Partners Group

REALIZING POTENTIAL IN PRIVATE MARKETS

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Quarterly Loan Market Commentary

US loan market overview

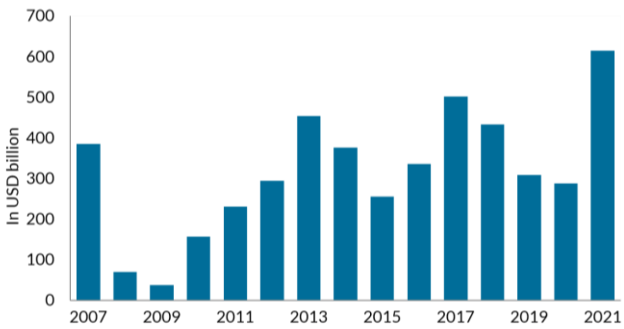
As anticipated, 2021 was indeed a year for the record books for the US leveraged loan market, with new-issue volume topping USD 615 billion, far ahead of the previous annual record of USD 503 billion set in 2017. A desire to make up for lost time from the COVID pandemic, a sea of investable cash (both institutional and retail), and growing expectations of rising interest rates were unstoppable demand catalysts for loans in 2021, a unique combination perhaps unlikely to reoccur. This constant demand from CLOs, mutual funds, and ETFs for new-issue loans (as well as high yield bonds) supported record M&A, sponsor-driven LBOs, dividend recapitalizations, and debt refinancings across all sectors. Issuers and investors alike bet on a robust and lasting recovery from the pandemic. Continual noise around rising inflation, supply bottlenecks, the inevitable Fed taper, the long advertised LIBOR to SOFR basis rate transition, the prospects of the "Build Back Better" legislation in Washington, and the latest COVID variant could not derail the market's upward momentum. Only the inevitable year-end holiday calendar succeeded in pushing investors and issuers to the sidelines for an overdue respite. Overall, 2021 loan issuance benefited from record-setting levels across many categories: sponsored transactions (USD 393 billion); dividend recapitalizations (USD 82 billion); and M&A (USD 331 billion). This all helped push US par loan outstandings to a record USD 1.35 billion by year-end.

US new-issue loan issuance

New loan issuance in Q4 2021 totaled USD 127 billion, well below the USD 155 billion tallied in Q3, but still stronger than any quarter in 2019 or 2020. While LBO activity in Q4 slipped, sponsor-owned acquisition activity remained robust, as did general corporate borrowing and refinancing activity. Also observed in Q4 tallies were many issuers quickly closing loans prior to year-end to maintain LIBOR-based coupons, instead of migrating to the new SOFR basis rate.

Much like in previous quarters, single-B rated issuers dominated the new-issue landscape in Q4, led by the single B-minus rated category which hit a record 40% (USD 245 billion) of total loan issuance in 2021. While the largest loan investor class (CLOs) were drawn to the higher yields of this rating category, those portfolios assumed a higher credit risk profile as a result. This is an interesting trend that bears closer watching going forward. Does it signal that the loan market is in the early days of a new business cycle or just more tolerant of higher risk moving forward?

US new-issue institutional loan volume

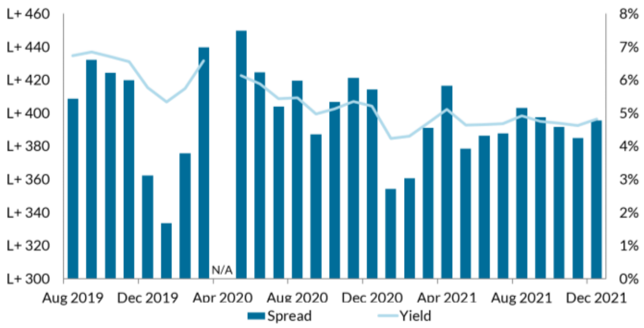


Source: S&P LCD, December 2021. For illustrative purposes only.

US new-issue loan spreads

Despite record issuance volume in 2021, loan spreads for the largest issuer cohort – those rated single B or B+ – were relatively range-bound throughout the second half of the year, ending Q4 at L+396bps and an all-in yield of 4.82% (LIBOR/LIBOR floor/spread). While certainly at tighter spreads and yields than seen in the early months of the COVID pandemic, these levels were notably wider (by 50bps) than recent tights in Q1 2021 and continued to make the CLO equity arbitrage attractive through year-end.

