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## The debt hangover and its impact on debt markets

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## The debt hangover and its impact on debt markets

### EXECUTIVE SUMMARY

As traditional providers of debt financing are still struggling with the aftermath of the financial crisis, structural shifts in the composition of global debt markets are opening up appealing opportunities. With collateralized loan obligations (CLOs) acting as the other "traditional" source of capital for leveraged buyouts (LBO) in recent years, the current low issuance of new CLOs as well as the looming expiration periods of existing CLOs leave a gap, thus creating opportunities for credit funds and other providers of private debt. At the same time as funding from CLO vehicles is becoming scarcer, banks are in the midst of the deleveraging process, especially in Europe where the banks face huge refinancing requirements for an estimated EUR 1.7 trillion of maturing debt over the next three years. Morgan Stanley expects European banks to shrink their balance sheets by EUR 1.5-2.5 trillion over the next 18 months, of which a large proportion is likely to be the result of restricted lending activity.

In the midst of this situation, we expect to see continued investment activity and sustained demand for LBO debt. The current "dry powder" of roughly USD 400 billion in private equity funds is expected to lead to potential demand for debt financing of nearly USD 500 billion, assuming a market standard equity contribution of approximately 45%. As another prominent driver for strong loan demand, European corporates will be forced to find refinancing solutions for EUR 63.4 billion of loans due to mature between 2012 and 2015.

In the first half of 2011, there were signs in the leveraged finance market that the European high yield market would "ride in and come to the rescue" with the second half of the year subsequently demonstrating how notoriously sensitive the high yield market is to the macro environment as new issue high yield volumes nearly disappeared in Europe. Although the high yield market is expected to play a prominent role in the LBO financing over the coming years, the volatility and availability of high yield will create challenges for many companies in need of capital. With this evidenced clearly in recent transactions, the high yield market has been seen to have its limitations in funding this upcoming financing gap.

With the available data indicating that loss rates are higher and recovery rates lower in the high yield market compared to leveraged loans, the current market environment offers the investor with capital and sourcing capabilities significant opportunities and attractive returns. Newly issued senior secured debt in Europe today (typically with opening senior leverage at or below ~4x and total leverage at or below ~4.4x) will offer current yields of Euribor/Libor +4.5-6.0%. Senior loans in the US middle market typically contain LIBOR floors and spreads over LIBOR of 5.0-6.5%. In short, despite lower leverage levels, lenders today benefit from higher spreads.

We conclude that the private debt market, specifically the senior secured loan and mezzanine markets, will exhibit a supply/demand imbalance over the coming years. This dynamic will offer well-capitalized investors opportunities for achieving attractive risk-adjusted returns.



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### UNDERSTANDING THE SUPPLY/DEMAND IMBALANCE FOR LEVERAGED FINANCE

Financial institutions are still in the midst of recovering from the aftermath of the global financial crisis, especially in Europe where bank write-downs are lagging their US peers and where bank leverage levels are still considerably higher. Coupled with rigorously tight upcoming Basel III capital requirements, financial institutions are left with little leeway to continue providing bank loans which require risk-based capital. As a result, Partners Group believes that commercial banks, especially in Europe, will further decrease their loan portfolios and reduce their balance sheet.

At the same time as financial institutions are scaling back their lending businesses, the other traditional providers of private debt financing, collateralized loan obligations, are also decreasing in volume. These developments create a vast array of opportunities for non-traditional lenders, as these aggressive dominant players no longer side-line unconventional lenders and credit fundamentals are once again moving to the forefront of the investment process.

We expect reduced competition amongst institutional and bank debt providers to result in lower leverage ratios and higher risk-adjusted returns given an inherent scarcity premium and the still uncertain macroeconomic environment. However, we are convinced that corporate fundamentals remain sound. Nonetheless, remaining selective is vital and thorough due diligence skills as well as in-depth insights at sector and company levels are key to benefit from these opportunities. In particular, we expect dedicated private debt funds will profit from higher relative spreads, lower risk, the strong position in the capital structure and in particular from their superior sourcing capabilities.

### THE SUPPLY SIDE

#### Further de-leveraging in the leveraged finance world ahead

##### *Leveraged buyouts and the rise and fall of European CLOs*

In the boom years 2006/2007, leveraged buyout activity benefited from an abundance of cheap debt at inflated leverage levels. In the US for instance, where a functioning leveraged loan market has existed for several decades, leveraged loan volumes reached nearly the same level as seen in the high yield market.<sup>1</sup> In Europe, CLOs absorbed roughly half of the USD 100 billion of leveraged loans issued in 2006.<sup>2</sup>

Since the financial crisis, however, demand for CLOs has been diminishing. In Europe, the issuance of new CLOs remains at very low levels today. For instance, 2009 to 2011 saw less than EUR 3 billion new European CLO volume issued<sup>3</sup>. At the same time, the reinvestment periods of existing CLOs are increasingly set to expire in the quarters and years to come (see chart on the next page). S&P LCD estimates that, based on the expiration profile of existing CLOs' reinvestment periods, in Europe alone there is expected to be approximately EUR 46 billion (or 80%) less debt capacity available by 2014.<sup>4</sup> This shortfall should create attractive opportunities for credit funds and other providers of private debt.

