Partners Group
REALIZING POTENTIAL IN PRIVATE MARKETS

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Quarterly Loan Market Commentary

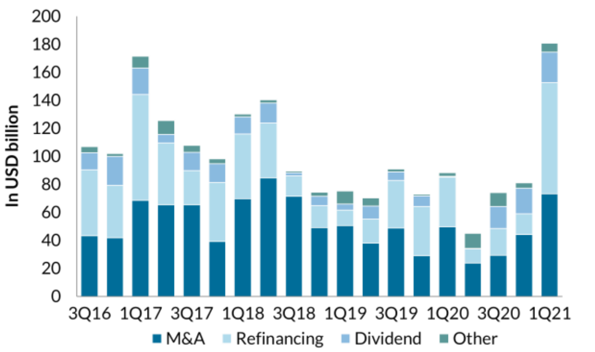
US loan market overview

US loan investors quickly jumped out of the gates in early January, as growing cash balances, attractive CLO issuance conditions and a growing optimism over a post-COVID economic recovery fueled investor demand, both in primary and secondary markets. While the anticipation of wider vaccine rollouts across the US in 2021 had already positively impacted loan markets in Q4, investors were quick to close the door on the noise of 2020 and re-position investment strategies for the new year. The resounding consensus for investors was a strong buy-in for a quick post-COVID recovery in the US. At the same time, growing market expectations of rising rates due to a very accommodative posture by the new Biden administration, with promised additional stimulus and major infrastructure spending, prompted retail investors (via mutual funds and ETFs) to push more cash at the already hot US loan market rally.

US new institutional loan volume

With nearly every factor favoring loan creation, Q1 2021 new institutional loan issuance volume soared to USD 180.8 billion, the highest quarterly volume on record. This stood USD 9 billion higher than the previous record of USD 171.4 billion from Q1 2017. The lead driver of this surge in Q1 was refinancings at USD 79.4 billion (44% of total issuance), as issuers smartly took advantage of insatiable investor demand to refinance loans to lower spreads knowing investors would concede. These refinancings also allowed many issuers to extend maturities. Not far behind, merger, acquisition and LBO financings topped USD 73.1 billion in Q1 (40% of total issuance), led by LBO volume of USD 37.5 billion, followed by acquisition financings of USD 20.0 billion and mergers of USD 15.7 billion. Not included in these loan issuance (i.e. "new money") tallies, but equally relevant to the red hot market conditions were USD 148.5 billion of loan repricings, which took place in Q1 as well. This was the highest volume of repricings recorded in four years. Of these Q1 repricings, 77% were initiated by single-B rated issuers. Post-COVID, many of these issuers were last in the market in 2020, and after issuing at very wide spreads, were able to reduce spreads by as much as 50-100 bps. A final sign of the "risk-on" investor sentiment was a large number of B-minus rated issuers which successfully issued in Q1, accounting for a total of USD 67.6 billion or 37% of all quarterly new issuance.

US new-issue institutional loan volume



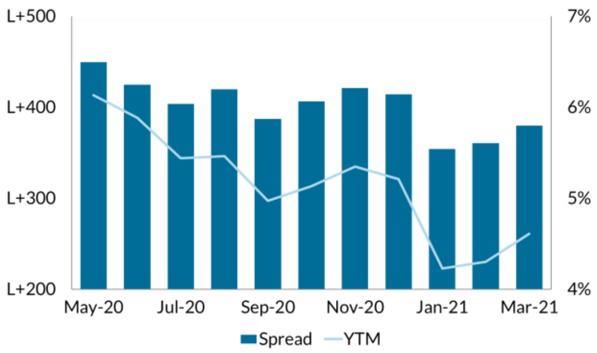
Source: S&P LCD, March 2021. For illustrative purposes only.

US new-issue loan spreads

With demand in Q1 opening very strongly, new issue institutional loan yields for B/B+ rated US issuers (the core holdings of CLOs) quickly tightened 98 bps to 4.23% in January. However, the loan supply pipeline quickly grew in February and March in response, causing a reversal of loan yields to 4.61%

in March. While investor demand remained robust throughout March, it was the unprecedented total number of new issues hitting the market at once which conspired to drive spreads wider. Investors simply could not manage the volume of transactions and a crowding-out occurred.

