Quarterly Liquid Loan Market Commentary

Q3 2023 | Issue 17

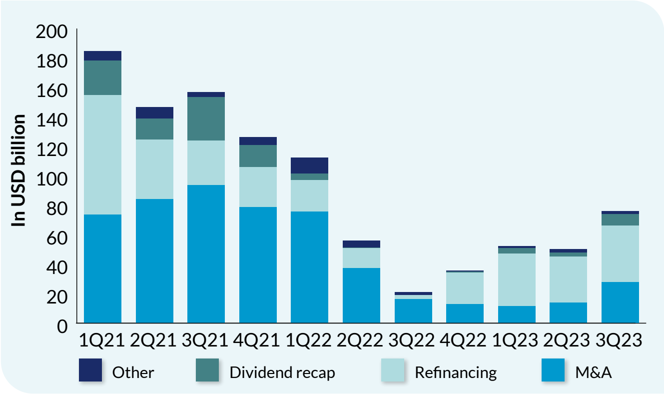
US liquid loan market overview

The US leveraged loan market sprung to life in the third quarter of 2023. Shaking off the specter of a looming recession, persistent inflation and growing market concerns of "higher for longer" interest rates, new-issue institutional loan volumes hit the highest quarterly levels seen since the Fed began hiking rates in Q1 2022. Perhaps encouraging loan investors and arranger banks alike, many issuers reported surprisingly good financial results for the first half of 2023, while a variety of sectors displayed resilient performances despite continuing headwinds. Both retail and insitutional loan investors responded with positive investment support driven by rising monthly cash inflows into retail funds and a surprisingly active collateralized loan obligations (CLO) issuance cycle prompted by tightening CLO liability spreads. While refinancings, repricings and amend and extend (A&E) transactions were all active during the quarter, LBO- and M&A-driven loan issuance also increased notably, confirming the market's new-found "risk-on" outlook. Beside typical loan issuance, issuers also used private credit and high yield bonds to meet issuance needs during the quarter. And as loan demand continued to outpace new issue volume, a secondary loan trading rally which began in late Q2 accelerated through September. But not all news was welcoming for loans, as economic conditions and higher rates took a toll on several underperforming loan issuers, resulting in a higher pace of credit rating downgrades and more triple-C rated loans in portfolios.

US new-issue loan issuance

New institutional loan issuance in Q3 topped USD 76 billion, the highest tally since Q1 2022 (before the Fed began raising interest rates) and substantially above the USD 50.3 billion of new issuance posted last quarter. While refinancings of USD 38.7 billion continued to be the lead story of Q3, M&A activity contributed a healthy USD 27.8 billion and dividend recap financing added another USD 7.6 billion. Hidden in the loan activity statistics for Q3 once again was repricing and A&E activity, which totaled USD 26.6 billion and USD 40.6 billion, respectively (statistics not included in total new loan issuance data). Repricings and loan extensions

US new-issue institutional loan volume



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

combined brought activity for the quarter to USD 143 billion, a level not seen since the loan market's record -setting year in 2021

Also noteworthy in Q3 issuance totals was the larger number of new issuers rated B/B+ or higher, compared to just B-, which has contributed a large portion of new loan issuance since COVID. This was in part a reflection of investor demand preferences for higher rated loans, in light of weaker economic conditions.

Lastly, new activity also reflected the need for certain loan issuers to address near-term (2024/2025) loan maturities. The third quarter saw a significant number of maturity extensions well beyond 2025 for loan issuers rated B/B+ or higher. Certain B- issuers also succeeded in pushing out maturities on loans, but this was clearly a more challenging and selective undertaking.

US new-issue loan spreads

Despite the pickup in issuance volumes, new-issue loan spreads for B-rated issuers tightened slightly in Q3 ending the quarter at SOFR+421bps, compared to SOFR+436bps at Q2 end. These still lofty spreads contrasted with BB/BB- spreads on new issue, which notably tightened to SOFR+284bps in Q3 compared to SOFR+325bps at the end of Q2. All-in-yields for B/B+ rated new loan issue at the end of Q3 were 10.38%, essentially flat compared to 10.39% at the end of Q2. All-in-yields for BB/BB- rated new loan issue at the end of Q3 were 8.60%, compared to 8.99% at Q2 end.