<sup>1</sup> BNY Mellon Asset Management, June 2010

<sup>2</sup> S&P LCD, Q4 2011

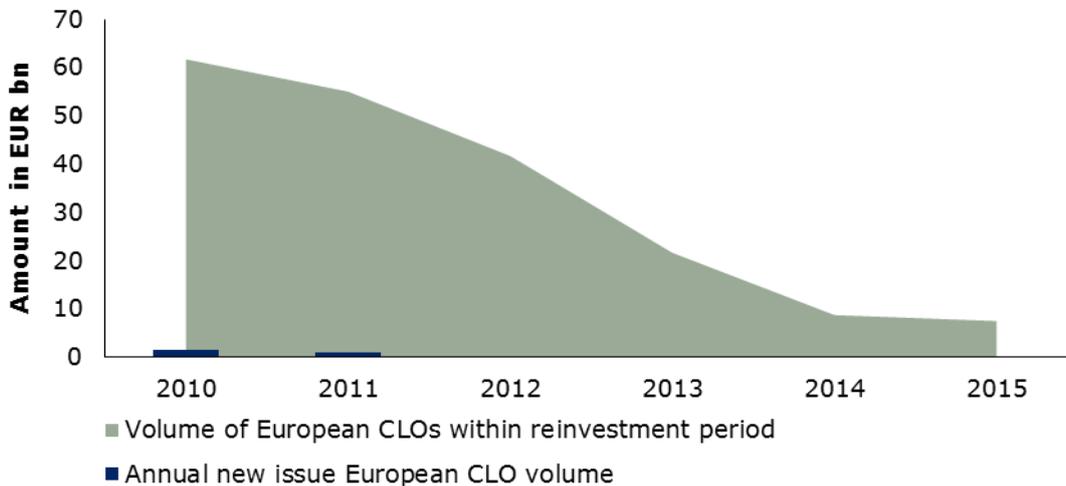
<sup>3</sup> Standard & Poor's LCD Global Leveraged Lending Report Q4 2011

<sup>4</sup> S&P LCD European Weekly Topical (22 October 2010); S&P LCD Global Leveraged Loan Review Q4 2011



## The debt hangover and its impact on debt markets

### Exhibit 1: Supply from European CLOs will dwindle



Source: S&P LCD Global Leveraged Loan Review, Q4 2011, and JP Morgan Structured Finance Research, 2011

#### *Opportunities appearing in the US middle market*

Consistent with the trends seen in Europe, the providers of senior debt in the US market, primarily the money center banks and CLOs have become more constrained, thus impacting the overall supply of debt. The banks have become more risk averse due to the regulatory environment and increased capital ratio requirements. CLOs, which prefer larger, liquid senior loans, face expirations of their reinvestment periods, while the overall number of newly issued CLO vehicles has only begun to rebound in the US. This dynamic has created opportunities for private debt providers in the US to address the growing need for capital to help fund new LBO activity, growth financing and the refinancing of existing capital structures. We see the greatest such opportunities in the US middle market segment which does not compete directly with high yield.

#### **De-leveraging in the banking sector**

At the same time as funding from CLO vehicles is becoming scarcer, banks are in the midst of the deleveraging process, especially in Europe where the main bulk of bank deleveraging still looms ahead. While leverage in the US banking sector had fallen to 13x by mid-2011, the European average stood north of 25x<sup>5</sup>. Also, European banks are vulnerable to funding pressures, facing huge refinancing requirements for an estimated EUR 1.7 trillion of maturing debt between 2012 and 2014<sup>6</sup>, exacerbated by the sharp drop in USD-funding via the commercial paper market and Solvency II restrictions for insurance companies that get penalized for investing in long-dated bank bonds. While the European Central Bank's (ECB) recent low-interest rate, three-year liquidity provision (the so-called LTRO) has addressed the immediate liquidity needs of European banks, banks nonetheless will have to refinance this cheap source of funding in three years' time in the capital market, most likely at much tighter terms.

