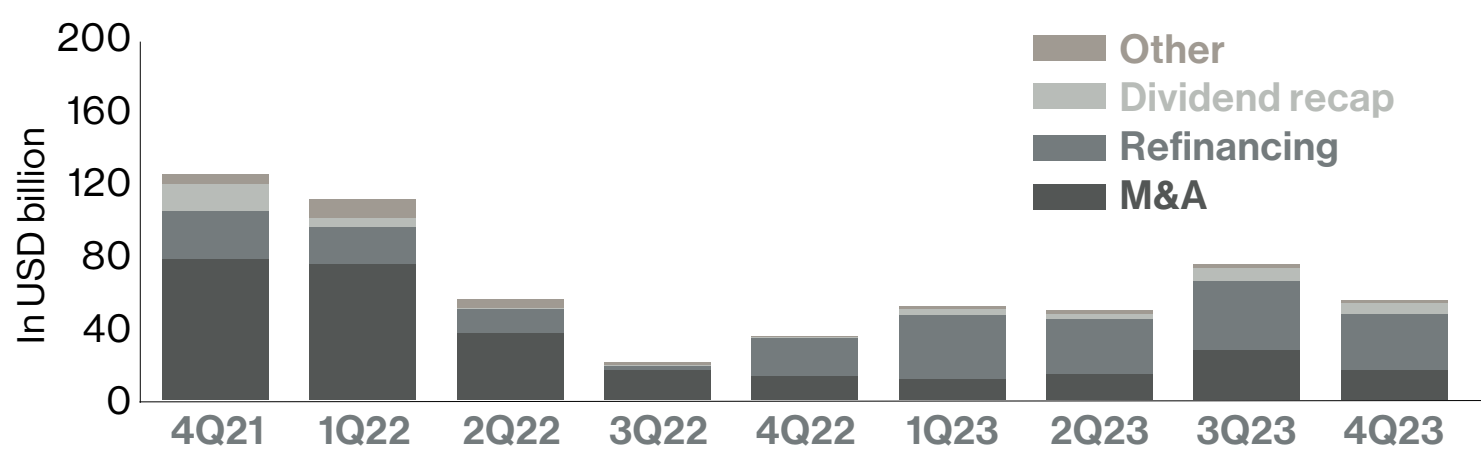
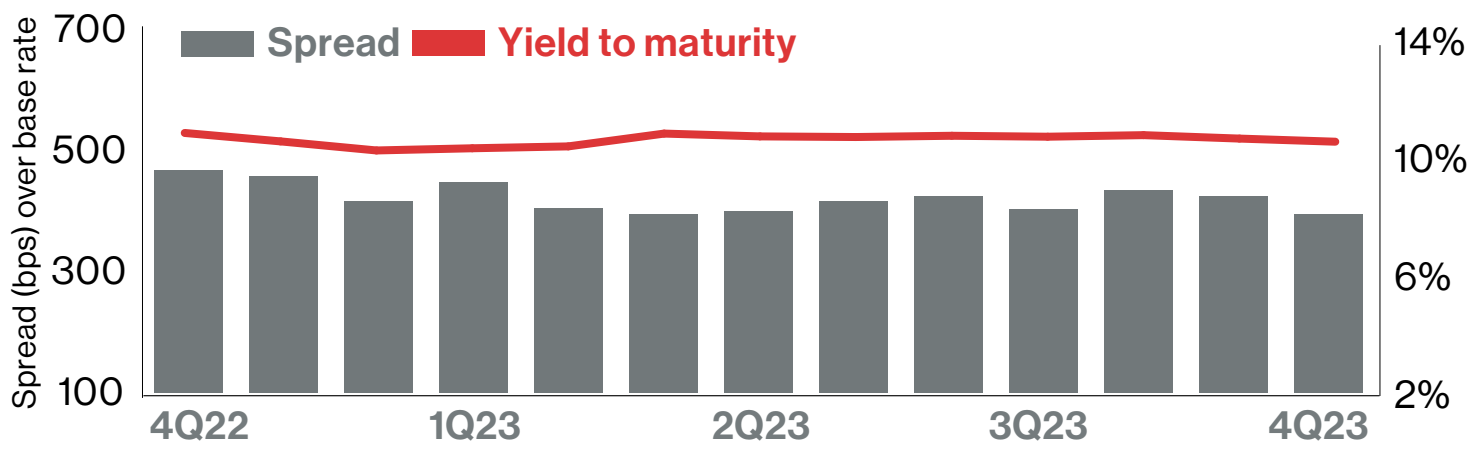


