Partners Group

REALIZING POTENTIAL IN PRIVATE MARKETS

Quarterly Liquid Loan Market Commentary

Q1 2023 | Issue 15

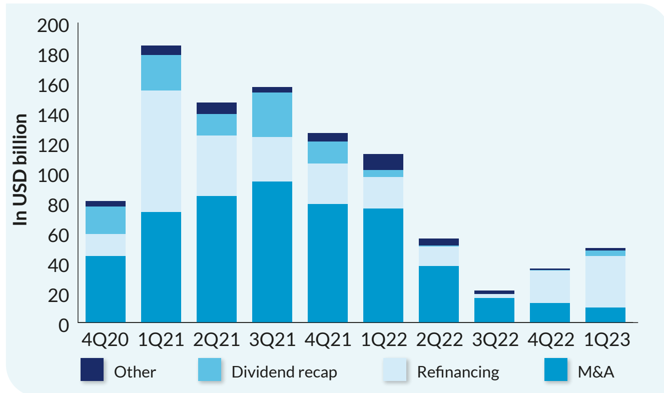
US liquid loan market overview

Following the slowest year of new loan issuance activity in over a decade last year, investor expectations for 2023 were modest. The persistent headwinds of high inflation, rising interest rates and a slumping economy tempered market interest as Q1 began. But with the advent of a new year and new investment budgets, the US loan issuance market surprised many with a robust start. A small window opened accommodating some better performing loan issuers which sought to refinance or extend loan maturities. And with the continued lack of M&A and LBO activity in the US, loan investors were approachable for quality issuers seeking to place small add-on loans or extend maturities despite the otherwise challenging environment. The weak banking climate also opened the door again for private direct lenders to step in and finance new loan demand typically led by money center banks. CLOs, driven by a surprisingly strong issuance calendar, focused most of their attention on secondary loan offerings. This triggered a decent loan rally for much of the quarter, even while retail funds experienced significant outflows (USD 8.2 billion in Q1). But this rally came to an understandable halt in mid-March as the Silicon Valley Bank, Signature Bank and Credit Suisse bank failures caught the market by surprise.

US new-issue loan issuance

New institutional loan issuance in Q1 2023 topped USD 49.5 billion, considerably higher than the USD 35.8 billion posted in Q4 2022, but comparitively lower than typical quarterly issuance observed from 2017 to 2019 or in 2021. Much of the Q1 issuance volume was attributed to a robust slate of refinancings in the first half of the quarter (USD 34.5 billion), allowing many loan issuers with upcoming 2024 and 2025 maturities to extend their debt duration. While loan refinancings were active in Q4, they were heavily weighted toward double-B rated loan issuers at 60% of the total, while single-B rated issuers accounted for only 27%. In Q1 however, this ratio flipped with single-B rated issuers accounting for 68% of total refinancing activity, compared to double-B rated issuers at 19%, highlighting

US new-issue institutional loan volume



Source: LCD, April 2023. For illustrative purposes only.

the market's expanding acceptance of extending risk. New issue loan activity from M&A in Q1 slid to USD 9.8 billion, while dividend/recaps and other activity could only add a combined USD 5.1 billion to total issuance. Following trends from the previous quarter, there was an acceleration of amend-and-extend (A&E) activity during Q1 totaling USD 20.7 billion, compared to the USD 11 billion in Q4.[1]

US new-issue loan spreads

With the stronger market technicals for loans in Q1, new issue loan spreads for single-B/B+ rated institutional loan issuers tightened to SOFR + 443bps by March end, although they reached as low as SOFR + 410bps during February ,when a series of reverse-flexes on loan spreads ensued due to excess investor demand. All-in yields on new-issue loans finished Q1 at 10.42%, down slightly from 10.50% at the end of Q4. This decrease in loan yield would have been greater if not for rising SOFR rates in Q1 as the Fed tightening cycle continued.

