Partners Group
REALIZING POTENTIAL IN PRIVATE MARKETS

Q2 2021 | Issue 8

Quarterly Loan Market Commentary

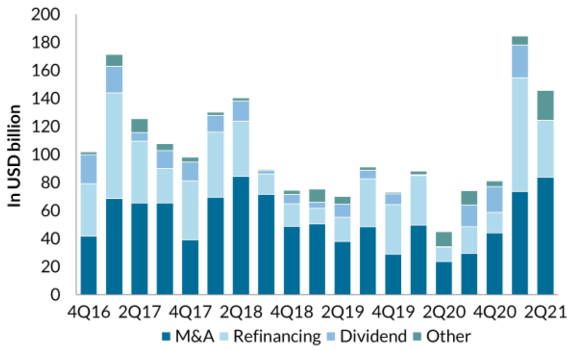
US loan market overview

Following record loan market activity in the first quarter of 2021, it was not surprising that Q2 activity could not keep pace. While the third strongest quarter in the past five years, new loan issuance volume in Q2 still fell 20% short of Q1. Nonetheless, the US post-COVID "re-opening trade" remained center stage for institutional investors, boosting appetite for both new-issue and secondary-traded loans across all sectors. As a result, new US CLO issuance in Q2 totaled USD 39 billion, matching Q1 levels. At the same time, expectations of higher inflation following a year of active monetary easing and stimulus also attracted new retail investor money into floating-rate loans, resulting in USD 13 billion of Q2 net inflows into loan mutual funds and ETFs. Much like in recent years, in response to robust loan investor demand, M&A volumes in Q2 jumped to near-record levels, led by buyouts, and corporate and PE-backed acquisitions. In the secondary market, loans also continued their year-long rally during Q2, pushing market bids to new highs. Repeating a familiar theme of the last three quarters, the US loan market was open for business and investors had shaken off most COVID-related concerns.

US new institutional loan volume

At the risk of repeating an all-too-familiar storyline, Q2 was another "risk-on" quarter for the US institutional loan market. Q2 loan issuance reached USD 145.8 billion, a strong posting despite being 20% below the record of USD 184.5 billion established in Q1. Leading the way in Q2 were buyouts, which contributed USD 83.9 billion, the largest tally seen since Q2 2018. Half of this amount came from LBOs, while corporate M&A and non-LBO PE activity made up the other half. Loan refinancing volumes (excluding repricings) in Q2 were also strong at USD 40.4 billion, albeit down 50% from the record USD 81 billion posted in the first quarter. Meanwhile, loan repricings totaled USD 39 billion in Q2, exceptional levels that were still far below the record USD 148 billion of repricings from Q1. The last sign of the frenetic "risk-on" investor sentiment came from the high volume of B-minus rated new loan issues in Q2, which accounted for a record 43% of all new issues (37% in Q1), taking advantage of insatiable investor demand and the growing acceptance of highly leveraged loan structures.

US new-issue institutional loan volume



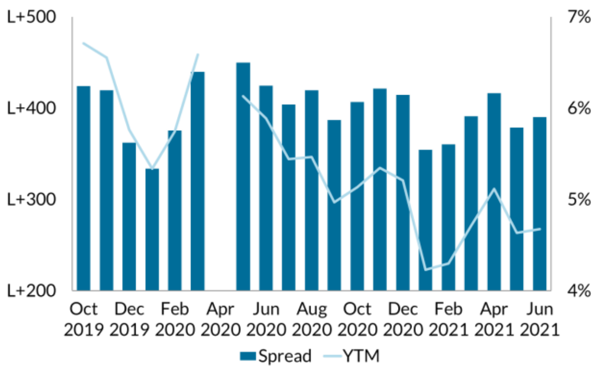
Source: S&P LCD, June 2021. For illustrative purposes only.