US average new-issue loan spread and yield

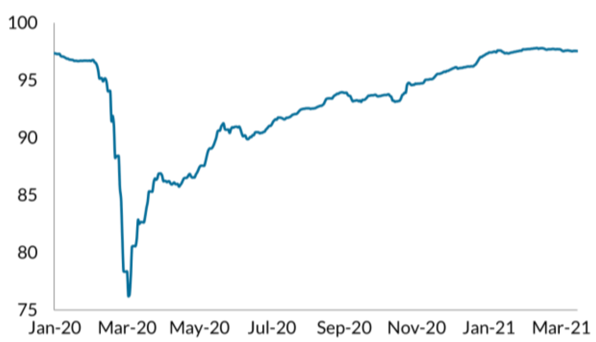


Source: S&P LCD, March 2021. For illustrative purposes only.

US loan bids

Market fundamentals pushed secondary loan prices higher from the outset in January, with the US Leveraged Loan Index (LLI) opening at 96.22%, and then rallying 160 bps into February. But as the heavy volume of new loan issues began allocating in late February and March, secondary bids lost some steam and the LLI ended the first quarter at 97.55%. While just a moderate increase compared to the gains of the past three quarters, this 133 bps pick-up for the LLI in Q1 completed the round-trip recovery for the index, bringing it all the way back to pre-COVID, January 2020 levels.

US loan index average bid (LLI)



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

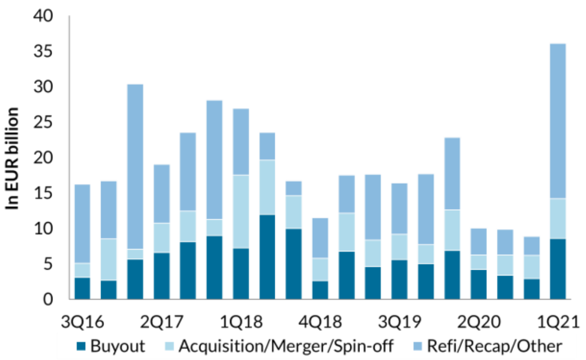
European loan market overview

While the pace of economic recovery from the COVID-19 pandemic has been slow and mixed across Europe, loan investors were increasingly engaged as "risk-on" during Q1. Flush with cash to spend, both loan and bond new issuers posted one of their strongest issuance quarters in years. CLO formation enjoyed a robust first quarter as well, as investor bids tightened CLO liability spreads and produced firm CLO issuance volumes. And despite record-breaking bond issuance in Q1, concerns around rates and rising inflation due to unprecedented central bank intervention and stimulus programs has started to take root. Going forward, this may re-focus some investors back on to loans with their floating rate coupons. While the US loan market typically experiences a return of retail investors during times of rising interest rates, Europe does not have a similar retail investor base. Besides global institutional loan mandates, demand for loans in Europe remains largely dominated by CLOs, and CLOs are buying the COVID recovery story.

European new institutional loan volume

With renewed investor demand, institutional loan issuance in Europe jumped to EUR 36.1 billion in Q1 2021, making it the third busiest quarter on record and the highest since Q2 2007. Compared to Q3 2020, at EUR 9.9 billion, and Q4 2020, at EUR 8.9 billion, this was a notable increase in volume, equal to 70% of total 2020 loan issuance. Unfortunately, from this EUR 36.1 billion of issuance, 61% was attributed to opportunistic refinancings and repricings. Despite the attractive headline number, investor demand was left unsatiated. New money loans in Q1 from buyout activity totaled only EUR 8.6 billion (24% of total), while acquisitions added just EUR 5.6 billion (15% of total). These were disappointing tallies for a hungry market, which then had to turn to the secondary loan market or the bond market to satisfy their demands.

European new-issue institutional loan volume

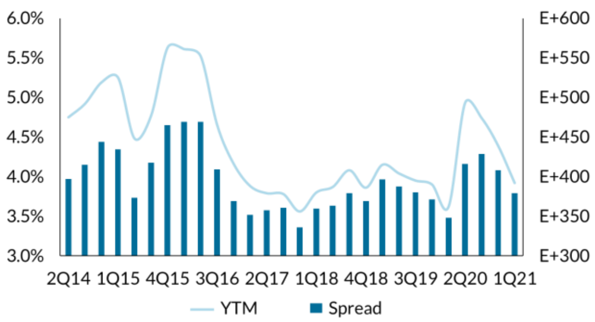


Source: S&P LCD, March 2021. For illustrative purposes only.

