Q4 2020 | Issue 6

Quarterly Loan Market Commentary

US loan market overview

2020 proved to be a momentous year for the US loan market. The much anticipated 2020 US Presidential election was quickly upstaged by a global pandemic the likes of which modern global markets had never experienced. For many loan investors, 2020 returns were largely driven by whether they sold early or held. For investors who stayed the course, in this case held onto loans through the darkest months of the COVID-19 surge last March and April as loan prices plunged to decade lows, they were ultimately rewarded with the fastest loan market recovery on record. Ultimately, US loans delivered a surprising 3.12% positive return for 2020, despite double digit negative returns during last Spring.

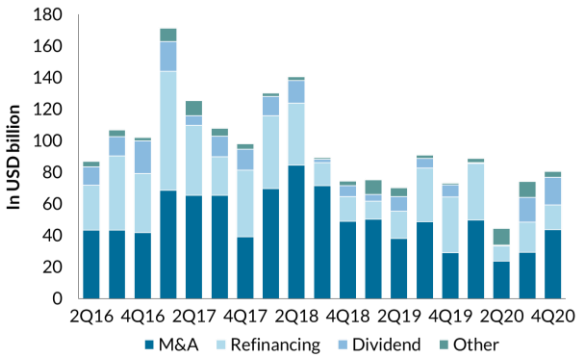
In the face of an unprecedented and accelerating medical and economic crisis, the US Federal Reserve and the US Treasury Department quickly accomodated US capital markets with ample liquidity to bolster corporate reserves and facilitate immediate cash needs for much of corporate America, including many leverage loan issuers. Combining this liquidity with flexibility already embedded in their capital structures, many companies were able to stabilize their short term finances and navigate their way through the worst months of the pandemic. However, those loan investors who panicked and sold in the market trough, unfortunately locked in deep losses and many were also left scrambling in the loan market rally that followed.

US new institutional loan volume

US loan demand finished 2020 exceptionally strong, continuing the rally from Q3, as the country recovered from the pandemic and anticipated the wide distribution of COVID-19 vaccines in early 2021. US institutional leverage loan issuance ended 2020 at USD 288 billion, down 7% from 2019, yet still quite strong given the loan issuance hiatus from March to May. For Q4 2020, loan issuance was USD 80.5 billion, the highest level since Q1 and a 9% jump from Q3 levels. Issuance volumes in Q4 were largely driven by buyouts and acquisitions, as buyers made up for lost time and sponsors tapped billions of dry powder. There were 33 LBO financings in the fourth quarter, a level not seen since 2018. Sponsor-driven dividend recapitalizations were also prominent, contributing 22% of Q4 issuance volume.

Away from the supply equation, the demand for new loan issue surged further in Q4, with growing US CLO issuance and an unrelenting secondary market rally. Noteworthy in the Q4 new loan issuance totals was the ever growing number of loans with B3/B- corporate ratings, a record 43% of total loan issuance volume in Q4 and 36% of total 2020 loan issuance, compared to 30.7% in 2019. This increase was in contrast to a notable reduction of BB– or higher rated issuers during 2020, confirming the "risk-on" investor sentiment that was prevalent despite COVID-19's wide impairment of the economy.

US new-issue institutional loan volume

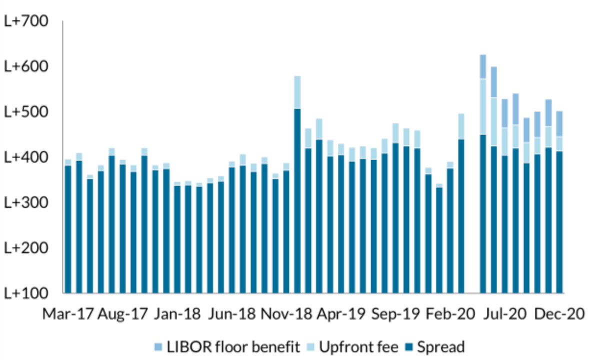


Source: S&P LCD, December 2020. For illustrative purposes only.