Quarterly Liquid Loan Market Commentary Q4 2023 Issue 18

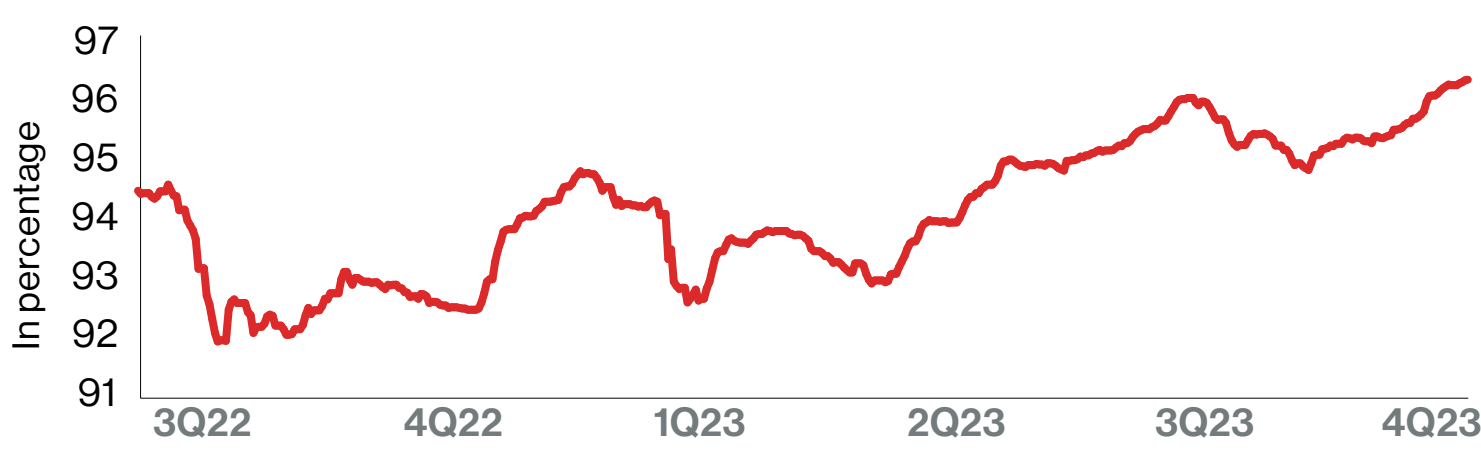
US new-issue institutional loan volume



US average new-issue loan spread and yield



US loans index average bid (LLI)



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

US liquid loan market overview

The US leveraged loans market ended the year with a frenetic last quarter in which continued sluggish new-issue loan volumes led to an extended secondary loan rally. Whether investors were shifting strategy back to “risk-on” or just seeking to redeploy cash, both institutional and retail investors were quickly drawn to most loan offerings, reflecting a growing fear of missing out. Collateralized loan obligations (CLO) issuance for Q4 remained solid, stimulating loan demand, despite the growing number of CLOs ending their reinvestment cycle. Retail investor demand was also positive for the second consecutive quarter as the search for yield continued. The steady bid for well-performing loans resulted in US leveraged loans posting a remarkable annual return of 13.32% for 2023, the second highest since the Global Financial Crisis. And with no meaningful pickup in M&A and LBO activity, loan refinancings and debt maturity extensions ruled the day for much of Q4.

