Partners Group
REALIZING POTENTIAL IN PRIVATE MARKETS

Q3 2021 | Issue 9

Quarterly Loan Market Commentary

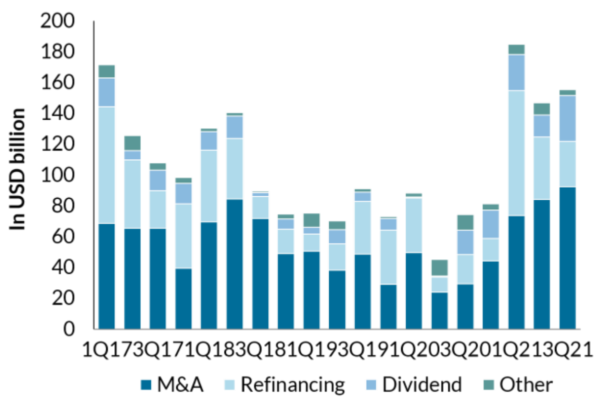
US loan market overview

Records are made to be broken. And in 2021, the US leveraged loan market is poised to shatter all records to date. Institutional loan issuance for the first three quarters of 2021 stood at USD 487 billion, closing in on the full year record of USD 503 billion set in 2017. This extraordinary issuance volume has come from all categories: M&A, dividend recaps, LBOs, and refinancings, with each category closing in on their own record. Led by CLO managers, loan buyers have chosen to look past many uncertainties in the market, including the impact of COVID variants, supply chain bottlenecks, escalating inflationary concerns, potential Fed tapering, the transition from LIBOR to SOFR interest rates, and landmark fiscal policies and spending bills under debate in Congress. The resulting investor demand for loans had US institutional loan outstandings hitting a record USD 1.3 trillion in Q3 2021.

US new-issue loan issuance

New loan issuance in Q3 2021 topped USD 155.3 billion, up 5% from the USD 146.8 billion posted in Q2. Issuance continues to be dominated by single-B rated issuers, a trend seen throughout 2021 attributed to investor appetite for higher yielding loans. Loan issue volumes were primarily driven by a strong pickup in M&A activity (USD 92.4 billion), while refinancing (USD 29.4 billion) and dividend recap (USD 29.6 billion) transactions made up the remainder. Breaking down M&A activity, LBOs totaled USD 44.4 billion, the highest quarterly levels recorded since the Global Financial Crisis, while private equity sponsor-led acquisitions contributed USD 27.6 billion and corporate-led acquisitions added USD 20.3 billion. While standard loan repricing and refinancing transactions slowed notably in Q3, there was a continuation of sponsor-driven dividend loan issuance which often included a repricing or refinancing component. Year-to-date, there have been USD 56.1 billion of sponsored dividend recapitalization transactions completed, underscoring the issuer-friendly market conditions.

US new-issue institutional loan volume

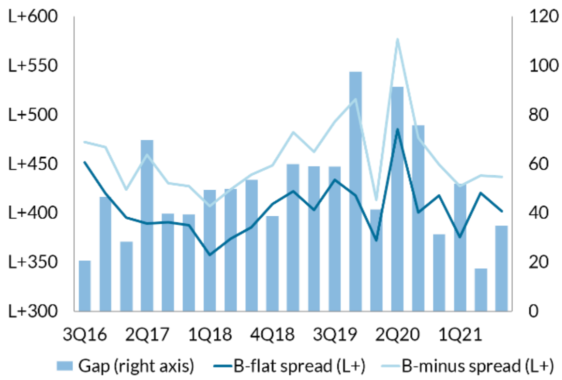


Source: S&P LCD, September 2021. For illustrative purposes only.

