MV|Credit

Markets: US vs Europe

INTRODUCTION

When plotted on the same chart, the S&P/LSTA US Leveraged Loan index and the S&P European Leveraged Loan Index ("ELLI") seem to track each other's movements over the peaks and troughs of the credit cycle. However, a closer look at the nuances of each market reveals a number of fundamental differences between the two. An understanding of these differences is critical for any investor looking prospectively at the two investment opportunities.

BOND MARKET PARALLELS AND COMPANY SIZE

The considerable differences between US and European High Yield ("HY") Bond Markets have implications for the respective Leveraged Loan Markets. The HY Bond and Leveraged Loan markets are considered close substitutes for one another; each providing capital to more highly levered companies outside of the Investment Grade space. **The US HY Bond Market exceeds Europe in terms of the size, number and variety of institutional investors.** As a result, the US HY market is more reliable, with larger issuers able to borrow throughout the credit cycle. In Europe, the HY Bond Market is less consistent and tends to "start and stop" with credit cycle peaks and troughs.

Consequently, most upper-mid/large sized US companies can rely on the HY Bond Market for financing and do not issue debt in the Leveraged Loan Market. **It follows that the typical size of issuers that utilise the US Leveraged Loan Market is lower than in Europe**. This has implications on the risk/return profile of the loans: the European market is better able to serve investors looking to invest in upper-mid/large sized companies.

SUBORDINATED DEBT

The term "Leveraged Loan" refers to debt across the capital structure - both senior and subordinated. **Differences in the terms, mechanics and usage of US and European loans are more pronounced when we compare the subordinated tranches**. US subordinated debt is typically issued for a range of reasons: corporate acquisitions, development capital and unsponsored transactions. **In Europe, subordinated debt is most frequently issued to fund PE sponsored transactions**. With regards to instrument mechanics, US subordinated Loans typically pay a fixed rate, while in Europe these loans pay a margin above LIBOR/EURIBOR, eliminating interest rate risk.

Furthermore, US subordinated loans generally contain more equity-like features than those found in Europe. In the US, equity warrants are often included allowing the holder to convert the debt to equity at a set strike price. This is rare in Europe.

The final structural difference is that subordinated European Leveraged Loans are typically secured against the underlying company which is not the case in the US. **Investors in Europe will benefit from having claim to the company's assets in an extreme downside scenario.**

	European Subordinated Debt	US Subordinated Debt
Fixed / Floating	Floating above floored EURIBOR / LIBOR	Fixed
Equity component	Rare	Common – warrants allow conversion to equity
Security	Secured	Unsecured
Transaction type	Funding of PE sponsored transactions	A wide variety: acquisitions, development capital, unsponsored transactions

BANKRUPTCY LAWS

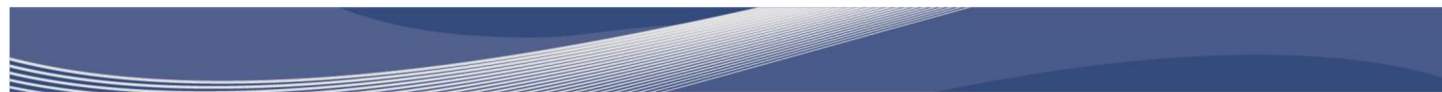
Insolvent companies in the US face a very different set of proceedings to similar companies in Europe. Chapter 11 bankruptcy laws allow the court to oversee restructuring proceedings while the firm continues to operate. The steps behind this process are well established and understood. All parties know the rules and enter proceedings with a dependable expectation of what the outcome will be.

A comparable European bankruptcy case will be much more complicated given there is no recognised set of rules and proceedings to follow. Businesses and their debt and equity holders are spread across different regions where bankruptcy laws vary and there is no set legal framework that guides the restructuring process.

Without no established set of rules in place, a successful outcome for a European company is often reached through collaboration between all parties involved. It is common for relationships between lenders and PE sponsors to play a part here. **This collaborative spirit is unique in Europe as all parties know it is the only way to reach a favoured outcome.** The result is that European investors tend to benefit from higher recovery rates than in the US.

GEOGRAPHY

The European Leveraged Loan Market is arguably more complex than that of the US. Europe contains a wider variety of political, economic and cultural institutions with some being more lender friendly than others. Upper-mid/large sized European businesses with multiple revenue streams tend to operate across multiple countries, with cash flows and supply chains extending across borders. Firms of a comparable size in the US tend to operate between different states but not



outside of the US. **The largest US companies that operate internationally tend to be served by international corporate bond markets.**

The reasoning above indicates that risk factors associated with political or fiscal shocks are naturally more diversified within the European market. US Leveraged Loan risk factors include a concentrated exposure to shocks caused by US government policy.

CONCLUSION

Differences between the US and European Leveraged Loan markets are both pronounced and engrained given the permanence of factors discussed here. Structural differences between subordinated loans in the two regions are significant and should not be overlooked. **Investors in the European market tend to benefit from: better access to companies in the upper-mid market; a collaborative approach to the restructuring process that often leads to higher recovery rates; and natural diversification against geopolitical risk factors.**

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