US new-issue loan issuance

New institutional loan issuance in the US in Q4 slid to USD 55.6 billion, compared to USD 75.8 billion in Q3, but was still at a welcomed level compared to Q1 and Q2 volumes. The pickup of M&A activity seen during Q3, however, could not be sustained, with M&A during the final three months of the year slipping to USD 16.7 billion, compared to USD 27.5 billion in Q3. The

void in M&A-related loan issuance was quickly filled by existing loan issuers rushing in with refinancing transactions, which totaled USD 31.2 billion in Q4. But this refinancing volume was also lower than Q3 activity. While partially driven by the need to extend upcoming maturities in 2025 and 2026, loan issuers who saw their loans trade consistently above par quickly seized on the opportunity to reduce loan spreads, especially those loans which printed just six to nine months earlier.

Also noteworthy in Q4 was that more than half of the issuers refinancing or extending maturities were higher-rated companies (BB- or better) who enjoyed strong investor demand against otherwise weak economic conditions. Lastly, Q4 saw a moderate amount of dividend recap activity, similar to Q3 levels, after being quiet for the past year.

For the full year, total loan activity volume was at USD 233.9 billion, marginally higher than 2022 and driven mainly by sizable refinancing activity of USD 136.6 billion. Meanwhile, M&A activity only contributed USD 70 billion in 2023. This was the second lowest M&A-related loan activity posted in the past decade and less than 21% of the total M&A activity during the record-shattering COVID reopening year of 2021 of USD 330.4 billion. From these 2023 totals, it was easy to see how the large supply-demand imbalance during last year triggered a relentless loan rally in the second half.

US new-issue loan spreads

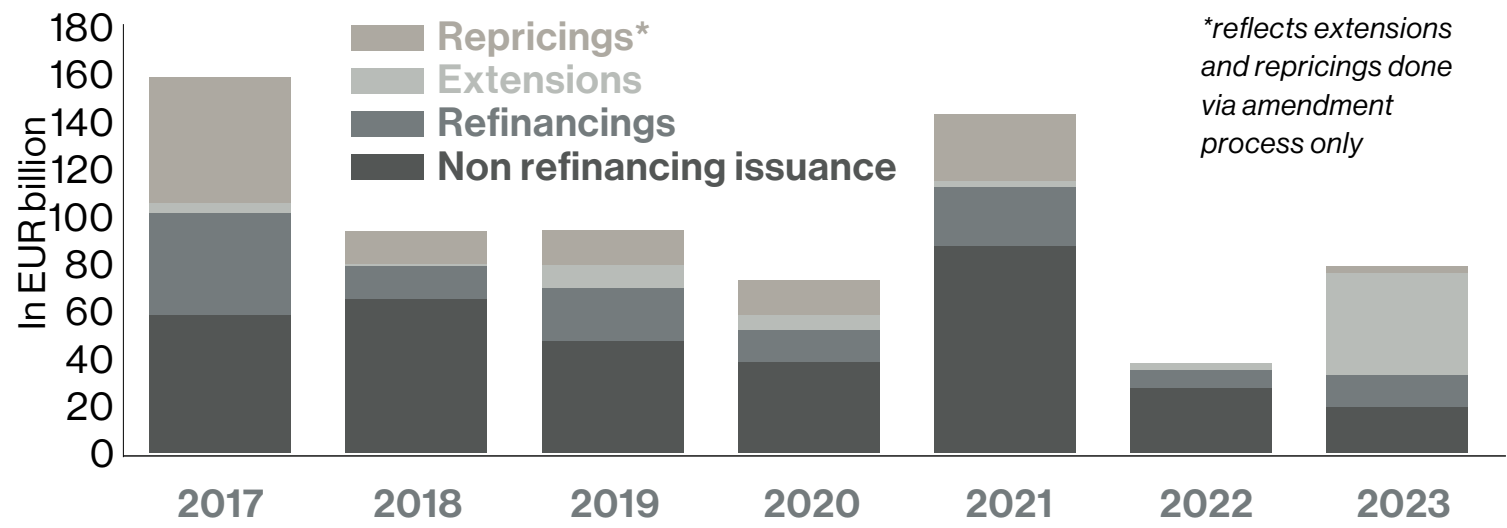
With such strong investor demand prevailing, new-issue loan spreads by the end of Q4 for single B/ B+ rated loan issuers ticked down 30 bps to SOFR +391bps from Q3 2023 – notably lower than the SOFR+463bps from a year earlier.