European new-issue loan spreads

With market fundamentals strongly favoring issuers, the average yield to maturity of single-B rated Euro loans in Q1 tightened for the third consecutive quarter, dropping to 3.92%. Notable here is the small premium in spread which was paid by B-/B3 rated issuers (E + 375-400bps) compared to B/B2 issuers (E + 350 bps), but a differentiation between issuers was observed in tighter or looser documents and loan margin ratchets. Overall, loan investors in Q1 became reluctant takers on pricing and terms, with many acknowledging that desired stipulations on pricing and terms were largely dismissed by issuers and arranging banks given new issue oversubscriptions. While not a concern currently, such loans may prove to have less appeal to secondary investors in the months to come, should market conditions return closer to equilibrium. But for now, CLOs, which are also enjoying tightening new issue liability spreads, conceded to declining loans spreads.

European loan spreads

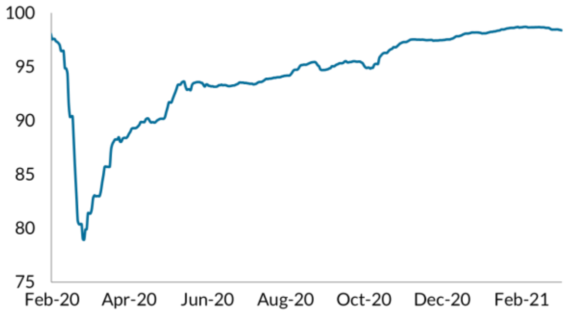


Source: S&P LCD, March 2021. For illustrative purposes only.

European loan bids

Fresh off a remarkable recovery in prices during the second half of 2020, Euro secondary loan prices in Q1 had returned to pre-pandemic levels. The European Leveraged Loan Index (ELLI) ended Q1 2021 at 98.41%, a 19% increase from the 82.80 price the ELLI posted at the end of Q4 2020. The price rally was widely spread across the market and should continue to benefit from the growing number of newly issued CLOs and the many ramping CLO warehouses in Q2.

Euro loan index average bid (ELLI)



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

US collateralized loan obligations

In Q1 2021, the US CLO market experienced its most active quarter on record, including the largest quarter of new CLO issuance in the past decade. Driven by huge investor demand for CLO liabilities across the capital stack, liability spreads fell rapidly over January and February, before plateauing and then slightly reversing course wider in late March. Despite the strong appetite, CLO investors were eventually overwhelmed by new issue, refinancing and reset volumes, as managers anxiously tried to capture lower liability costs. US CLO issuance activity accelerated so much by March that the rating agencies could no longer accommodate new rating requests for Q1, forcing managers to reschedule transactions into April and May.

During the first quarter, 81 new CLOs from 61 different managers were issued, for a total of USD 39.3 billion. Notably, most of these new CLO issues in Q1 included the market-standard five-year reinvestment period, compared to the shorter three-year reinvestment period more common in 2020.

However, the story does not end there. When combining CLO new issuance of USD 39.3 billion with USD 37.7 billion of CLO refinancings and USD 30.7 billion of CLO resets, total US CLO activity for Q1 hit a staggering USD 107.7 billion. Yet, despite this heavy supply, the surge of investor demand for CLO liabilities in Q1 pushed the weighted average cost of capital for CLOs down to L + 163 bps, from L + 193 bps recorded in Q4 2020. CLO AAA liabilities led the way in Q1, falling to an average of L + 116 bps, compared to L + 136 bps in Q4. Several top-tier managers tested three-year AAA lows, before the market began backing up from the aforementioned supply overhang.

