



Quarterly Loan Market Commentary

Q4 2022 | Issue 14

US loan market overview

Notwithstanding a modest increase of loan issuance and some new found loan market stability in the fourth quarter of 2022, the loan market just completed a disappointing year. It came as no surprise to most market participants that the numerous headwinds of high inflation, rising interest rates, a looming recession, lingering supply chain challenges, scattered labor shortages and unprecedented geopolitical worries would chill the US loan market. As a result, M&A activity was notably lower, and new loan creation posted its slowest year of activity since the Global Financial Crisis (GFC). There was also a clear demarcation in secondary loan trading prices, which reflected either a flight to quality or low tolerance for missed budgets or credit rating downgrades. Following 18 months of improvement in credit ratings after the COVID re-opening cycle, negative credit rating migration across loan portfolios has taken center stage once again. While the broadly syndicated loan market remained open for business in Q4, it favored only the stronger performing and widely followed loan issuers. Smaller borrowers and those experiencing challenges (or higher leverage profiles) instead turned to private lenders who were still selectively putting capital to work. Banks, retail funds, and older re-investing CLOs largely withdrew to the sidelines.

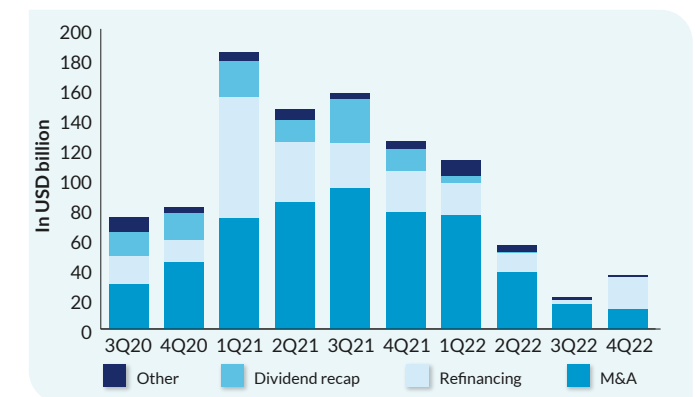
US new-issue loan issuance

New loan issuance ticked higher in Q4 2022 to USD 35.7 billion, compared to USD 21.2 billion in Q3, but was still the second-lowest quarterly total recorded in the past



decade. In addition to economic headwinds, a considerable backlog of large LBO underwritings from early 2022, prevented many arranger banks from pursuing new credit mandates throughout much of the year, and as a result large cap M&A and LBO activity idled. A majority of Q4 issuance activity instead came from the refinancing of near-term debt maturities by stronger BB-rated issuers, while M&A loan activity made up just 40% of volumes, its lowest quarterly dollar amount posted since 2010. Additionally, the market saw amend-and-extend loan activity increase to USD 11 billion in Q4, but again only for better performing issuers (this activity is not typically included in loan volume statistics).

US new-issue institutional loan volume



Source: S&P LCD, January 2023. For illustrative purposes only

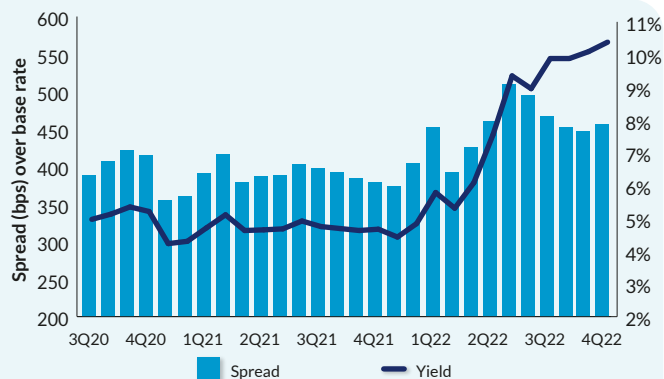
For the full year 2022, new loan issuance totaled USD 225 billion, the lowest annual amount since 2010, and 63% below the record shattering issuance of USD 614.6 billion in 2021. Of this USD 225 billion, M&A activity accounted for USD 142.4 billion (with more than half this M&A generated in Q1 2022). Refinancings totaled USD 58.6 billion, while dividend recap activity was only USD 5.9 billion.

US new-issue loan spreads

New issue loan spreads in Q4 for single B/B+ rated issuers remained elevated, averaging SOFR + 453bps, although this was notably lower than the recent high of SOFR + 510bps observed during June 2022.