US new-issue loan spreads

Despite the lower volume of new issue during Q2, spreads for both B-minus and B-flat rated new loans widened throughout the quarter, as the market was asked to absorb a growing calendar of B-minus rated loans to finance the heavy flow of LBO and opportunistic dividend activity. B-rated loans (43% of all new issue) saw spreads widen out to 420bps in Q2, versus 375bps in Q1, while B-flat rated loan spreads widened out to 438bps, versus 427bps in

Q1. This loan spread widening also dampened refinancing and repricing opportunities for most of Q2.

US average new-issue loan spread and yield

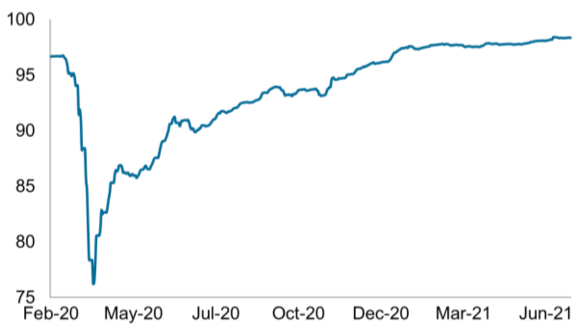


Source: S&P LCD, June 2021. For illustrative purposes only.

US loan bids

With strong new CLO formation and heavy retail fund inflows, loan secondary trading prices in the US market continued an upward trajectory towards Par during the second quarter. Starting on 1 April at 97.55%, the US Leveraged Loan Index ("LLI") rose steadily month by month, reaching a 98.36% average bid price by 30 June, notably higher than where the LLI traded in the months before COVID. This secondary rally was broadly felt across all sectors and rating categories, as investors bid up everything, including stressed and CCC-rated issues, in fear of missing out later.

US loan index average bid (LLI)



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

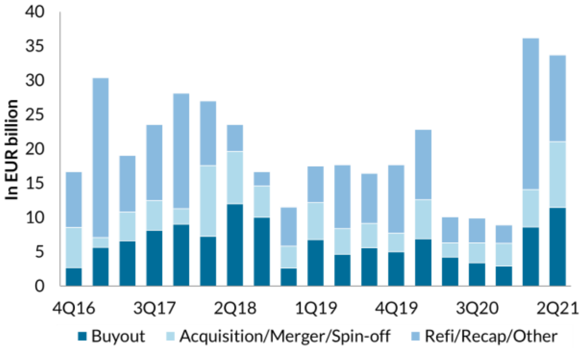
European loan market overview

Despite a slightly slower economic recovery in Europe, investor appetite for leveraged credit (loans and bonds) remained quite robust in Q2. Another solid quarter of new CLO issuance, coupled with other multi-strategy investors returning to the loan market, were the primary drivers. Loan issuers happily responded to the demand with another heavy quarter of new-issue activity. Drawing upon vast stockpiles of dry powder, private equity firms led the charge launching numerous buyouts, tapping both the loan and bond markets at levels not seen since before the Global Financial Crisis. The combined Q1 and Q2 2021 loan issuance of EUR 81 billion easily topped loan issuance totals for 2020 and was the strongest first half of Euro loan issuance since 2007. The vibrancy of the Euro loan market was also evidenced by rising secondary loan prices, with the European Leveraged Loan Index ("ELLI") posting trading highs not seen since 2018.

European new institutional loan volume

Institutional loan issuance in Europe for Q2 continued at a formidable pace, tallying EUR 33.7 billion, not far from the EUR 36.1 billion hit in Q1. This issuance could have been even stronger, if not for the slight market reprieve during the April Easter holiday week. More importantly, 62% of new loan issuance volume in Q2 comprised "new money" transactions accretive to the market, led by buyouts and M&A activity. Loan refinancing and repricing activity consequently declined in Q2, contributing just 38% to total loan volumes, resulting in a small surplus of loans. This helped bring the market down to a "simmer" from a "full boil" in Q1.