US new-issue loan spreads

As investor demand for new issue loans ratcheted higher during the summer, loan spreads in Q3 for B-flat rated issuers tightened from L+420bps to L+402bps, although spreads on B-minus rated loan issuance were unchanged at L+437bps. Despite being hungry for yield, institutional investors selectively channeled buy interest towards higher quality B-rated risk, versus lower single B-rated risk. Both of these senior secured loans however offered attractive risk-adjusted returns when compared to lower-rated new issue high yield bonds (unsecured and subordinated), which tightened to a record low average yield of 5.12% during Q3.

US average new-issue loan spread and yield

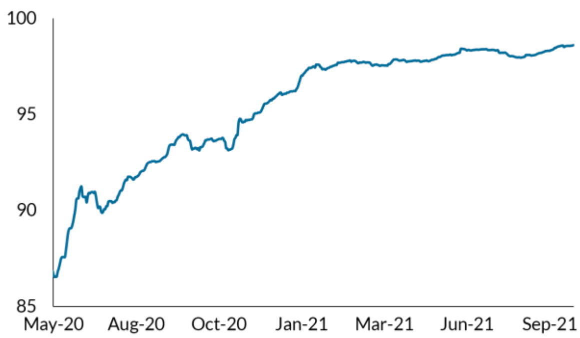


Source: S&P LCD, September 2021. For illustrative purposes only.

US loan secondary trading

Relative stability returned to the US secondary loan trading market in Q3, as investors alternated their focus between a heavy new issue calendar and secondary purchases. The continuing stream of new CLO issuance throughout Q3, combined with a steady inflow of cash into retail funds, created consistent demand pushing secondary trading prices higher. The US Leveraged Loan Index ("LLI") opened Q3 in July at 98.37% and, while range bound, ended September higher at 98.61%. This placed the LLI at the highest level recorded since 2018 and closing in on a five-year high. It was also worth noting that the rally was very broad based, as over 90% of LLI issuers were trading at a price of 98% or higher, the highest percentage recorded in the last seven years.

US loans index average bid (LLI)



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

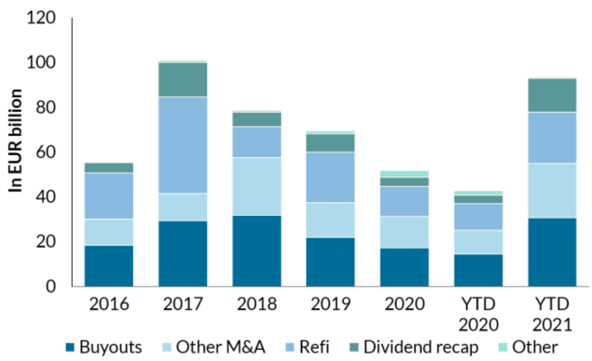
European loan market overview

Following a hectic pace of activity in the first half of 2021, new Euro loan issuance pulled back considerably in Q3. While many attribute the decline in new loan issuance to market participants finally taking long-postponed vacations (post-COVID), others viewed it as just a red-hot issuance market taking a pause to regroup. But with Q3 new CLO issuance hitting record levels, additional CLO warehouses opening, and a healthy new loan issue pipeline slated for Q4, this pause should be short lived.

European new-issue loan issuance

Euro new loan issuance volumes in Q3 fell 40% to EUR 24.8 billion, compared to the EUR 41.3 billion posted in Q2 and EUR 41.2 billion in Q1. However, at EUR 107.3 billion for a combined three quarters of 2021, this exceptionally high loan issuance total is already approaching the full-year record of EUR 120.8 billion set in 2017. The primary difference in loan issuance composition this year has been the larger number of M&A-related transactions. Topping 60% of the total, M&A loans are dominating the 2021 market, compared to just 41% in 2017. Refinancing activity, on the other hand, made up only 24% of new loan activity thus far in 2021, compared to 43% of activity for the same period in 2017. M&A activity overall has been very constructive for the Euro loan market in 2021, introducing many new issuers into the market.

