Partners Group
REALIZING POTENTIAL IN PRIVATE MARKETS

Q2 2020 | Issue 4

Quarterly loan market commentary

US loan market overview

In Q2 2020, the US economy continued to wrestle with the uncertainty and risk created by COVID-19. Despite challenging headwinds, numerous loan issuers were still able to access liquidity through revolver drawings or incremental loan or bond issuance, while some other companies found sufficient investor demand to clear new issues tabled in Q1.

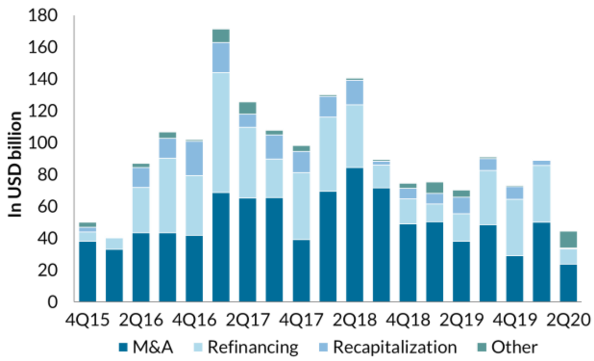
A combination of improving investor sentiment, massive governmental market intervention, and some promising medical advances toward COVID-19 treatment and vaccines prompted a surprising "risk on" mentality to sweep through the US loan market. Almost as fast as prices declined in March, the secondary loan market staged an amazing rally, recovering 75% of recent price declines. The loan market concluded that the COVID-19 pandmemic would not be a repeat of the 2008 Global Financial Crisis.

US new institutional loan volume

Unsurprisingly, new US loan issuance in Q2 only totaled USD 44.4 billion, the lowest level recorded since Q1 2016, and significantly lower than the USD 70.3 billion posted in Q2 2019. Loan investors withdrew from the new issue market as they struggled with weakening credit, accelerating loan downgrades and a deminished fundraising environment, due to slow CLO issuance and retail loan fund redemptions.

While loan demand was off, high yield bond issuance unexpectedly rebounded in Q2, with USD 54.8 billion of new bonds issued, marking the first time since 2009 that US quarterly bond issuance had exceeded loans. Retail bond funds were flush with cash and debt issuers were happy to accomodate the demand given the market conditions. Of the USD 44.4 billion of new loans issued in Q2, more than half occured in June, as higher quality transactions (some which were stuck in the pipeline since Q1) found willing investors. In spite of a very weak Q2, first half 2020 US loan issuance still totaled USD 133.5 billion, only 8% below the same period in 2019, as a result of the heavy issuance levels achieved in early Q1 pre-COVID.

US new-issue institutional loan volume



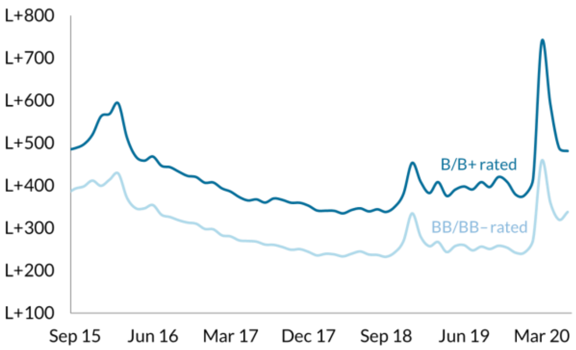
Source: S&P LCD, July 2020. For illustrative purposes only.

US new-issue loan spreads

In April, the new issue loan market was slow to develop, reeling from the COVID-19 shock, but it slowly recovered and new issue loans found selective buy interest. The first challenge for the loan market was how to price new issue loan risk.

CLO warehouses were largely sidelined as buyers and loan pricing became ratings agnostic, with average pricing for new issue loans in Q2 averaging L+425bps for both single-B or double-B rated issuers. In many instances, pricing became sector driven, where a double-B rated airline issuer cleared new loans at L+525bps, while a single-B chemical company could issue at L+300bps. Reacting to these buyer uncertainties, bankers liberally widened or tightened original-issue discounts to meet the required clearing yield for each loan. Lastly, Q2 saw a welcome investor development with the return of Libor floors for many new loan issues, in response to rapidly declining USD Libor rates starting in April (3mos. USD Libor was 1.285% on 1 April, compared to only 0.278% on 30 June).

