



Quarterly Loan Market Commentary

Q3 2022 | Issue 13

US loan market overview

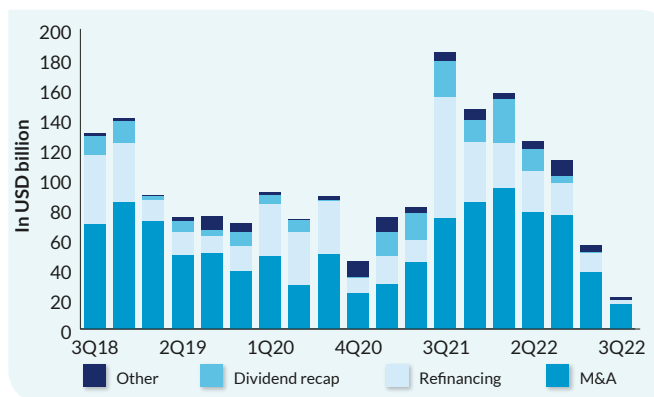
The US loan market was generally non-constructive in Q3 2022. Faced with unrelenting economic headwinds led by rapidly rising interest rates and surging inflation, institutional US loan issuance volumes were effectively tabled, posting their worst new issuance quarter since the Global Financial Crisis (GFC). New loan creation continued to be hindered by weak US M&A and buyout activity, and notably lower lending conviction from large arranger banks. Despite this, investors were not all “risk-off”. Demand for secondary traded loans emanated from newly-issued CLOs in Q3, perhaps a surprising development to many observers. Rapidly rising CLO liability spreads were largely offset by a growing supply of lower priced loans, which helped meet minimum equity return hurdles. The flow of “print and sprint” CLOs, which aim to allow a quicker execution of CLOs, sparked a short-lived technical loan rally in July and August, until wider weakness in the stock market and accelerating outflows from retail loan investors (selling from mutual funds and ETFs) in late August and September combined to snuff out the trading rally.

US new-issue loan issuance

New loan issuance in Q3 2022 dropped to a disappointing USD 21.4 billion, the weakest quarterly levels posted since the GFC in Q4 2009, and 86% below the loan issuance volumes posted just a year ago. The few new loans successfully brought to the syndication market in the quarter cleared, but at significantly deep discounts to par in order to

attract adequate subscription. Of this Q3 new-issue amount, 76% (USD 16.3 billion) was M&A activity. However, most of this M&A volume was actually underwritten much earlier in the year and under different economic assumptions. Also notable was that 54% (USD 11.6 billion) of the total Q3 new loan issuance was rated B- or B3 by one rating agency, and 76% was rated B or B2 or lower. This affirmed that despite the turmoil, certain higher risk and spread transactions could still appeal to investors, while also work for issuers and arranging banks. On the other hand, opportunistic refinancings or dividend recapitalizations totaled a modest USD 2.6 billion in Q3, demonstrating investors’ unease with the increasingly volatile market environment.

US new-issue institutional loan volume

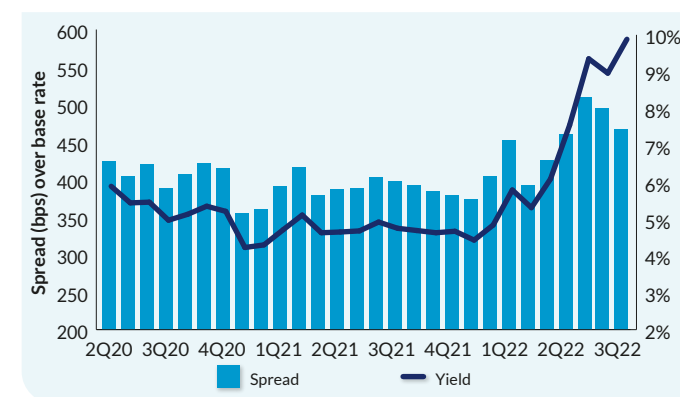


Source: S&P LCD, October 2022. For illustrative purposes only.

