Partners Group

REALIZING POTENTIAL IN PRIVATE MARKETS

Q3 2020 | Issue 5

Quarterly Loan Market Commentary

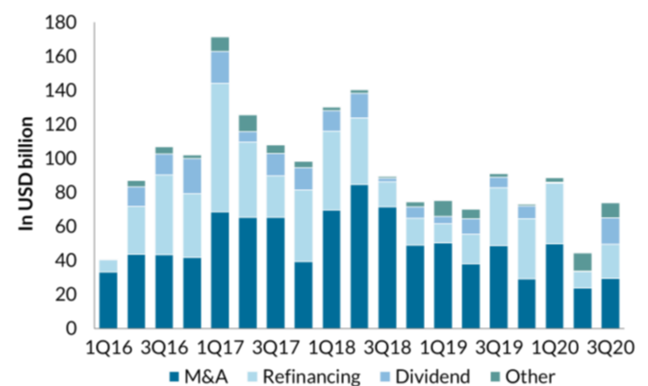
US loan market overview

While the US capital markets wrestled with the many challenges presented by the Covid-19 pandemic throughout the summer, US leveraged loans remarkably stabilized further in Q3 2020. Institutional loan investors again returned in force with a "risk-on" mentality. Notwithstanding some opportunistic credit buying during March's market lows, a broader resurgence of demand for loans in both the primary and secondary markets in Q2, and further in Q3, had market participants debating whether the pandemic's economic impact had been overestimated. While the sudden loan market recovery in Q2 may have felt like the calm inside the eye of a hurricane, the ensuing market stability throughout Q3 felt as if the storm had actually passed just as fast as it had arrived. While the US loan market returned closer to normal, it was the US high-yield bond market which took center stage once again in Q3. Debt issuers happily welcomed swelling investor demand for fixed-rate high-yield debt at ever tightening yields. The market priced USD 126 billion of new high-yield issuance in Q3, a very strong follow up to the record USD 140.5 billion high-yield issued in Q2 – now the two best US high-yield bond issuance quarters on record.

US new institutional loan volume

US loan demand continued to perk up in Q3, largely led by new CLOs that provided an aggressive bid to the market. Institutional new issue loan volume responded quickly and Q3 issuance jumped to USD 73.8 billion, compared to only USD 44.5 billion in Q2. This volume increase was driven more by opportunistic refinancings and sponsor dividend transactions, than traditional M&A activity which remained muted in Q3, much like it has been throughout 2020. M&A volumes contributed only 40% of Q3's loan issuance volume, compared to an average of 55% observed over the past three years. Meanwhile, dividend deals topped 21% during Q3, the highest levels recorded since 2010, according to S&P LCD. While loan issuance activity remained robust through the end of September and October's forward calendar looked equally accretive, the uncertainty around the US elections could be a catalyst for an early wrap up of 2020 issuance by the first week of November. Also notable in Q3 was a distinct absence of BB rated loan issuers. This may have been a function of the heavier BB loan issuance activity in previous quarters, when spreads were tightening (pre-Covid).

US new-issue institutional loan volume

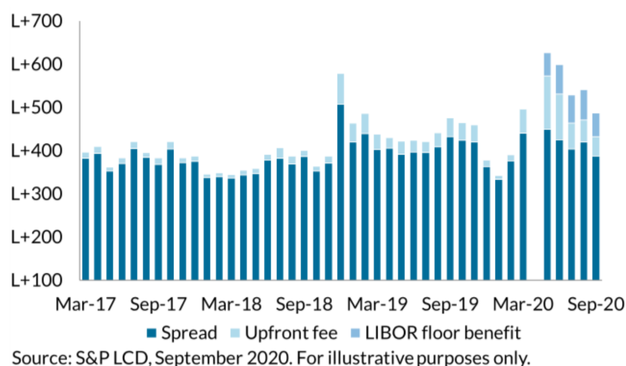


Source: S&P LCD, September 2020. For illustrative purposes only.

US new-issue loan spreads

In response to firm demand from CLOs (both warehousing and reinvesting), new loan issuance enjoyed strong buy demand resulting in syndication oversubscriptions for most new loans. Demand steadily grew through the quarter for higher risk/lower rated borrowers reflecting the market's greater "risk-on" sentiment. As a result, average loan spreads tightened throughout the summer, and ended the third quarter at Libor + 388bps for B+/B rated issuers, largely comparable to pre-Covid levels. Further stirring investor demand in Q3 was the wider prevalence of 50-100bps Libor floors on new-issue loans, which resulted in 25-75bps of spread pickup with USD Libor around 0.25% p.a. (see also our Spotlight topic).

