Index & ECUPUS 20 Index as of 26 April 2020
[13] Source: Bloomberg and Chenavari as 31 March 2020

Leveraged Loans and CLOs

There have been some very brutal market corrections e.g. European Leveraged Loan prices fell to 78/79c price levels and 95% of the market was trading below 90c within a month, whilst during the Global Financial Crisis, the lows were in the 60s and it took 8-9 months to normalize while this time, the speed of adjustment (both down and up) is more acute. For AAA CLOs, discount margin widened to 350 – 375bps in March but have since tightened nearer c. 200-225bps[14].

European CLOs Discount Margin Evolution



Technical factors, such as forced unwinds and smaller market size/depth, can explain some of these severe moves:

- Pre-COVID, CLO repos were offered at Euribor flat + 10-30bps at an advance rate of 85-90% on the AAA tranches. Throughout March, the advance rates were reduced significantly and offered at 200bps, which is more expensive than the prior spread, triggering some forced selling.

- In terms of market size/depth, the market in Europe is much smaller and less liquid with amounts outstanding at €125bn vs $612bn in the US[15]. The European Leveraged Loan market is also less liquid, less deep and portfolios tend to be less granular in Europe.

Looking at the fundamentals, European CLOs entered the current pandemic in a better shape, with stable credit trends and better-quality portfolios. Fewer European CLOs are currently subject to downgrade watch.

Pre-COVID, European CLOs had no pre-existing deterioration trend in CCC weights or over-collateralisation (OC) tests. This compares with rising CCC weights and falling OC test headroom in the US. These effects were most pronounced in the older, amortising vintages, suggesting a greater number of the underlying businesses were already struggling to meet their business plans. US amortising CLOs had an average of 7% in CCCs, vs. 2.3% in the European CLOs. European WAS were higher and median defaulted collateral percentages were zero. In addition, US CLOs have higher exposures to the Energy sector.[16]

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[14] Source: Citi Velocity, as of 8 May 2020
[15] Source: Barclays, CLO & Leveraged Loan Monthly Update, as of 6 April 2020
[16] Source: Barclays, CLO & Leveraged Loan Monthly Update, as of 6 April 2020

European vs US CLOs – CCC, Default Rate, WAS & and Median Junior OC Cushion[17]

		CCC Bucket (%)	Median Default (%)	WAS (%)
Amortising CLO 2.0s	*European*	2.33	0.00	4.00
	US	7.04	0.95	3.47
All CLO 2.0s	*European*	2.35	0.00	3.78
	US	3.67	0.39	3.49

Median Junior OC Cushion	Vintage	US CLOs		European CLOs	
		Apr-20	Apr-19	Apr-20	Apr-19
	2013	1.2%	3.8%	-	4.5%
	2014	0.7%	4.0%	3.5%	4.5%
	2015	1.8%	4.2%	3.5%	4.2%
	2016	2.0%	4.3%	3.8%	4.2%
	2017	2.3%	4.5%	3.8%	4.4%
	2018	2.7%	4.5%	4.0%	4.3%

Post COVID-19:

- As of 24 April 2020, no AAA or AA European CLO tranches have been put on downgrade watch. Junior BB and B notes have been the most affected, with 38% of the outstanding on downgrade watch mainly due to Fitch's aggressive rating actions, as Fitch assumed a 15% two-year cumulative default rate. S&P and Moody's have placed far fewer notes on downgrade watch to-date. This compares with 43% of BB notes and 56% of B notes in the US[18].

- Out of 900 CLOs that had updated on their holdings in the US, 21% are breaching at least one OC test. There has been a significant number of loan downgrades, which has pushed US CLO holdings of B- notes to 16% and CCCs to 12% based on S&P ratings and 8% on Moody's vs. under 4% on average in February. As CLOs require CCC exposure in excess of the 7.5% threshold to be marked to market, rather than par, this is affecting the OC tests[19].

- Within European loans:
  - Leisure and Retail have seen the largest price falls, while Food, Financial Services and Healthcare have been the most resilient.
  - There has also been decompression by rating with NR and CCCs falling more than BB and B rated loans.

For bonds with higher complexity and less liquidity such as CLO mezzanine tranches, we would expect the speed of the price correction to take longer over the next several months. In addition, central banks' measures to support eligible assets could create an opportunity for some strong non-eligible assets as they may become cheaper. Should there be further forced sellers (e.g. leveraged investors and open-ended funds) on the back of outflows and increased margin calls, possible market capitulation could resume, creating an attractive entry point for opportunistic investors who can price accurately and buy selectively.