US new-issue loan spreads

Following a stunning loan trading price recovery in Q2 and Q3, wider new-issue loan spreads continued to be the main attraction for investors in Q4, with the average institutional loan spreads topping 504 bps (comprised of 410 bps coupon, 37bps of accreted Original Issue Discount (OID), and 57 bps of average Libor Floor). Even with strong investor demand, average loan spreads in Q4 remained wider due to the prevalence of B-/B3 rated issuers and the risk premium demanded. As noted in our Q3 commentary, inclusion of Libor Floors of 50-75 bps (seen on 60% of 2020 new-issue) continued to be a large driver for all-in loan spreads, as three-month USD Libor stabilized near 0.25% pa (see the Spotlight feature in our Q3 2020 Loan Market Commentary for more on this topic).

US new-issue loan spreads



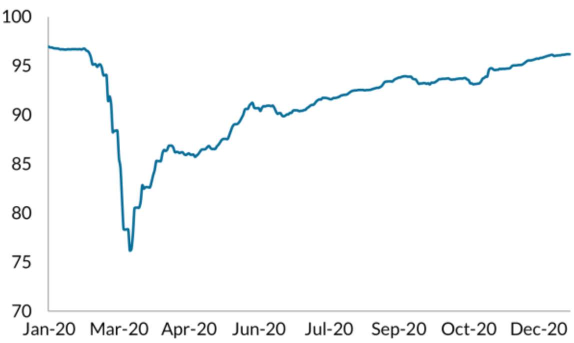
Source: S&P LCD, December 2020. For illustrative purposes only.

US loan bids

When looking back at a chart of year-end US loan prices and return levels in ten years, someone might conclude that 2020 was just another uneventful year. Missing from the headline will be the incredible round-trip journey loan prices took in 2020, a year impacted by the worse global pandemic in modern market history. The US Leveraged Loan Index (LLI) opened January 2020 at 96.72%, rallied into February peaking at 97.35%, before COVID-19 concerns suddenly gripped the marketplace. A month later, on 23 March, the LLI had fallen to a decade low of 76.23%, as market liquidity largely disappeared with the surging pandemic. But to almost everyone's surprise, after a bottoming out in March, loan prices quickly bounced back above 80% by March-end, as the massive Fed & Treasury support for US capital markets and commercial liquidity helped trigger a loan rally in April and May. By early June, the LLI had reached 90% and an anxious market took a collective sigh of relief. Loan prices climbed further upward in Q3 and Q4, and by year-end the LLI had effectively recovered to its pre-COVID-19 January levels, ending 2020 at 96.19%.

Following the initial market shock from COVID-19, and the rapid financial actions undertaken by both the government and the many impacted loan issuers, during the second half of 2020 investors refocused on the loan market's long-term fundamentals and recovery prospects. The resulting rally in loans was a remarkable testament to the resiliency of the loan asset class in the face of arguably the greatest financial confidence test it had ever endured.

US loan index bid (LLI)



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

European loan market overview

Much like the US, the European loan market experienced a whirlwind year in 2020. It began with a strong market rally where loan issuance and re-pricings were unrelenting, before this was abruptly halted by an unforeseen health pandemic which led to plummeting loan prices, only for this downward pressure to reverse itself in a sudden and sharp recovery by late Spring and early Summer. Investor demand which had opened the year so strong and then vanished for two months, gradually improved over Q2 and built sustained momentum throughout the second half of the year to the point where the market found itself having near fully recovered to pre-COVID-19 conditions.

Despite all that had happened in this most turbulent year, European leverage loans still delivered a 2.74% positive return for 2020, and the market looked forward to the new year with optimism for further growth. Although 2021 has begun with COVID-19 holding center stage, as European countries still wrestle with the uncertainties on how to best implement quarantine strategies and vaccine rollouts that will allow businesses to fully re-open and start the recovery process of their economies.