[1] *Note: A&E transactions are not categorized as refinancings in these market data statistics*

US loan secondary trading

Outflows of USD 8.2 billion from retail loan funds in Q1 did little to offset the rising loan demand in the market driven by strong new CLO issuance, which topped USD 33.5 billion in Q1. With nominal new loan supply added during the quarter, loan buyers turned to the secondary loan market for supply in January and February, sparking a minor loan rally. The LSTA Morningstar US Leverage Loan Index (LLI) began the quarter in January at 92.44%, and rose steadily through mid-February peaking at 94.68%, before retracing back to 93.28% by March end from a wider risk-off response to the recent bank failures. It would appear, however, that despite the uncertainties created by these failures, the constant bid for loans from the many new CLOs printed in Q1 likely staunched a greater loan selloff during March.

European liquid loan market overview

Q1 2023 seemed like another chapter in the same book we have been reading for the past year. That same story about economic headwinds, rising interest rates, inflation, labor issues, and geopolitical fears paralyzing the market. Not a healthy environment for M&A and new-issue loan activity. And the crisis involving a venerable European bank like Credit Suisse added a surprise plot twist.

But Q1 at least started with some positive momentum in January and February, as loan and bond investor demand kept capital markets engaged despite the macro conditions. New Euro loan issuance for the quarter easily surpassed Q4 levels, as fears of runaway inflation and a cold European winter did not play out as expected. Demand quickly outstripped new loan issue supply, so investors jammed the secondary market and pushed loan prices higher, at least until the shocking news about Credit Suisse hit in mid-March and buyers stepped to the sidelines.

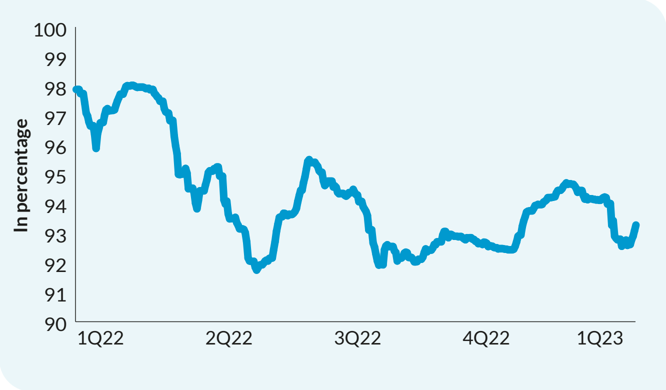
European new-issue loan issuance

New Euro institutional loan issuance volume totaled EUR 7.3 billion in Q1 2023, up markedly from the lackluster EUR 4.5 billion in Q4 2022 and easily the highest quarterly issuance posted since Q1 2022. This EUR 7. 3 billion of new loan issuance, however, was bested by EUR 12.3 billion of new-issue high yield

US average new-issue loan spread and yield

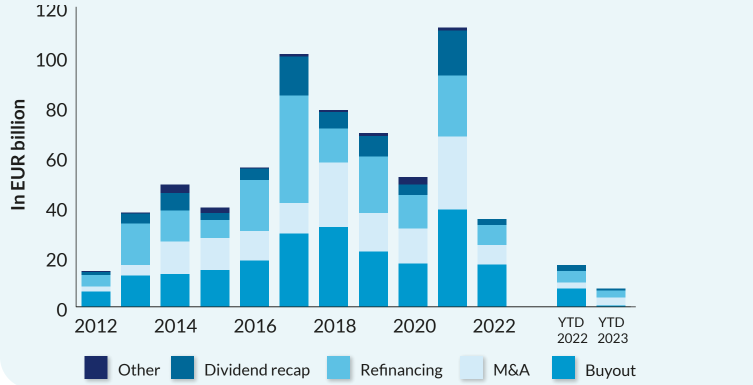
Source: LCD, April 2023. For illustrative purposes only.

US loans index average bid (LLI)



Source: LCD, April 2023. For illustrative purposes only.

European new-issue institutional loan volume



Source: LCD, April 2023. For illustrative purposes only.

