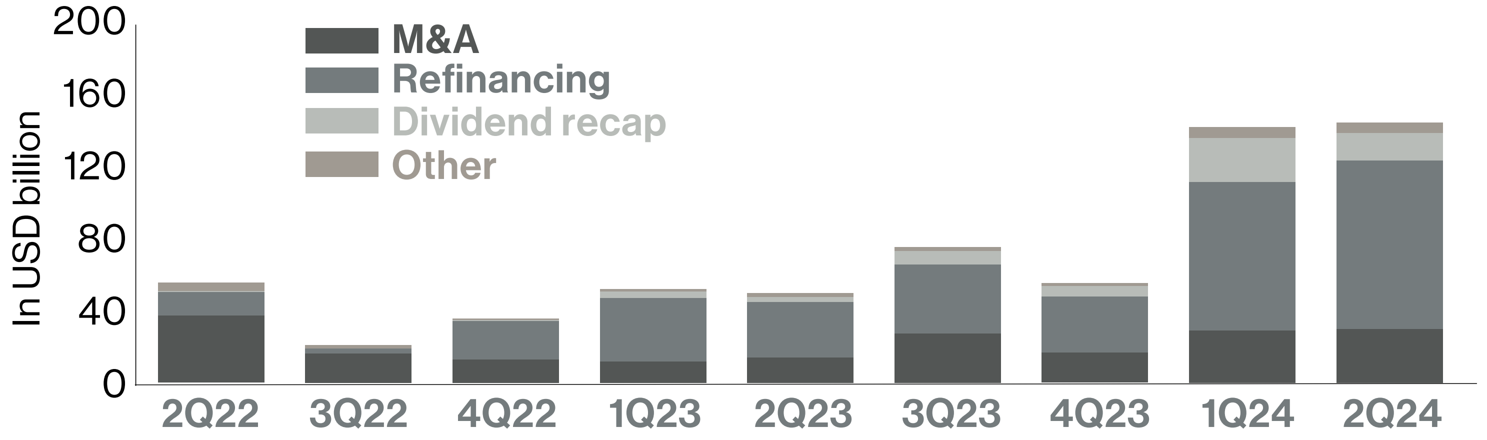
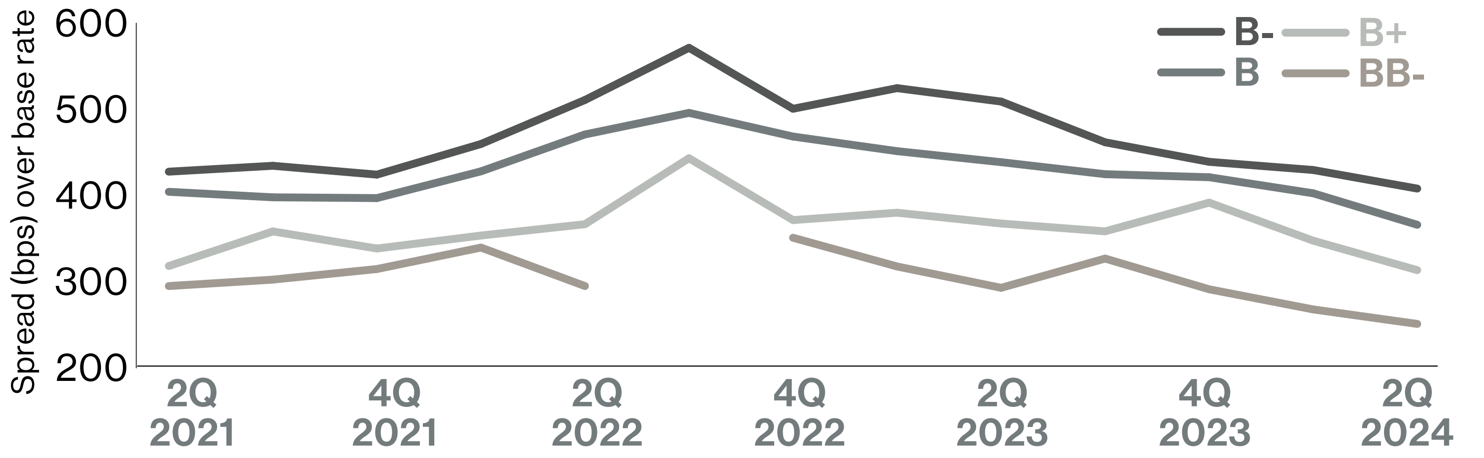
PARTNERS GROUP

Quarterly Liquid Credit Market Commentary Q2 2024 Issue 20

US new-issue institutional loan volume



US new-issue loan spreads



US loans index average bid (LLI)

Source: PitchBook | LCD • Data through 30 June 2024. For illustrative purposes only.

