FINANCIAL TIMES

December 13, 2011 6:49 pm

Risk for €250bn of leveraged loans

By Tracy Alloway and Robin Wigglesworth

European credit markets are bracing for more defaults as a vital cog in the region's deal-making and corporate lending machinery begins winding down next year.

Bankers are worried about how a wall of corporate debt set to mature in 2012 will be refinanced as the bulk of outstanding collateralised loan obligations – structured investment vehicles that buy loans made to private equity firms to finance acquisitions – goes into run-down mode.

Such CLOs have a finite life span after which they are not allowed to trade new loans for existing ones, or reinvest money received from repayments or interest on existing loans they hold.

By the end of next year, the majority of CLOs will have gone "static". By 2014, more than 98 per cent of European CLOs will have have a reached the same point, according to a report by Standard & Poor's.

This is expected to hurt the market's ability to refinance an estimated €250bn of leveraged loans maturing in Europe between now and 2017, and removing a source of credit to the wider economy.

"The CLO problem is going to become acute in the next 12-18 months," said one senior leveraged finance banker. "There are billions of euros worth of leveraged loans coming due, and the crunch will be particularly acute for the smaller companies."

CLOs bought two-thirds of the €166bn of leveraged loans issued in 2007, at the peak of the market, according to S&P. Leveraged loans are ones made to companies with higher levels of debt, and are considered riskier than other types of lending.

Most leveraged loan issuance was driven by demand from institutional investors, including private equity, with remaining financing coming from the banks.

However, Europe's embattled banking system is unlikely to be able to finance buy-outs to the same extent and hardly any new CLOs have been structured in Europe since the financial crisis, due to a lack of investor demand and regulatory changes.

"European banks have lots of this on their balance sheets already and are more keen to sell it to improve their capital ratios than anything else," said Michael Hampden-Turner at Citigroup.

With new sales of European CLOs still expected to languish in the coming years, credit experts say that could leave many corporate borrowers in a tight spot, and one which could potentially lead to another surge in leveraged loan defaults.

“The re-opening of the high-yield bond market would aid a lot of companies with leveraged loans coming due, but many may have a tough time,” predicted Michael Grayer, head of debt advisory at Lazard.

Some leveraged loan market participants are hoping that CLO managers will be able to extend the maturity of the better loans in their portfolios. That would help keep some credit flowing to the economy, while shaking out less viable companies.

“[Fewer CLOs] won’t necessarily cause a rash of defaults, as some can amend and extend on existing deals,” said David Parker at Marlborough Partners. “What’s likely is they can amend and extend the good deals, but will still put their foot down on the bad deals.”

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