Partners Group

REALIZING POTENTIAL IN PRIVATE MARKETS

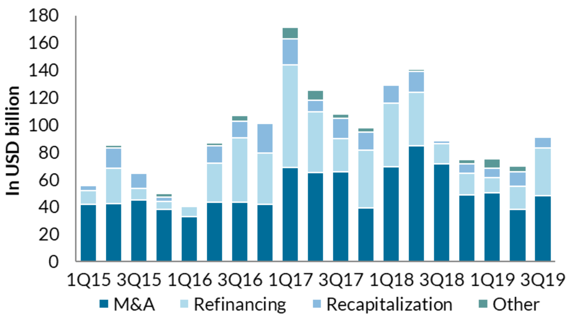
October 2019 | Issue 1

Quarterly Loan Market Commentary

US loan market overview

Activity in the US leveraged loan market picked up notably in Q3 2019. Large loan prepayments during the summer left many investors holding higher than expected cash balances. Arranger banks responded quickly and US institutional loan supply climbed 31% in Q3 to USD 91.9 billion through both acquisition-related transactions and opportunistic refinancings. This repeated an all too familiar theme in the US leveraged loan market, where loan supply and loan demand are rarely in equilibrium, making loan market conditions either issuer or lender friendly, but not balanced.

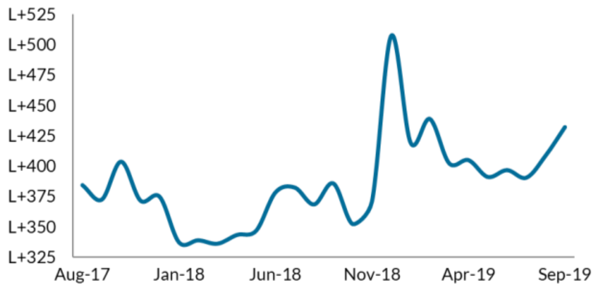
US new issue institutional loan volume



Source: S&P LCD, Q3 2019. For illustrative purposes only.

As for US loan investment demand in Q3 2019, continued trade tensions and the aging business cycle prompted another flight to quality for many investors. The strategy of enhancing institutional portfolios' credit quality metrics with higher rated loans was widespread, especially among collateralized loan obligations (CLOs). This resulted in a "bifurcated" risk market where new issue double-B rated loans were well received, while single-B rated loans were either oversubscribed or forced to widen pricing and offer tighter credit terms to clear the market.

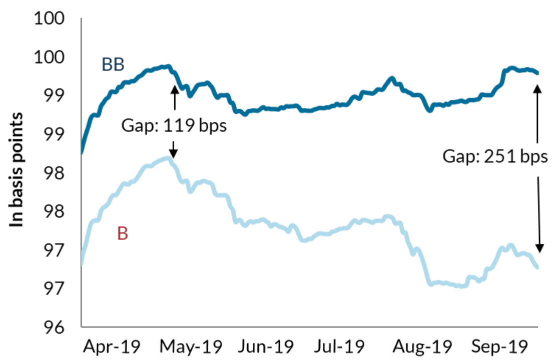
Single-B US loan spreads rising in Q3 2019



Note: Term Loan B spreads of B/B+ borrowers. For illustrative purposes only.
Source: S&P LCD, Q3 2019.

The portfolio bifurcation also impacted secondary loan trading, where bids for double-B rated loans pushed higher while single-B rated loans declined.

US weighted average bid of BB versus B rated loans

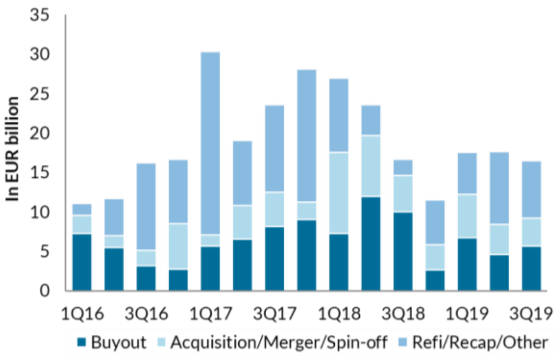


Source: S&P LCD; S&P/LSTA Leveraged Loan Index, Q3 2019.
For illustrative purposes only.

European loan market overview

European leveraged loan issuance slipped to EUR 16.4 billion in Q3 2019, compared to EUR 17.6 billion in Q2, impacted not only by the summer holiday period, but also the backdrop of global trade tensions, interest rate uncertainty and economic growth concerns. Following a slow August, European loan issuance rebounded in September and was greeted by robust demand from investors.

