Partners Group

REALIZING POTENTIAL IN PRIVATE MARKETS

April 2020 | Issue 3

Quarterly Loan Market Commentary

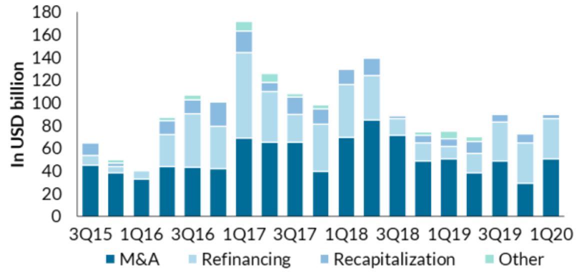
US loan market overview

In the previous issue of our Quarterly Loan Market Commentary, we put a spotlight on the long US economic expansion cycle (dating back to the end of the 2008 Global Financial Crisis). Following two more months of growth for a total tally of 129 months, in March 2020, the COVID-19 pandemic brought this record-breaking US expansion to an abrupt halt. While most economic downturns and recessions in the US have been led by specific distressed sectors, the rapidly growing and widespread economic deterioration caused by the COVID-19 crisis is without precedent. Unlike the sudden impact of 9/11, the pandemic's impact can be felt across every segment of the economy (see also our spotlight commentary on sector risks on page 4).

US new institutional loan volume

The first quarter of 2020 began with a flood of issuance in the US loan market, as investors resumed a "risk on" attitude. Issuers were quick to take advantage of this through refinancings or new loans at ever lower spreads. The volume of new issue activity hit USD 90 billion in the middle of Q1, but quickly came to a halt by late February as the COVID-19 pandemic spread across the US. New issue loan volume, which topped USD 65 billion in January and then USD 25 billion in February, dropped to USD 0 in March. The new loan issuance market in the US effectively closed down, postponing USD 24 billion of issuance in the queue.

US new-issue institutional loan volume



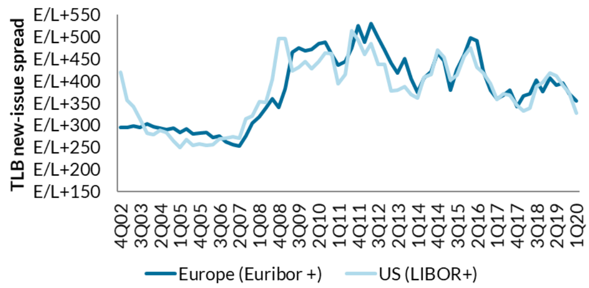
Source: S&P LCD, April 2020. For illustrative purposes only.

US new-issue loan spreads

In Q1, many US double-B rated loan issuers were able to reduce loan spreads to as low as L+175bps, while strong single-B rated issuers dropped spreads to L+250-275bps.

Double-B rated new issue loan spreads averaged just 211bps by the end of January, but gradually rose to 233bps later through February, as new issue demand evaporated. Single-B rated average loan spreads dropped to 333bps in January, but then reversed course to 375bps during February and were around 440bps by early March when new issuance shut down.

US and European average new-issue institutional loan spreads

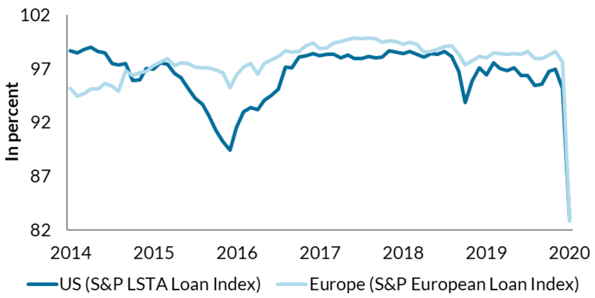


Source: S&P LCD, April 2020. For illustrative purposes only.