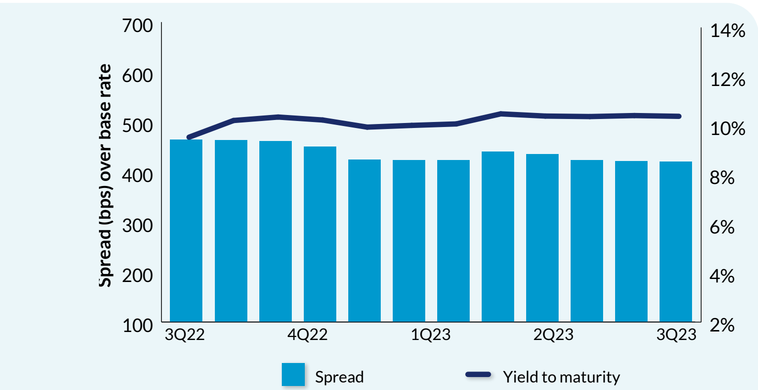
US secondary loan trading

As investors shifted back to "risk-on" mode, new issue supply was unsatisfactory and secondary prices steadily rallied from July to September to meet growing demand. The Morningstar LSTA US Leverage Loan Index (LLI) opened the quarter in July at 94.29% and, after hitting an intra-year high at 95.91% in mid-September, closed out the quarter at 95.59%. Similar to Q2, hidden in Q3 statistics was an even stronger rally for many well-performing credits typically acquired for new portfolios, offset by additional downgraded and underperforming issuers which became targets of investor selling. For the first nine months of 2023, the US secondary loan rally has been quite impressive. The LLI has risen over three points, having started the year at 92.44%, and ending September at 95.59%, resulting in the LLI posting a lofty 10.16% return in the first nine months of 2023.

European liquid loan market overview

The European new loan issuance market continued its recent pattern of alternating up and down quarters, this time attaining the highest level of quarterly loan issuance activity since the Russian invasion of Ukraine commenced in Q1 2022. Unfortunately, this volume increase was driven more by loan refinancings and less by accretive M&A activity. And while bank arrangers were amenable to underwriting more leveraged credit, a lack of prospective transactions was an impediment. For M&A specifically, the disconnect in valuations between buyers and sellers continued, curtailing the loan issuance the market has been so accustomed to over the past decade (excluding the COVID pandemic period). Both corporate strategic- and sponsor LBO-driven transactions remain impeded by continuing economic headwinds, leaving syndicated loan mandates in 2023 near decade lows. Additionally, syndication banks find themselves in greater competition with high yield bonds and private credit

US average new-issue loan spread and yield



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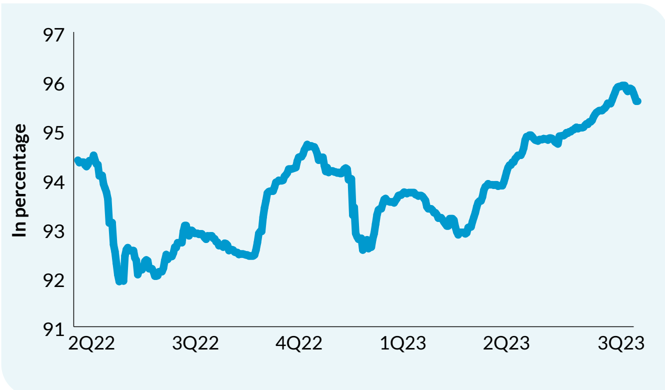
US loans index average bid (LLI)