All-in yield of new loans by Q4’s end remained slightly above 10.0%, due to elevated loan spreads, SOFR of 5.3%, average original issue discount (OID) of 1.2%, and a market average SOFR credit spread adjustment of 6 bps. With growing refinancing and amend and extend (A&E) activity tightening loan spreads further and the probability of interest rate cuts beginning in 2024, the average all-in yield for B/B+ rated loans is unlikely to stay above 10% much longer.

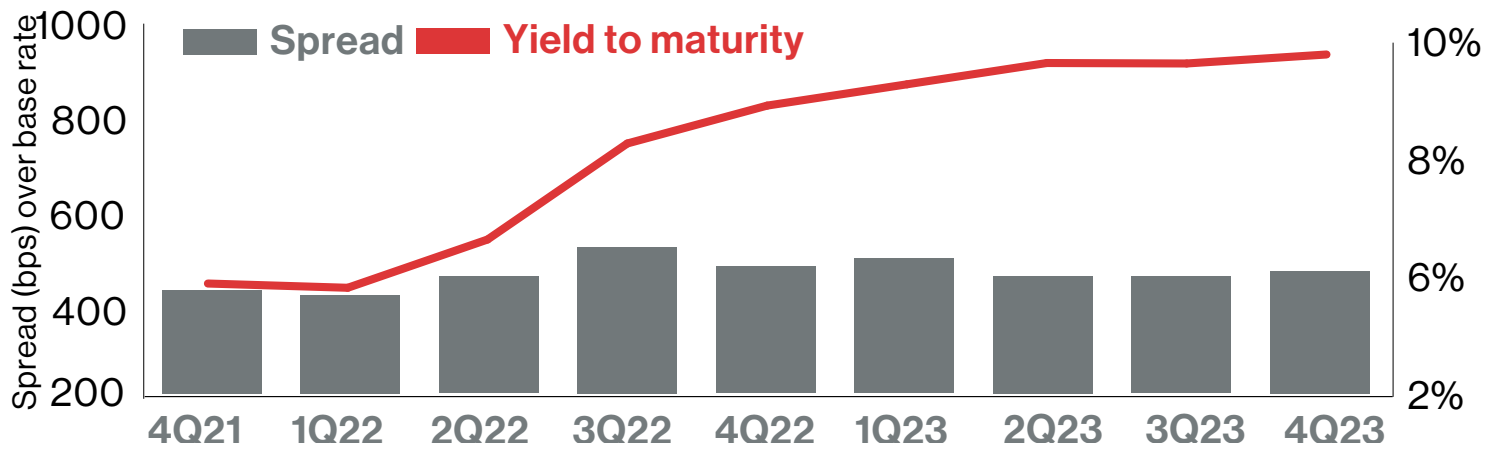
US secondary loan trading

US secondary loan trading was stabilized in Q4 reflecting a better balance of supply and demand. The Morningstar LSTA US Leveraged Loan Index (LLI) began October at 95.56% and ended the year at 96.23%, the highest level posted since May 2022. Loans which typically populate new CLOs were the strongest to rally in price, with many trading above 100% in Q4 for the first time in years. Loans trading at lower discounts also rallied, but it was clear that credit quality was still the primary driver.