US loan bids

Q1 2020 saw some of the greatest secondary loan trading volatility on record, as retail accounts faced large redemptions and investors shed credit risk across most sectors in light of the growing pandemic. The year began with the average market bid for US loans at 96.72% and traded within a tight one-and-a-half-point range through late February. However, as COVID-19 became an overwhelming threat to the US markets, loans began experiencing wild intraday price swings and took on a persistent negative outlook. By 1 March, the average loan market bid was 95.18%. It then declined to 88.42% on 15 March and hit a decade low of 76.35% on 22 March before gradually recovering to 82.85% by 31 March. During this rapid market decline, both double-B and single-B rated loans fell in unison. However, double-B rated loans enjoyed a slight recovery by quarter end, benefitting from a flight to quality among investors.

US and European average Loan Index bids



Source: S&P LCD, April 2020. For illustrative purposes only.

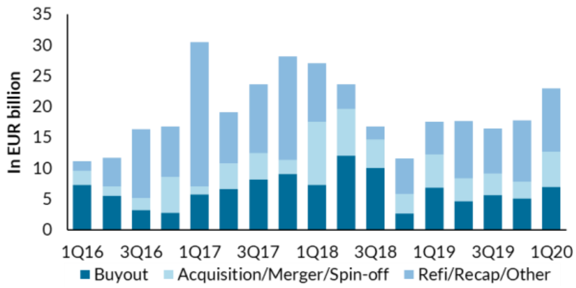
European loan market overview

Q1 2020 saw a continuation of a positive "risk on" market environment in Europe, as already witnessed in Q4 2019. Strong CLO formation in Europe remained a positive catalyst entering 2020, giving the Euro market another boost in demand against a reduced channel of loan supply.

European new institutional loan volume

Much like in the US, new loan issuance volume in Europe began at a strong pace in January, balanced across buyouts, M&A activity and repricings. At EUR 17.2 billion, January contributed 67% of Q1's total loan issuance of EUR 25.5 billion. After another EUR 8.1 billion was issued in February, the market succumbed to the worsening pandemic conditions across Europe and closed abruptly. Despite almost no issuance activity in March, Q1 2020 Euro loan issuance statistically ranked as one of the busiest quarters on record.

European new-issue institutional loan volume



Source: S&P LCD, April 2020. For illustrative purposes only.

European new-issue loan spreads

Recognizing the continued strong investor demand in the Euro loan market in January and February, loan issuers smartly seized the opportunity to quickly push down loan spreads on both double-B and single-B rated issuance to 243bps and 372bps, respectively. However, loan spreads would surely have reversed in March in response to growing credit risk brought on by the pandemic if there had been meaningful issuance volume (see chart on page 1 for European institutional loan spreads).

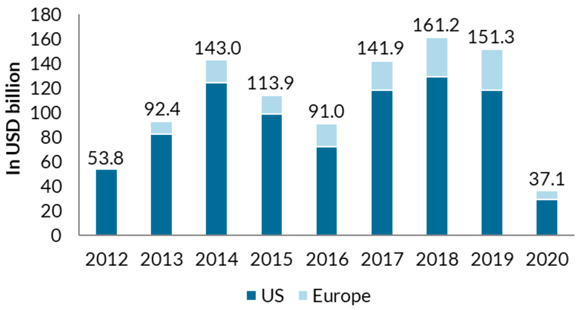
European loan bids

With increasing investor demand for loans in January (despite tightening new issue loan spreads), the average loan bid increased from 98.28% on 1 January to 98.58% by 1 February. Bids held firmly in this range through late February, until COVID-19 concerns dominated market sentiment. Loan bids then began a precipitous decline, down to 97.60% on 1 March, 90.40% on 15 March and 82.80% by quarter end. Again, much like in the US market, investor attitudes switch to "risk off" in Europe (see chart on the left of this page for European Loan Index bids).

US collateralized loan obligations

Following a very strong 2019, US CLO issuance was slow to evolve in Q1 2020, as issuers and investors initially struggled to find common ground on CLO liability spreads which could meet equity return hurdles. Nonetheless, investors slowly returned to the market by late January/early February and CLO issuance volumes picked up, with 35 Q1 transactions totaling USD 17.8 billion – much of this volume came from the 15 CLOs totaling USD 10.3 billion issued during February.

