LEVERAGED FINANCE | JANUARY 2025

2024 marked another strong year for European leveraged loans, with above-average coupon carry expected to continue in 2025

MANDATUM
ASSET MANAGEMENT

BRIEF REVIEW OF 2024

Strong volumes but LBOs lagging

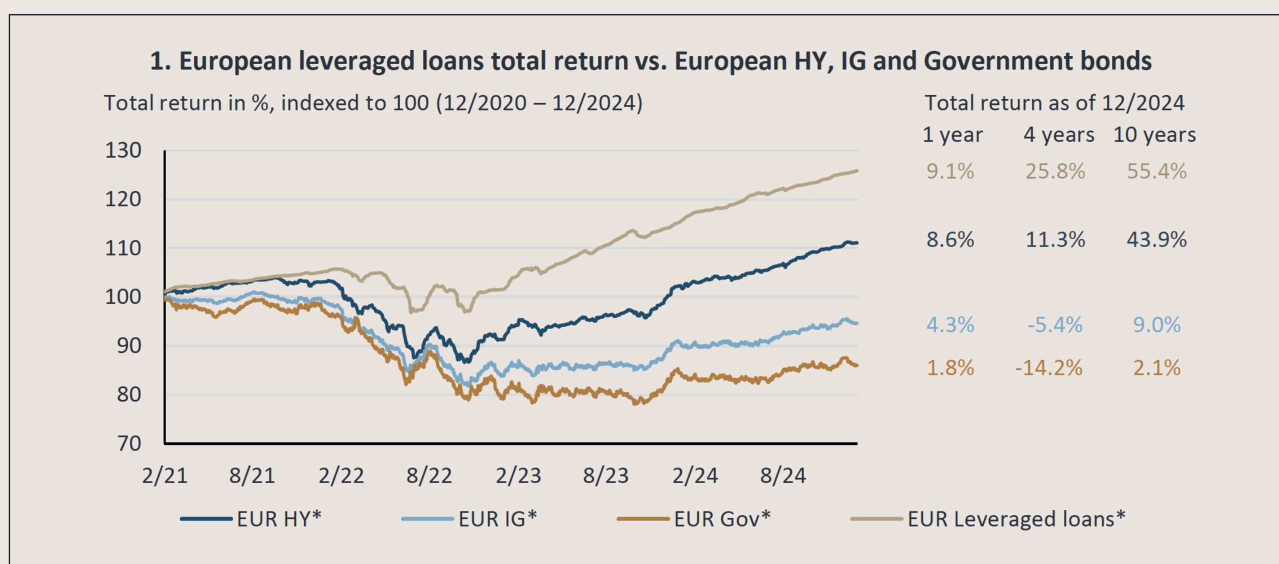
2024 marked a significant improvement in leveraged finance issuance across bonds and loans. Total volume for each market reached c €100bn, an increase of c 130% from 2023 and thus marking a step up from the modest levels seen in 2022–2023. Most of the increase in loan volume was driven by sponsor-backed deals, which accounted for almost 80% of total loan issuance compared to the below-average 60% seen in 2022-2023. The increase in total loan volume was evident across different types of deals (half of the volume as refinancings c +120%, third as M&A c +130%), even recapitalisations (one sixth) picked up considerably from a marginal base. Although not reflected in the above numbers, following a year of amend & extend in 2023, we saw a record amount of repricings complete in 2024. Such is not surprising after a period of elevated borrowing costs followed by a constructive market characterised by unmet demand and tighter credit spreads across credit overall.

Slowly recovering M&A activity was seen in new LBO (buyout) transactions which doubled from 2023 to c €15.5bn (being still c half of the longer-term average). While private debt alternative has captured market share from the public/liquid market (i.e. bonds and loans), we saw a fair amount of direct lending refinancings take place via syndicated loan market providing incremental new money supply and new names to meet growing demand for loans.

Structural considerations and 2024 returns

ELLI surpassed €300bn for the first time in 2024 (+11%), while EUR HY remained flat after two years of contraction. Of the European leveraged finance new issue, loan deals accounted for 54% while bond-only structures represented 28%. Bonds regained c 3 ppts but their share remains below pre-2022 average of 33%. The supply of junior debt is still limited but rather replaced by the repayment of costly 2nd lien tranches alongside an increased focus on PIK tranches bridging debt and equity in higher valuation transactions. New issue valuations indicate moderating multiples from the 2020 peak, while our own observations, however, are quite encouraging, particularly for assets of good or high quality (even >20x multiples). Average new issue equity contributions remain in line with historical context of close to 50%.

2024 delivered another set of attractive returns (Table 1). EUR leveraged loans recorded a +9.1% gross return, outperforming EUR HY for the fourth year in a row by 14.5% cumulatively despite volatile yet generally declining rates. Notably, 2024 did not experience a single month of negative returns for loans, similar to 2021. As discussed in our January 2024 white paper[1], we found loan spreads and yields attractive and market dynamics favourable for 2024, while the year turned out even more positive. Further upside potential from prices materialised (0.7%) and coupon returns were stronger than expected at the time as the curve indicated c 40bps lower base rate (2.3%) by year-end 2024.



