Partners Group
REALIZING POTENTIAL IN PRIVATE MARKETS

Quarterly Liquid Loan Market Commentary

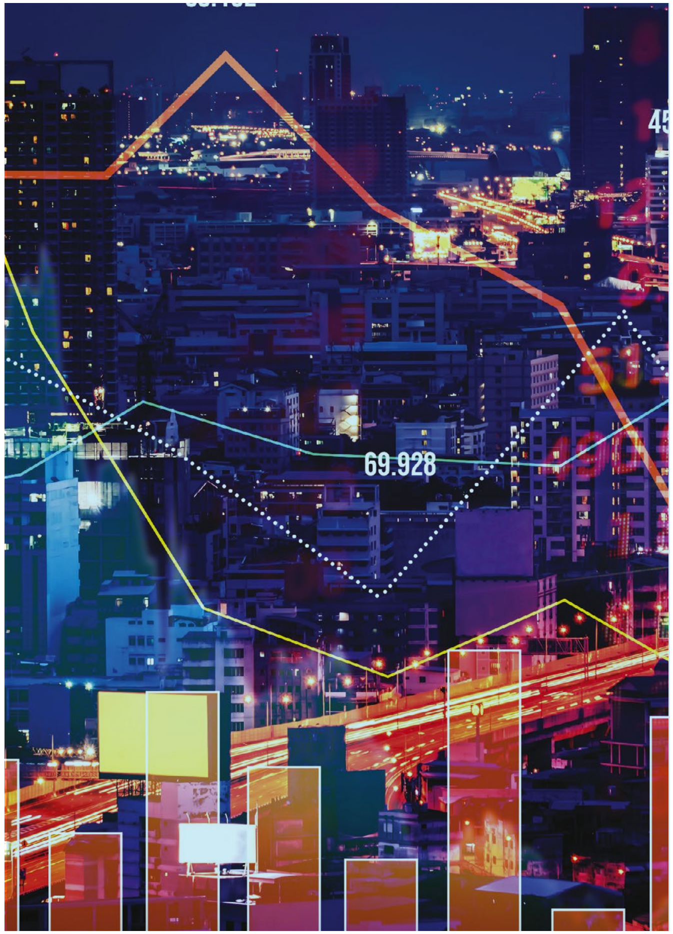
Q2 2023 | Issue 16

US liquid loan market overview

In a replay of the last few quarters, the US leveraged loan market continued to limp along in Q2 2023. The turmoil in March surrounding US regional bank failures and the Credit Suisse crisis did not linger long into April. However, persistently rising interest rates, inflation and the growing expectations of a US recession in the next 12 months weighed heavily on both new loan issuance and the financial performance of many issuers. So, it was not at all surprising that mergers and acquisition (M&A) activity continued to idle in Q2 and market expectations for the remainder of the year are also not positive. Loan refinancings and amend-and-extend (A&E) transactions, while limited, were the only meaningful source of activity for the loan market. While private debt capital sources once again significantly helped bridge the gap for many companies, a growing number of issuers also took advantage of rising fixed income demand by issuing new bonds during the quarter. For loan investors, the secondary market was the focus of activity. Aggressive bids for performing names proliferated, and attempts to sell down lagging and downgraded credit names were usually met with tumbling bids.

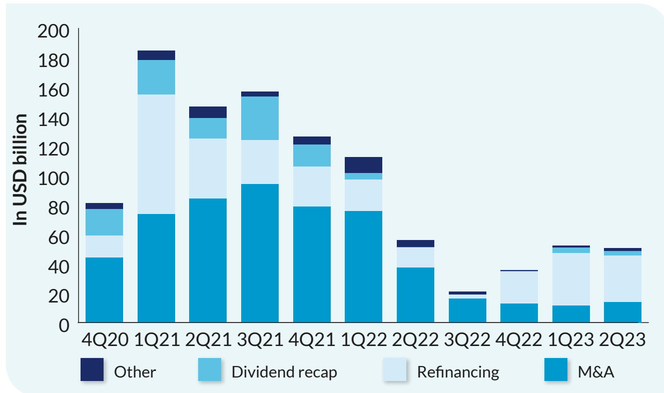
US new-issue loan issuance

New institutional loan issuance in Q2 2023 totaled USD 50.5 billion, slightly lower than the USD 52.4 billion in volumes posted in Q1. A bulk of this Q2 new issuance came from refinancings at USD 31.6 billion, followed by



USD 13.9 billion of buyouts and M&A and USD 4.9 billion from other activity. A&E activity (not counted as new issue volumes as no new money is being added) contributed USD 13.7 billion to market activity. Continuing a trend observed in Q1, refinancings during Q2 were primarily driven by well-regarded single-B rated issuers (74%), indicating the market was open to transactions for lower-rated credits if performing well. This was in stark contrast to refinancing activity in the second half of 2022, which was dominated by double-B rated loan issuers due to a broader “risk-off” buyer sentiment at that time. On the M&A front, Q2 saw 57% of activity generated from LBO transactions, while 34% was private equity backed (non-LBO) transactions.