US loan spreads

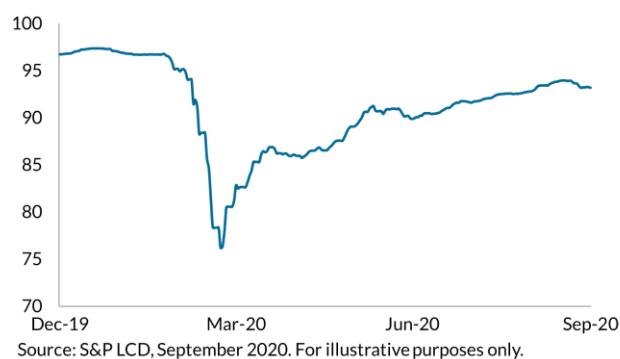


Source: S&P LCD, September 2020. For illustrative purposes only.

US loan bids

As loan investors pushed through Q3, their strengthening bid was well reflected in the US Leveraged Loan Index ("LLI"), which began the quarter at 89.94% and moved progressively higher to 93.18% by quarter end on 30 September. While well below the 2020 highs hit last January (97.35%), the speed of the recovery of the LLI from its decade-low price of 76.23% in March was truly unprecedented. It was a testament to how loan investors readjusted their micro and macro credit views, after their initial risk assessment of Covid's impact on their portfolios. As new institutional loan demand flowed into the US market, bolstered by renewed CLO issuance, almost all loans (liquid and illiquid) were bid up quickly across all rating categories. Even most distressed and CCC rated loans, which were hardest hit by Covid in March, recovered much of their price declines by Q3. This all but confirmed that the dramatic loan market plunge in March was largely a market-value and illiquidity driven event, and that credit risks embedded in the LLI were much more resilient, requiring market prices to reset higher.

US loan index bid (LLI)



Source: S&P LCD, September 2020. For illustrative purposes only.

European loan market overview

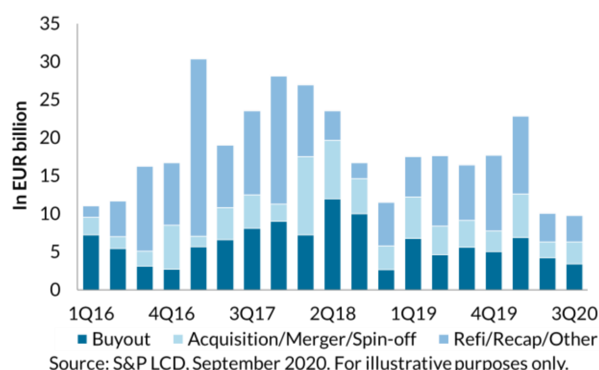
European loan market fundamentals in Q3 2020 continued to improve from Q2 levels, bolstered by significant governmental support efforts (job-retention, loans, tax relief and monetary support programs) from most major European member states. This backdrop spurred institutional investor demand for loans across new issue and secondary markets by Q3, although demand remained well below the pace seen in the pre-Covid markets in January and February.

European new institutional loan volume

The loan market remained reasonably constructive in Q3 despite the typically quiet vacation month of August. Spurred by demand from new CLO formation, institutional loan issuance in Q3 was EUR 9.8 billion, only slightly below Q2 levels of EUR 10.1 billion, although far short of the EUR 22.9 billion posted back in Q1. The key factors impacting Q3 issuance were: 1) a reduction of sponsor buyouts,

which totaled just EUR 3.4 billion in Q3 compared to EUR 4.2 billion in Q2 and EUR 6.9 billion in Q1; and 2) lower refinancing/recapitalization activity at EUR 3.5 billion in Q3, compared to EUR 3.8 billion in Q2, and EUR 10.3 billion in Q1. Similar to the US market, European high-yield bond issuance in Q3 was a far bigger story, enjoying an exceptionally strong quarter at the expense of loan issuance, with EUR 21.6 billion of bonds being issued, taking advantage of lower interest rates and surging investor demand for fixed rate debt.