European new-issue institutional loan volume

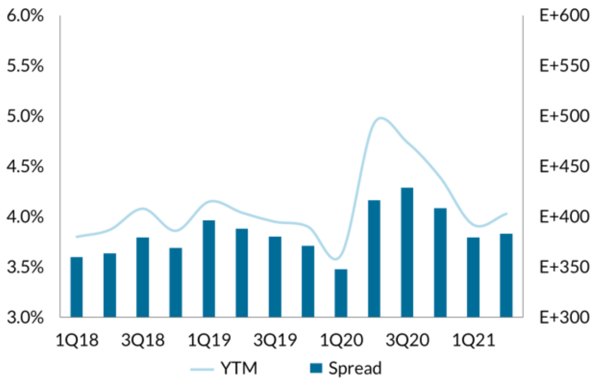


Source: S&P LCD, June 2021. For illustrative purposes only.

European new-issue loan spreads

Following the minor shift in supply-demand dynamics in Q2, new-issue loan spreads reversed course from the tightening of the past two quarters. Average B-rated new-issue loan spreads widened to E + 384bps, compared to E + 380bps in Q1. But somewhat hidden in these numbers is the steady climb in spreads from E + 375bps at the start of April to E + 398bps by the end of June. In addition to the growing net loan supply, higher CLO liability spreads played a large factor in wider new-issue loan spreads. CLO managers became increasingly sensitive to the gap between leveraged loan and CLO liability spreads needed to make the CLO "arbitrage" work. For buyout and M&A activity to continue to grow further in Q3, new- issue loan spreads may need to widen further to clear the market.

European loan spreads

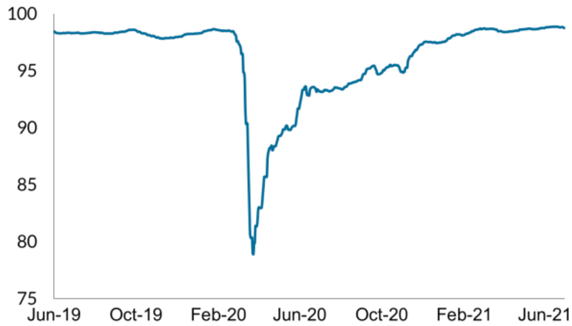


Source: S&P LCD, June 2021. For illustrative purposes only.

European loan bids

After several quarters of loan prices being in full rally mode from the COVID lows in March 2020, European secondary loan prices became range-bound in Q2. Beginning in April at 98.41%, the European Leverage Loan Index ("ELLI") gradually rose to 98.75% by the end of June. Although this may be surprising to some, this tighter price range is more the norm for the market, compared to the wild price movements seen in 2020 due to the pandemic. This welcomed return of price stability (and building towards Par) is another sign of how well the Euro loan market has recovered from the unprecedented COVID crisis.

Euro loan index average bid (ELLI)



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

US collateralized loan obligations

With a steady supply of new loan issuance and attractive and stable CLO liability spreads, Q2 US CLO activity continued at an almost unrelenting pace. During the quarter, 84 new CLOs issued, totaling USD 41.3 billion, as compared to USD 39.3 billion of CLOs issued in Q1. When combining new-issue volume with reset and refinancing activity, Q2 delivered USD 105.4 billion of total CLO activity (comparable to Q1 total CLO activity of USD 110.7 billion). And when compiling all CLO activity (new, reset & refinancing), year-to-date 2021 activity totaled a record-shattering USD 216 billion. Even with these record volumes, market sentiment remains generally bullish, with high expectations for sustained CLO activity throughout the rest of the year.

Despite the heavy amount of issuance year-to-date, CLO liability spreads have remained stable through much of Q2. The market saw AAA-rated liability tranches remain range-bound in the mid-to-high teens (Q2 average AAAs were L + 116bps), but a slight widening across lower-rated CLO liabilities had developed by June. Nonetheless, CLO weighted average cost of capital ("WACC") for Q2 averaged L + 167bps, just a few ticks higher than the average CLO WACC for Q1 of L + 163bps. Stable CLO liability spread levels, combined with a growing new-issue loan supply and wider loan spreads, explain how the CLO market was able to remain so incredibly active in Q2, and will be the key factors shaping CLO volumes during the second half of 2021.