US liquid loan market overview

US liquid loan activity in Q2 2024 continued at a remarkable pace, thanks to unrelenting demand from both institutional and retail loan investors. Collateralized loan obligations (CLO) issuance activity also boomed in Q2, as CLO liability tranche spreads experienced tightening week after week. However, new loan supply did not keep pace with growing demand. M&A-related new issue volumes disappointed again in Q2. With M&A loans serving as the primary source of new supply for the loan market, the continuation of a weak transaction environment against heavy investor demand fueled secondary trading bids higher. Loan issuers continued to seize on this opportunity to pursue refinancings, repricings and maturity extensions. Now, halfway through 2024, refinancings and repricings have already eclipsed record annual volumes dating to 2013 and 2017. However, dividend recap loans, another area of loan activity, slipped during Q2, despite favorable market conditions. Yet, even at a slower pace in Q2, dividend recap transaction volume for the full year should easily exceed annual records.

While the long awaited Fed interest rate cut cycle has been delayed until the second half of 2024, loan returns slipped in Q2 due to tightening loan spreads across all sectors. In the first six months of the year, already 30% of all US leveraged loans outstanding have completed a repricing transaction. Additionally, with most loan investors unwilling to reject repricing and refinancing requests in fear of accumulating even more cash to invest, many loan issuers successfully pursued aggressive loan spread reductions of 50 to 75bps. There was no mistaking in Q2 that this was a one-way "sellers' market". Investors had little choice but to agree or risk being prepaid in the process. Based on the first two quarters of data for 2024, the US primary loan market is now positioned to shatter post-financial crisis records for US leveraged loan market activity, surpassing the recent highs posted in 2013, 2017 and 2021.