US average new-issue loan spread and yields

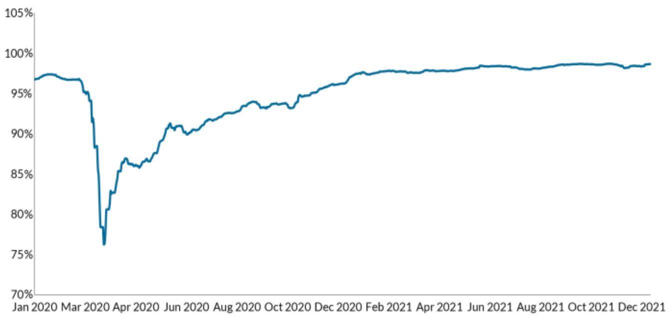


Source: S&P LCD, December 2021. For illustrative purposes only.

US loan secondary trading

Relative stability in US loan trading continued throughout the fourth quarter, as investor attention was largely drawn to new-issue loans or secondary par names, versus opportunistic buying. Both CLOs and retail funds were ready to buy loans on weakness, keeping price trading levels within a tight band. The US Leverage Loan Index ("LLI") opened Q4 at 98.61% and ended the quarter marginally higher at 98.64%. The lack of meaningful price improvement over the second half of the year should in no way diminish an excellent total return year for the LLI, which opened in January 2021 at 96.19% and delivered a very attractive 5.2% total return for 2021, compared to the 3.1% total return posted in 2020.

US loans index average bid (LLI)



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

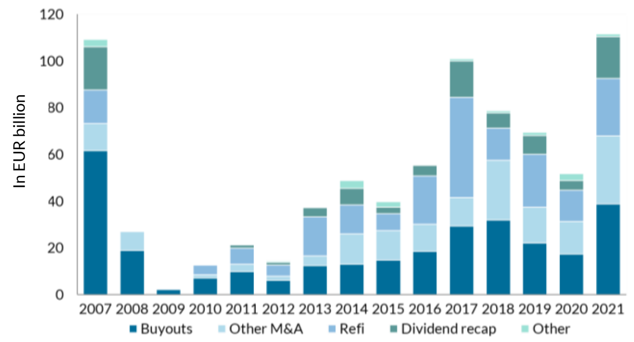
European loan market overview

Not to be outdone by the US market, the European leveraged loan market broke records of its own in 2021, feeding into unprecedented investor demand. The EUR 117.7 billion of new institutional loan issuance posted in 2021 was the busiest year on record, besting the EUR 117.1 billion from 2007, and doubling the COVID-impacted EUR 51.7 billion total loan issuance of 2020. Leading the way in 2021 was buyout activity, which tallied EUR 38.9 billion, followed by other M&A at EUR 29.1 billion, refinancings at EUR 25.6 billion, and dividend recapitalizations at EUR 18.0 billion.

European new-issue loan issuance

Euro new loan issuance volumes in Q4 slipped to EUR 18.8 billion, compared to the EUR 24.4 billion posted in Q3, with much of the new volume occurring in October as news of the Omicron variant spread started in November. Q4 activity was driven by EUR 8.3 billion from buyouts, plus EUR 4.8 billion from M&A and EUR 4.6 billion from refinancing & recapitalization activity. The forward loan calendar included several large transactions which were pushed out into 2022 to avoid any upset from the COVID variant noise and the growing year-end investor fatigue.

European new-issue institutional loan volume

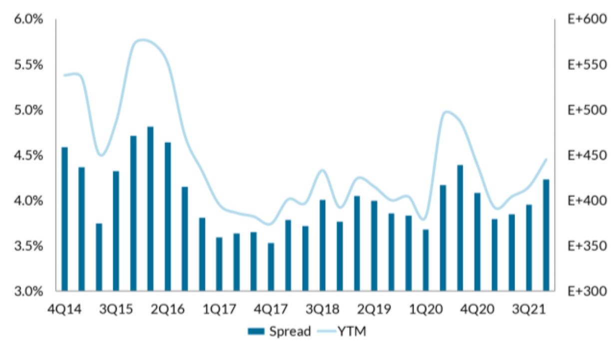


Source: S&P LCD, December 2021. For illustrative purposes only.