The all-in yield of new loans in Q4 however reached a decade high of 10.4%, driven by deep original issue discounts (OIDs) offered by arranger banks, wide loan spreads, plus continually rising benchmark interest rates as the Fed rate raising cycle continues its rapid climb. OIDs on new issue loans in Q4 averaged 96%, ranging from 91% to 98% and impacted by ratings, issuer performance and size.

US average new-issue loan spread and yield



Source: S&P LCD, January 2023. For illustrative purposes only

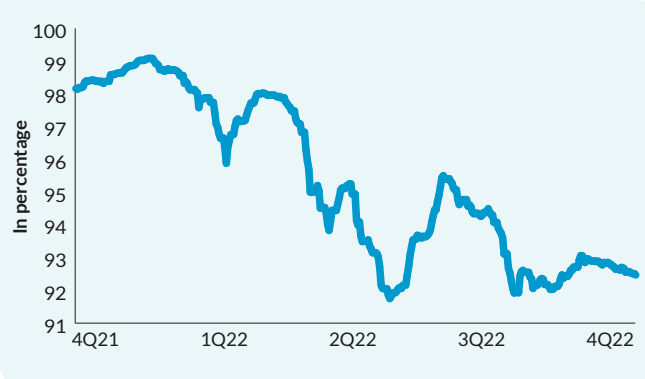
US Loan Secondary Trading

Secondary loan trading was surprisingly stable during Q4. The LSTA Morningstar US Leverage Loan Index (LLI) opened October at 91.94%, ticked up to a high of 93.06% by mid November, before ending December lower again at 92.47%. While the supply of new loan issuance was below average, weak investor demand from retail funds and reinvesting CLOs helped keep the LLI price levels in check. Although new CLO issuance remained active in Q4, many of the loans populating these new CLOs were acquired three-to-nine months prior and this did not disrupt the loan supply-demand balance or impact secondary loan prices.

For the full year 2022, the market observed a much higher level of loan trading volatility. The LLI opened the year at 98.64%, slipped to 97.60% by the end of Q1, dropped further to 92.16% by mid-year, and then was range bound for much of the second half of 2022, closing Q4 at 92.47%.

For the fourth quarter, the LLI posted a strong 2.74% return largely due to the market's new found stability, but it could not make up for recent negative quarters

US loans index average bid (LLI)



Source: S&P LCD, January 2023. For illustrative purposes only

and for the full year 2022, the LLI posted a disappointing -0.60% return.

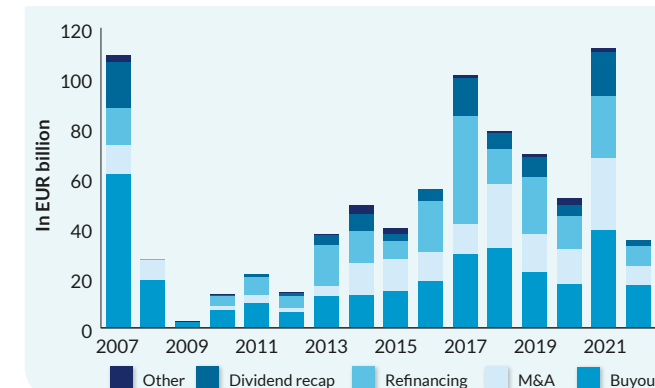
European loan market overview

The European loan market capped off 2022 with another lackluster quarter in Q4, which brought full-year new loan issuance totals to the lowest volumes observed since 2012. Much like in the US market, the economic headwinds of inflation, rising interest rates, labor and energy costs, and the ongoing Ukraine conflict muted M&A activity and large cap credit underwritings, resulting in a notable decline of new loan issue activity. It was noteworthy, however, that despite these considerable challenges, at least the loan market remained open and marginally constructive. And with new issuance volumes lower, loan issuers and arranger banks instead turned their focus to exploring opportunities to refinance or extend upcoming 2024 and 2025 loan maturities.

European new-issue loan issuance

Q4 2022 saw new European institutional loan issuance slip to EUR 4.5 billion, from EUR 7.2 billion posted in Q3, as M&A-related credit underwriting and refinancing