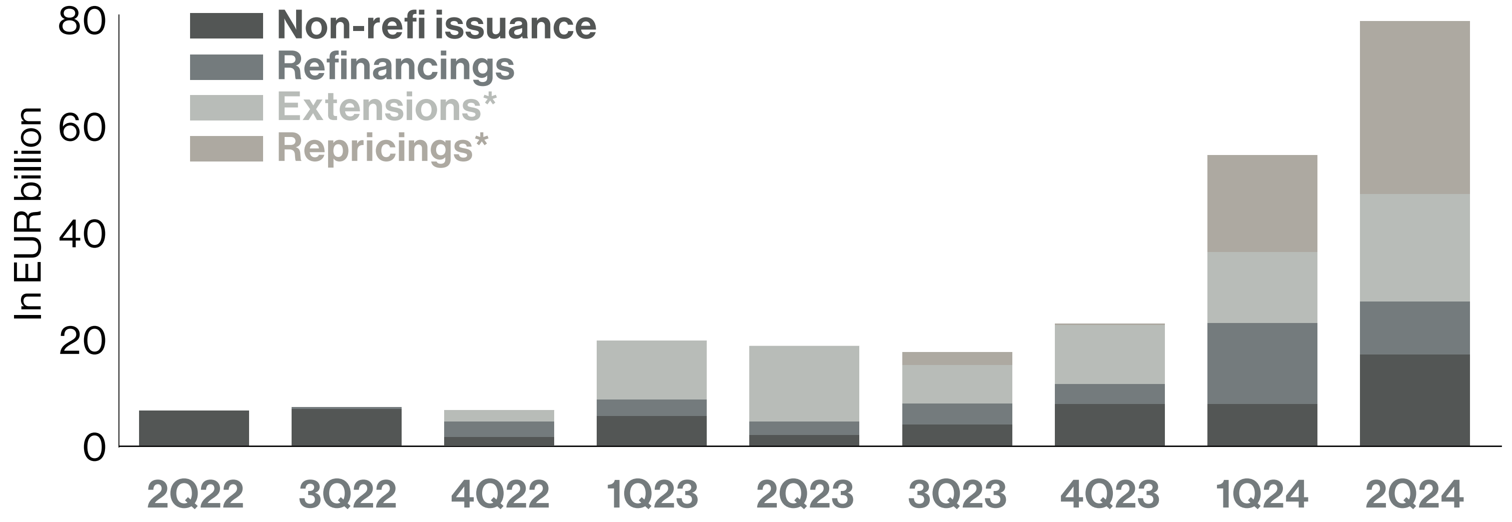
US new-issue loan issuance

Q2 2024 saw record US leveraged loan activity of USD 405 billion, following an already robust USD 331 billion posted in Q1. The story of the second quarter revolved around the unrelenting wave of loan repricings totaling USD 223.4 billion, after the record USD 154.8 billion closed in Q1. Loan investors found themselves confronted with numerous repricing requests, often from a dozen issuers or more concurrently. Refinancing activity during Q2 also jumped, reaching USD 94.3 billion, compared to USD 83 billion in Q1. Lastly, loan maturity extension activity produced USD 35.9 billion of volume in Q2, slightly higher than the USD 33.2 billion in Q1. As for new loan creation, M&A-driven issuance was flat in Q2 at USD 30 billion, compared to USD 29.3 billion in Q1. Dividend recaps, typically a staple during most loan rallies, surprisingly trailed off during Q2, posting only USD 15.7 billion, after reaching USD 24.9 billion in Q1. But even at a reduced pace, dividend recapitalizations are still poised to shatter records this year, if current market conditions prevail in the next two quarters. Finally, it is worth noting that US loan market activity in Q2 was also well balanced across credit rating categories from B- to BB-. This rising tide lifted all boats, as both institutional and retail loan investors were unabashedly "risk-on" across the entire credit rating spectrum.

US new-issue loan spreads

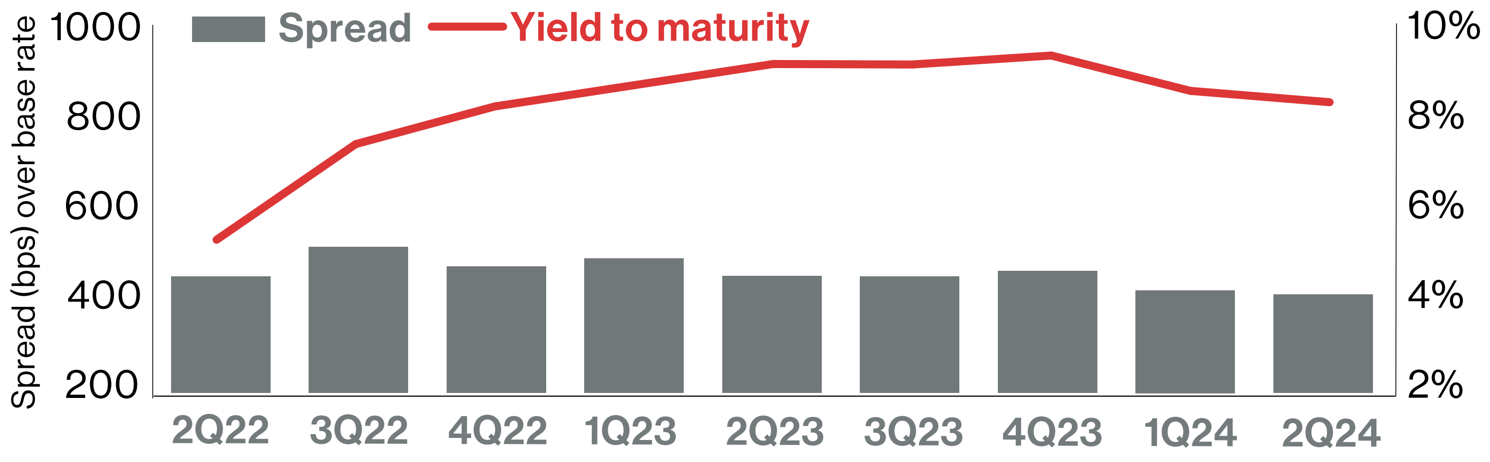
The paltry new loan issue that came to market in Q2 was certainly well received by loan investors regardless of credit rating. With the excess demand, loan issuers tightened loan spreads on new issue by 15 to 50bps during the second quarter. While not meaningfully lower, issuers rated BB- reduced average spreads to 249bps in Q2, compared to 267bps in Q1. Issuers rated B+ captured the largest spread reduction of Q2, with average spreads down to 314bps, from 350bps in Q1, while loan issuers rated B and B- netted average spreads of 369bps and 413bps, respectively, compared to 407bps and 436bps in Q1. Even more significantly, these lower new-issue loan spreads in Q2 helped establish market benchmarks for comparably rated loan issuers seeking to reprice or refinance loans during the quarter. While the SOFR base rate remained relatively range bound around 5.3% during the past two quarters, total loan yields have been steadily declining across almost every loan