US loan spreads

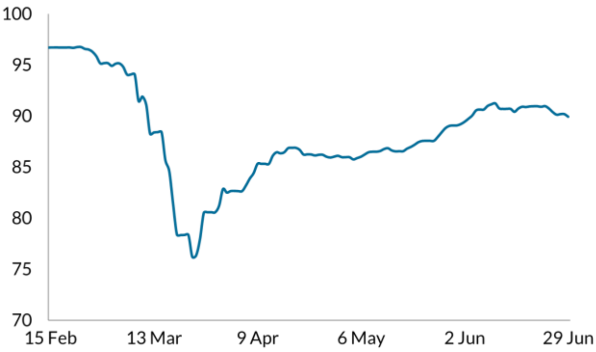


Source: S&P LCD, July 2020. For illustrative purposes only.

US loan bids

While new issue loans struggled in Q2, secondary loan prices posted a phenomenal recovery where the US Leveraged Loan Index ("LLI") opened 1 April at 82.51%, peaked at 91.24% on 10 June, and finished the quarter at 89.94%. This stunning rally could be attributed to a combination of factors: an end to panicked selling into a thin trading market, a reprieve from the flood of loan rating downgrades in March, aggressive federal government intervention in US capital markets, and a sustained shift in investor mentality triggering a risk-on or fear-of-missing-out ("FOMO") rally. Even though investors had little financial data to assess COVID-19's initial risk impact on issuers and sectors, a wide consensus developed that many loans had sold off too fast, and if an investor had the conviction (and the cash) to be a buyer, quality loans were cheaply available.

US loan index bid (LLI)



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

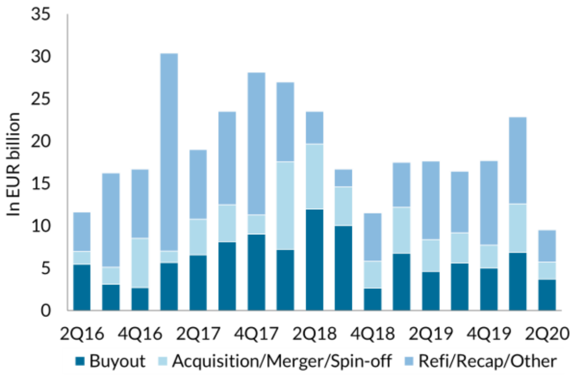
European loan market overview

The weak tone of the European loan market in Q2 2020 closely matched the US market, since COVID-19 was a global pandemic. The risks and challenges for investors were universal. After market lows were hit in late March, the Euro loan market staged its own speedy recovery, with similar drivers, such as an oversold market, aggressive European Central Bank (ECB) intervention, surprisingly strong liquidity positions for many loan issuers, and a faster paced pandemic recovery throughout much of Europe. The improving conditions in Europe would not lift new loan issuance until June, however.

European new institutional loan volume

With buyout and M&A activity largely at a standstill, the new issue loan market was slow to develop, and issuance for Q2 only totaled EUR 9.5 billion, compared to EUR 22.9 billion posted in Q1 (a quarter which included almost zero loan issuance in March). Issuers in need of immediate liquidity, or desiring to stockpile cash, tapped revolvers or used incremental loan tranches within their credit facilities for a quick solution. Issuing larger loan facilities remained challenging throughout April and May, as CLOs withdrew as active buyers, focusing instead on a raft of recent CCC loan downgrades. As a result, many issuers shifted over to a welcoming bond market, pushing high yield bond issuance to EUR 17.8 billion in Q2, nearly double the amount of loan issuance for the quarter.

European new-issue institutional loan volume

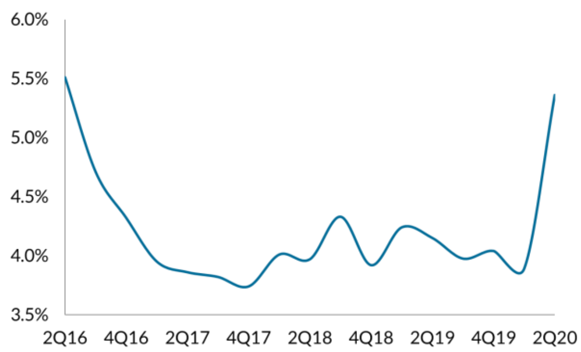


Source: S&P LCD, July 2020. For illustrative purposes only.