European new-issue institutional loan volume



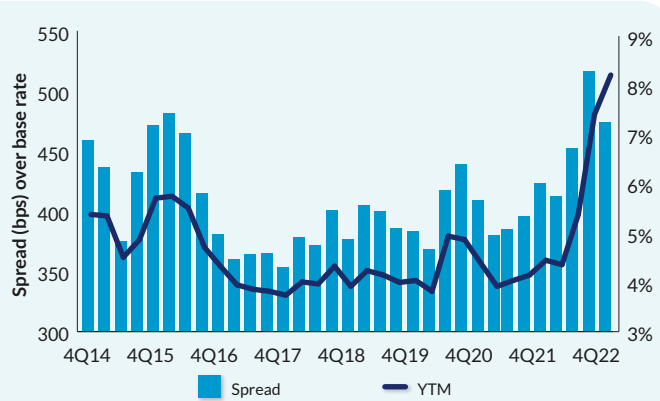
Source: S&P LCD, January 2023. For illustrative purposes only

activity remained quiet. The much discussed syndicated loan backlog from earlier credit underwritings was largely cleared during the second half of 2022. For the full year, new institutional loan issuance totaled only EUR 35 billion, down 69% from the 2021 new issuance volume of EUR 111.7 billion, and the lowest tally recorded since the EUR 14.4 billion posted in 2012. Moving forward into 2023, market expectations are for a continuation of low new issuance in the first half of the year and more activity centered around refinancings or maturity extensions.

European new-issue loan spreads

With the small decline in loan issuance in Q4 2022, new single-B-rated institutional term loans were pricing tighter in Q4 at an average of EURIBOR + 470bps and at a yield to maturity of 8.21%. This compared to EURIBOR + 515bps and a yield to maturity of 7.44% observed in Q3. The Q4 yield to maturity of 8.21% was the widest quarterly yield posted for European new loan issuance since the GFC. This new loan yield represented a significant increase from levels observed back in Q1 2022, when EURIBOR was closer to 0% and loan yields were in the mid-4% range. Undoubtedly, a new loan yielding over 8% presents an

European loan spreads



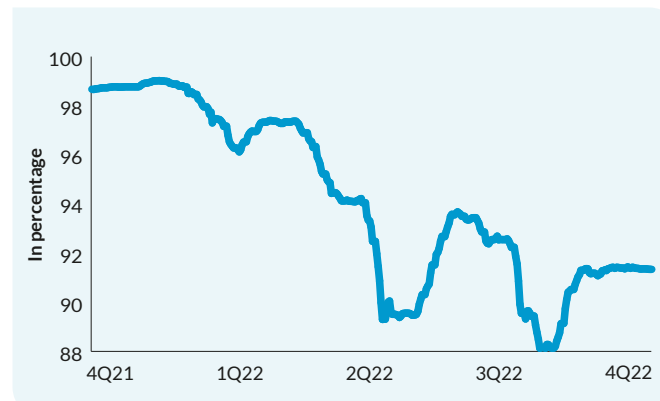
Source: S&P LCD, January 2023. For illustrative purposes only

attractive level for many investors, but also significant deterrent for many new loan issuers and leveraged M&A activity overall.

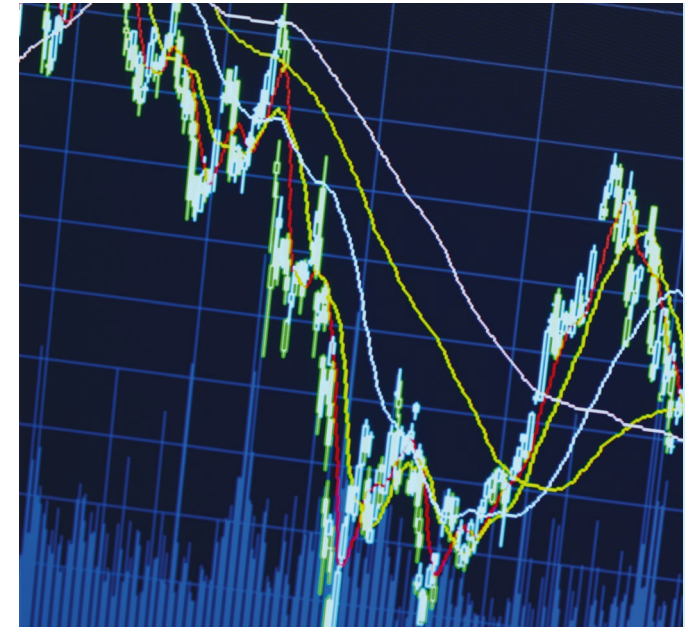
European loan secondary trading

As new-issue loan volumes for Q4 remained relatively constrained, Euro loan investors continued to focus on the secondary market to deploy available cash. Similar to the US, Euro secondary loan prices steadily rose through much of Q4, before stabilizing during December. The Euro Leverage Loan Index (ELLI), which opened the fourth quarter at 89.55%, slipped to 88.13% by mid-October before a slow but steady rise brought the ELLI to 91.34% at year end. For the full year 2022 however, the ELLI posted a significant drop and ultimately could not overcome the prevailing economic and geopolitical headwinds dominating much of the year. Opening at 98.77% in January 2022, the ELLI closed Q1 at 97.32%, Q2 at 89.61%, and Q3 at 89.55%, before concluding Q4 at 91.34%. This resulted in the ELLI posting a -3.06% return for 2022, the first negative return observed since the GFC in 2008, and a notable outlier compared to the ELLI's +4.81% return delivered in 2021, or its recent ten-year average return of +3.69%.