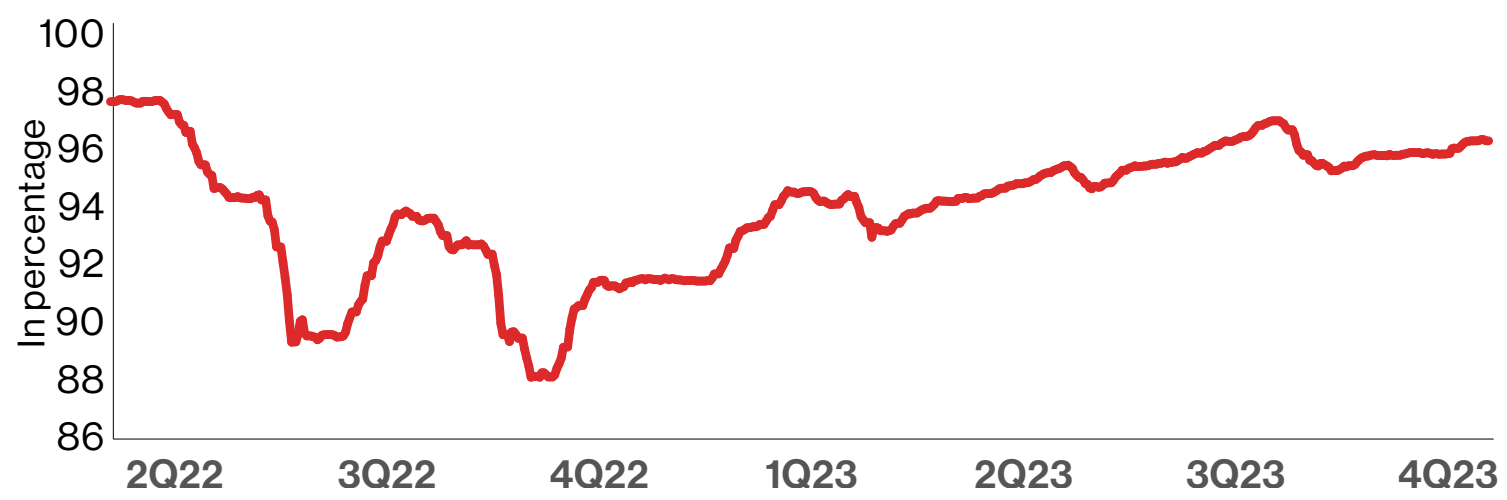
European new-issue institutional loan volume



European average new-issue loan spreads and yield



European loan index (ELLI)



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

For all of 2023, the secondary loan market saw an impressive rally in the LLI, which opened in January at 92.44%, and rose ever higher before closing out at 96.21% in December. Overall for 2023, the LLI posted an impressive 13.32% return, the best year observed since the Global Financial Crisis, and an astonishing reversal from last year’s return of -0.77%.

European liquid loan market overview

While 2023 was a busy year in the European leveraged loan market, it was certainly not due to any meaningful resumption of M&A activity. Much like in the US market, rising rates, inflation and economic headwinds in Europe continued to stifle M&A activity and limit new-loan issuance volume.

But after observing the steady investor demand, loan issuers used the opportunity to amend and extend, refinance and issue incremental loans, while capturing tighter loan spreads, and extending the duration of capital structures. This had a significant impact on the leveraged loan maturity wall in Europe, which by the end of 2023 saw almost no remaining 2024 maturities outstanding, and just EUR 11.5 billion of 2025 maturities remaining.

European new-issue loan issuance

New loan issuance in Europe was again disappointing in 2023, as M&A-related financing activity struggled, producing just EUR 16.2 billion of new issuance for the full year. But there was still strong market activity elsewhere, as refinancings, maturity extensions and



repricings filled this void, especially during the second half of the year. For the full year, European leveraged loan activity totaled EUR 78.4 billion, with only EUR 19.1 billion coming from non-refinancing (i.e. new money) transactions.

Maturity extensions soared to a record EUR 43.3 billion, refinancings topped EUR 13.4 billion, and loan repricings came in at EUR 2.6 billion. 2023’s total was twice the amount of loan activity achieved in 2022 (EUR 37.4 billion). The primary difference

in increased activity was in the massive wave of extension activity completed, which cleared out most 2024 loan maturities, reduced a large portion of loans due in 2025, and extended the median loan maturity in Europe from 2026 to 2028.