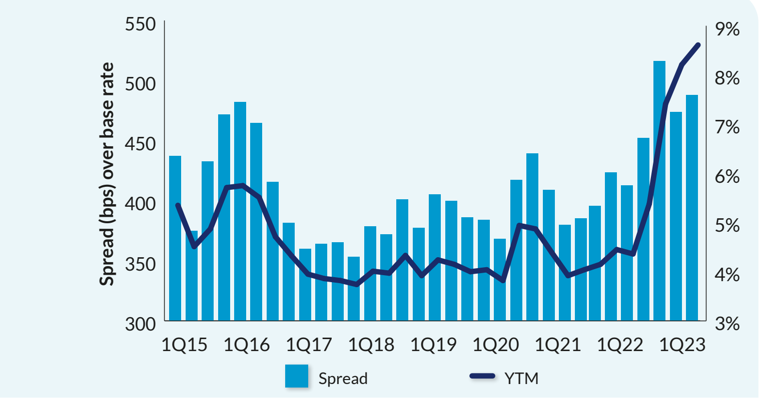
bonds during Q1, with rising rates a strong motivation for issuers to lock in fixed rate coupons where possible. Noteworthy as well for the Q1 loan issuance market were the 13 amend-and-extend ("A&E") financings completed totaling EUR 10.8 billion.[2] Additionally, also missing from these stats is the growing market share that private direct lenders gained financing many European LBOs in recent years, as regulator or self-imposed constraints hit many European banks. Private direct lenders smartly seized the opportunity to provide financing on eight out of nine LBOs brought to market in Q1 2023, continuing a relatively unnoticed but dominating shift in the institutional lending market share since the 2020 COVID pandemic.

European new-issue loan spreads

New issue Euro loan spreads and yields rose in Q1 for single-B rated term loans to an average yield to maturity of 8.61% and a loan spread of Euribor + 488bps, compared to a 8.21% yield and a spread of Euribor + 474bps in Q4 2022. However, strong investor demand resulted in tighter upfront fees (original issue discounts – OIDs) offered for new issue loans, with Q1 OID at 1.15%, versus Q4 at 1.85%, all leading to tighter all-in yields and spreads for Q1. With continued slower M&A conditions, much of the activity came from add-on loans to existing credit facilities for well-liked issuers to finance small bolt-on acquisitions and refinance revolver borrowings.

[2] *Note: A&E does not get included in new-loan volume totals since no new money is involved, just an extension of maturities and perhaps wider loan spreads.*

European loan spreads

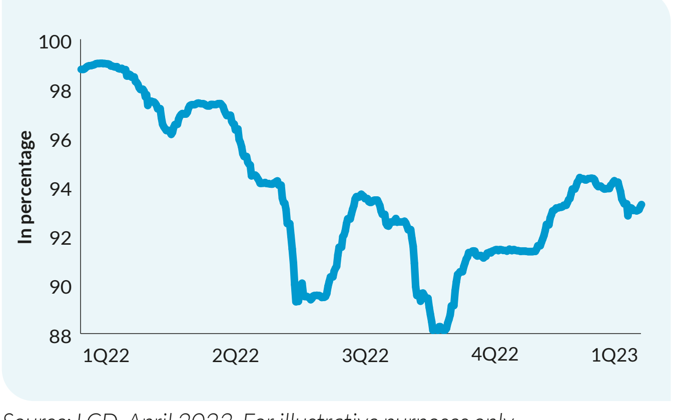


Source: LCD, April 2023. For illustrative purposes only.

European loan secondary trading

Much like in the US, European loan investor demand could not be met by new-issue volumes. The secondary market rallied throughout much of January, February and early March, before momentum was paused by the news of Credit Suisse's collapse and eventual acquisition by UBS. The Morningstar European Leveraged Loan Index (ELLI) opened January at 91.34%, progressed to a high of 94.36% by mid-February before drifting lower to 93.26% by March end. This resulted in the ELLI to post a strong return of 3.8% for Q1, a great result considering the stunning Credit Suisse bank crisis. Quick regulator action calmed the market and loans perhaps avoided a larger selloff.

Weighted average bid of European loans



Source: LCD, April 2023. For illustrative purposes only.