<sup>5</sup> Phoenix Capital Research, 09 December 2011; based on calculations by the IMF. Leverage is defined as tangible assets to tangible common equity for domestic banks

<sup>6</sup> Morgan Stanley, European Banks 2012 Outlook – Deleveraging remains the key theme, 06 December 2011

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While a large amount of this additional ECB liquidity is being used to refinance maturing debt, a significant portion has been flowing into government bonds, further increasing banks' exposure to sovereigns and potential mark-to-market losses on these holdings. As a result, ongoing concerns about sovereign exposure and bank downgrades are pushing up the cost of capital and forcing banks to increase collateral. This, coupled with increased regulation (9% Tier 1 capital ratio requirement by June 2012, Basel III and Solvency II), leads us to conclude that the question is not if, but by how much European banks will delever. Despite the recent liquidity provision by the ECB, Morgan Stanley expects European banks will shrink their balance sheet by EUR 1.5-2.5 trillion over the next 18 months<sup>7</sup>. A large proportion of this can be attributed to restricted lending activity, including lending for leveraged buyouts, and lending to other asset classes, such as long-term and relatively illiquid infrastructure projects and real estate. For instance, in H2 2011, a French bank had to withdraw an offer of financing to a US renewable energy biomass infrastructure project which eventually received financing from a mezzanine investor.

Morgan Stanley expects European banks to focus de-leveraging on the following areas:

### Exhibit 2: Likely areas of European bank deleveraging

Categories	Non-performing loans/Distressed	Performing loans and high grade securities	Run-offs	Non-core divisions
<b>Assets in focus include</b>	<ul style="list-style-type: none"> <li>■ Securitized assets (heavily downgraded/ impaired)</li> <li>■ Synthetic collateralized debt obligations</li> <li>■ Other</li> </ul>	<ul style="list-style-type: none"> <li>■ International syndicated loans</li> <li>■ Infrastructure/ Project finance loans</li> <li>■ Leveraged, SME, real estate loans</li> <li>■ Other</li> </ul>	<ul style="list-style-type: none"> <li>■ Syndicated lending</li> <li>■ Trade finance</li> <li>■ Working capital for SMEs</li> <li>■ Other</li> </ul>	<ul style="list-style-type: none"> <li>■ Other</li> </ul>
<b>Estimated amounts</b>	EUR 50-100bn	EUR 500-1'000bn	EUR 500-1'000bn	EUR 100-700bn

Source: Morgan Stanley, LTROs underestimated, but Great Deleveraging ongoing, February 2012

Amidst bank deleveraging, companies in many parts of Europe find it increasingly difficult to get bank financing, and the bank loans that are available come with more restrictive terms. The ECB's lending survey shows that European banks are increasingly tightening their lending standards. Additionally, the largest monthly drop in loan growth, since records began in 1991, experienced in December 2011 has further increased concerns that credit conditions are deteriorating and declining lending activity will impact economic activity.<sup>8</sup>

Within the last ten years, bank's share of the primary loan market has decreased substantially from 57% to 16% in the US and from 78% to 54% in Europe.<sup>9</sup> Given the new challenges listed above, we expect the reduction of credit supply from this investor base may become even more pronounced.

<sup>7</sup> Morgan Stanley, LTROs underestimated, but Great Deleveraging ongoing, February 2012

<sup>8</sup> Bloomberg, January 2012

<sup>9</sup> S&P LCD European Weekly Topical as of 22 October 2010; S&P LCD Global Leveraged Loan Review Q3 2011

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The following chart depicts how bank lending activity has been scaled back by European banks in Q4 2011 on a quarter-over-quarter basis, reflecting in particular the negative impact on loan growth in the leveraged loan space and infrastructure project finance.

### Exhibit 3: European banks have scaled back lending in H2 2011

#### Changes in new lending by type of lender and loan<sup>1</sup>

Loan type	Change in new lending between Q3 2011 and Q4 2011, by type of lender; in %		
	Weaker EU banks <sup>2</sup>	Other EU lenders	All lenders worldwide
All loans	-14.6	-6.0	0.4
Dollar-denominated	-16.2	2.4	4.4
Leveraged <sup>3</sup>	-43.0	-43.4	-18.3
Project finance	-39.0	-21.4	-7.0
Trade finance	-23.5	-9.8	-4.6
Aircraft/ship leasing	-40.5	-12.9	7.3

Color coding: [**<-30**] [-30 to -15] [-15 to 0]

<sup>1</sup> Lending measured as newly signed syndicated and larger bilateral loans by consolidated organizational groups, excluding any loans subsequently cancelled or withdrawn. Where the relative contributions to syndicated loans were not reported, these were assumed to be distributed evenly between participants.

<sup>2</sup> The 31 banking groups with EBA capital shortfalls, plus all Greek banking groups.