US new-issue institutional loan volume



Source: PitchBook | LCD, July 2023. For illustrative purposes only.

US new-issue loan spreads

With the weaker volume of new loan issue in Q2 and sustained investor demand, new issue loan spreads for a typical single-B issuer tightened to SOFR + 396bps, compared to SOFR + 443bps at the end of Q1. All-in yields at the end of Q2 were 9.96%, down almost 0.50% compared to the end of Q1, as SOFR rates stabilized (perhaps temporarily) off the Fed's "pause" in June. Considering the rapid Fed rates hikes initiated last year, during the first half of 2023 the average single-B new issue loan was paying an all-in yield of 10.1%, the highest all-in loan yield seen since the GFC in 2008, and double where new single-B rated loans were being priced just two years ago in 2021.

US secondary loan trading

Despite the startling headlines surrounding the recent bank failures in Q1 2023 (which had little impact directly on US leveraged loan performance), bid levels on secondary US loans enjoyed a notable uptick in April, followed by some softness in May and then another solid rally through June. The Morningstar LSTA US Leveraged Loan Index (LLI) opened Q2 in April at 93.40%, and closed out June at 94.24%, resulting in a modest but welcome rally for the LLI. But buried in this market data was the dichotomy of a strong rally for performing loans being offset by recently downgraded or underperforming issuers and their resulting slumping bids. For the first six months of 2023, the US secondary loan rally was impressive. The LLI rose nearly 2 points, having started the year at 92.44%. This along with rising LIBOR and SOFR, allowed the LLI to post a healthy 6.62% return for the first half of 2023, despite very challenging conditions.

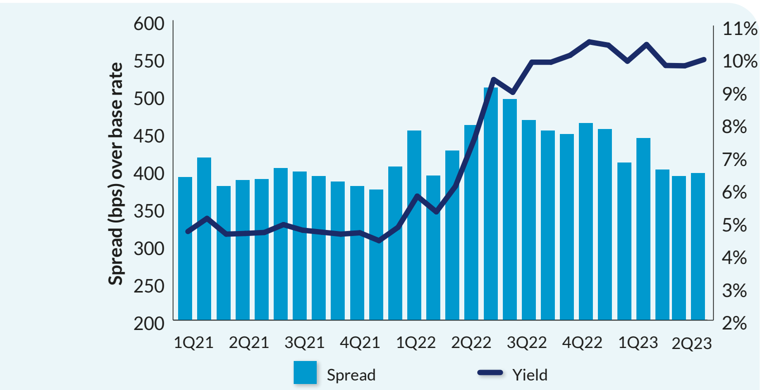
European liquid loan market overview

To no surprise the European new issue leveraged loan activity remained weak in Q2. Euro M&A conditions showed no meaningful improvement, having declined steadily since the start of 2022. European economies remain challenged by rising interest rates, inflation, and geopolitical turmoil, weakening the general business sentiment. Without certainty on the direction of rates and inflation, M&A will likely keep struggling. As a result, new issue institutional volumes in Q2 hit a ten-year low, with the Q3 new issue loan calendar appearing equally bleak. The only positive market action observed in Q2 came from A&E transactions, where certain stronger performing issuers with nearing loan maturities were successful in extending loan maturities out to 2028 and beyond.

European new-issue loan issuance

Second quarter new Euro institutional loan issuance slipped to EUR 4.1 billion, compared to EUR 8.6 billion in the first quarter of 2023. The decline in Q2 was largely attributed to the very weak buyout and M&A climate, which could only contribute EUR 1.6 billion to second quarter issuance, compared to EUR 4.7 billion in Q1. Refinancings totaling EUR 2.3 billion made up much of the remaining Q2 loan issuance, but volumes were similarly down from Q1 levels. Noteworthy for its growing size, A&E activity (amounts not included in new loan issuance totals) increased nicely in Q2, with EUR 14 billion and loan maturities extended an average of 3.3 years. This was the most active quarter of A&E transactions recorded in Europe and was extremely valuable in pushing the market median loan maturity to 2028, considering that many Euro CLOs will become maturity constrained (WAL tests) due to the continued absence of CLO liability reset opportunities in the near term.