European new-issue loan spreads

With demand at less than EUR 10 billion for new loan issuance in Q2, loan issuers were relegated to being price takers. The robust seller's market of pre-COVID Q1, with new loans yielding an average of E+369bps, was now just a memory, and loan yields quickly rose to an average E+536bps by late June. But even at this point, loan investors remained discriminating. For the right credit (or also when faced with an oversubscribed syndication), some new loans could still price tighter. It was just quickly evident to loan issuers and syndication banks alike, that Q2 had turned into a buyer's market.

European loan spreads

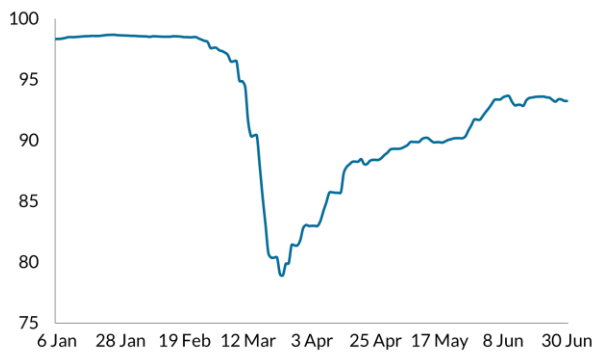


Source: S&P LCD, July 2020. For illustrative purposes only.

European loan bids

Euro Loan bids, as measured by the Euro Leverage Loan Index (ELLI), hit a decade low at 78.92% in late March 2020 in reaction to the COVID pandemic, but bounced back strongly in April, with the ELLI hitting 89.24% on 30 April. This rally continued throughout May and June, with ELLI ending the quarter at 93.23%. Much like what was seen in the US loan markets during Q2, a surprising risk-on and FOMO mentality engulfed the Euro loan market. Prompted by popular sentiment that loans were largely oversold, the ECB would continue to take aggressive market intervention, and many parts of the European economy could soon be re-opening, it was hard for investors to fight the positive market momentum.

Euro loan index bid (ELLI)



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

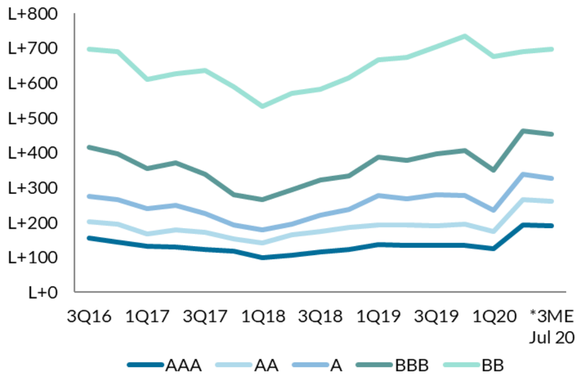
US collateralized loan obligations

CLO managers began the quarter in April much like March, preoccupied with plummeting loan prices, rapid loan downgrades, growing CCC baskets and new credit defaults. Many older vintage CLOs began facing quarterly compliance pressure or failures as a result. Secondary CLO trading prices plummeted, making the liabilities of new issue CLOs far too costly for most issuers to proceed. Against these negative headwinds, there was little expectation the market of new CLO issuance could resume in Q2.

However, just like the loan market, and many other asset classes, CLO liabilities caught a surprising and welcomed bid as part of the risk-on sentiment that took hold in April, and a CLO rally was born. New issue CLOs slowly tested the market in mid-April, provided they could present a clean warehouse of collateral. CLO structures were smartly modified with less leverage, and shorter reinvestment and non-call periods, to broaden the universe of CLO buyers. With the market being ever adaptable, arrangers found ways to get new CLOs printed in April and May, and the buyer landscape for CLOs improved deal by deal. CLOs, with their well-tested structures and circuit breakers, were designed to withstand current market stresses and in Q2 it seemed that investors slowly began to appreciate that resilience.