The prerequisite to generating alpha during these uncertain times is the ability to source deals as well as to analyse, monitor and compare fundamental performance of CLOs. Our team, who also went through the GFC

[17] Source: Moody's CLO interest report, March 2020, based on January data & Morgan Stanley ABS Strategy, European ABS Chartbook, 11 May 2020.
[18] Source: BofA Global Research, CLO Weekly, Can you CCC it coming: Market views and review of April reports
[19] Source: BofA Global Research, CLO Weekly, Can you CCC it coming: Market views and review of April reports

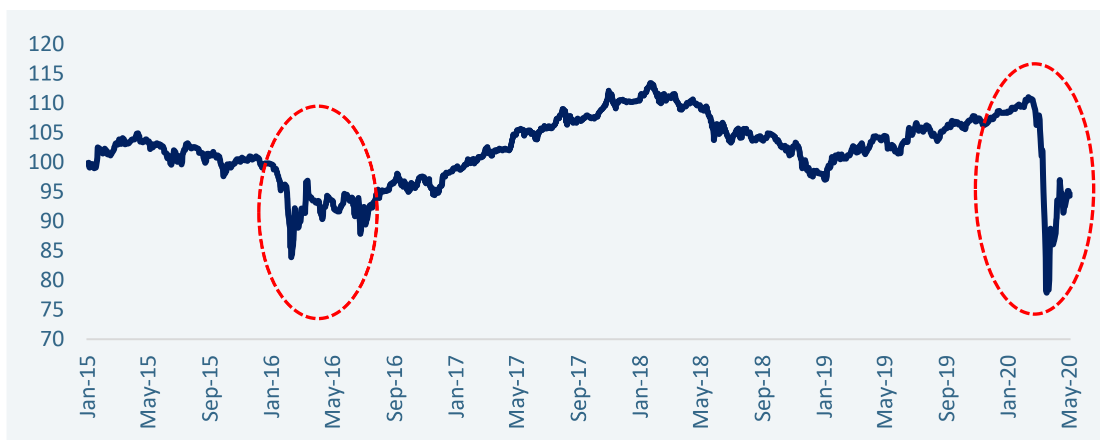
and has been investing in this asset class since 2009, is currently focussing on structures which could sustain high level of defaults for a prolonged period of time but still achieve a high single to low teens return under extreme stressed scenarios.

European Financials

In European Financials, the Subordinated Debt (AT1) market has experienced one of the sharpest price actions since its inception. Although the market has since recovered 15-20% from its lows, it is still currently 11% down compared to beginning of the year[20]. Technicals have played a part in this market, as European Financials funds tend to offer weekly (even daily) liquidity, whilst AT1s can become illiquid during market stress. This market has grown exponentially to €200bn+[21] since 2011 and has also become rather "commoditised", as investors in the Financials funds treat AT1s like other plain vanilla bonds without a clear understanding of the fundamentals and the complex nature of these instruments.

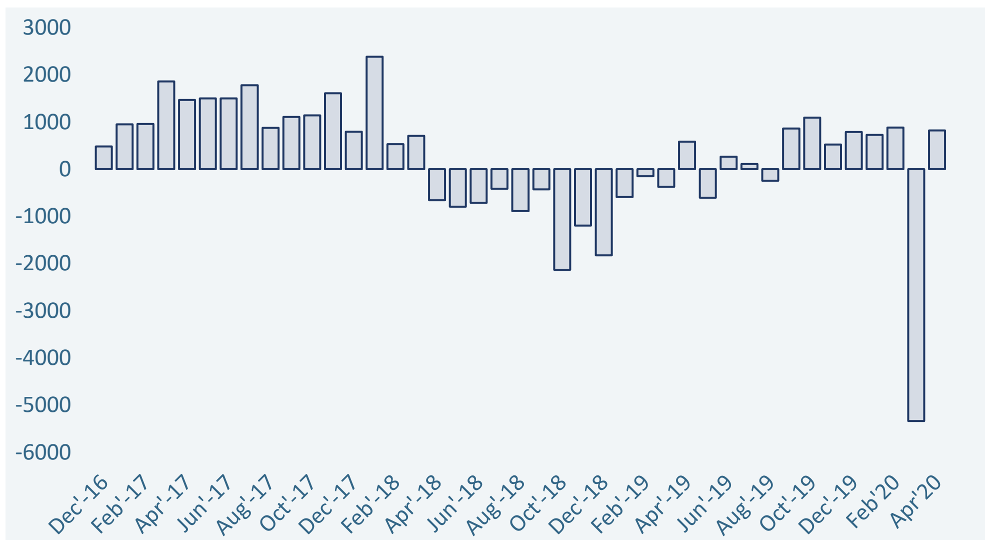
The relief measures put forward by the various regulators in Europe since the start of the COVID-19 crisis (at least €250bn of CET1 uplift for European banks), as well as the easing of TLTRO-III terms and the introduction of new Pandemic Emergency Longer-Term Refinancing Operations (PELTROs) announced by the ECB, are all designed to support banks in this downturn, explaining the continued recovery observed in credit instruments, especially in the AT1s. The strength in the market was further underpinned by results reported by European banks, with only a few of them posting losses for the quarter so far, such as those of Société Générale, BBVA, with the vast majority showing resilience in absorbing the increase in cost of risk linked to the pandemic.

