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5 Predictions for the European Leveraged Finance Market in 2020

As Europe enters 2020, our leveraged finance and high yield team predict what lies ahead. With increased certainty around Brexit, a strong end to 2019 and a low interest rate environment it could be a good year.

1. A STRONG START

2020 will start with a flurry of deals compared with the subdued start to 2019. According to Reuters, around €14bn of leveraged loans are set to hit the European market in the first quarter of 2020. In part that reflects M&A deals done in the last quarter of 2019 which still need to be syndicated, but there are also several auction processes underway which will require financing. In addition, Europe is likely to see an uptick in opportunistic refinancings, as corporates and sponsors alike continue to lock in the ultra-low rates available.

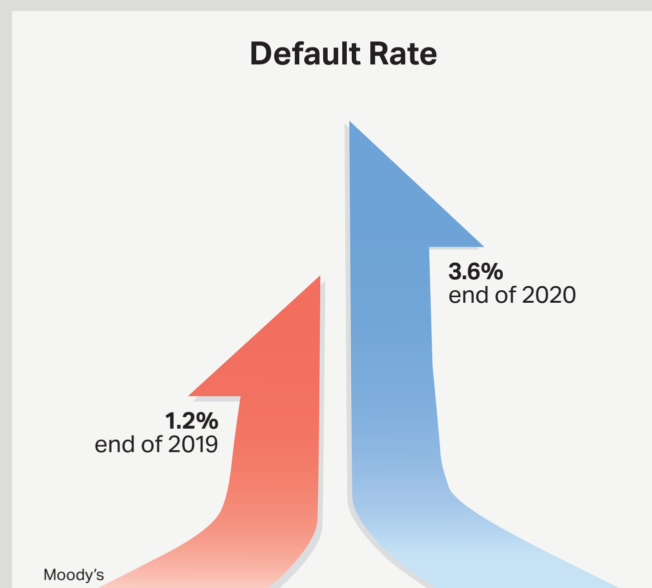
Financing activity driven by M&A transactions is expected to increase throughout 2020, now that the investor community feels much better about the economic and geopolitical outlook than it did a year ago. Plus the dry powder amassed by private equity houses isn't going to spend itself (see our third prediction below).

The European market is deeper than ever, and seemingly insatiably hungry for new supply. An increase in supply will lead to more choice for loan investors, and we expect to see investors differentiate between credits more than in 2019 – they can afford to be pickier. Documentation flexibility for borrowers in 2020 will depend as much on the supply-demand dynamics at the time of syndication as on absolute credit quality. As a result, sponsors will continue to push aggressive terms, but allow underwriters extensive flex rights in case they need to row back. The risks of getting this wrong are higher, as the Evonik deal has proven. An early test of the market's appetite is likely to be the re-launched syndication for that deal. Further tests of the depth of liquidity could come in the form of mega-trades backing the purchase of Thyssenkrup's elevator business, or even a possible $50bn financing for KKR's bid for Walgreens Boots Alliance.

2. DEFAULT RATE WILL REMAIN LOW

Moody's predicts a 3.6% default rate by the end of 2020 for speculative grade corporates (up from 1.2% now, but still low by historical standards). While many more borrowers may be carrying an unsustainable level of debt, only a few have looming maturities, and given the prevalence of covenant lite paper, there are few contractual triggers for a restructuring provided interest rates stay low.

Senior secured loans are still perceived to be a safer high-yield investment than unsecured bonds. But the market has not yet seen how the covenant lite term loan B product will perform in a default cycle in Europe, without the magic of a Chapter 11 process to implement a restructuring. The fact is that real, unadjusted leverage remains very high, and as we approach the end of the credit cycle investors are set to be more rigorous in their analysis of credit quality.



3. PRIVATE EQUITY DRY POWDER WILL DRIVE NEW DEALS

The dynamic of the last few years has been of PE houses taking advantage of a great exit environment and distributing more cash to investors – they have been harvesting the winners in their portfolios. That, coupled with a benign fundraising environment, means that they are now sitting on an estimated $1.5 trillion of dry powder.

Although global trade tensions and high valuations will continue to be headwinds, the increased certainty around Brexit and a low interest rate environment should drive an increase in new M&A activity.

In 2019 there was an increased number of P2P transactions in the UK (with an aggregate value of £10.7bn according to Private Equity Wire, almost half the total activity levels). That was driven by a decline in public company valuations and a cheap pound. Plus secondary transactions run through highly competitive auction processes drove many investors to look elsewhere. Those trends are expected to continue in 2020. TMT and healthcare will continue to be hot sectors with investors ready to pay high multiples.

But it is not all good news: already-high asset prices and a massive stockpile of capital will squeeze returns. Therefore, global players will continue to diversify into other asset classes, including real estate, growth, venture and credit.

4. DIRECT LENDERS WILL CONTINUE TO TAKE MARKET SHARE

The direct lending market is expected to continue to grow, with the biggest funds continuing to write large cheques for the right deal. They were constantly in the mix in 2019, either wholly or substantially underwriting large debt packages in both the mid-market and jumbo market.

A frothy fundraising environment over the last 2-3 years has allowed the top players to amass significant war-chests (for example, Bluebay's €6bn fund, Alecntra's €5.5bn, Tikehau's €2.2bn and Pemberton' €2bn). Ares provided more than £1bn of debt to BT company Daisy in February 2019, taking advantage of their market-leading €6.5bn fund raised in 2018. GSO lent €1.5bn to back Advent's takeover of Evonik's acrylic sheet business.

But the price of participating in the large-cap end of the market has been an erosion in both pricing and terms. The premium paid for a direct lender deal came down in 2019, and will continue to do so as direct lenders compete with investors in the broader loan and capital markets. Covenant protection has also been eroded, a trend expected to continue into 2020. A decade ago, the high yield bond, US term loan B, European leveraged loan and direct lending products were all pretty distinct. But not anymore – pricing and terms are harmonising.

5. HIGH YIELD WILL CONTINUE TO ATTRACT INVESTORS

The European high yield bond market should have a strong first half, driven by opportunistic corporate refinancings and large acquisition financings. According to Bloomberg, around €11.75bn of bonds end their non-call period between January and March, and quality issuers in non-cyclical, non-carbon sectors are likely to refinance to lock in lower rates. Many forecasters expect credit spreads to widen later in 2020, so there may be a rush to hit the market early. We expect there to be enough demand from the buyside, given the healthy fundamentals among many high yield issuers and default rates are expected to remain low. Whether there is enough demand to finance the potential private equity mega-trades described above remains to be seen.

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