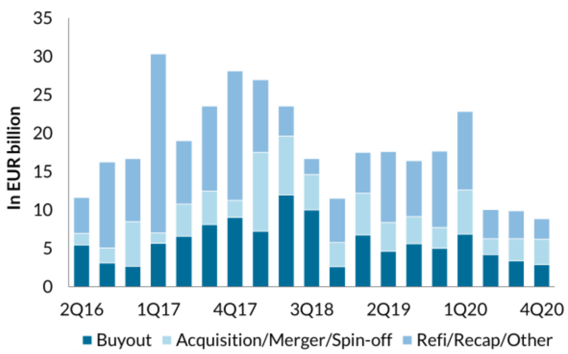
European new institutional loan volume

New European institutional loan issuance slid 25% in 2020 to EUR 51.7 billion, from EUR 69.5 billion posted in 2019. This marked the fourth consecutive year of issuance declines for the Euro institutional loan market, despite a strong bid for loan paper from CLOs.

In 2020, the market witnessed another disappointing year of buyout activity, compounded further by the pandemic, with buyout volume down 21% compared to the year earlier. Additionally, a sharp increase in primary loan pricing following the COVID-19 induced loan sell off in March dampened refinancing and dividend recapitalization activity for several quarters, with levels dropping off 35% from 2019. Institutional loan issue for Q4 2020 hit a low of only EUR 8.88 billion, less than half the levels posted in Q4 2019 (EUR 17.7 billion).

This disappointing level of activity was further compounded by Euro high yield bond issuance which enjoyed its strongest year since 2017, with EUR 85 billion of new high yield bonds issued in 2020 fueled by low rates and abundant debt refinancing opportunities, far outpacing the loan issuance tally.

European new-issue institutional loan volume

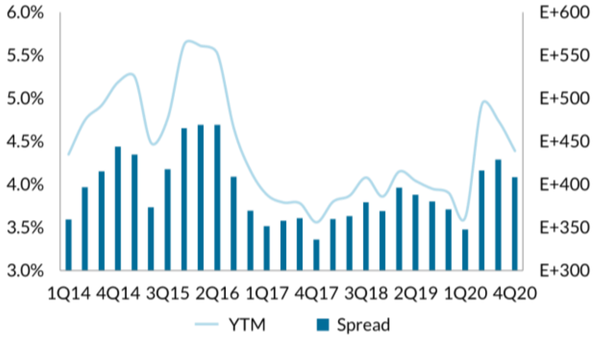


Source: S&P LCD, December 2020. For illustrative purposes only.

European new-issue loan spreads

A notable decline in new loan issuance in the second half of the year against a backdrop of surging loan investment demand, led to the average yield to maturity of single-B rated issuers dropping to 4.39% in Q4, down 0.35% from the previous quarter. This was the third consecutive quarter of declining European new-issue loan yields despite COVID-19. By year-end, loan yields had made the round-trip journey back to levels prevailing last January, when loan re-pricings dominated the market. Even with this rally, European loan yields at the end of 2020 remained attractive and were still 0.50% above the recent lows of late 2017. Moving forward, the direction of European loan yields in 2021 will largely depend on whether new-issue loan supply can grow enough to satisfy rising investor demand or loan yields will tighten further.

European loan spreads



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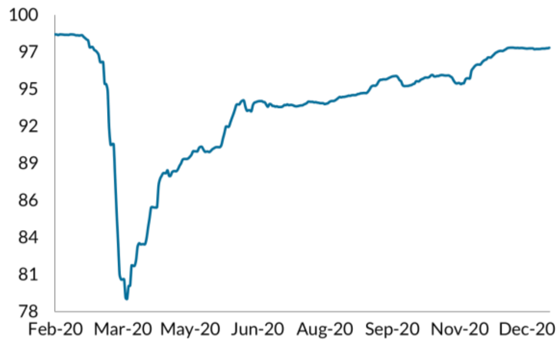
Euro loan index bid (ELLI)



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

European loan bids

The European loan market, like its counterpart in the US, experienced a trading year unlike any other on record. The European Leverage Loan Index ("ELLI") opened the year at 98.28% reflecting the strong "risk-on" investor sentiment which was driven by growing cash balances and steady CLO issuance. The ELLI topped out at 98.66% in late January, and then declined steadily in February and March as the world began to grasp the severity of the developing COVID-19 pandemic.