European Bank AT1s – Average Cash Price[22]



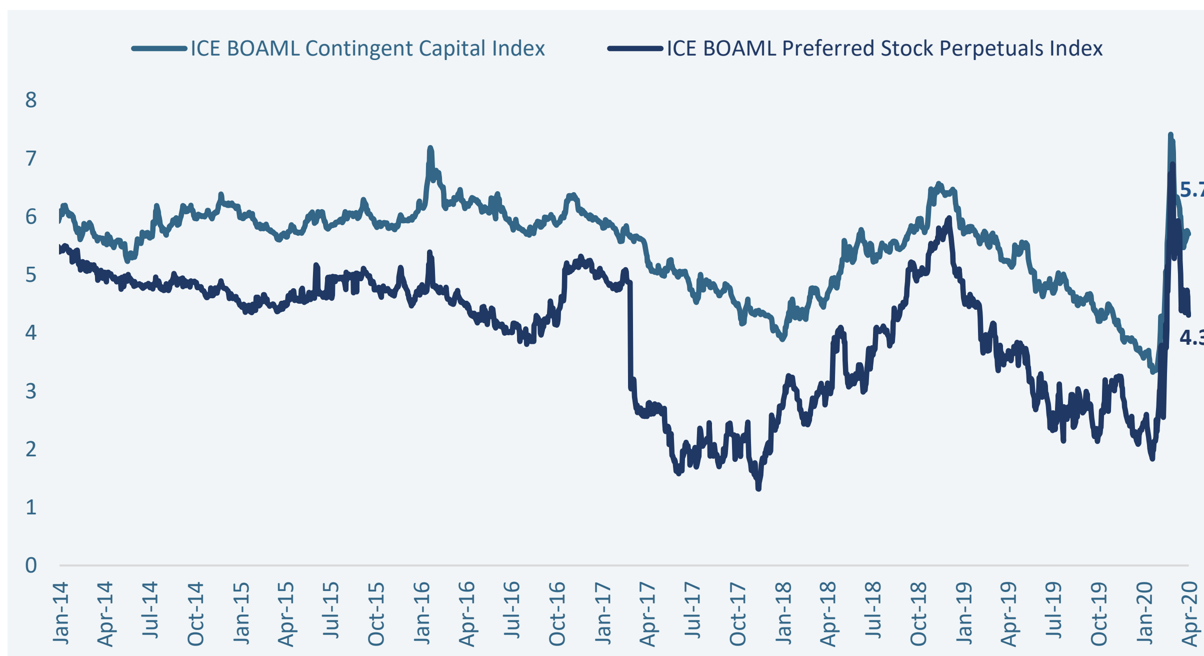
[20] Source: Bloomberg, IBXXC2D1 Index as of 11 May 2020
[21] Source: Chenavari estimates, as of 30 April 2020
[22] Source: Bloomberg (Markit iBoxx EUR AT1 Index), as of 5 May 2020

European Financials Funds, €m (as of 1 May)[23]



Compared with US Preferred Shares, European AT1s have been trading wider yield-to-worst than their US counterparts by an average of around 150 bps.

European AT1s vs US Preferred Shares Yield-to-Worst[24]



- Although such a differential can be partially attributable to the more complex structure, as there is no standardisation across the AT1 issues and more regulators (i.e. more complexity) are involved across the continent, there are opportunities to secure attractive cash-on-cash yields (to call/to maturity), provided that investors have the capacity to understand the complexity behind these instruments.