<sup>3</sup> Loans rated below investment grade, plus some non-rated loans depending on pricing and characteristics. All loans for leveraged buyouts included. All loans for asset financing excluded.

Source: Bank for International Settlements, Quarterly Review, March 2012

## THE DEMAND SIDE

### Still sustained demand for debt

#### *Resilient buyout activity ahead*

On the demand side, we expect to see continued investment activity and demand for LBO debt as a result of the record fundraising activity prior to the credit crisis. The current "dry powder" of roughly USD 400 billion in private equity funds is expected to lead to potential demand for debt financing of nearly USD 500 billion, assuming a market standard equity contribution of approximately 45%.<sup>10</sup> This is further supported by corporate M&A activities seeking inorganic growth in an environment of low economic expansion.

<sup>10</sup>Preqin, 24 January 2012; includes Buyout and Growth and Partners Group

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### *The looming maturity wall*

As another prominent driver for strong loan demand, European corporates will be forced to find refinancing solutions for EUR 63.4 billion of loans due to mature between 2012 and 2015. Including the US this number approaches EUR 500 billion over the next seven years<sup>11</sup>, although we expect a large share of US demand to be filled by the much more liquid bond markets. Typically, refinancings are carried out during the 12-18 months prior to maturity. This expected replacement of maturing facilities is expected to create substantial demand for private debt financing in the near future.

### **De-leveraging and refinancing of sovereigns**

On top of private sector deleveraging, private debt investors will also be presented with attractive investment opportunities from the public side. Due to stretched government balance sheets and still historically high fiscal deficits, governments will be looking to sell existing infrastructure and real estate assets to shore up fiscal finances. In addition, we expect that in particular, a large share of infrastructure projects in the advanced world will be financed by private sources of capital going forward.

Governments will have to cut spending and reduce deficits before markets force corrective measures. And timing is vital: Bloomberg estimates that governments of the world's leading economies have more than USD 7.6 trillion of debt maturing in 2012, with most facing rising borrowing costs. We believe that excessive indebtedness will be ultimately addressed through a combination of measures including 1) growing out of debt (not sufficient in many cases); 2) reducing balance sheets (fiscal austerity and de-leveraging via asset sales as mentioned above); and 3) inflating away the real debt burden, a topic we have discussed in greater detail in past editions of our Private Markets Navigators and which would increase the attractiveness of floating-rate debt as opposed to fixed-rate investments.

## **CURING THE DEBT ADDICTION: WHO WILL COME TO THE RESCUE?**

### **Curing the leveraged finance addictions**

Memories in the financial sector are often said to be short, but the hangover from the debt binge of the 2005-2007 period will remain for some time as investors, lenders and other financial institutions grapple with the aftermath. And the hangover in Europe is particularly pronounced, for the reasons cited above. Below we touch on possible new sources of capital to address the funding shortfall, with a focus on Europe.