US average new-issue loan spread and yield



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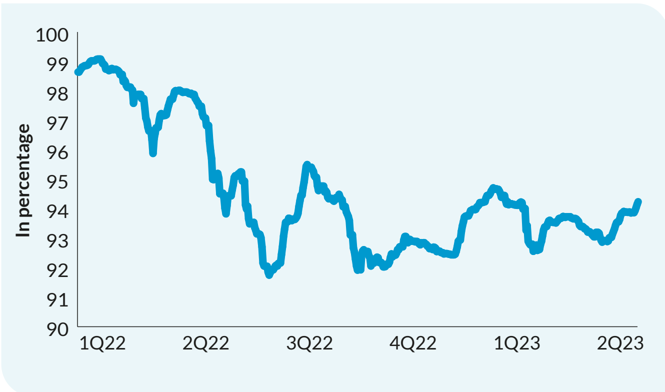
US loans index average bid (LLI)



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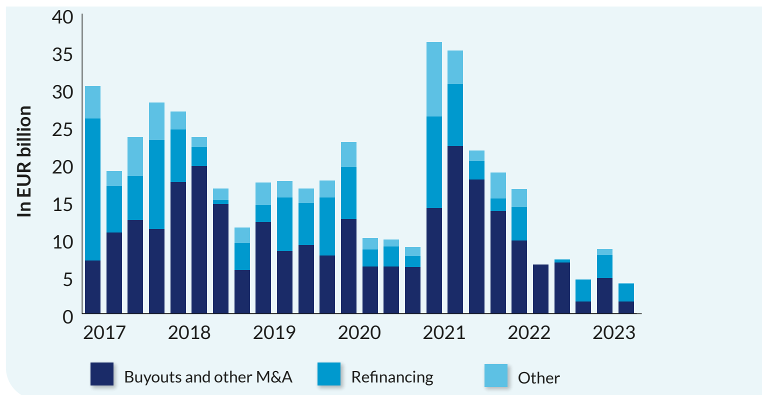
Quarterly European institutional loan volume



Source: PitchBook | LCD, July 2023. For illustrative purposes only.

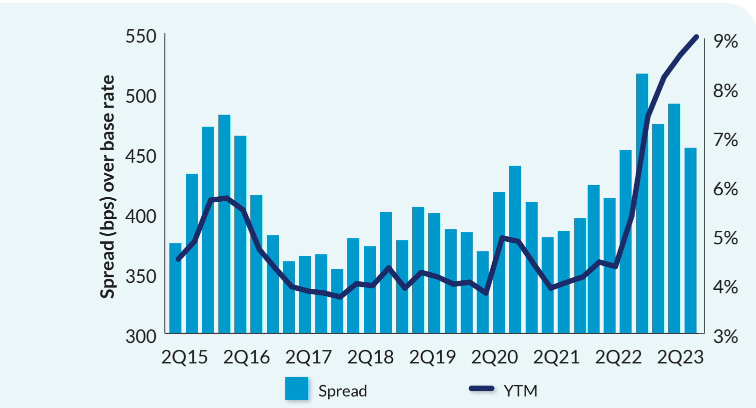
European new-issue loan spreads

With a dearth of new loan issue, new Euro loan spreads and average yield to maturity tightened in Q2. New loan spreads for single-B rated issuers averaged EURIBOR + 454bps, compared to EURIBOR + 491bps in Q1, although average yield to maturity actually rose to 9.03% in Q2 from 8.66% in Q1, driven largely by rising base interest rates (note: three-month EURIBOR has risen from -0.18% on 1 July 2022 to +3.58% on 30 June 2023).

European secondary loan trading

As investor demand for loans continues to go unfilled due to low new issuance, Euro investors focused their attention on the secondary market to deploy cash. The Morningstar European Leveraged Loan Index (ELLI) opened the second quarter in April at 93.27% and rose steadily through June (high mark of 95.21% hit on 19 June), before drifting lower at the end of June to 94.42%. For the first six months of 2023, this massive secondary loan rally has pushed the ELLI up over 3 points, having started at 91.34% in January. This resulted in the ELLI posting an exceptional return of 7.06% for the first half of the year, in light of challenging market conditions.