Weighted average bid of European loans



Source: S&P LCD, January 2023. For illustrative purposes only



US collateralized loan obligations

US issuance

Perhaps defying the expectations of many, US CLO issuance continued to be constructive in Q4 despite continually rising CLO liability spreads, as many CLO managers needed to de-risk aging CLO warehouses before year-end, even at the cost of accepting razor thin target equity returns. Q4 saw 53 CLOs issued, totaling USD 22.5 billion, compared to 77 CLOs and USD 33.6 billion issued in Q3. Of the 53 CLOs issued in Q4, 8 were “static” CLOs with no reinvestment period, while 26 other CLOs had shorter reinvestment periods – less than the typical five years – in an effort to reduce liability spreads or gain more issuer flexibility.

For the full year 2022, new CLO issuance topped USD 129.3 billion from 283 CLOs, making it the second most active new US CLO issuance year on record, but this

was still 30% below the record new CLO issuance levels of USD 186.7 billion recorded in 2021. Considering the market headwinds and dramatically lower investor demand in Q3 and Q4, this issuance result for the full year 2022 was still impressive, despite the weak comparison against 2021 totals.

US CLO liability spreads

Even as new-issue CLO volume declined during Q4, the growing absence of many traditional CLO liability investors pushed liability spreads wider month over month in Q4. The weighted average cost of capital (WACC) for new CLOs in Q4 jumped to an average of SOFR + 293bps, up 15bps from Q3, and 100bps from Q1 2022 levels. AAA-rated CLO liabilities, a majority of the CLO liability stack, averaged SOFR+227 bps in Q4, compared to SOFR+211bps in Q3. Remaining CLO liability tranches rated AA to BB priced upward as well in Q4, 12-to-44bps above Q3 levels, as supply exceeded demand across most tranches.

US CLO liabilities spreads

US CLO average coupon and weighted average cost of capital (bps)						
Time frame	AAA	AA	A	BBB	BB	WACC
Q221 (LIBOR+)	116	171	209	319	654	168
Q321 (LIBOR+)	118	170	214	324	661	171
Q421 (LIBOR+)	116	172	217	325	660	172
Q122 (SOFR+)	136	192	233	348	702	193
Q222 (SOFR+)	163	233	294	411	756	224
Q322 (SOFR+)	211	302	400	532	833	278
Q422 (SOFR+)	227	318	412	576	852	293
Change from Q322	15	16	12	44	20	15
Change from a year ago	111	146	195	252	193	121

Source: S&P LCD, January 2023. For illustrative purposes only

US CLO secondary trading

US CLO secondary trading in Q4 capped off a strong 2022 in terms of trading volume, with Q4 up 25% year-over-year (YoY), and 2022 overall up 82% YoY. The trading was largely concentrated in the safer AAA-BBB-rated tranches, driven by certain buy-and-hold investors in the secondary market seeking trading liquidity (AAA CLO notes trading volume in 2022 was up 149% YoY). Junior CLO liability notes were generally flat for the quarter. Across the capital structure, discounted spreads on CLO liabilities reached their widest levels in recent history, with AAA notes topping 260bps, while BB notes were as high as 1,200bps, but discounted spreads across the stack tightened towards year end.

European collateralized loan obligations

Once again in Q4, European CLO issuance was surprisingly resilient despite weakening new Euro loan issuance volumes and economic headwinds. However, much like in Q3, CLO managers were flexible on structure terms and utilized shorter reinvestment periods – one-to-four years versus the standard five years and even “static” CLOs – during Q4 to move issuance forward. For asset ramp-ups, with new issue loan volumes low, new CLOs turned to the secondary trading markets to source loans to fill portfolios. Euro loan prices which had stabilized in August and early September began to decline again in late September and in October, which lowered loan acquisition costs, benefitting CLO equity returns despite wider CLO liability spreads.

Euro CLO issuance

For Q4 2022, 17 new CLOs priced, totaling EUR 6.1 billion, effectively matching Q3 totals of 17 CLOs and EUR 6.4 billion. As observed in Q3, there was no CLO reset activity in Q4, as wide CLO liability spreads remained unattractive to managers.