#### *Is high yield really an alternative?*

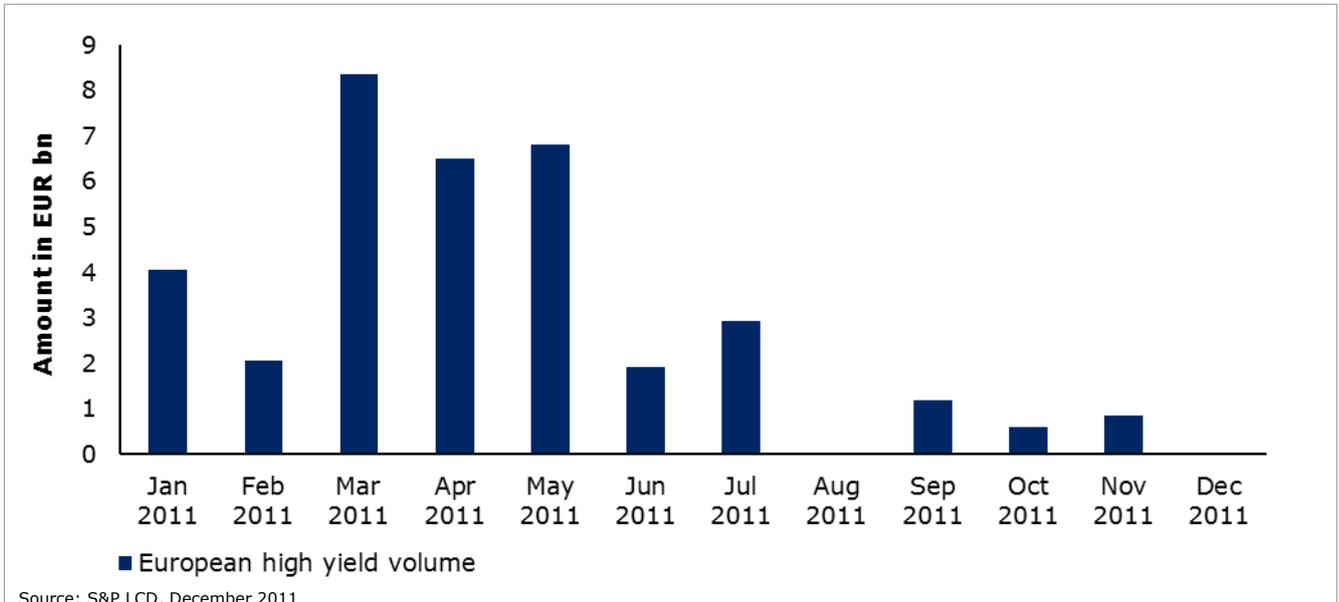
In the first half of 2011, there were signs in the leveraged finance market that the European high yield market would "ride in and come to the rescue", especially for large-cap corporates with looming maturities. But the second half of 2011 showed how notoriously sensitive the high yield market is to the macro environment as new issue high yield volumes nearly disappeared in Europe. Nonetheless, high yield is expected to play a prominent role in the LBO financing over the coming years, particularly with regards to refinancing (rather than new LBO situations). However, the volatility and availability of high yield will create challenges for many companies in need of capital. This was evidenced clearly in the Securitas Direct deal which was structured with high yield at the peak of the liquidity in June 2011 but, as high yield demand receded, it presented an opportunity for a mezzanine facility to be structured in its place (this was the largest mezzanine facility in Europe in 2011 and a deal where Partners Group acted as

<sup>11</sup>S&P LCD, Q4 2011

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an arranger). As a result, the high yield market has been seen to have its limitations in funding this upcoming financing gap.

### Exhibit 4: European high yield volumes all but disappeared in H2 2011



#### *Private capital expected to be more likely to fill the gap*

One of the likely new sources of capital going forward will be the large institutional investors (pension funds, insurance companies, corporates, etc.) which look to initiate or expand their exposure to the asset classes. We think their historically low allocations could increase over time as the risk/return profile of senior secured and mezzanine loans in the leveraged loan space become increasingly obvious, researched and documented. Further, with record low central bank target rates, there is the prospect for lower expected annualized equity returns compared to the 1980-2007 period. Additionally, with the turbulence in the sovereign debt markets and the uncertainty associated with inflationary pressures, pension fund managers looking for a safe haven for their clients' capital will find the returns offered by senior secured debt - typically at Euribor/Libor+4.5-6.0% in Europe and at Libor+5.0-6.5% in the US - and by mezzanine - at 12-14% for Europe and 13-14% in the US - attractive in consideration of their risk profile. Over the last 20 years, leveraged senior loans have posted a principal loss of an average of 1.7%<sup>12</sup>, whilst Partners Group's lifetime capital loss rate has averaged 1.2% p.a.<sup>13</sup> In this context, while some pension managers may choose to access the market directly, we anticipate that many large institutional investors may prefer to leverage the credit capabilities and expertise of existing private debt managers.

A small number of listed senior debt funds have launched in Europe (including Neuberger Berman, among others) and other managers are understood to be exploring similar opportunities. However, the amount raised by listed vehicles over the last 24 months is less

<sup>12</sup>Moody's Investor Services, February 2011

<sup>13</sup>Figures & FX rates as of 31.12.2011; for Partners Group investments only; across over 170 credits; includes senior secured debt and mezzanine. The lifetime capital loss rate is defined as the default rate multiplied by one minus the lifetime preservation rate. The default rate for an investment year is the principal of defaulted loans as a percentage of the average principal outstanding during the year. The lifetime preservation rate for an investment year is the total value (realized and unrealized) of defaulted loans as a percentage of the principal of defaulted loans.

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than ~EUR 1.2 billion<sup>14</sup>, a tiny fraction representing less than ~0.5% of the prevalent supply/demand imbalance relating to the looming wall of maturity, the low issuance of new CLOs, the looming expiration periods of existing CLOs as well as demand from private equity dry powder.

### SO WHERE ARE THE OPPORTUNITIES?

For the investor with capital and sourcing capabilities, there are significant opportunities across many different areas of the debt markets, with perhaps the most transparent of those seen in the leveraged loan market in Europe where we expect the opportunities to increase as maturity walls approach.