US new-issue loan spreads

For the new US loan issues that launched into the syndicated market in Q3, new-issue loan spreads in Q3 for a B/B+ rated issuer averaged SOFR + 491bps, a sizable increase compared to the average of SOFR + 426bps in Q2. Combining loan spreads with deep purchase discounts of c. 95%, all-in new-issue loan yields averaged 9.40% in Q3, compared to just 6.32% in Q2, the widest yields seen since the start of COVID in 2020. While this yield was derived from a small sample size of new loans syndicated in Q3, it set a formidable benchmark for loan yields, which any bank seeking to liquidate recently funded loan mandates from their balance sheet or bidding on new loan underwritings would need to concede.

US average new-issue loan spreads and yields



Source: S&P LCD, October 2022. For illustrative purposes only.

US loan secondary trading

The secondary loan trading market was at the center of the action in Q3 2022. Opening the quarter at 92.16%, the LSTA Morningstar Leveraged Loan Index (LLI) initially slipped lower to 91.75% during the first week of trading, but with new CLOs steadily issued throughout the quarter creating additional purchase demand across a broad range of liquid names, a bear-market loan rally was born. From there, the LLI steadily advanced to a high of 95.50% by mid-August, before another stock market selloff plus retail loan investor outflows took the wind out of the rally's sails. Investors then eagerly waiting for the traditional post-Labor Day re-opening of the US new-issue loan syndication calendar were generally unimpressed with both the quality and relative value offered by several marquee new loans, and the new-issue loan market quickly lost buyer traction. By mid-September, investor buying in the secondary market also began to recede. Loan prices slumped, with the LLI falling more than 3.50% to 91.92% by quarter end. The loan market had basically taken an unusual three-month long roundtrip journey, with good trading action in the middle, to effectively see the LLI end up right back where it started the quarter. For the nine-

US loan index average bid (LLI)



Source: S&P LCD, October 2022. For illustrative purposes only.

month period ending 30 September 2022, the total return for the LLI stood at a discouraging -2.53%, compared to a robust +5.20% return posted for the full year 2021.

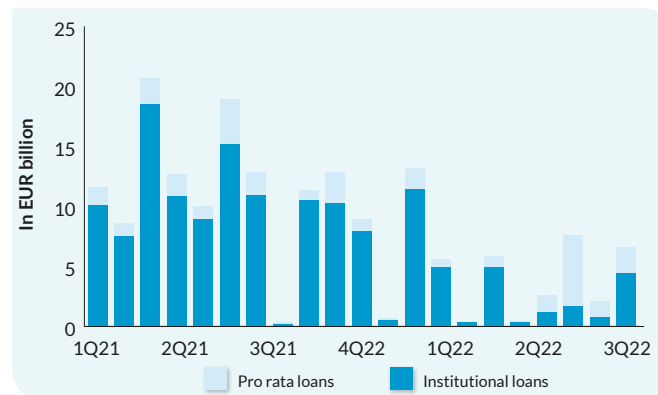
European loan market overview

The good news of the quarter was that European loan market conditions in Q3 2022 did not continue to decline. The bad news was that the market only marginally improved from Q2 levels. Weakening economic conditions across Europe continue to cast a long shadow over capital markets and loans were no exception. While not the same as the environment during the start of the pandemic two years ago, the European market's struggle with surging inflation, a growing energy crisis, rising interest rates, and evolving UK monetary and fiscal problems, has muted buyout and M&A activity. Arranger banks appear more focused on protecting their balance sheets and much less inclined to underwrite new credit risk in the face of the market turmoil.

European new-issue loan issuance

New European institutional loan issuance in Q3 2022 totaled EUR 7.0 billion, a nominal increase over the EUR 6.6 billion posted in Q2, but still a positive movement.

European new-issue institutional loan volume



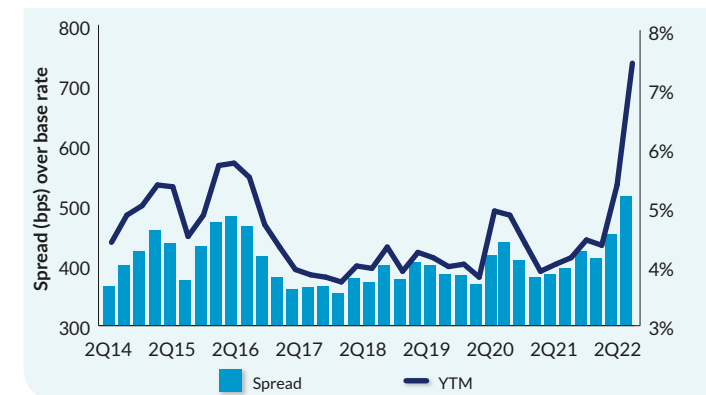
Source: S&P LCD, October 2022. For illustrative purposes only.