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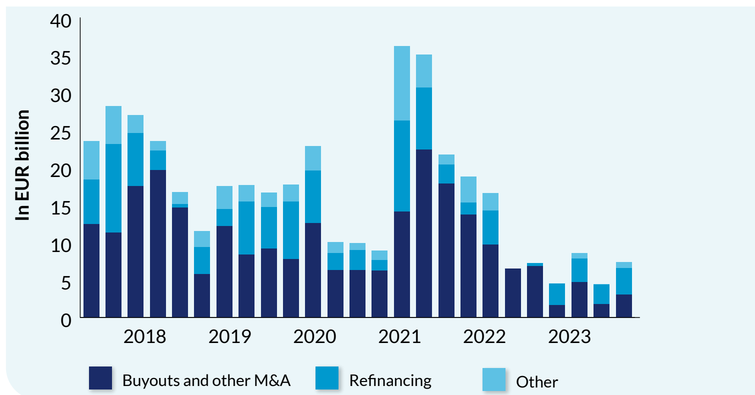
Quarterly European institutional loan volume



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

funds. However, with lower transaction volumes, all parties were left unsatisfied.

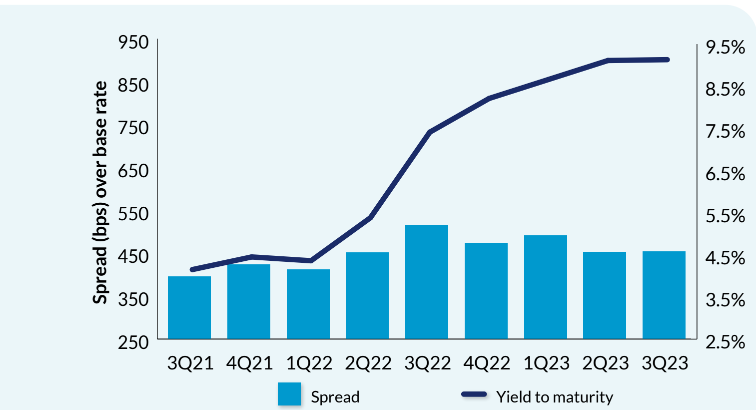
European new-issue loan issuance

Third quarter institutional loan issuance ticked upward to EUR 7.4 billion, compared to EUR 4.5 billion in the second quarter of 2023. The increase was attributed to slightly higher buyout and M&A activity, which improved from EUR 1.8 billion in Q2 to EUR 3 billion in Q3, and greater refinancings, which increased from EUR 2.6 billion to EUR 3.6 billion. Noteworthy also in the quarter was A&E activity (amounts not included in new loan issuance totals), which has steadily increased during 2023 and resulted in EUR 32.5 billion of loans extended an average of 3.2 years. This has significantly reduced 2024 and 2025 loan maturities, pushing the median market loan maturity well into 2028.

European new-issue loan spreads

Despite the pickup in issuance activity in Q3, new Euro loan spreads and average yield to maturity were relatively unchanged. New loan spreads for single-B rated issuers averaged Euribor+455bps, compared to Euribor+453bps

European loan spreads



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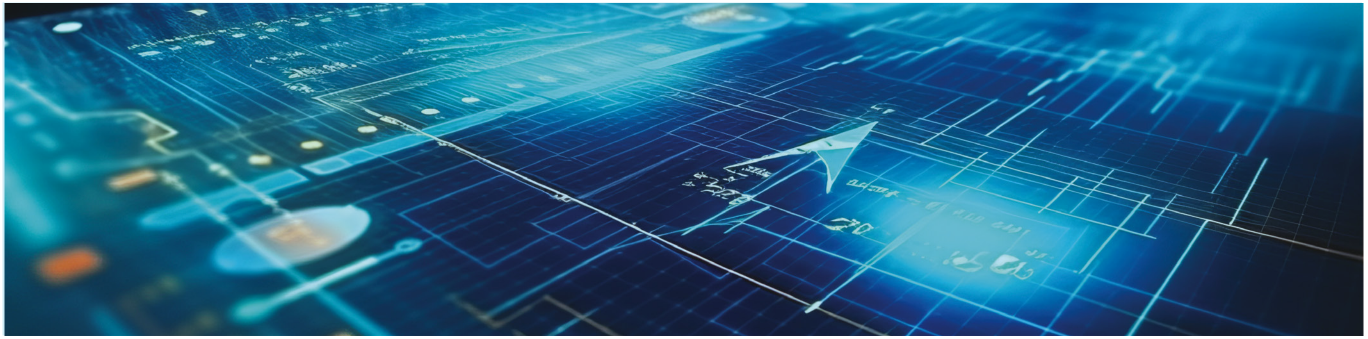
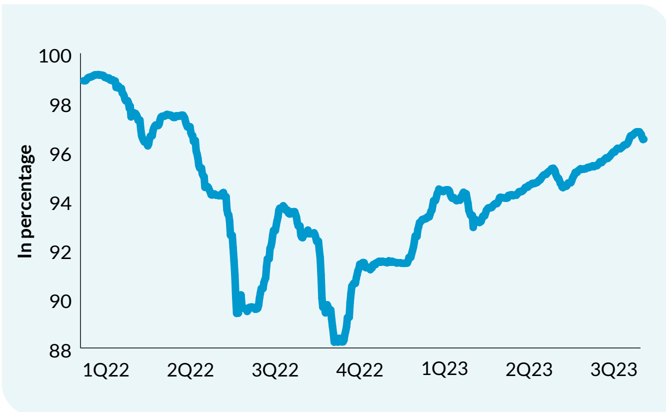