#### The leveraged loan market

##### *Attractive risk profile of senior secured debt*

In an environment of low growth, low or even negative real-yields and high volatility in the equity markets, senior secured loans provide a current income with inherent moderate-to-low risk features, most notably:

- Most senior part in capital structure & collateralized: low default probability and high recovery rate in such scenarios;
- Covenants allow lenders to step in before a default occurs. If in breach, lender rights are strong, which contrasts specifically high yield where investors do not typically benefit from such protections;
- High equity cushion, which has risen from ~33% of the capital structure in 2005-2007 to nearly 45% today;<sup>15</sup>
- Concentrated and well-“organized” debt holder community facilitates restructuring issues; and
- Superior private information allowing for detailed diligence to be undertaken.

##### *Attractive return outlook*

Today, newly issued senior secured debt in Europe (typically with opening senior leverage at or below ~4x and total leverage at or below ~4.4x<sup>16</sup>) will offer current yields of Euribor/Libor +4.5-6.0%. Senior loans in the US middle market typically contain LIBOR floors and spreads over LIBOR of 5.0-6.5%. Furthermore, consistent with capital structures seen in Europe, leverage levels have come down materially in the US since the boom years of 2005-2007, with loans on new issue deals benefiting from substantial equity cushions and covenants. In short, despite lower leverage levels, lenders today benefit from higher spreads.

At the beginning of 2011, we saw relatively high senior debt margins of around E+500bps in several transactions in the market (e.g. IMCD, Takko, Capio Sanidad and GEO), whereas borrowers tested the market with lower margins in mid-2011 at around E+425-450bps (e.g. R Cable, Dorna and Emitel). Towards the end of the year, however, margins again increased to highs of E+525-550bps (e.g. Genesys, with a 1.5% Libor floor).

At the beginning of 2012, transactions have spreads of at least Euribor+500bps and Original Issue Discounts (OID) have been introduced. Examples are patent and intellectual property management group CPA Global with a spread of Euribor+537bps and a 98.5% OID, Dutch

<sup>14</sup>“Investment Companies”, Numis, March 2012; Partners Group information

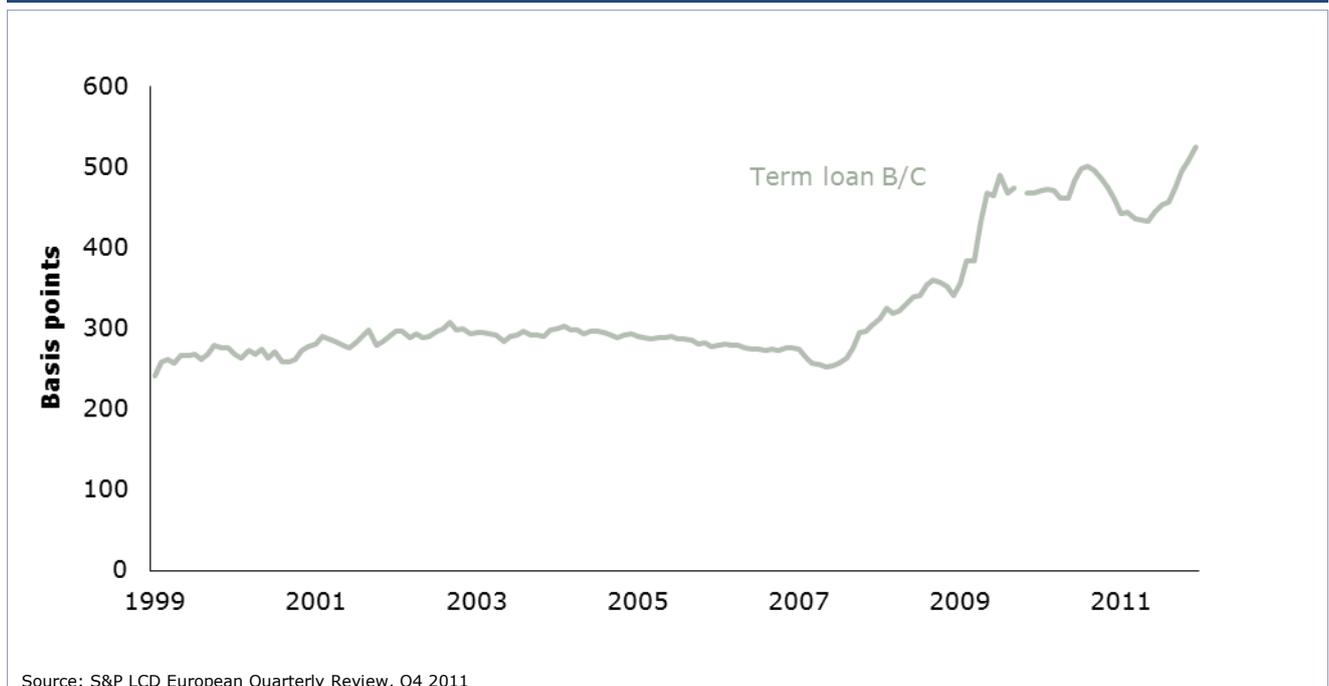
<sup>15</sup>S&P, LCD Leveraged Loan Review Global, December 2011; Partners Group information