European new-issue institutional loan volume

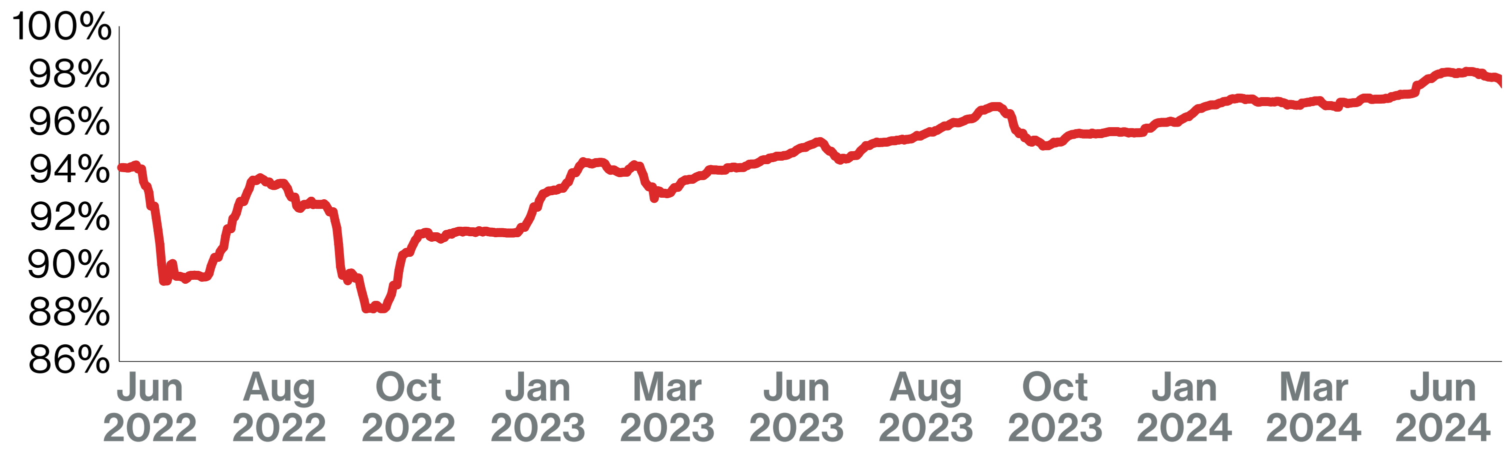


Reflects extensions and repricings done via amendment process only.

European average new-issue loan spreads and yield



European loan index (ELLI)



Source: PitchBook | LCD • Data through 30 June 2024. For illustrative purposes only.

portfolio. The average market loan spread at year-end 2023 was 439bps with an average yield-to-maturity of 10.74%. Six months later in June 2024, average market loan spreads have declined to 373bps and the average yield-to-maturity was at 9.55%.

US secondary loan trading

The loan supply-demand imbalance kept secondary loan trading levels strong through most of Q2, albeit range bound. The Morningstar LSTA US Leveraged Loan Index (LLI) began April 2024 at 96.76% but ended June at 96.55%, trailing off slightly in the last few weeks of the quarter. Indicative also of continuing strong secondary market demand was that at least 40% of all leveraged loans were bid above par during the quarter. For Q2, the LLI gained 1.90%, after posting 2.46% in Q1. While nowhere close to matching the historic returns posted during 2023, this six-month return for the LLI still compares quite favorably to those from 2020, 2021 and 2022.