US collateralized loan obligations

US issuance

Expectations for new US CLO issuance for Q1 2023 were subdued to start the year, as the market braced for overwhelming headwinds of wide CLO liability spreads, loan volatility, weak loan issuance volumes, thin CLO equity arbitrage, rising credit rating downgrades and loan default expectations for 2023. Add in the sudden shock of bank failures in March, and it would have been quite reasonable for CLO issuance to totally pause. Yet, amazingly, none of this seem to slow down issuance flows and CLO liability demand improved month by month driving liability spreads tighter and prompting further issuance. It appears that CLOs in Q1 again demonstrated their time-tested resilience and growing investor appeal as an asset class. Remarkably, 77 new CLOs priced in Q1 totaling USD 33.6 billion, compared to 55 CLOs for USD 22.5 billion in Q4. Setting aside the record-breaking quarterly CLO issuance levels that were achieved in 2021, statistically, CLO issuance in Q1 2023 would have been one of the best quarters recorded since 2016. This was also achieved against a backdrop of the largest CLO AAA liability investors (large money center US banks) being notably absent from the buying market again in Q1. Lastly, there were no CLO reset or refinancing transactions during Q1 given the higher liability spreads.

US CLO liability spreads

With the strong investor demand, US CLO liability spreads for new-issue CLOs tightened in Q1 2023. Weighted average cost of capital (WACC) was SOFR + 270bps in Q1, compared to SOFR + 293bps in Q4 2022. With WACC staying at or above SOFR + 270bps since Q3 2022, CLO formation was largely driven by obtaining the average cost of a portfolio of loans at a deeper discount of 96% - 98% to make the equity arbitrage work. New AAA rated liability spreads averaged SOFR + 197bps in Q1, tightening through most of the quarter despite the market noise, compared to SOFR + 231bps in Q4. There was also meaningful tightening in Q1 across all other liability tranches,

US CLO liabilities spreads

US CLO average coupon and weighted average cost of capital (bps)						
Time frame	AAA	AA	A	BBB	BB	WACC
Q321 (LIBOR+)	118	170	214	324	661	171
Q421 (LIBOR+)	116	172	217	325	660	172
Q122 (SOFR+)	136	192	233	348	702	193
Q222 (SOFR+)	163	233	294	411	756	224
Q322 (SOFR+)	211	302	400	532	833	278
Q422 (SOFR+)	231	322	415	582	850	293
Q123 (SOFR+)	197	261	334	538	821	270
Change from Q422	-34	-62	-81	-44	-29	-23
Change from a year ago	61	69	101	190	120	77

Source: LCD, April 2023. For illustrative purposes only.

with BB-rated spreads declining 29 bps, while A-rated spreads dropped 82 bps. Also noteworthy in Q1 is that a majority of new CLOs were structured with the standard five-year reinvestment and two-year non-call periods. Lastly, AAA rated tranches were more typically broadly syndicated (10+ investors), compared to a lead "anchor" AAA investor taking a majority of the tranche.

US CLO secondary trading

Volatility from macro factors continued to translate into USD CLO secondary trading activity. Despite a rally in January/February which brought discounted AAA liability spreads to a low of 150bps (near Q1 2022 levels), AAA secondary spreads rose to 180bps at the end of March amid the banking turmoil (although Q1 levels stayed well inside the Q4 2022 highs of c. 260bps). BB liability spreads followed a similar pattern and ended the quarter at c. 950bps, also below the Q4 2022 highs of 1100-1200bps. US CLO secondary trading volume in Q1 2023 was c. USD 14bn, down 38% YoY (Q1 2022), driven by three primary factors: elevated volumes in Q1 2022 due to demand for liquidity during the Ukraine invasion; reduced selling during the March banking turmoil; and fewer motivated sellers at lower cash prices in Q1 2023. Interestingly, during previous macro events (COVID and the UK's LDI crisis), CLO secondary volumes doubled, whereas the recent banking sector volatility had the opposite effect on volumes.