With the ELLI having hit a decade low of 78.92% in late March as loan buyers retreated, the resolve of European governments to provide unprecedented monetary stimulus during Q2 succeeded in turning loan investor sentiment positive again. Euro loan trading quickly rallied back, with the ELLI hitting 90% by mid-May, 95% in early September, and ending the year at 97.55%, effectively going full circle in less than 12 months. Again, much like in the US loan market, this fantastic trading recovery reflected a strong confidence by investors in the long-term prospects for the Euro loan market, even in the face of the most extraordinary and unpredictable economic challenge posed by the global pandemic.

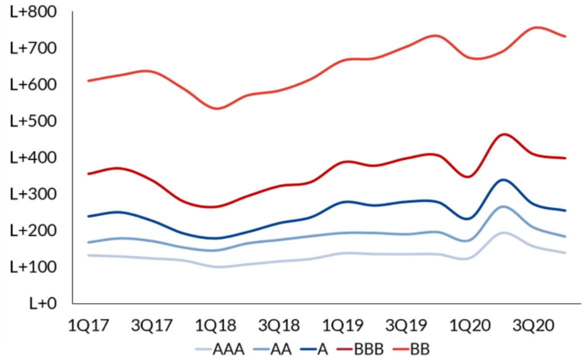
US collateralized loan obligations

As the performance of existing US CLOs continued to improve in late 2020, so did investment demand. The fourth quarter saw 74 CLOs issued totaling USD 30.8 billion, easily topping the 55 deals and USD 23.4 billion completed in the third quarter. As a result, CLO liability spreads were tightening throughout the quarter, with AAAs averaging L + 136 bps, compared to L + 160 bps in Q3 (note: many of these CLOs used shorter three-year reinvestment periods). The weighted average capital cost for US CLOs tightened 24 bps, from L + 217 bps for Q3 to L + 193 bps for Q4.

For the full-year 2020, CLO issuance totaled 215 deals for USD 92.1 billion, compared to 246 deals and USD 118.3 billion in 2019. Much of the 2020 issuance decline was attributed to the market shutdown last March and April at COVID-19's onset and the slow return of AAA investors. As with the US leveraged loan market, general market conditions for CLOs ended 2020 close to where it began the year (pre-COVID-19), it is just the unusual journey taken that really stands out.

Despite a global pandemic which resulted in an unexpected economic recession, CLOs generally performed as anticipated, validating their time-tested structures and once again providing great value to investors across the CLO liability stack. CLO compliance test metrics, including the important weighted average rating factor, triple-C basket and overcollateralization coverage tests, steadily improved throughout the second half of the year. US CLO equity returns also delivered in 2020, with a median annualized cash return on equity of 13.6% (Wells Fargo; January 2021), the tenth straight year of double-digit cash equity returns. The largest headwind for CLOs by late 2020 was the inadequate supply of new-issue loans to ramp up the growing number of CLO warehouses. If this trend continues well into 2021, it could impact US CLO issuance momentum.

US CLO liabilities spreads



Source: S&P LCD, January 2021. For illustrative purposes only.