European new-issue institutional loan volume

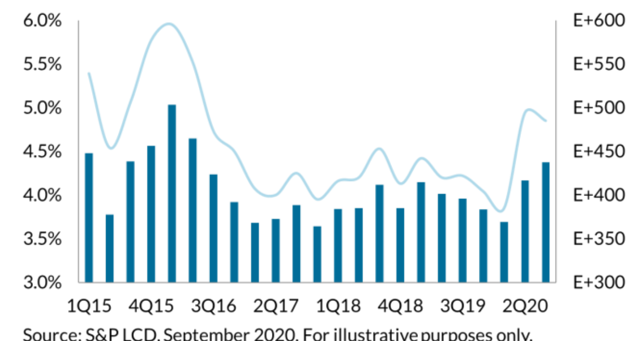


Source: S&P LCD, September 2020. For illustrative purposes only.

European new-issue loan spreads

With issuance volumes flat yet investor demand growing in Q3, the average yield to maturity for single-B rated Euro loan issues tightened slightly to E+4.85%, compared to E+4.94% in Q2. This lower average yield in Q3 was a function of tighter original issue discounts ("OIDs") during the quarter due to broad subscription demand, offset by marginally higher loan spreads. Pricing for many issuers remained variable, with certain sectors better favored, yet higher premiums being charged on larger issuance size.

European loan spreads

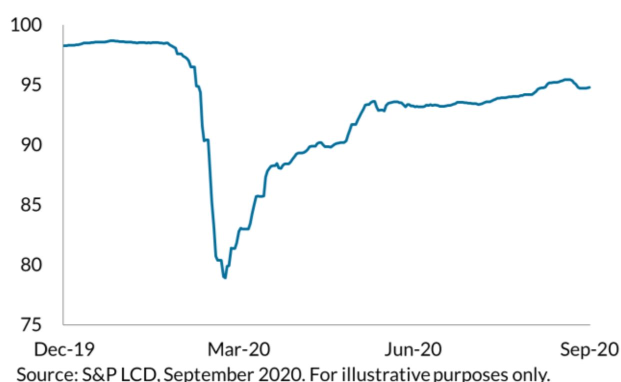


Source: S&P LCD, September 2020. For illustrative purposes only.

European loan bids

With European new issue loan supply falling short in the face of strong demand from CLOs in Q3, secondary loan bids continued to rally from Q2 levels, with the Euro Leveraged Loan Index ("ELLI") climbing to 94.79% by the end of September, just four points below the ELLI 2020 high mark of 98.66% posted in late January. The continued market recovery in Q3 was further reflected in the improved distribution of market bids, with just 11% of ELLI loans trading below 90% by the end of Q3, compared to 72% at the depths of the Covid-induced market panic in mid-March. The market even saw a small percentage of ELLI loans trading above par in September, something not seen since February.

Euro loan index bid (ELLI)



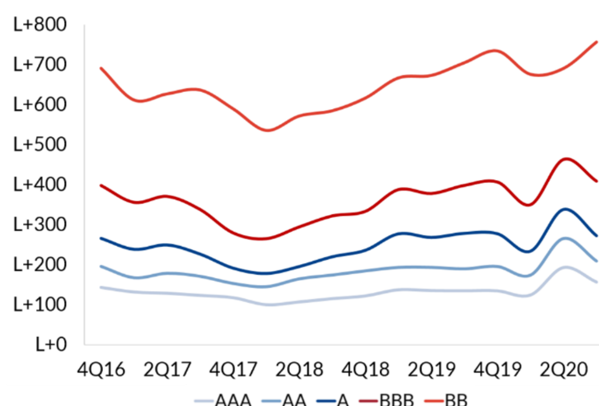
Source: S&P LCD, September 2020. For illustrative purposes only.

US collateralized loan obligations

While most US CLO portfolios continued to stabilize and show improving metrics in Q3 for WAS, WARF and CCC baskets, a small percentage of CLOs were failing OC tests in September and the CLO market had clearly not fully recovered. However, new CLO issuance conditions continued to show positive improvement. Some managers proceeded with new CLO issuance decisions based on a need to clear out aging warehouses which had finally recovered on a mark-to-market basis, or because attractive asset prices, rising WAS and tighter CLO liability spreads had finally synched to meet equity return hurdles. Other managers moved forward, feeling pressure to launch just to keep pace with their annual AUM targets, or to slip inside a narrowing window of opportunity ahead of the November US national elections. Regardless of reason, 55 US CLOs printed during Q3 2020 totaling USD 23.4 billion, well ahead of the 42 CLOs (USD 16.3 billion) issued in Q2. While perhaps the busiest CLO issuance quarter of the year, Q3 2020 still ranked the third lowest CLO issuance quarter since 2017.