US CLO liabilities spreads

US CLO average coupon across the stack and weighted average cost of capital (bps)

Period	AAA	AA	A	BBB	BB	WACC
3Q19 (L+)	135	190	278	398	704	206
4Q19 (L+)	134	196	277	406	734	203
1Q20 (L+)	124	174	234	349	675	182
2Q20 (L+)	193	266	338	463	690	241
3Q20 (L+)	160	213	279	417	757	217
4Q20 (L+)	136	181	250	392	737	193
1Q21 (L+)	116	155	199	313	647	163
Change from 4Q20	**-21**	**-26**	**-51**	**-78**	**-91**	**-30**
Change from a year ago	**-8**	**-19**	**-35**	**-36**	**-28**	**-19**

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

European collateralized loan obligations

Like the US markets, European CLO demand in Q1 was strong, pushing CLO liabilities spreads significantly tighter throughout the quarter. This brought many new CLO issues to market while also triggering a wave of repricings and resets. With robust investor demand, many CLO issuers were also able to secure longer reinvestment periods of 4.0 or 4.5 years, not seen since the outset of COVID-19. Given the market's strong fundamentals, there are also growing expectations that Q2 CLO liability spreads could hit the tightest levels recorded since the Global Financial Crisis, unless CLO new issue volumes increase significantly. Any such increase in CLO issuance would also strongly depend on higher new loan volumes, as already high secondary loan prices impede warehouse ramp-ups.

European CLO issuance in Q1 2021 posted 20 new issues totaling EUR 7.8 billion. While slightly ahead of Q4 issuance of EUR 7.4 billion from 22 deals, this was a much better result compared to Q1 2020, which only saw 14 deals for EUR 5.8 billion (albeit a somewhat unfair comparison as COVID shut down markets by March 2020). While certainly not at the same pace as in the US, European CLO repricings in Q1 totaled EUR 11.1 billion, while resets added EUR 8.2 billion. Combining these with new issues made Q1 2021 one of the busiest quarters in years, with EUR 27.1 billion of total EU CLO activity. But with investor demand not being answered, the new issue CLO weighted average cost of capital in Q1 2021 fell to E + 166 bps, compared to E + 201 bps in Q4 2020. This impressive tightening was primarily driven by AAA liabilities spreads averaging just E + 83 bps in Q1, compared to E + 110 bps in Q4, although spread tightening was also achieved across all other liability tranches.

Euro CLO liabilities spreads

EU CLO average coupon across the stack and weighted average cost of capital (bps)

Period	AAA	AA	A	BBB	BB	B
3Q19 (E+)	106	179	251	394	619	855
4Q19 (E+)	95	167	248	401	652	903
1Q20 (E+)	95	170	224	349	574	832
2Q20 (E+)	172	253	322	471	688	774
3Q20 (E+)	136	198	286	400	630	768
4Q20 (E+)	110	180	281	411	642	809
1Q21 (E+)	83	136	223	330	584	802
Change from 4Q20	**-27**	**-44**	**-58**	**-81**	**-57**	**-7**
Change from a year ago	**-13**	**-34**	**-1**	**-19**	**10**	**-30**

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

Spotlight topic: A few thoughts on inflation

Following aggressive monetary easing and fiscal stimulus measures taken in the US and Europe over the past year to combat the COVID-19 pandemic's devastating impact on local and regional economies, inflation has resurfaced as a popular topic in financial markets. As treasury yield curves steepen and commodity prices rise in certain sectors, it is worthwhile to take a moment to reflect on inflation and its potential impact on various segments of the debt market.

There is no doubt that inflation is negative for fixed-rate assets (specifically high yield bonds in our universe) and could eventually restrict the availability of credit from banks. But inflation in smaller doses can actually have a positive impact on leveraged loans. Fundamentally, leveraged loans incorporate a floating interest rate base (LIBOR*) in their coupon. And with a LIBOR rate base, leveraged loans and CLOs offer investors a built-in hedge against inflation. As short-term interest rates rise, so will coupons. Loan and CLO investors could also benefit from a larger supply of new issue leveraged loans and wider spreads, as corporate issuers reduce high yield bond issuance in favor of loans to avoid being locked into higher fixed-rate coupons. Of course, none of this assumes a spiraling inflation rate environment, last witnessed some 40 years ago. High, long-term inflation would certainly weaken the cash flows of most corporate issuers, diminish debt service capabilities and inevitably lead to a recession. However, moderate inflation over a shorter period of time could be a net positive for leveraged loans, as well as the CLOs those loans sustain.

**The long-awaited termination of LIBOR as a base rate is also a timely topic, which will be addressed in a future issue of our Quarterly Loan Market Commentary.*

About the author

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