Notably, almost two-thirds, or EUR 4.5 billion, of this EUR 7.0 billion new loan issuance was executed in September, making up for a long summer of inactivity. However, investor demand tailed off towards the end of the quarter. Given increasing expectations for a quiet fourth quarter and 2022 loan volumes through 30 September at EUR 30.3 billion, loans look to be on track for one of the slowest issuance years recorded since 2012.

European new-issue loan spreads

Despite only a modest increase in new-issue volume in the third quarter, new single-B-rated institutional term loans were priced at an average of EURIBOR + 515bps, and a yield to maturity of 7.44%, compared to EURIBOR + 452bps, and a yield to maturity of 5.38% during Q2. The "risk-off" investor sentiment throughout much of Q3 continued to dampen loan demand, resulting in the widest new-issue spreads and yields observed since 2011-12. While the smaller number of transactions and issuer risk profiles in Q3 may have skewed loan spreads and yields to an extent, undoubtedly there will be challenges for any loans attempting to syndicate in Q4 unless macroeconomic conditions improve.

European loan spreads

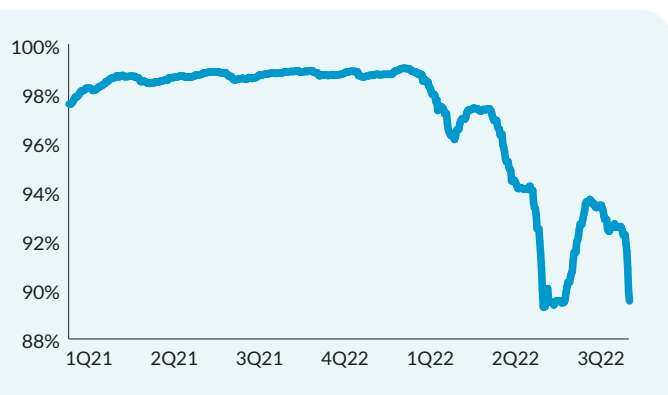


Source: S&P LCD, October 2022. For illustrative purposes only.

European loan secondary trading

With new-issue activity in Q3 remaining subdued, Euro loan investors elected to turn to the secondary market to deploy available cash. Much like the secondary loan market trends in the US, following a slow start, Euro loan trading began to pick up in late July and a loan rally ensued. The Euro Leveraged Loan Index (ELLI), which started the quarter at 89.61%, topped out at 93.68% in mid-August, before cooling down in September and returning back to where it started, ending Q3 at 89.55%. This left the ELLI posting a disappointing -6.34% total return for the nine months ending 30 September 2022, compared to a more agreeable +4.81% return posted for the full year of 2021.

European loan index average bid (ELLI)



Source: S&P LCD, October 2022. For illustrative purposes only.

US collateralized loan obligations

Despite the challenging economic environment, US CLO issuance continues to be a stand-out performer. Q3 saw 75 US CLOs issued, totaling USD 33.1 billion, following CLO issuance of USD 40.2 billion in Q2, and USD 31.2 billion in Q1. At this pace, 2022 could be the second highest CLO issuance year on record (behind 2021). Notably absent in Q3, however, was CLO

reset and refinancing activity as a result of the wide liability spreads.

The continuing flow of new CLO issuance activity in 2022 could be viewed as a strong endorsement of the asset class (and the loans being securitized), along with the growing appeal for floating rate securities against the backdrop of rising rates. Additionally, investors in search of yield have been drawn to the segment by historically wide CLO liability spreads across all rated tranches. Remarkably, lower loan prices and rising loan spreads have been the necessary offset to wider CLO liability spreads to allow equity investors to capture sufficient (albeit lower) equity returns from the CLO asset-liability arbitrage. Depending on timing, CLO managers could still find windows to assemble attractive loan portfolios at average dollar prices of 95-97%. Then, with the expectation of a market recovery by 2024, these CLOs could later be reset at lower liability spreads and produce an enhanced equity return profile over the long term.