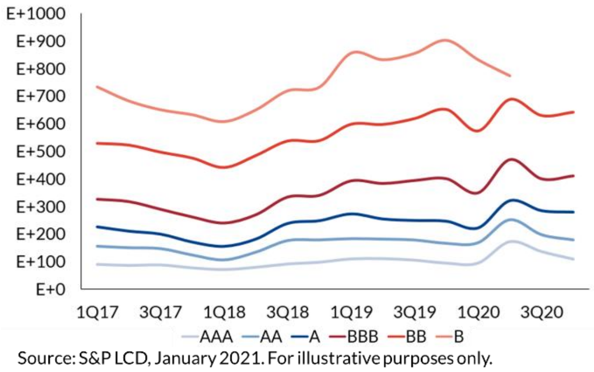
European collateralized loan obligations

The sustained rally in Euro leveraged loans in the second half of 2020 was largely fueled by the market's main investor: CLOs. In Q4 2020, there were 22 new CLOs issued totaling EUR 7.4 billion, up 60% over Q3's tally of 14 CLOs for EUR 4.6 billion. As older CLOs continued to deliver improved performance metrics following the COVID-19 induced market trough in Q2, investor demand across the CLO liability stack started to pick up in earnest. With continued investor interest in CLOs, the cost of CLO liabilities tightened further across much of the capital stack. In Q4, AAAs notes averaged E + 110 bps, compared to E + 136 bps in Q3, far off the widest levels hit in Q2 at E + 172 bps. AAA spreads tightened even more to E + 105-107 bps in December. The weighted average capital cost for Euro CLOs tightened 15 bps from E + 217 bps in Q3, to E + 202 bps in Q4, with spread tightening seen across most liability tranches except BBBs and BBs which struggled with investor demand.

For the full year 2020, there was EUR 22.1 billion of total new issuance from 66 CLOs, compared to EUR 29.8 billion from 72 CLOs in 2019. It is worth noting that most EU CLOs issued from April through December 2020 opted for a less expensive three-year reinvestment structure, versus the common five-year reinvestment period. Additionally, the average CLO size during this timeframe was EUR 335 million, compared to EUR 414 million in 2019, reflecting lower demand in 2020.

Thus, as CLO demand continues to improve over 2021, the size of issuance and length of reinvestment period will be good indicators of how far CLOs have recovered since the pandemic began. When considering how challenging the market environment was just last Spring, European CLOs, like their US counterparts, have generally performed as planned. In 2020, Euro CLOs delivered a median annualized cash return on equity of 14.0% (Wells Fargo; January 2021) for a decade long string of double-digit annual cash equity returns.

Euro CLO liabilities spreads



Source: S&P LCD, January 2021. For illustrative purposes only.

Spotlight topic: what about loan defaults?

The speed and suddenness of the COVID-19 pandemic induced recession of 2020 led market-wide expectations for a quick spike in loan defaults. The many uncertainties surrounding COVID-19's short- and long-term impact prompted rating agencies, banks and investors alike to estimate loan defaults topping 8%-10% by the end of 2020. But despite one of the weakest earnings quarters recorded in several years, pandemic lockdowns stifling business activity, leverage multiples hitting 7x for a third of US Loan Index issuers, weakened revenues and EBITDA levels, and aggressive credit rating downgrades, leveraged loan defaults at the end of 2020 (measured by issuer count in the corresponding Loan Index) were only 4.2% in the US, and 4.5% in Europe (LCD News; January 2021). Many of the defaults in 2020 occurred in cyclical sectors such as Oil & Gas, Metals & Mining, and Retail, or in COVID-19 impacted sectors such as Leisure, Transportation, and Services. While the default levels are a meaningful increase from the 1-2% average default levels observed over the past five years, they remain well below the dire predictions of just nine months ago. This is largely thanks to aggressive government intervention and highly accommodative capital markets from the onset of the pandemic. Of course, we must recognize that the economic downturn is not over. Defaults can take 12-24 months to manifest, often depending on an issuer's recovery of its revenue and cash flow, near-term liquidity, and debt repayment schedule. Given the higher number of CCC rated issuers (c. 8-10% across the US and Europe) at the end of 2020, near-term default rates may remain elevated in the 4-5% range throughout 2021 and into 2022. However, it appears that the high loan default wave that was anticipated may have been avoided.

About the Author

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