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**
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
2Q21 (L+)	116	171	208	318	654	167
Change from 1Q21	**0**	**15**	**10**	**4**	**7**	**4**
Change from a year ago	**-77**	**-95**	**-130**	**-145**	**-36**	**-74**

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

European collateralized loan obligations

Perhaps to no one's surprise, activity in the European CLO market continued to be equally robust during Q2. Strong new-issue loan volumes pushed loan spreads wider, and steady investor appetite for new-issue CLO liabilities were once again positive catalysts for the market. The second quarter saw 17 new CLOs issue for a total of EUR 6.9 billion, compared to the record 20 new CLOs for EUR 7.8 billion issued in Q1. When combining new CLO issuance with reset and refinancing activity, total Euro CLO activity in Q2 was EUR 25.7 billion, totals not far from the record of EUR 27.4 billion achieved in Q1.

While still relatively attractive to CLO issuers, Euro CLO AAA liability spreads widened throughout Q2. Beginning the quarter at E + 80bps and ending the quarter at E + 94bps, new-issue AAAs priced at an average spread of E + 86bps during the quarter. The widening in AAA spreads was likely due to a combination of factors: manager tiering; reduced value of the Euribor floor; oversupply of AAA paper; and reduced appetite from certain core investors during Q2. The direction of CLO liability spreads on the other tranches of the capital stack, however, was more mixed during the second quarter. AA-, BB- and B-rated liability spreads widened, while A- and BBB-rated liability spreads tightened. The resulting impact of this was a slight widening of the average WACC to E + 172bps for Q2, compared to E + 167bps for Q1. The CLO market could remain constructive throughout the second half of the year. However, given the volume of CLO issuance already absorbed year-to-date, loan spreads may need to further widen to persuade managers to keep issuing CLOs at wider liability spreads – and wider CLO liability spreads will likely reduce CLO reset and refinancing activity in the near term.

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**
4Q19 (E+)	95	167	248	401	652	188
1Q20 (E+)	95	170	224	349	574	177
2Q20 (E+)	172	253	322	471	688	243
3Q20 (E+)	136	198	286	400	630	217
4Q20 (E+)	110	180	281	411	642	201
1Q21 (E+)	83	136	223	330	584	167
2Q21 (E+)	86	158	210	315	593	172
Change from Q1 21	**4**	**22**	**-13**	**-15**	**9**	**5**
Change from a year ago	**-85**	**-94**	**-113**	**-156**	**-95**	**-71**

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

Spotlight topic: ESG and the loan & CLO markets

While applying environmental, social & governance ("ESG") standards and criteria to credit investment decisions is not a new concept, ESG's popularity and market awareness has increased significantly over the past few years. Today, ESG has become one of the leading topics of discussion across global capital markets. Consequently, loan investors and CLO portfolio managers in Europe and the US are increasingly considering, if not already adopting, ESG principles and criteria to potentially screen out negative ESG loan issuers and sectors from their portfolios. Equally, investors and managers are open to rewarding positive ESG behavior, offering issuers improved debt economics upon meeting pre-established ESG KPIs. While certainly more common in Europe than in the US, a growing number of leveraged loan facilities have included ESG-linked loan margin ratchets, which could lower debt financing costs by 5-10bps per annum, should the ESG KPIs be met or maintained. The early challenge with ESG-linked margin ratchets has been the need to set relevant, meaningful and challenging KPIs that are appropriate for each issuer, are reasonably attainable, and can be independently measured. As market dialog around ESG expands, there are clear indications that investors and managers are prepared to reward positive ESG behavior in their own portfolios, paying a premium to loan issuers and CLO managers who embrace positive ESG behavior. Conversely, debt issuers who continue to demonstrate negative ESG characteristics and behavior, may begin to experience higher financing costs and reduced access to the capital markets over time.

About the author

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