European loan spreads



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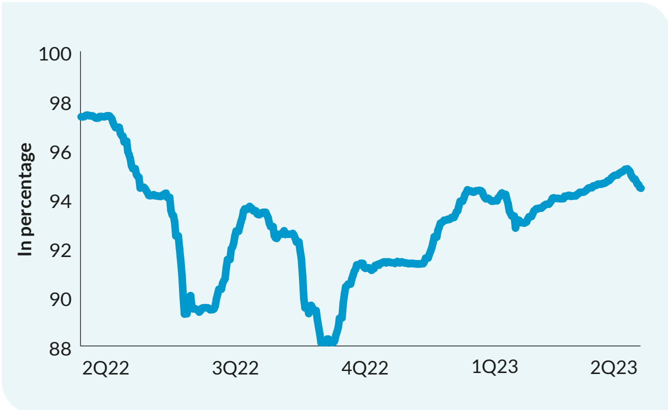
Weighted average bid of European loans



Source: PitchBook | LCD, July 2023. For illustrative purposes only.

US collateralized loan obligations

US CLO issuance

During Q2 2023, US CLO issuance dropped to the lowest quarterly levels posted since Q2 2020 during the Covid-19 pandemic. The challenges for new CLO issuance were on both sides of the ledger. The lack of new issue loan volume forced managers to bid up for desirable performing loans to fill new portfolios, while elevated CLO liability spreads persisted due to the continuing absence of several large investors (US money center banks which buy AAA tranches in size), resulting in an inadequate CLO equity return (equity arbitrage).

Q2 saw only 50 CLOs issued totaling USD 21.6 billion, compared to 77 new CLOs in Q1 for USD 33.6 billion.

Additionally, only one CLO reset/refinancing transaction occurred during Q2, with high liability spreads again to blame. Top tier managers (20+ CLOs under management) also continue to dominate new CLO activity, responsible for 67% of all second quarter issuance, which can be attributed to their access to cheaper liability spreads (cost of capital).

US CLO liability spreads

With market uncertainty throughout most of Q2, new issue CLO weighted average cost of capital ticked slightly higher to SOFR + 275bps, compared to SOFR + 270bps in Q1. The modest spread increase was driven by slightly higher AAA liability spreads, which averaged 199bps in Q2, compared to 197bps in Q1. Spreads on other liability tranches rated AA to BB also widened, especially at the lower end of the capital stack. BB liability spreads on top of SOFR were often offering better yields than the projected CLO equity at issuance. There was also a notable tiering differential for AAA spreads between top-tier active managers versus smaller managers, with a difference in spreads ranging up to 40bps during Q2 (averaging 185bpps vs 225bps). Structurally, five-year reinvestment periods with two-year non-call continued to dominate new CLO issuance, similar to Q1.

US CLO liabilities spreads

US CLO average coupon and weighted average cost of capital (bps)						
Time frame	AAA	AA	A	BBB	BB	WACC
4Q21 (LIBOR+)	116	172	217	325	660	172
1Q22 (SOFR+)	136	192	233	348	702	193
2Q22 (SOFR+)	163	233	294	411	756	224
3Q22 (SOFR+)	212	302	400	533	834	278
4Q22 (SOFR+)	231	322	415	582	850	293
1Q23 (SOFR+)	197	261	334	538	821	270
2Q23 (SOFR+)	199	273	339	554	856	275
Change from 1Q23	2	12	5	16	34	5
Change from a year ago	36	40	45	144	100	51

Source: PitchBook | LCD, July 2023. For illustrative purposes only.

US CLO secondary trading

Primary CLO new issuance volumes in Q2 were relatively weak, but secondary volumes remained stable compared to Q1, at USD 14 billion (a 33% YoY decrease). Spread tightening occurred across the capital structure, spurred by interest from both real and fast money managers. This was due to the attractive all-in yield and relative value offered compared to other credit and securitized products. As with the new issue market, a clear tiering emerged in the secondary market, depending on the CLO and manager quality, particularly in the mezzanine tranches. High-quality BBBs could trade in the low 400s bps, while lower-quality ones reached as high as the top end of the 600s. The effect was less pronounced for AAAs but still evident, with levels ranging from 165bps to 220bps and averaging around 175bps by the end of the quarter.