As the second quarter developed, price discovery for each new CLO was complex. CLO liability costs had already hit decade-wide spreads, reflecting the multitude of COVID-19 related risks on the underlying loans held as collateral. But as new CLOs started testing the waters in mid-April, some CLO issuers were quickly willing to accept AAA clearing levels at previously unthinkable spreads of 230 - 270bps, in order to de-risk warehouses and move their businesses forward. With each passing week in April and May, AAA spreads tightened, eventually moving below 200bps. There was also spread tightening across the rest of the liabilities stack from AA to BB tranches. While certainly nowhere close to the average liability spreads seen pre-COVID in February, new issue AAA spreads closed the quarter at 165-175bps, a remarkable feat considering a global economy still in the throes of an epic pandemic. Despite all the challenges, 42 new US CLOs were priced during Q2 totaling USD 16.3 billion, compared to 35 deals for USD 17.7 billion in Q1.

US CLO liabilities spreads



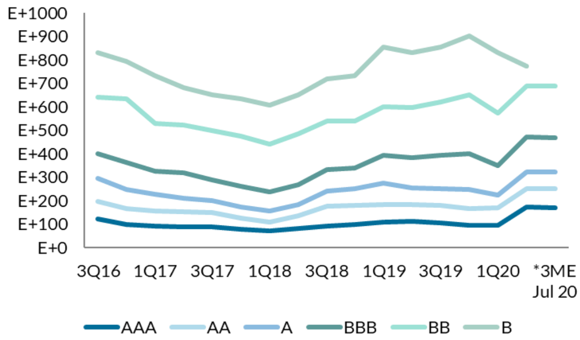
Source: S&P LCD, July 2020. For illustrative purposes only.

European collateralized loan obligations

The Euro CLO market entered Q2 facing the same headwinds and challenges as earlier described for the US market. CLO liability spreads were significantly wider in secondary trading in response to evolving COVID risks, making price discovery for the new CLOs that dared to launch in April a very challenging exercise. But issuers and arrangers got creative again, reducing deal size, leverage, and slashing reinvestment periods to attract a broader investor audience. AAA spreads for the first few CLOs printed in late April and early May began at levels of 170-190 bps, almost twice pre-COVID AAA spreads seen in February. But these higher spread levels then attracted more investor interest, and soon AAAs were tightening to 150-160bps in June, bringing the average AAA spread for the second quarter to 171bps.

Additionally, spreads offered on AA to BB rated liability tranches, which had widened 80-100bps in April (compared to February levels), steadily improved throughout the quarter as well. By the end of June, Q2 Euro CLO issuance had managed EUR 4.3 billion from 16 deals (compared to EUR 5.8 billion from 14 deals in Q1). In the face of an unprecedented global pandemic, this was an encouraging result.

Euro CLO liabilities spreads



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

Spotlight topic: liquidity for the storm

The uncertain impact of COVID-19 on corporate debt issuers has placed a considerable premium on accessing and maintaining adequate liquidity. However, cash is not something that leveraged issuers typically hold much of, given the high cost of their debt and a desire to maximize the return of excess cash to equity holders. So, when a global pandemic strikes, companies, regardless of which industry they operate in, would do well to show the market a ready access to liquidity. But how? In times of crisis, capital markets often shut down, making it challenging, if not impossible, to issue bonds, equity or asset securitizations. While this quarterly commentary focuses its attention on liquid term loans, most of these same term loan issuers possess the valuable option of drawing on revolver facilities, which were syndicated concurrently with those term loans. Maintaining a revolver facility does come at a cost, in the form of commitment fees paid on unborrowed balances. However, having access to a USD 50, 100 or a 200 million revolver facility is invaluable in times like this. S&P LCD News recently reported that over USD 315 billion of revolver borrowings had been drawn under US syndicated credit facilities between March and June in response to the COVID pandemic, with half of these revolver borrowings attributed to non-investment grade companies. While some of these borrowers had an urgent need for cash to manage working capital imbalances, pay critical suppliers, service other debt obligations, or even make payroll, some companies just drew down their revolvers to demonstrate their ability to do so. With a revolver's flexibility to continually draw and repay, there are many companies that have recently repaid these revolver drawings, deeming that the worst of the storm was behind them.

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