As the volume of issuance continued to grow in Q3, the weighted average cost of capital for new CLOs continually rose during Q3, hitting an average of SOFR + 278bps, up over 50bps from Q2. AAA-rated CLO liabilities, a majority of the capital stack, averaged SOFR + 211bps in Q3 (compared to SOFR + 163bps in Q2), while other liability tranches (rated AA to BB) increased 70bps to 120bps.

European collateralized loan obligations

Despite the lack of activity in European new loan issuance given the economic headwinds, European CLO issuance activity showed surprising resilience in Q3 2022. Q3 saw 17 new CLOs totaling EUR 6.4 billion, compared to just 10 new CLOs and EUR 4.0 billion issued in Q2. This was a surprising outcome given CLO liabilities continued to widen across the

US CLO liabilities spreads

US CLO average coupon and weighted average cost of capital (bps)						
Time frame	AAA	AA	A	BBB	BB	WACC
Q121 (LIBOR+)	115	155	198	313	645	163
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
Change from Q222	49	69	106	121	77	55
Change from a year ago	94	133	186	208	171	107

Source: S&P LCD, October 2022. For illustrative purposes only

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
Q420 (E+)	110	180	281	411	642	201
Q121 (E+)	83	136	223	330	584	167
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
Change from Q222	71	132	105	124	28	107
Change from Q321	90	193	233	291	162	123

Source: S&P LCD, October 2022. For illustrative purposes only

capital stack and loan prices rallied through much of the quarter, making the equity arbitrage increasingly challenging. New CLO structures remained innovative and incorporated the use of short reinvestment periods, higher credit enhancement, AAA-rated tranches issued in loan form, and unfunded B-rated tranches.

Investor demand for new-issue AAA-rated CLO tranches was largely driven by European banks during Q3, as American banks remained notably absent from the market. This drove liability spreads considerably wider and the average AAA spreads in Q3 jumped to EURIBOR + 189bps, compared to EURIBOR + 117bps in Q2. Liability spreads for lower-rated CLO tranches (AA to BBB) were also dramatically wider, up 30bps

to 130bps, pushing the weighted average cost of capital for Euro CLOs in Q3 to EURIBOR + 306bps, substantially higher than EURIBOR + 232bps posted in Q2, or EURIBOR + 199bps in Q1 2022. Accepting liability costs this high was a function of CLO managers either running out of time on CLO warehouse financing,

or finding the right window of opportunity to both lock in CLO liability costs and buy a majority of the loans required at the right price in the secondary market (a “print and sprint” CLO). Either way, the expectations of additional windows of issuance opportunity re-appearing in Q4 are decidedly low.

Spotlight topic: Do loan issuers have their backs against the (loan maturity) wall?

In periods of reduced loan issuance activity and economic volatility, loan investors will often focus on the “maturity wall” of loan portfolios. This maturity wall is simply a measure of how many loans in a portfolio will soon face contractual maturity dates, and thus be subject to elevated refinancing risk. In challenging economic market conditions, even well-performing companies could experience limited access to capital markets for refinancing, while underperforming companies could well be shut out. This can quickly amplify credit risks in loan portfolios with shorter duration.

billion are set to mature in 2024. On the European side of the loan market, EUR 205 billion or 76% of all loans in the ELLI will mature in 2026 or later, while only EUR 3.5 billion will mature in 2023, and EUR 20.5 billion mature in 2024. Thus, the loan maturity risk in both the US and Europe appears quite manageable. Much of this can be attributed to the many loan issuers that wisely refinanced or extended debt maturities in 2021. US and European loan markets experienced unprecedented issuance volumes as part of a post-COVID economic “re-opening” where investors were flush with cash and very constructive on taking on risk. While some loan issuers will still need to address upcoming maturities, the majority of loan issuers can certainly wait for improved market conditions.

Based on S&P/LSTA loan index data from September 2022, USD 1.1 trillion or 77% of all loans in the US LLI are set to mature in 2026 or later, while only USD 13.1 billion will mature in 2023, and another USD 100.6



About the author

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