For the full year 2022, new CLO issuance was EUR 26.2 billion from 67 CLOs. This compared unfavorably to the record issuance totals from 2021 of EUR 38.6 billion

and 94 CLOs, but still ranked 2022 as the fourth most active CLO issuance year on record in Europe. As for CLO resets and refinancings in 2022, just EUR 6.1 billion was completed, all occurring in Q1 and Q2. As referenced earlier, given significant global economic headwinds and muted investor demand in Q3 and Q4, the total CLO issuance result for 2022 was impressive, in comparison to annual totals posted over the last decade.

Investor demand for new issue AAA-rated CLO tranches was notably impacted during the early weeks of Q4 by the continuation of Euro pension funds actively selling higher-priced, liquid assets including CLO liabilities, as part of short-term liability-driven investment (LDI) strategies. This “LDI-led selloff” pushed CLO liability secondary prices lower until buyers – largely US asset managers – stepped in to provide liquidity and stabilize levels. To make up for much of the lost demand from pension funds, European banks increased CLO investment further, accounting for as much as 70% of Euro new-issue CLO demand in Q4.

Euro CLO liabilities spreads

European CLO average coupon across the stack and weighted average cost of capital (bps)						
Time frame	AAA	AA	A	BBB	BB	WACC
Q221 (E+)	87	158	209	314	593	172
Q321 (E+)	99	169	218	316	607	182
Q421 (E+)	97	175	225	331	625	183
Q122 (E+)	100	208	281	393	679	199
Q222 (E+)	117	231	346	482	741	232
Q322 (E+)	189	363	450	606	769	306
Q422 (E+)	210	387	467	625	790	312
Change from Q322	21	25	17	19	21	7
Change from Q421	113	212	242	294	166	129

Source: S&P LCD, January 2023. For illustrative purposes only

Euro CLO liability spreads

Accounting for the added volatility for Euro CLO liabilities described above, new-issue AAA-rated spreads rose to EURIBOR + 210bps in Q4, compared to EURIBOR + 189bps in Q3. Liability spreads for all other lower-rated CLO tranches (AA to BB) widened as well in Q4 by around 17-24bps, pushing the WACC for new Euro CLOs in Q4 to EURIBOR + 312bps, slightly above Q3’s WACC of 306bps, but notably higher than the 232bps posted in Q2 or 199bps in Q1 2022. The motivation for managers to price CLOs at these higher liability costs was likely a function of maturing warehouse credit lines, risk management of ramped assets, or the desire to keep increasing CLO assets under management and management fees despite the challenging market conditions.



About the author

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Euro CLO secondary trading

While Euro CLO new issuance was slower during Q4 given continuing market volatility, secondary trading volumes grew 150% YoY for the quarter and 100% for the year. Trading volumes grew across AAA-BB-rated CLO liability tranches, most notably across the top of the capital

structure (AAA & AA), as typical buy-and-hold investors frequently accessed the secondary market for liquidity. As in the US, Euro CLO liability discounted spreads across the capital structure reached their widest levels in recent history, with AAAs topping 270bps and BBs at 1,200bps, before spreads tightened before year-end.

Spotlight topic: Winter arrives and there is a chill of rating downgrades for CLO assets.

Having to confront the multiple headwinds of inflation, labor shortages, supply chain disruption, rapid Fed rate increases and geopolitical turmoil, it is no surprise that both US and Euro investors have been witnessing a degrading of credit risk and return across loan portfolios in 2022. Rating agencies, often criticized for acting slowly, have chosen to quickly downgrade loan issuers following any disappointing performance metrics. As such, the number of triple-C-rated loans has been rising consistently and has become a regular topic of market discussion over the past few quarters. While very important to CLO portfolios, which must maintain prescribed weighted average ratings test compliance, recent data from Bank of America’s Global Research is projecting triple-C-rated loans held by US CLOs to quickly rise to an average of 5.6%. Other market estimates predict a possible range

of 10%-12% triple-C-rated loans held across US CLOs during this latest cycle, which would be notably above the triple-C-rated loan concentration limit of 7.5% common to most CLOs. As seen during the 2020 COVID cycle, rating agencies want to appear pro-active by aggressively downgrading many loan issuers “deemed” at risk, which will trigger a spike in triple-C-rated loans. Another cycle of quick credit rating downgrades in response to an “expected” recession would weaken secondary loan prices again and create the biggest challenge CLO managers could face during 2023. Actively managing triple-C-rated loans below the 7.5% threshold limit for CLO portfolios would become a top priority. CLO managers would undertake necessary portfolio actions to assure key CLO compliance metric tests are passed to allow quarterly CLO equity distributions to continue unabated.

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