in the second quarter, while the average yield to maturity was 9.13% in Q3, nearly unchanged from 9.11% in Q2, as base rates stabilized during the quarter.

European secondary loan trading

With continued strong demand from investors and inadequate new issue supply, secondary loan prices rallied strongly in Q3. The Morningstar European Leveraged Loan Index (ELLI) opened the third quarter in July at 94.50% and rose steadily through September ending Q3 at 96.39%. For the first nine months of 2023, this impressive secondary loan rally pushed the ELLI up

Weighted average bid of European loans



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

over five percentage points, having started at 91.34% back in January. This all resulted in the ELLI posting an exceptional return of 11.50% for the first nine months of the year, despite challenging market conditions.

US collateralized loan obligations

US CLO issuance

Q3 saw new US CLO issuance get back on track after disappointing volumes in the previous quarter. While higher inflation and interest rates persisted, growing investor demand for CLO liabilities resulted in tightening spreads, allowing some managers (especially those with captive CLO equity) to issue and hit minimum equity return targets, despite the ensuing loan rally in Q3. Combining these tighter CLO liability spreads with an improved “risk-on” investor sentiment for loans, CLO issuance was surprisingly strong even during the typically quiet month of August.

US CLO issuance for Q3 totaled USD 28 billion from 63 CLOs, up significantly from the USD 22.4 billion and 52 CLOs posted in the second quarter. While volumes certainly improved, this tally still ranked as the third slowest quarter of issuance since 2020 during the depths of the COVID pandemic. Tightening CLO liability spreads also led to a return of CLO refinancing and resets during Q3, with 17 CLOs (USD 7.2 billion) reset and seven CLOs

(USD 2.7 billion) refinanced. While a positive development, there is a growing number of outstanding CLOs which are technically eligible for refinancing or reset awaiting much tighter liability spreads to pursue a refinance or reset within the next few quarters. It would be hard to imagine the market rallying sufficiently in the near term to satisfy the growing reset demand.

US CLO liability spreads

After widening out slightly in Q2, CLO liability spreads tightened meaningfully during Q3. New-issue CLO weighted average cost of capital (WACC) in Q3 fell to SOFR+260bps, compared to SOFR+275bps in Q2. The decline in liability spreads was across all tranches, with AAA spreads averaging 188bps in Q3, compared to 198bps in Q2. Spreads on other liability tranches (rated AA to BB) also tightened, especially at the lower end of the capital stack. There was also less tiering differential on AAA spreads between top-tier managers and mid-to-smaller managers, with the AAA spread differential tightening down to 24bps in Q3 versus 32bps in Q2. Structurally, the standard five-year reinvestment period with two-year non-call structures continued to dominate new CLO issuance.