European new-issue loan spreads

European investors continued to be more selective in Q4, pushing single-B-rated new-issue Euro loan spreads wider to E+423bps and average yields to 4.45%, compared to E+396bps and 4.15% seen in Q3. These were the highest quarterly levels logged since Q3 2020, when loan issuance was just recovering from the initial COVID pandemic shock. The widening loan spread levels in Europe were also surprising given that CLO issuance in Q4 remained robust from continual investor demand. The loan spread increase was partially attributed to non-CLO fund demand in Europe declining through the second half of 2021, plus a number of smaller loan facilities being relegated by many CLO managers in favor of larger cap issuers. The higher new-issue loan spreads and wider new CLO liabilities during the second half of the year prolonged the attractive CLO equity arbitrage environment in Europe.

European loan spreads

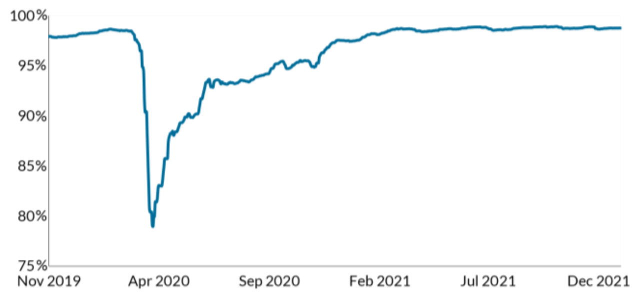


Source: S&P LCD, December 2021. For illustrative purposes only.

European loan secondary trading

Since Q2 2020, Euro secondary loan trading prices have shown a steady, upward trajectory towards par. Investor demand for loans continued to outstrip new-issue supply and secondary trading filled the gaps. But after six consecutive positive quarters, the European Leverage Loan Index ("ELLI") slipped slightly in Q4 2021, starting October at 98.90% and ending December at 98.77%. Even with a nominal decline as the year concluded, the ELLI still generated a 4.8% return for 2021. This was a welcome result following the modest 2.7% return realized in 2020, and also surpassed the 4.5% return from a strong loan year in 2019. These trading levels in 2021 also helped corroborate the safer investment profile of leveraged loans compared to high-grade and speculative-grade corporate bonds, which were subject to notable volatility throughout the year.

European loans index average bid (ELLI)



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

US collateralized loan obligations

As was the case with new loan issue demand, institutional investors continued to purchase US CLO liabilities in Q4 due to several drivers: the continuing COVID re-opening story; demand for floating-rate assets in the face of rising interest rates; low credit default incidence post-COVID; attractive equity returns; and an active pipeline of new issue, with varying investment profiles to choose from.

US CLO new issuance in Q4 2021 topped USD 56.4 billion from 115 CLOs, far exceeding the record of USD 47 billion (92 CLOs) just reached in Q3. Q4 saw the sixth straight quarterly increase in new US CLO issuance since the pandemic idled markets from March to May 2020. Additionally, CLO refinancings and resets in Q4 contributed USD 20.1 billion and USD 32.8 billion, respectively, to the extremely high Q4 CLO activity.

Even if Q4 activity pulled forward some issuance from Q1 2022 due to the mandatory LIBOR to SOFR benchmark transition starting on 1 January 2022, Q4 CLO volume reached a remarkable milestone for the asset class. Investor appetite across the CLO liability stack was relentless through mid-December, until CLO arrangers finally ran out of time to close LIBOR-based transactions prior to year-end.

When looking at the full year 2021, new CLO issuance tallied an astounding USD 186.7 billion, crushing the old record of USD 128.9 billion set in 2018. Adding in refinancings (USD 109.3 billion) and resets (USD 135.5 billion), total CLO activity for 2021 was a staggering USD 431.4 billion. The symbiotic relationship between CLOs and loans propelled the market to unexpected heights, and CLO managers were poised and ready to tap the market as long as this issuance window remained open.

For the fourth consecutive quarter, US CLO liability spreads on new issuance during Q4 remained in a tight range, as CLO supply and investor demand remained in close equilibrium. Spreads for AAA-rated liability tranches tightened slightly to L+116bps (from L+118bps in Q3), while other sections of the liability stack were plus or minus 1-2bps from their Q3 spread levels. Overall, the weighted average cost of capital for new-issue US CLOs in Q4 remained unchanged at L+172bps and was still very accretive to CLO equity arbitrage (i.e. CLO asset spreads less liability costs and operating fees).