European liquid loan market overview

Activity in the European syndicated leveraged loan market during Q2 also exploded with total institutional loan issuance topping EUR 134 billion, the strongest quarter of activity recorded since Q2 2021. While European M&A and dividend recap activity picked up slightly in the second quarter, the lack of meaningful new supply continues to push investors to the secondary market to source assets. This scenario has also prompted a greater willingness to approve repricing and refinancing amendments in order to retain assets under management and not add to cash balances. These market technicals contributed to another strong rally in secondary prices and further tightening of loan spreads and yields in Q2.

European new-issue loan issuance

New loan issue volumes in Europe for Q2 increased to EUR 17 billion, compared to EUR 7.7 billion in Q1, driven primarily by EUR 11 billion of M&A volume. Dividend recap transactions ticked higher as well, posting EUR 3.9 billion in Q2, compared to EUR 1.8 billion in Q1. Despite these improved metrics in new loan supply, it was loan repricings and maturity extensions that really pushed loan activity in Q2 to another level.

Repricings totaled EUR 32.4 billion, compared to EUR 18.2 billion in Q1, while maturity extensions contributed EUR 20.2 billion, compared to EUR 13.3 billion in Q1. Refinancing transactions, however, were lower in Q2 at EUR 9.9 billion, after having posted EUR 15.3 billion in Q1. But it should be noted that volumes in Q1 were extraordinary, and the Q2 refinancing volume was still the second highest recorded since 2021. From the EUR 79.6 billion of total institutional loan activity recorded in Q2, only EUR 17 billion was actually added to loan supply.

European new-issue loan spreads

As investor demand continued to exceed loan supply, the limited new loan issuance was well received and resulted in tighter spreads in Q2. New-issue loan spreads for a single B-rated credit tightened to 431bps in Q2, compared to 422bps in Q1, and 464bps at the end of 2023. The average yield-to-maturity for new issue loans also declined in Q2 to 8.30%, from 8.52% in Q1, and 9.29% at the end of 2023.

European secondary loan trading

With significant investor focus on the secondary market to source loans after new issue volumes again failed to produce sufficient supply, European secondary loan prices rose higher in Q2. The Morningstar European Leveraged Loan Index (ELLI) started April at 96.87%, rose steadily through mid-June, before moving slightly lower to 97.61% by June end. This price rally in the second quarter resulted in a total return of 2.36% for the ELLI. Year-to-date June 30, the ELLI return was 4.89%.

US collateralized loan obligations

US CLO issuance

Records are made to be broken, and 2024 CLO issuance appears to be well on its way to do just that. With over 40% of all US CLOs entering 2024 past their reinvestment period, numerous CLOs have been called (liquidations) or subjected to active AAA tranche amortization (resulting in cash returned to CLO investors). With many CLOs no longer able to reinvest eligible cash created by recent loan refinancings and prepayments, given CLO compliance test restrictions and limits, CLO investors quickly found themselves flush with cash.

US CLO liabilities spreads

US CLO average coupon and weighted average cost of capital (bps)

Time frame	AAA	AA	A	BBB	BB	WACC
3Q22 (SOFR+)	212	302	400	533	834	282
4Q22 (SOFR+)	231	322	415	582	850	299
1Q23 (SOFR+)	196	261	335	541	825	270
2Q23 (SOFR+)	198	273	336	549	853	275
3Q23 (SOFR+)	187	260	314	495	790	260
4Q23 (SOFR+)	176	256	302	483	786	254
1Q24 (SOFR+)	157	209	255	392	689	213
2Q24 (SOFR+)	150	190	230	349	638	194
Change from 1Q24	-7	-19	-25	-43	-51	-19
Change from a year ago	-48	-83	-106	-200	-215	-81

Source: PitchBook | LCD • Data through 30 June 2024. For illustrative purposes only.

Q2 2024 saw an astounding USD 52.6 billion of new-issue US CLO volume generated from 108 issues, topping an already extraordinary USD 49 billion (106 issues) of new volume tallied during Q1. Worth noting of this impressive Q2 result – the second best issuance quarter on record – was that June volumes actually slowed down meaningfully. It was almost as if the market decided to take a moment to collectively catch its breath to prepare for more of the same activity in the second half of the year. While unclear if this high level of volume is sustainable over the second half of 2024, this year will certainly be at least a top-three issuance year on record. In a ddition to the heavy volume of new CLO issue, CLO resets and refinancings were notably active, with Q2 resets totaling USD 48.3 billion and refinancings USD 24.5 billion, compared to Q1 resets of USD 24.4 billion and refinancings of USD 14.6 billion, as tightening liability spreads spurred more activity.