European new-issue loan spreads

With new European loan supply well below investor demand, new-issue loan spreads tightened in 2023, even as EURIBOR base rates increased loan yields throughout the year. Nonetheless, the mix of riskier issuers in the market pushed spreads wider in Q4 to an average of 464bps, compared to 452bps in Q3. Q4 average yield to maturity of 9.29% per annum established the widest loan yield observed in the European market in the past decade, and more than 1% higher than loan yields posted at the end of 2022. While great for investors, these higher yields posed a growing challenge for loan issuers.

European secondary loan trading

As the demand for loans remained steady through most of the year but the new issue market lagged, investors seeking to redeploy cash or those ramping new CLOs were forced to rely on the secondary trading market. This launched a massive loan rally which saw the Morningstar European Leveraged Loan Index (ELLI) rise from 91.34% at the start of January 2023 to a peak of 96.69% in late September, before finishing the year at 96.02%. When combined with the rapid rise in EURIBOR, this culminated in an astonishing 13.42% annual return for the ELLI in 2023, which was even more remarkable when compared to the -3.0% return in 2022.

US collateralized loan obligations

US CLO issuance

US CLO issuance continued on a solid path in Q4, even as loan prices rose, thanks to tightening CLO liability spreads. While CLO equity return (arbitrage) was arguably tight through most of Q4, causing some managers to refrain from hitting the market, 74 CLOs were issued in Q4, totaling USD 31.9 billion, compared to 63 CLOs and USD 28.0 billion issued in Q3.

US CLO liabilities spreads

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

Time frame	AAA	AA	A	BBB	BB	WACC
1Q22(LIBOR+)	136	192	233	348	702	193
2Q22 (SOFR+)	163	233	294	411	756	224
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	257	303	484	786	255
Change from 3Q23	-11	-3	-11	-10	-3	-5
Change from a year ago	-55	-66	-112	-98	-64	-44

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

For the full year, new CLO issuance totaled USD 115.8 billion from 266 CLOs, compared to USD 128.9 billion from 282 CLOs in 2022. While still a reasonably good result for 2023 in light of weak economic conditions, the issuance volume was a step backwards for the second straight year, making 2023 volume only the seventh best annual issuance volume posted in the past decade.

While subdued for much of 2023, a pickup in CLO reset and refinancing activity was finally observed in Q4, driven by high-liability spread 2022 vintage CLOs with shorter non-call dates. For the full year, there were 43 reset transactions totaling USD 19.6 billion, of which USD 12.4 billion occurred in Q4. This year’s total nearly equaled the USD 20 billion of resets completed in 2022. Moreover, 2023 saw USD 5.0 billion of refinancings completed, a slight increase over the USD 4.8 billion of refinancings completed in 2022.

US CLO liability spreads

As referenced earlier, CLO liability spreads continued to tighten in Q4 as investor demand for the asset class remained strong. The weighted average cost of capital (WACC) for new CLOs in Q4 declined to an average of SOFR+255bps, down 5bps from Q3, and 44bps from a year ago.

AAA rated CLO liabilities, the largest portion of the CLO liability stack, averaged SOFR+176bps in Q4, compared to SOFR+187bps in Q3. The remaining CLO liability tranches rated AA to BB also priced lower in Q4, down by 3 to 11bps from Q3 levels, as investor demand remained steady across all tranches.



US CLO secondary trading

While Q4 started with some spread widening due to renewed macro concerns, November and December brought a strong rally across asset classes that continued into the new year. Despite a large primary pipeline, the Christmas holidays and CLO conferences, the secondary market remained quite active, with USD 13.6 billion changing hands in the quarter. Volumes were up 3% year-on-year, supported by the need to recycle capital returned to investors due to an increasing number of liquidations and some resets. The mezzanine tranches were still the best performing across the stack, delivering equity-like returns in the +25% area for the 2023.

European collateralized loan obligations

European CLO issuance for 2023 remained surprisingly strong despite economic conditions. Low volume of new-loan issuance and rising secondary loan prices made CLO ramping a daunting challenge, but it still did not impede activity. With tighter equity arbitrage, most of the CLO managers that issued in 2023 were those with captive equity or with third-party equity investors more willing to be flexible around target returns.