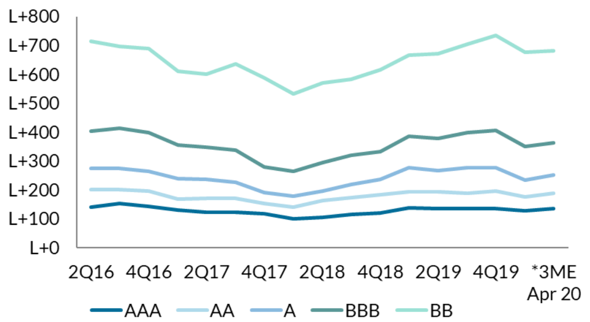
Global arbitrage CLO volume



Source: S&P LCD, April 2020. For illustrative purposes only.

Triple-A CLO new issue spreads improved throughout Q1 2020, averaging L+128bps, as the pace of investor demand picked up. Lower rated liability spreads (double-A to double-B) also tightened from the wide levels seen in Q4 2019, improving CLO arbitrage[1] levels.

Average new US CLO liability spreads



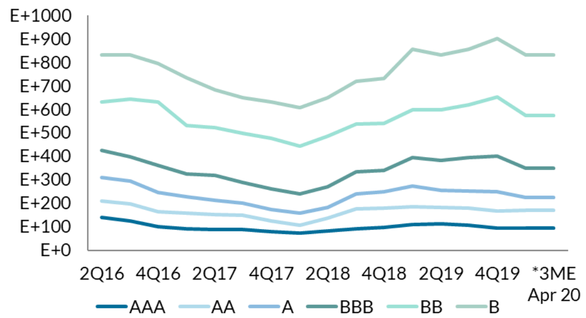
Source: S&P LCD, April 2020. For illustrative purposes only.

European collateralized loan obligations

European CLO issuance in Q1 2020 totaled EUR 5.8 billion from 14 transactions. As in the US, CLO issuance in Europe started slowly in January with only three CLOs (EUR 1.3 billion) priced. Issuance accelerated in February with eight more transactions (EUR 3.3 billion), but then quickly tailed off to just three more CLOs issued during March (EUR 1.2 billion), as investor demand disappeared in the face of the global pandemic.

Pricing on new issue triple-A liabilities during Q1 2020 matched Q4 2019 levels, averaging Euribor+95bps, but new CLOs benefitted from notable spread tightening across the lower rated liability tranches (from single-A to single-B), improving equity arbitrage.[1]

Average new European CLO liability spreads



Source: S&P LCD, April 2020. For illustrative purposes only.

1 CLO arbitrage refers to the difference between the CLO collateral's interest income and the cost of CLO liabilities and ongoing expenses, available to be distributed to CLO equity investors.

Spotlight topic: sector risk in a global pandemic

As news of the growing COVID-19 pandemic swept across the US and Europe in February and March 2020, the initial business risks were expected to hit commodity-driven sectors such as oil & gas and mining & metals, as well as consumer discretionary spending segments such as travel, hotels, gaming, retail and entertainment. This view proved true initially, as these sectors were broadly hit with the first wave of underperformance, credit deterioration, rating downgrades and market selloffs. What has become more apparent as the crisis has evolved is that the pandemic has impacted almost every industry and region. The above-mentioned sectors are no longer the only risk focus for investors and credit management activity. Secondary and tertiary sectors of local and global economies, some of which were long-viewed as resistant or immune to economic downturns and recessions, have had little defense against the surging pandemic. Defensive industries such as healthcare, food & beverage, technology and finance are also facing growing business challenges, as the impact of COVID-19 has been so sudden and broad-based. Sector by sector, country by country, investors must re-underwrite not only company credit risk, but also industry risk, with little guidance or a relevant playbook from the past to review and draw upon. With no reliable timetable as to when cities, states and countries can re-open or normalize commercial activity, as investors, we believe it has become critical to focus on debt issuers' abilities to prudently manage cash and financial resources, maintain adequate liquidity and service debt obligations until economies can move into recovery mode.

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