With improving investor demand, tightening CLO liability spreads were dramatic during the quarter and an obvious catalyst for the stronger Q3 CLO issuance levels. Average AAA spreads which had peaked at L + 193bps in Q2, quickly dropped to L + 160bps during Q3, with spread improvements so rapid that by late September a few large CLO managers achieved sub L + 130bps AAA levels. The offset to tighter CLO liability costs, however, was that most structures were still limited to three-year reinvestment periods, versus the standard five years. Disappointing as that may have seemed, this was all welcomed progress for the market. Moving forward, a return to two-year non-call / five-year reinvestment periods, with L + 130bps AAAs, and weighted average cost of capital ("WACC") below 200 bps, would be a sign that the US CLO market has truly recovered.

US CLO liabilities spreads

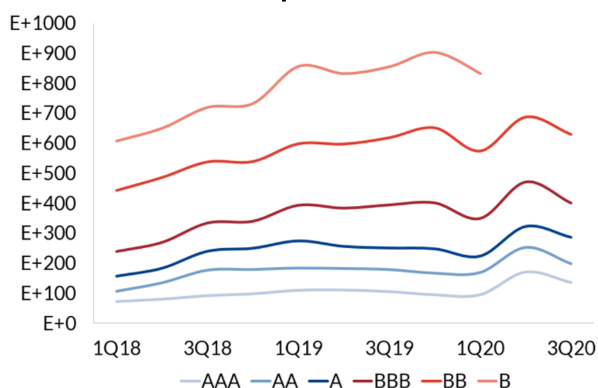


Source: S&P LCD, September 2020. For illustrative purposes only.

European collateralized loan obligations

Optimism also continued to grow in the European CLO market during Q3, as better loan market conditions spurred by new loan issuance with elevated loan spreads, declining rating downgrades, and low defaults, enhanced the performance metrics for existing CLOs, as well as many CLO warehouses in mid-ramp during the Covid panic. The improving liability spreads across the CLO capital stack allowed 14 CLOs to print in Q3 totaling EUR 4.6 billion, following up the 16 CLOs (EUR 4.3 billion) which priced in Q2. While still well below the EUR 7.6 billion issued in Q4 2019, the CLO market had found its footing post-Covid, and CLO issuance predictions for the full year also increased to EUR 18-20 billion.

With the increased investor demand for CLO liabilities building through the summer, against limited new issue supply, CLO liability spreads rapidly tightened, with the most dramatic improvements seen across AAA liabilities. For Q3 2020, AAA spreads tightened to an average of E+136bps, compared to E+172bps in Q2. While certainly far above pre-Covid AAA spread levels of E+95bps posted in Q1, there were a few issuers during September who succeeded in printing AAAs at or below E+120bps.



Source: S&P LCD, September 2020. For illustrative purposes only.

Spotlight topic: Return of Libor floors on US leveraged loans

Even while financial markets prepare for the eventual end of Libor as an interest rate benchmark at the end of 2021 (a future Spotlight topic), US loan investors have turned their focus to the resumption of Libor floors in broadly-syndicated US term loans as a means to insulate investors from a near-zero benchmark rate environment. Once common in over 90% of all newly-issued US syndicated loans in 2016 (note 3 month US Libor remained below 1% from 2010 to 2016), the use of Libor floors ranging from 50-100bps declined over the past three years, dropping to just 23% of all newly issued loans in 2019 (coinciding with 3 month Libor at or above 1% from 2017 to 2019). However, as the US Federal Reserve Bank slashed US interest rates in 2020 in response to the Covid pandemic, US Libor rates quickly declined as well, with 3 month US Libor falling from 1.9% on January 1 to 0.23% by September 30, putting Libor floors back "in the money". Today, these Libor floors result in 25-75bps of additional spread pickup for loan investors. As the new issue US loan market attempted to recover from the Covid shocks in the spring, loan investors strongly pushed for the broader return of Libor floors. Since May, over 70% of all new loan issues have included floors. This has resulted in 40% of all US syndicated loans having active Libor floors at the end of Q3, with 90% of these floors set at 1%.

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