European collateralized loan obligations

Euro CLO issuance

Beginning 2023 with modest expectations, CLO issuance in Europe during Q1 surprised to the upside. While CLO managers were motivated by tightening liability spreads at the start of the year, they were equally anxious to lock in lower loan collateral prices before a loan market rally eroded the already thin equity arbitrage. Managers quickly surmised that lower new loan issuance totals would surely be insufficient to ramp new portfolios and secondary loan trading prices would be the critical component to a CLO's success. Assembling a portfolio at an average price of 96%-97% could still work for equity arbitrage hurdles, but loan prices moving any higher could close the window.

New Euro CLO issuance was EUR 6.7 billion in Q1 from 18 CLOs, a slight increase over Q4 issuance of EUR 6.1 billion and 17 CLOs. Considering the economic and geopolitical climate, the Q1 2023 issuance volume was an acceptable outcome and was the most active issuance quarter since Q1 2022 (EUR 9.8 billion/23CLOs). Attracted to the wide CLO liability spreads, the market also experienced growth in the number of new investors engaging. Lastly, for the third consecutive quarter, there was no CLO reset or refinancing activity as CLO liability spreads remained wider than normal.

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
3Q21 (E+)	99	169	218	316	607	182
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
Change from 4Q22	-30	-91	-73	-48	-63	-38
Change from a year ago	80	89	113	184	49	76

Source: LCD, April 2023. For illustrative purposes only.

Euro CLO liability spreads

AAA liability spreads on new Euro CLO issue in Q1 sharply tightened to EURIBOR + 180bps, 30bps lower than the EURIBOR + 210bps posted in Q4. There was, however, a wider dispersion on AAA prints during the quarter, ranging from a low of 165bps to a high of 220bps, driven by both manager tiering and the presence of certain AAA anchor investors. Liability spreads for the remaining CLO tranches (AA to B) tightened in Q1 as well, from as little as 9bps lower on B-rated tranches, to as much as 90bps lower for AA-rated tranches. This helped lower Euro CLO WACC to EURIBOR + 275bps in Q1, significantly tighter than the WACC of EURIBOR + 312bps from Q4. This 38bps improvement in WACC, combined with capturing average asset purchase price in the range of 96%-97%, provided enough equity arbitrage to keep issuance moving.

About the author

Mark Hanslin is a Managing Director & Senior Portfolio Manager in Partners Group's Private Debt Liquid Loans Team based in New York. He has over three decades of liquid loan investment and portfolio management experience for global corporate banks and investment management companies.

Euro CLO secondary trading

Activity in the EUR CLO secondary market followed a similar pattern as seen in the US. The secondary market rallied in January/February, with discounted AAA rated liability spreads tightening to c. 180bps, and then widening back out at the end of the quarter to c. 230bps amid the banking sector volatility, although this is still below the Q4 peaks of 250-270bps. BB rated discounted spreads followed suit, tightening to c. 875bps in January/February and then widening back out to c. 1,000bps, still inside Q4 highs. EUR CLO trading volumes were c. EUR 4 billion for Q1 2023, down 15% YoY driven by similar factors as in the US: elevated demand for liquidity in Q1 2022 due to Russian invasion of Ukraine; reduced selling amid the banking crisis; and fewer motivated sellers at lower cash bids.

Spotlight topic: Update on US Loan Defaults

It would be reasonable to state that market expectations of a US economic recession beginning in 2023 have risen over the past quarter. And whether there will be a "hard-landing", "soft-landing" or the ever-hopeful "no-landing" scenario, US loan defaults will likely increase. But could loan defaults overwhelm portfolios over the next year? It would currently appear the answer is "no". After touching a ten-year low of 0.19% in Q1 2022, US loan defaults began 2023 at 0.7% (this compares to an average loan default rate of 1.9% over the past ten years). Three months later at the end of March 2023, loan defaults had climbed to 1.3% and are poised to steadily rise quarter by quarter. Recent polling of market participants by LCD (March 2023) reflected median market expectations of the trailing twelve-month loan default rate to be 2.5%–3.0%. This would reflect an almost doubling of loan defaults between March 2023 and March 2024. While notably higher, a 3.0% default rate would still seem manageable for market investors, and not at all approaching COVID-era 2020 default levels (4.2%) and considerably lower than loan defaults experienced in the Global Financial Crisis in 2009 (10.8%).

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