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	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+)	188	262	317	501	796	260
Change from 2Q23	-10	-11	-19	-48	-57	-15
Change from a year ago	-25	-40	-83	-32	-38	-22

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

US CLO secondary trading

Despite the summer months, CLO trading activity reached a peak of USD 16 billion in Q3, up 11% year-on-year and 14% quarter-on-quarter. On the back of stronger credit markets, discount margins rallied to YTD tight levels at the end of September, both in the primary and secondary markets, supported by an inadequate primary issuance and a more positive macroeconomic outlook. Due to higher investor demand, tiering observed in the first half of the year between larger and smaller managers reversed and spreads compressed, with high-quality and high coupon paper routinely bid above par. The mezzanine liability tranches rallied the most, with total returns for the BB tranches reaching +18% YTD, the highest of any fixed income product.

European collateralized loan obligations

Euro CLO issuance

The European CLO market saw improved new issuance activity in Q3 as liability spreads tightened meaningfully across all tranches, spurred by growing demand and lack of any CLO issuance activity for many weeks in June and July. This investor demand remained intact throughout August before supply developed, restoring some balance in early September. Equity returns (CLO arbitrage) then shifted again back to unattractive by quarter end.

Third quarter issuance activity totaled 17 CLOs for EUR 6.5 billion, compared to 13 CLOs for EUR 5.0 billion in the second quarter. While issuance totals notably improved, Q3 issuance was comparatively no better than four of the last six quarters. Also, for the fifth consecutive quarter there were no CLO resets or refinancings concluded in Europe.

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
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
3Q23 (E+)	174	256	336	512	732	262
Change from 2Q23	-16	-64	-74	-106	-61	-34
Change from a year ago	-14	-106	-115	-94	-38	-44

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

Euro CLO liability spreads

In response to a lack of issuance activity in late Q2, pentup CLO investor demand helped push new issuance liability spreads significantly tighter during the third quarter. This resulted in WACC for CLOs to decline to Euribor+262bps in Q3, compared to Euribor+296bps at Q2 end. Average AAA liability spreads declined to 174bps from 191bps in Q2.

Spreads across the other liability tranches tightened notably as well, with A, BBB and B rated liability tranches posting the greatest improvements. Despite this liability tightening, newly issued B rated tranches still averaged Euribor+938bps during the quarter, creating a competing return to equity. If economic conditions fail to improve and interest rates remain elevated, CLO liability spreads will likely remain range-bound for the remainder of 2023, stifling additional CLO issuance.

Euro CLO secondary trading

The European CLO market was unexpectedly active during Q3, both in the primary and secondary markets, with EUR 4.7 billion put on auction during the quarter. This was slightly below the previous quarter, but 8% above Q3 2022, despite the "Mini-Budget" driven sell-off back in September 2022. The elevated trading activity was supported by a strong risk-on rally and redeployment of cash toward a continuous stream of new issue, with spreads grinding tighter on the whole capital structure. However, some signs of buyer fatigue started to appear by the end of September, particularly in the mezzanine tranches.

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.

Spotlight topic: Loan returns – also "higher for longer"?

As capital markets players repeat the popular 2023 catchphrase of "higher for longer", many investors might assume this only refers to interest rates in the US and Europe, which have been steadily on the rise since early 2022. But perhaps to some investors higher for longer could also describe the stubborn inflationary levels prevailing in the US and European economies. Global credit markets may further see higher for longer reflected in the increasing number of debt rating downgrades and the growing CCC-rated assets populating credit portfolios. Left up to interpretation, each view may be correct. But when considering loan portfolios specifically, higher for longer might also be a way to describe the exceptional returns posted by loans during 2023. At the end of Q3 2023, USD term SOFR was well above 5.00% p.a., while Euribor was nearing 4.00% p.a. Tack on leveraged loan spreads averaging 4.00- 4.50% and combine that with attractive secondary loan trading prices, and the result was an astonishing double-digit total return for leveraged loans. In the first nine months of the year, the US Leveraged Loan Index (LLI) has delivered a 10.16% return, while the European Leveraged Loan Index (ELLI) posted even higher, at 11.50%.

With growing market expectations of continuing higher rates, wide loan spreads and strong secondary bids, total returns for loan portfolios could remain higher for longer as well.

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Source: Partners Group (2023).