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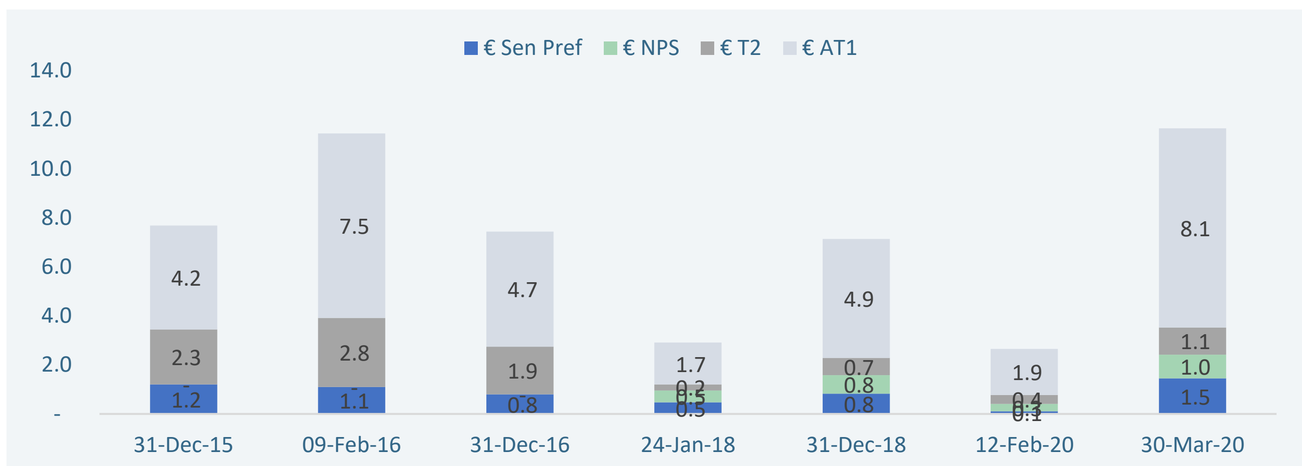
[23] Source: Chenavari and Bloomberg, as of 1 May 2020
[24] Source: Bloomberg, as of 24 April 2020

- Fundamentals, particularly the Maximum Distributable Amounts (MDAs), are key, as not every issuer is the same.
  - As CET1 equity ratios fall due to losses such as a potential rise in NPLs, the CET1 ratio has to stay above the MDA level for the banks to continue to pay AT1 coupons, discretionary pay and equity dividends/ buybacks. In normal times, CET1 will have several points of headroom above the MDA level.
  - Since 2008, Basel III and other regulations have increased bank CET1 ratios and European banks have increased CET1 capital by more than 50% since 2011 at an average CET1 ratio of 14.8%[25]. As such, European banks are much better placed to withstand an NPL cycle triggered by the current crisis.
  - Furthermore, to protect CET1 ratios and keep them above the MDA levels, regulators have so far banned European bank dividends and share buybacks and have relaxed capital buffers.
  - Based on Q1 results, most, if not all, European banks should be able to maintain their AT1 coupon payments and the key is to select fundamentally strong issuers with higher MDAs headroom.

- In addition, on an absolute basis, incremental yield for investing in AT1s has become a lot more interesting compared with February 2020 and February 2016. For example, in March 2020, the yield-to-call pickup of investing in AT1s is 810bps compared to Tier 2 (vs 190 bps in February 2020 or 470 bps in December 2016).

Bank Capital Structure € (YTC for AT1/T2)[26]



- As in the case of Structured Finance, the prerequisite to generating alpha during these uncertain times is the ability to analyse and monitor the fundamentals and, for European Financials, the ability to understand the implications of the regulations as well as the rhetoric from each regulator, and to adapt quickly to the market environment is essential. Our team has been investing in this asset class since its inception and their ability to conduct detailed fundamental analysis (e.g. screening of all issuers including callability, extension risk) and technical analysis (e.g. funds inflows/outflows) have helped the team to quickly adjust our funds' exposures to this market segment. Indeed, we have significantly reduced the exposure to the asset class since the end of January/February, as the markets were priced to perfection and the funds had a low/neutral risk during the period where extreme price action was observed. Our team is currently focusing on issuers with appropriate capital buffers and on parts of the capital structure with attractive upside upon normalisation.

[25] ECB, Supervisory Banking Statistics, Q4 2019
[26] Source: Chenavari, as of 24 April 2020