US CLO liability spreads

Much as it was in Q1, strong new issue volumes in Q2 were driven by continually tightening CLO liability spreads throughout the quarter. Weighted average cost of capital (WACC) for new CLOs declined to 194bps in Q2, from 213bps in Q1. For AAA-rated liability tranches, spreads declined from 157bps in Q1 to 150bps in Q2, while spreads on tranches rated AA to BB experienced spread declines of 19 and 51bps, respectively.

US CLO secondary trading

Trading volumes in Q2 were roughly flat year-on-year but down 15% quarter-on-quarter, given much of the investor focus was on the busy primary market, which meant the premium between the two markets continued to grow. Demand for CLO liabilities was so high that multiple bonds changed hands with a negative spread-to-worst, while high coupon bonds routinely traded 4 to 5 points above par. Secondary liabilities spreads compressed by -10bps down to 120bps for AAA-rated bonds, and -15bps down to 650bps for BB-rated bonds, with the magnitude of the compression much more pronounced for Tier 1 CLO managers.

European collateralized loan obligations

European CLO issuance increased nicely in Q2 2024, as tightening liability spreads combined with stronger investor demand pushed CLO managers to increase the pace of issuance. Similarly to the first quarter of 2024, CLO resets and refinancings were also active.

Euro CLO liabilities spreads

Euro CLO average coupon and weighted average cost of capital (bps)

Time frame	AAA	AA	A	BBB	BB	WACC
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
3Q23 (E+)	174	256	336	513	733	263
4Q23 (E+)	172	266	357	560	789	266
1Q24 (E+)	149	224	276	407	674	227
2Q24 (E+)	145	210	263	376	661	222
Change from 1Q24	-4	-14	-13	-31	-13	-5
Change from a year ago	-46	-111	-147	-242	-132	-74

Source: PitchBook | LCD • Data through 30 June 2024. For illustrative purposes only.

Euro CLO issuance

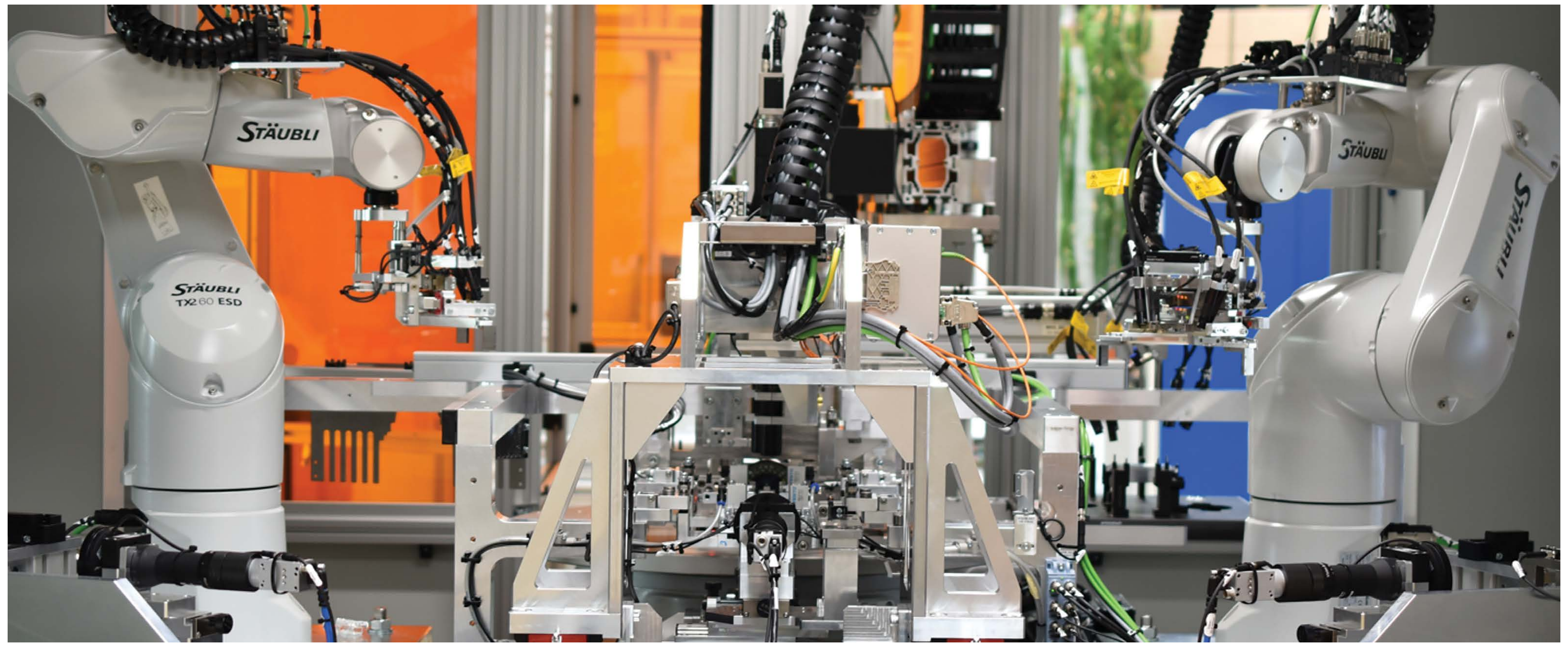
New European CLO issuance totaled EUR 13.6 billion from 32 CLOs in Q2, improving on the EUR 10.9 billion from 26 CLOs issued during Q1. This was easily the best quarter of CLO activity observed in Europe since Q4 2021, when 31 CLOs totaling EUR 13 billion were issued. Concurrently, CLO reset and refinancing activity picked up as well, totaling EUR 4.7 billion in Q2, compared to EUR 4 billion for Q1. This brought total CLO activity for Q2 to EUR 18.3 billion, compared to EUR 14.9 billion in Q1.