Euro CLO liabilities spreads

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

Time frame	AAA	AA	A	BBB	BB	WACC
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
3Q23 (E+)	174	256	336	513	733	263
4Q23 (E+)	172	266	358	560	789	266
Change from 3Q23	-2	10	21	48	55	3
Change from a year ago	-38	-121	-110	-65	-2	-46

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

Euro CLO issuance

For Q4, 20 new CLOs priced totaling EUR 7.6 billion, the strongest issuance quarter since Q1 2022, and modestly higher than the 18 CLOs and EUR 6.9 billion of Q3. Also, as observed during Q3, a handful of shorter dated 2022 CLOs pursued reset opportunities in Q4, even as wide CLO liability spreads remained unattractive to many other managers. Five CLOs from the 2022 vintage were able to reset before year-end. For full year 2023, new CLO issuance totaled EUR 26.2 billion from 69 CLOs, almost equal to 2022 activity, and tied for the fourth busiest year on record for Europe.

Also, for the second consecutive year 44 different managers issued CLOs in Europe during 2023, including the debut issuance from seven new managers.

Euro CLO liability spreads

Q4 2023 saw a return of volatility for Euro CLO liabilities, as new issue AAA rated spreads tightened slightly during the quarter to 172bps, compared

to 174bps in Q3. AA, A, BBB and BB rated liability spreads increased between 10 and 48 bps during the quarter, as investor demand waned when the year began to close. Despite the tighter AAA spreads, Q4 average WACC rose to 266bps, from 263bps in Q3. Overall, 2023 was a positive year as CLO liability spreads tightened meaningfully from Q2 on, but there remained much room for improvement compared to the spreads prevailing in the European market before the Ukraine invasion.

Euro CLO secondary trading

The relentless primary issuance suppressed secondary trading activity in Europe to EUR 3.2 billion, with volumes down 32% quarter-on-quarter and 48% year-on-year. A notable outperformer was the equity tranche, for which the volume was down only 5% year-on-year, supported by a limited arbitrage in new issue equity and rising returns in seasoned tranches. Spreads rallied strongly into the end of the year, with strong demand coming from an expectation of further tightening in the new year.



Spotlight topic: SOFR credit spread adjustment on US loans – Now you see it, now you don’t

Just six months after the US loan market transitioned from a LIBOR to a SOFR interest rate base, the leveraged loan market is now observing a rapid elimination of the SOFR-driven credit spread adjustments (CSA) from new loan transactions, loan repricings, and amend and extend transactions. CSAs – typically 11/26/43 bps added to 1-, 3- or 6-month SOFR rates to offset the credit risk component missing in comparison to LIBOR – was a highly debated topic in the quarters leading up to the mandatory SOFR adoption on 1 July 2023. Loan issuers, initially opposed to including CSAs, mostly capitulated by the SOFR inception date, although certain stronger loan issuers successfully negotiated a lower than market convention CSA (e.g., 10 bps). For CLOs, a CSA on loan assets and on CLO liabilities was largely expected to offset each other.

Jumping forward six months to late 2023, however, we began to see

many loan issuers taking advantage of the relentless investor demand for loans by issuing or amending loans with no CSA. The assumption that hungry loan investors would acquiesce on CSAs continuing, or instead accept the proposition that it was embedded as part of the loan’s spread, proved correct. CLOs, typically 70% of all US leveraged loan holders, quickly discovered many of their portfolio assets would not only have tighter loan spreads (e.g., on average 25-50bps reductions) but would drop CSAs as well. And just like that, CSAs on many loans began vanishing just as fast as they appeared 6-12 months ago. Meanwhile, CLOs were still required to pay a CSA on SOFR based liability tranches. This unexpected change to CLO economics could eventually reduce equity returns by 1-2% per annum. Absent a CLO reset or refinance to also eliminate CSAs from liability tranches, there is no way to remedy this latest development.

About the author



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¹ Source: Partners Group (2023).

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