US CLO liabilities spreads

US CLO Average Liability Spreads & WACC (bps)						
Time frame	AAA	AA	A	BBB	BB	WACC
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
4Q21 (L+)	116	171	216	324	659	172
Change from 3Q21	**-2**	**1**	**2**	**-1**	**-2**	**0**
Change from a year ago	**-22**	**-10**	**-34**	**-68**	**-78**	**-21**

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

European collateralized loan obligations

CLOs, the dominant buyer of Euro leveraged loans, continued to expand and absorb much of the new loan issuance in Q4, while existing CLOs were equally ready to buy loans upon any secondary weakness. With new-issue loan spreads remaining very attractive and CLO warehouses continuing to be opened, new-issue CLOs remained the primary market focus, while reset and refinancing activity, so prevalent earlier in 2021, languished.

European CLO new issuance in Q4 2021 totaled EUR 13.0 billion from 31 CLOs, a new European quarterly issuance record. This level was significantly higher than the EUR 10.5 billion (25 CLOs) recorded just a quarter earlier in Q3, keeping the post-COVID CLO issuance machine running. CLO resets and refinancings contributed to total Q4 activity, albeit in smaller numbers. Q4 resets accounted for just EUR 7.5 billion, while refinancings were only EUR 3.2 billion. Combined, this was a notable decline from the very active first half of 2021 for resets and refinancings, but it still resulted in total Q4 CLO activity to reach EUR 23.6 billion.

To no surprise, the full-year 2021 European CLO new issuance was a record-breaking EUR 38.6 billion (from 94 CLOs), far exceeding the most recent high of EUR 29.8 billion (from 72 CLOs) set in 2019, and ahead of the long-standing record of EUR 35.5 billion during the CLO 1.0 cycle in 2007. When combining new CLO issuance with an equally strong

EUR 41.8 billion of CLO resets and EUR 19.2 billion of refinancings, 2021 was a landmark year hitting total Euro CLO activity of EUR 99.6 billion. Regardless of the exceptional volume of new-issue activity in the Euro CLO market in Q4, CLO liability spreads remained relatively tight over the quarter. AAA liabilities, driven by an ever-growing appetite from global banks and insurance companies, saw average liability spreads on new issuance decline 2bps to E+97bps in Q4. AAA liabilities may have tightened even further in November and December if not for the noise around the Omicron variant and, to a large extent, an investor base that ran out of energy to keep buying as the end of the year neared. Spreads on AA- to BB-rated CLO liabilities, on the other hand, drifted wider in Q4, with BBB and BB liabilities becoming the most challenging classes to place by year-end. This all culminated in the weighted average cost of capital for Euro CLOs to rise to E+185bps in Q4, compared to E+182bps in Q3, and E+172bps in Q2. But as was the case in the US, the Euro CLO equity arbitrage continued to be sufficiently attractive to push CLO issuance higher.

Euro CLO liabilities spreads

European CLO Average Liability Spreads & WACC (bps)

Time frame	AAA	AA	A	BBB	BB	WACC
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
4Q21 (E+)	97	175	225	331	624	185
Change from Q3'21	**-2**	**6**	**7**	**15**	**17**	**3**
Change from Q4'20	**-12**	**-5**	**-56**	**-80**	**-18**	**-16**

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

Spotlight topic: Will 2022 be a repeat of last year or see a return of stress and volatility?

The early months of the COVID pandemic in 2020 triggered significant financial underperformance across many leveraged loan issuers and industries. Rapid declines in secondary loan trading prices signaled numerous stressed credits, but also offered substantial return opportunities for those brave enough to jump into the fray. Even more stunning than these large drops in loan prices in early 2020 was the rapid price recoveries seen during the ensuing months, as many loan issuers were able to conserve cash, cut costs, and re-engineer their product and service offerings, while unprecedented government stimulus and intervention, and resilient capital markets, provided critical liquidity lifelines to hundreds of loan issuers. The capital markets recovery over the past 18 months has now left many investors believing that the business cycle has effectively reset itself. Conversely, other investors debate whether 2022 could be a year of disappointment and setbacks, as loan issuers wrestle with the impacts of COVID variants, labor shortages, supply-chain breaks, surging inflation, and rising borrowing costs, which could lead to disappointing financial performance and loan trading volatility. No doubt many companies will be challenged to duplicate the extraordinary revenue and cashflow performances posted during the 2021 recovery, but it remains much too early to begin predicting how 2022 will play out.

About the author

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