<sup>16</sup>S&P, LCD European Quarterly, December 2011; Partners Group information

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chemicals business Taminco with a spread of Euribor+500bps and a 98.0% offer price and Scandinavian construction products distributor Ahlsell which was priced at Euribor+550bps and offered at 98.0%.<sup>17</sup>

**Exhibit 5: Weighted average rolling 3m senior (term loan B/C) spread in Europe**



### *Floating rates provide low sensitivity to changes in interest rates and inflation protection*

Senior loans to borrowers usually pay a floating rate of interest and therefore are typically described as a low duration asset class, that is to say that the secondary prices for such loans have a relatively low sensitivity to changes in interest rates. From an investors' perspective, the floating rate element of senior secured loans provides a form of inflation protection. Although not a pressing concern on the minds of investors at the moment, we see the possibility of an increase in base rates over the medium term coupled with a sharp steepening of swap curves, as inflation concerns mount. Whilst high yield bonds, which have fixed rate coupons, offer no protection against rising interest rates, senior secured loans offers protection and, even, a possible upside. Based on the JP Morgan Aggregate Global Bond Index, the price of fixed rate bonds falls on average by ~5.9% (modified duration) when interest rates increase by 1.0%.<sup>18</sup>

### *Attractive secondary pricing*

For the astute investor in secured debt, the attractive opportunities may not just be found in newly issued credits. Although the secondary loan markets have recovered into early 2012, history shows that opportunities to acquire debt at a discount in the secondary market may arise in the event of another macro shock and/or recessionary concerns. In 2009, the secondary loan market in Europe reached a trough at price levels between 60 and 65. We do not see a drop to these distressed levels as likely, but could imagine scenarios of macro-economic uncertainty leading to strong credits being bought and sold in the secondary markets at meaningful discounts to par.

<sup>17</sup>Source for all loans quoted is S&P, LCD Leveraged Loan European Weekly Commentary, March 2012

<sup>18</sup>Bloomberg, 2 November 2011

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### *Extensive networks and strong sourcing capabilities drive consistent deal flow*

Private debt markets can take advantage of the significant pick-up in secondary deal flow from European financial institutions in the private equity, real estate and infrastructure sectors. For instance, in late 2011, Partners Group acquired a quality portfolio of private equity and infrastructure assets at a 20% discount to NAV from a European bank that sought to scale down its balance sheet in order to meet new regulations.

Furthermore, the debt managers with close relationships with the financial sponsors will be better positioned in the primary market. This is particularly the case for mezzanine investors where banks are not involved in arranging mezzanine and sponsors drive this form of financing. Partners Group, with its strong network of advisory board seats and deep relationships with sponsors across the globe, is well positioned to benefit from this dynamic.

### *Private capital advantages*

Studies have shown that higher returns and lower volatility of secondary market prices for senior loans have historically combined to deliver attractive risk/return characteristics when compared with other competing asset classes. Compared to high yield, Partners Group believes that leveraged loans benefit from a number of features associated with stronger protection/protective characteristics, notably:

- Strong covenants in leveraged loans;
- Generally higher level of dispersion in the typical high yield syndicate (which prevents high yield investors from coordinating effectively in the event of a restructuring); and
- More limited information flow associated with high yield.

In Europe, the high yield market is relatively young and we have not seen how this market would react under severe stress. Anecdotal evidence would appear to point to lower recovery rates in Europe as compared to those in the US. Furthermore, lower liquidity levels and a smaller universe of potential debt buyers in Europe suggests that debt pricing would be more sensitive in a credit default scenario. Certainly, the data that is available indicates that loss rates are higher and recovery rates lower in the high yield market compared to leveraged loans. Fitch data shows that, over the last ten years, leveraged senior loans have preserved an average of 98% of principal while high-yield bonds have preserved only 96%.<sup>19</sup> Partners Group lifetime loss rate in its portfolio is 1.2% which compares favorably.<sup>20</sup>