European new-issue institutional loan volume

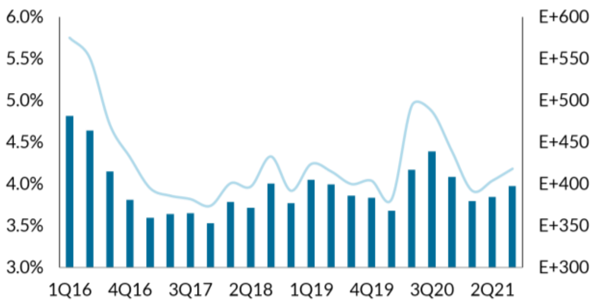


Source: S&P LCD, September 2021. For illustrative purposes only.

European new-issue loan spreads

As buyers became more selective during Q3, loan spreads on Euro new issuance widened to E+398bps, compared to E+385bps in Q2 2021. This widening occurred despite spread tightening on several prominent, oversubscribed loan syndications in September. Also, several M&A transactions with large unfunded tranches resulted in investors demanding higher spreads and ticking fees to secure buy orders. Lastly, as CLOs continued to be the dominant buyer of new-issue loans, CLO managers sought to maintain or improve the differential between new loan spreads and the weighted cost of CLO capital to ensure that the equity arbitrage remained sufficiently attractive to sustain the active CLO issuance cycle.

European loan spreads

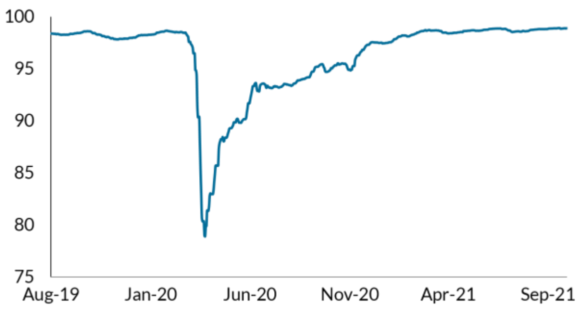


Source: S&P LCD, September 2021. For illustrative purposes only.

European loan secondary trading

With CLO formation and issuance in Q3 driving loan demand, the secondary loan bid in Europe continued to grind higher each week. The European Leveraged Loan Index ("ELLI") ended Q3 at 98.90%, the highest level the ELLI had posted since late 2017, besting 98.75% at the end of Q2, and 98.41% at the end of Q1. The Euro loan market rally from mid-2020 continued unabated.

European loans index average bid (ELLI)



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

US collateralized loan obligations

Like the pace of new loan issuance, US CLO issuance edged higher in Q3 2021, totaling USD 46.6 billion (from 91 CLOs), compared to USD 43.4 billion posted in Q2 and USD 40 billion in Q1. This was the third consecutive record quarter of new CLO issuance. By also adding CLO refinancings (USD 22.4 billion) and CLO resets (USD 31.0 billion) to the new issue levels in Q3, total CLO activity for the quarter topped USD 100 billion. On a year-to-date basis, new CLO issuance through September totaled USD 130 billion (262 CLOs from 109 managers), already breaking the full-year record of USD 129 billion from 2018. The drivers of this unrelenting CLO issuance pace were numerous: the continuing COVID re-opening story; investors seeking floating-rate coupon assets as a rising interest rate hedge; diversified, high-quality asset portfolios with low credit default rates; strong equity returns; and ample new loan issue volumes to fill the growing number of new CLOs. While market conditions remain constructive for continued CLO expansion in Q4, the biggest concern confronting the US CLO market over the near-term is capacity constraints at CLO structuring banks and rating agencies to accommodate the growing flow of CLO activity.

And with supply and demand for new CLO issuance remaining in close equilibrium, CLO liability spreads in Q3 remained in a tight range. AAA rated liability spreads in Q3 were L+118bps, slightly higher than the L+116bps posted in Q2. Similar increases were seen across the remainder of the CLO liability stack (from AA to BB rated tranches), resulting in the weighted average cost of capital for CLOs in Q3 to tick up slightly to L+172bps (compared to L+168bps in Q2). This marginally higher liability cost, when combined with tightening loan spreads and rising secondary loan prices, eroded CLO equity arbitrage, but there still remains enough equity arbitrage to keep the CLO issuance market constructive in Q4.