European collateralized loan obligations

Euro CLO issuance

The European CLO issuance market in the second quarter was relatively quiet but still open for business. Market technicals including weak new loan issuance, rapidly rising secondary loan prices and widening CLO liability spreads conspired to deter Euro CLO issuance volumes in Q2 once again. The projected CLO equity return (CLO arbitrage) proved to be too low for most managers, especially those reliant on raising third-party equity for each issuance, or in comparison to current BB tranche yields. Managers were instead left to sit on the sidelines to wait for better opportunities.

Consequently, Q2 2023 issuance totalled just 13 new Euro CLOs for EUR 5 billion, the lowest quarterly issuance recorded since Q2 2022, when the start of the invasion of Ukraine curtailed markets. This low Q2 issuance could not even keep pace with the weak average quarterly issuance volumes of EUR 6-6.7 billion posted the past three quarters.

Euro CLO liability spreads

Uncertainty on the economic front quickly translated into rising CLO liability costs in Q2 2023. New issue Euro CLO weighted average cost of capital jumped to EURIBOR + 296bps, compared to EURIBOR + 275bps in Q1. AAA liability spreads at 191bps were 11bps higher from Q1 levels of 180bps. Spreads across other liability tranches (rated AA to BB) widened even further, most notably for BBB and BB tranches which often came with large discounts (original issue discounts – OIDs). Again, deep OID on BB tranches offered yields that met or exceeded projected equity returns at present. Tiering of liability spreads between top and lower tier managers was also observed. However, given the smaller number of CLOs issued in the quarter, quantifying this tiering impact is difficult.

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
4Q21 (E+)	97	175	225	331	625	183
1Q22 (E+)	100	208	281	393	679	199
2Q22 (E+)	117	231	346	482	741	232
3Q22 (E+)	189	363	450	606	769	306
4Q22 (E+)	210	387	467	625	790	312
1Q23 (E+)	180	297	394	577	728	275
2Q23 (E+)	191	321	410	618	793	296
Change from 1Q23	11	24	16	41	65	22
Change from a year ago	73	90	64	136	52	64

Source: PitchBook | LCD, July 2023. For illustrative purposes only.

Euro CLO secondary trading

Following a sluggish Q1, which was attributed to a strong new issue pipeline and later to the banking crisis, secondary volumes made a comeback, rising +25% over Q1 to EUR 5.5 billion (and remaining flat YoY). Money managers actively deployed cash in the secondary market when the primary market was deemed too tight or the desired manager/paper wasn't readily available. The latter half of June, particularly after the Annual Global ABS conference, saw heightened trading activity as renewed optimism pushed AAA levels on high-quality assets to around 160bps. Similar to the US, a distinct tiering between high- and low-quality CLOs was evident, with mezzanine tranches of the two trading as much as 200bps apart.

About the author

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Spotlight topic: The slowing CLO issuance market's impact on loan demand

CLO markets have faced significant challenges over the past year: declining economic conditions; rising interest rates; weak new issue loan volumes; episodic secondary loan price rallies; broader credit underperformance and rating downgrades; elevated CLO liability spreads; a closed CLO reset window; and now the end of asset reinvestment periods for many pre-2019 vintage CLOs. Per Pitchbook LCD data (June 2023), the market is anticipating that as many as 40% of all outstanding CLOs could exit their reinvestment periods by the end of 2023, unless a window for CLO resets or refinancings opens soon. If these older CLOs are unable to reset or refinance, there will be a notable reduction in demand for longer duration loan assets by CLO managers, both in new issue loans and A&E transactions. Loan arranging banks have wrestled with this problem over the past two quarters as they attempted to syndicate such transactions. The driving issue for these older CLOs is their weighted average life or "WAL" test (a test designed to reduce quarterly to lower portfolio duration), which will soon begin breaching maximum limits based on typical CLO portfolios. This will restrict the addition of longer duration loans in the post-reinvestment period, even if structurally permissible (CLO rules may permit a reinvestment of principal proceeds from risk-asset sales or unscheduled prepayments, if otherwise in compliance with specific tests). The longer this trend continues, the weaker loan demand from CLOs becomes. As CLOs typically comprise over 70% of the total loan investing market, this is a significant concern for the broadly syndicated loan marketplace. While an improved economy would certainly help reignite loan demand via new fund and CLO creation, until this occurs the liquid loan supply-demand imbalance will widen. This could result in further market volatility and drive business uncertainty for loan issuers and investors alike.

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Source: Partners Group (2023).