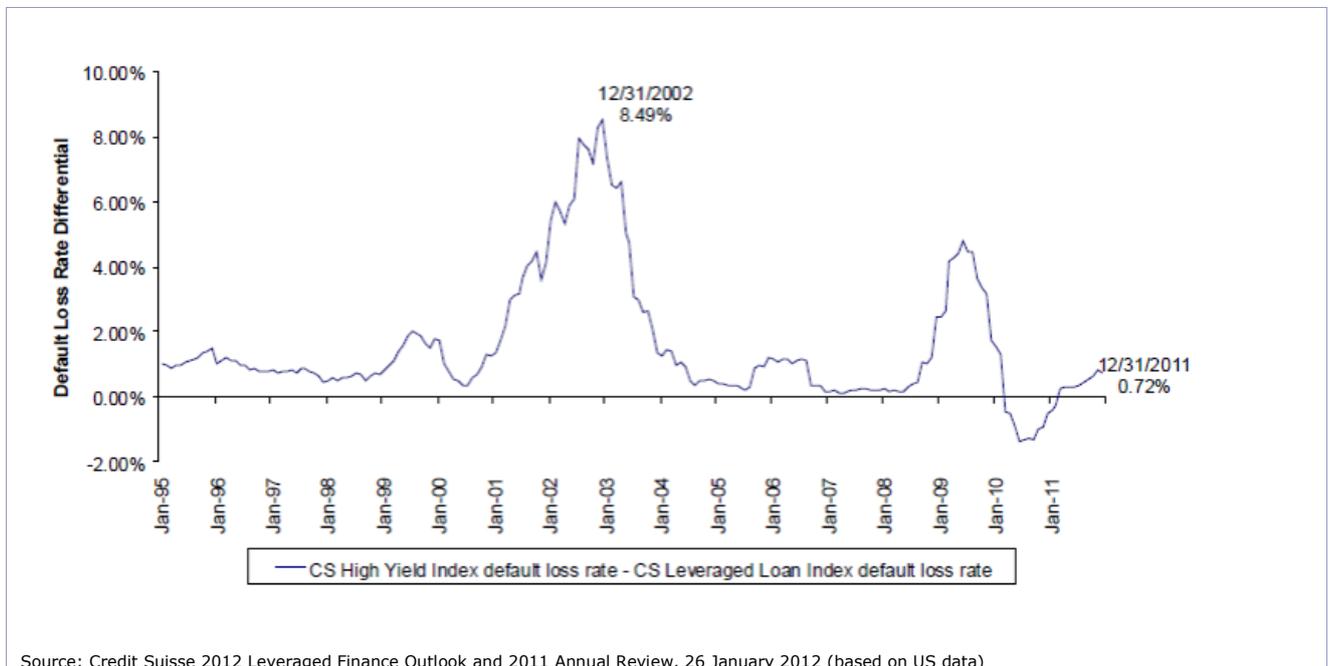
The chart below shows the loss rate of the high yield index less the loss rate of leveraged loans. Over time, the loss rate of the high yield index has been consistently higher than the loss rate of the leveraged loan index.

<sup>19</sup>Moody's Investors Service (February 2011), Fitch (March 2011)

<sup>20</sup>Figures & FX rates as of 31.12.2011; for Partners Group investments only; across over 170 credits; includes senior secured debt and mezzanine. The lifetime capital loss rate is defined as the default rate multiplied by one minus the lifetime preservation rate. The default rate for an investment year is the principal of defaulted loans as a percentage of the average principal outstanding during the year. The lifetime preservation rate for an investment year is the total value (realized and unrealized) of defaulted loans as a percentage of the principal of defaulted loans.

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**Exhibit 6: Difference between High Yield Default Loss Rate and Leveraged Loan Default Loss Rate: 1995 - 2011**



### CONCLUSION

The private debt market, specifically the senior secured loan and mezzanine market, will exhibit a supply/demand imbalance over the coming years. This dynamic will offer well-capitalized investors opportunities to achieve attractive risk-adjusted returns.

We expect the supply/demand imbalance to be particularly pronounced in Europe, as funding from CLO vehicles becomes scarcer and banks find themselves in the midst of the deleveraging process. As the continued investment activity should result in a sustained demand for LBO debt, a likely new source of capital will be the large institutional investors such as pension funds, insurance companies and corporates which are expected to initiate or expand their exposure to the asset class. With the turbulence in the sovereign debt markets and the uncertainty associated with inflationary pressures, pension fund managers looking for a safe haven for their clients' capital will find the returns offered by senior secured debt - typically at Euribor/Libor+4.5-6.0% in Europe and at Libor+5.0-6.5% in the US - and by mezzanine - at 12-14% for Europe and 13-14% in the US - attractive relative to their risk profiles.

While some pension managers may choose to access the market directly, we anticipate that many large institutional investors may prefer to leverage the credit capabilities and expertise of existing private debt managers. We anticipate a key differentiator is likely to be an extensive industry network and close relationships with financial sponsors.

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