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
1Q20 (L+)	124	174	234	349	675	182
2Q20 (L+)	193	266	338	463	690	241
3Q20 (L+)	156	213	279	417	757	217
4Q20 (L+)	137	181	250	392	737	193
1Q21 (L+)	115	155	199	313	647	163
2Q21 (L+)	116	171	209	318	654	168
3Q21 (L+)	118	170	214	324	661	172
Change from 2Q21	**2**	**-1**	**5**	**6**	**8**	**4**
Change from a year ago	**-38**	**-43**	**-65**	**-93**	**-96**	**-45**

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

European collateralized loan obligations

The European CLO issuance market continued its robust 2021 pace in Q3, with 25 CLOs issued totaling EUR 10.5 billion in the quarter (the strongest Euro CLO issuance quarter on record), compared to EUR 7.3 billion of CLOs issued in Q2 and EUR 7.8 billion issued in Q1. Year-to-date new CLO issuance totaled EUR 25.7 billion from 63 issues. There is expectation that the full-year 2021 new CLO issuance totals will set a new European record, as Q4 needs only to deliver another EUR 4.2 billion of additional issuance. Although Q3 new Euro CLO issuance was strong, CLO reset and refinancing volumes declined in Q3 compared to the previous two quarters of 2021. Q3 CLO resets contributed just EUR 9 billion (22 CLOs) and CLO refinancings added only EUR 3 billion (9 CLOs) to total CLO activity in Q3.

With an exceptionally large number of new Euro CLOs flooding the market in Q3, CLO liability spreads widened out during the quarter. AAA liability tranche spreads averaged E+99bps in Q3, compared to E+87bps in Q2 and E+83bps in Q1. Other liability tranches rated AA to BB saw spreads widened as well. As a result, new issue CLO weighted average cost of capital in Q3 rose to E+182bps compared to E+172bps in Q2. However, the increase was offset by higher new issue loan spreads, which rose 13bps during the quarter, keeping CLO equity arbitrage attractive.

Euro CLO liabilities spreads

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

Period	AAA	AA	A	BBB	BB	WACC
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+)	87	158	209	314	593	172
3Q21 (E+)	99	169	218	316	607	182
Change from Q2 21	**13**	**12**	**8**	**2**	**14**	**10**
Change from a year ago	**-37**	**-29**	**-68**	**-85**	**-23**	**-35**

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

Spotlight topic: An update on loan defaults amid the pandemic

As we pass the eighteen-month mark of this unprecedented COVID pandemic, it may be instructive to revisit US and European loan default incidence. There were major concerns in the early days and weeks of the pandemic on how leveraged loan issuers would fare in a disruptive environment of collapsing revenue and cash flow, supply chain breakdowns, customer and employee stay-at-home mandates, and dislocated financial markets. From February to August 2020, the lagging twelve-month US and Euro leveraged loan default rates (by issuer) quickly doubled to 4.31% and 3.63%, respectively. But fast forward one year to August 2021 and the lagging twelve-month leveraged loan default rates surprisingly had declined to 0.79% in the US and 2.51% in Europe. The rapid improvement in default rates over the past year has been widely attributed to the flood of liquidity – via public and private channels – provided to many stressed loan issuers to bolster short-term liquidity. This access to liquidity was critical for many companies, while providing a safety net for others. And while the worst of the COVID crisis seems to have passed and conditions are much improved, not all pandemic-related issues have been resolved. There will remain numerous challenges and concerns across many sectors regarding revenue normalization, supply chains, labor shortages, inflation, and the eventual tapering of public relief funding, which could still imperil or delay recoveries for many US and Euro leveraged loan issuers over the next few years.

About the author

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