Euro CLO liability spreads

Despite the higher volume of new CLOs, resets and refinancings, the WACC for European CLOs issued in Q2 declined to 222bps in Q2, compared to 227bps in Q1 and 296bps in Q2 2023. Reductions in liability spreads were seen across the capital stack. AAA spreads tightened to 145bps in Q2 from 149bps in Q1, while liability spreads in other liability tranches declined from 14bps on AA-rated tranches to 31bps for BBB-rated tranches. Much like in US, for the Euro CLO issuance cycle to continue, loan (collateral) spreads must either stop declining or CLO liability costs must tighten further to make the CLO equity arbitrage and minimum equity target return levels work.

Euro CLO secondary trading

Secondary CLO liabilities trading volume was subdued in Europe during Q2, registering only EUR 3 billion of activity. This was down approximately 36% quarter-on-quarter and 43% year-on-year, driven by a flood of primary issuance which hit the market during the quarter. The limited volume in the secondary market led to additional spread tightening across the capital structure, with the spread premium versus the primary issuance on AAA rising to 30bps by the end of the quarter. Thanks to the elevated base rates and strong demand for credit products, European CLOs posted a 13.7% annualized gain for the quarter.



Spotlight topic:

(Re)moving the loan maturity wall

The massive refinancing and maturity extension wave in the US loan market in the first half of 2024 has had a huge impact on extending the loan maturity wall. At the start of January 2024, USD 93 billion (6.7% of the total) of US loans outstanding had maturities before year-end 2025, while loans due in 2026 totaled USD 174.5 billion (12.6%) and USD 252.6 billion for 2027 (18.2%).

Jump forward six months to June 2024 and loans due by the end of 2025 stood at only USD 36.6 billion, a 61% reduction. The number of loan maturities have also declined significantly for the following years: USD 90.1 billion by the end of 2026 (down 48%) and USD 180.8 billion by the end of 2027 (down 28%). Many US loan issuers benefitted from this latest refinancing window, extending loan duration by 1-2 years, while also reducing loan interest expense in the process. While this has resulted in lower returns on longer duration loans held in portfolios, it has also served to reduce tail risk and refinancing uncertainty for many loans. With over 77% of all US syndicated leveraged loans outstanding currently maturing in 2028 or later, the US loan market has successfully reduced maturity risk and, in doing so, eliminated a significant risk element from investor focus.

About the author

Mark Hanslin is a Managing Director & Senior Portfolio Manager who leads Partners Group's Liquid Credit Team in New York. He has over three decades of liquid credit underwriting, investment and portfolio management experience for global corporate banks and investment management companies.

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