European new issue institutional loan volume



Source: S&P LCD, Q3 2019. For illustrative purposes only.

Additionally, the market received EUR 7 billion of loan prepayments, which further disrupted demand. With a borrower friendly market, reverse flexes on new issue loan spreads prevailed.

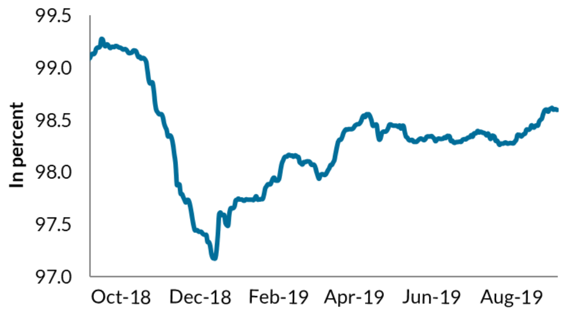
As European CLO issuance should continue to grow moving forward, additional loan market tightening is likely throughout Q4. Given year-to-date M&A-related activity has dropped to only 58% of institutional flow (from 70% in the same period in 2018), an increasing percentage of transactions may reflect opportunistic refinancings at lower spreads.

Single-B European loan spreads declining in Q3 2019

Source: S&P LCD, Q3 2019. For illustrative purposes only.

Secondary loan bids continue to climb in response to the supply imbalance, with the European Loan Index (ELLI) rising to 98.6% and the share of Index loans trading above par now at 55%.

Weighted average bid of S&P Euro Leverage Loan Index



Source: S&P LCD; S&P European Leveraged Loan Index, Q3 2019. For illustrative purposes only.

In 2019, we also observed European loans succumbing to trends that are more prevalent in the US, where weakening loan documentation, aggressive EBITDA add-backs, higher leverage, looser transferability restrictions and covenant-lite issuance have become market standard.

US collateralized loan obligations

With a more challenging environment for issuing CLO liabilities throughout 2019, US CLO new issuance slipped from USD 35.8 billion in Q2, down to USD 24.9 billion in Q3.

Slowing demand from prospective AAA CLO investors led to a restrained pace of issuance in Q3 and CLO mezzanine liability spreads widened, resulting in tighter arbitrage. New issue AAA CLO spreads continued to remain range bound in Q3, averaging LIBOR + 136bps (relatively unchanged from Q1 & Q2). With Q3 2019 year-to-date US CLO issuance at USD 89 billion, the chance of exceeding the total 2018 US CLO issuance of USD 129 billion appears unlikely.[1]

European collateralized loan obligations

European CLO new issuance in Q3 2019 came in at EUR 7.4 billion, slightly below the EUR 7.8 billion issued in Q2. On a 2019 year-to-date basis, however, issuance stood at EUR 22.2 billion, topping the EUR 20.8 billion posted for the same period in 2018.

Average new issue AAA spreads in Q3 tightened from Q2 and Q1 levels, coming in at EURIBOR + 105bps. Much of the tightening occurred in September, when AAA spreads declined to EURIBOR + 93bps, levels not seen since late 2018. On the flip side, new issue CLO mezzanine liabilities in Q3 were more challenging to place, with double-B liabilities widening to a 668bps discount margin and single-B liabilities to a 944bps discount margin, negating some of the recent AAA spread tightening. Nonetheless, market expectations remain on track for a record European CLO issuance of EUR 30 billion in 2019.[1]

1 All figures sourced from S&P LCD, Q3 2019.

Spotlight topic: bifurcated risk

Throughout 2019, loan market investors have been actively redefining their credit portfolios by "bifurcating" credit risks. As managers assess their portfolios, demand for higher yield and reduced credit risk is manifesting itself in a tiered investment strategy of buying higher yielding single-B rated credit risk and supplementing it with higher credit quality (but lower yielding) double-B rated credits. This allows loan portfolios, including CLOs that operate under strict risk quality, diversity and spread criteria, to remain fully invested, while meeting investment targets, and compliance and collateral quality tests.

The challenge is selecting and managing the correct blend of credits as many investors prepare for the next credit downturn. It is reasonable to contend that a bifurcated approach to credit risk is a prudent strategy in this environment as it allows a portfolio to generate a more consistent income stream from multiple and diverse risks.

www.partnersgroup.com

Media relations contact
Jenny Blinch
T +44 207 575 25 71
jenny.blinch@partnersgroup.com

Client contact
Alexander Ott
T +41 41 784 63 05
alexander.ott@partnersgroup.com