1) https://www.mandatumam.com/48fd1d/globalassets/mam/pdf/1-2024/mam_whitepaper_eng_0124_v5-1.pdf
*) ICE BofA bond indices; **) Morningstar European Leveraged Loan Index "ELLI"). Source: Bloomberg, Pitchbook Data Inc, ICE BofA.

BRIEF REVIEW OF 2024 (continued)

Spreads have normalised, but yields remain clearly above average

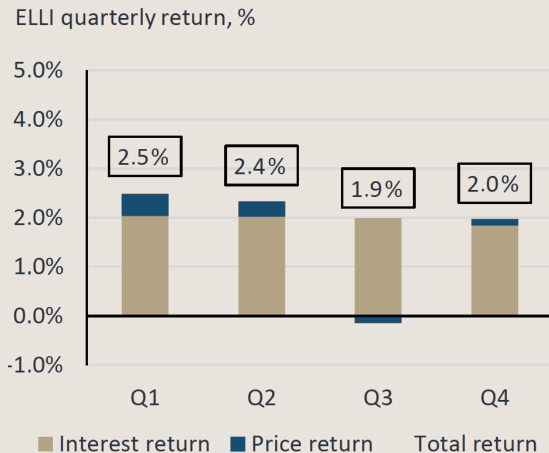
At the index level, loans ended 2023 with an average price of 96 and a discounted spread of 500bps, while 2024 respectively 98.0 and c 450bps. A more evident spread tightening was seen in primary, where loan spreads normalised from c 515bps to 415bps, driven by both margin and issue discount (roughly 50/50). The latter has largely narrowed down to levels seen in 2021 or pre-COVID (Table 3). Looking back at the period from 2017 to the onset of COVID, spreads were somewhat tighter, indicating that there is still capacity for further compression, provided demand-supply dynamics and market conditions remain favourable.

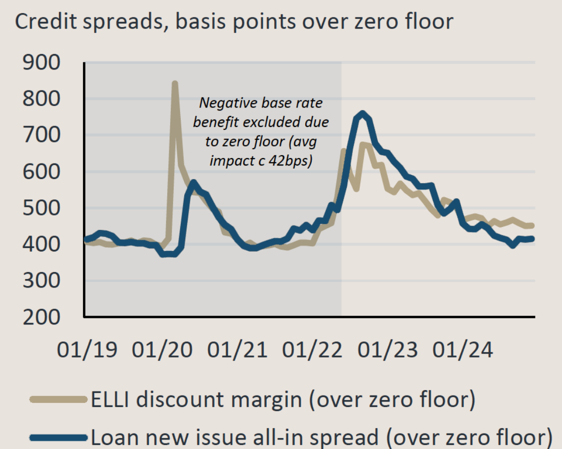
The 3-month Euribor started the year at c 3.9%. Since its decline from March onwards in anticipation of ECB rate cuts starting in June, the base rate ended the year at 2.7%. As a result, the year-end loan yield-to-maturity stood at 7.3% (Table 4) and including the curve at c 6.7%, which are clearly above the longer-term averages.

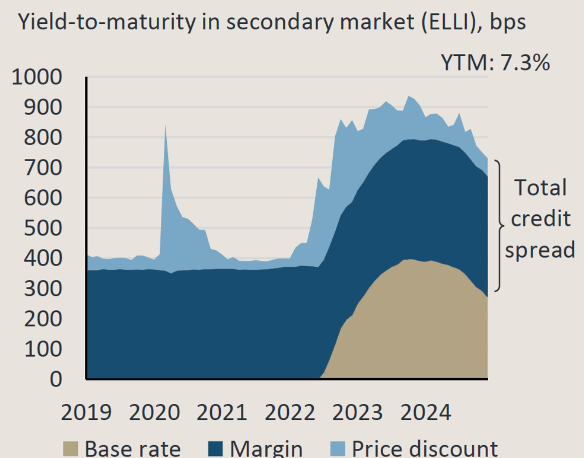
With respect to the secondary market, average prices increased by c 2pts. Anecdotally, 2024 has seen loans priced at par and above reach over 50% of the index, a level last observed during 2016-2017 and in 2019. This again signals strong and consistent demand for the asset class amid insufficient or below-average new money supply.

With respect to loan default rates (ELLI), since peaking at c 2-2.5% in early 2024 (below prior market fears) the headline figure is again below 1%. Broader distressed measures including restructurings and other LMEs* however indicate rates to be meaningfully higher, but to remain flat or decline somewhat into 2025. Our own observations do not suggest wider distress, but rather company specific issues after longer struggles that have finally had to be addressed, a theme which will likely continue into next year.

Looking at loan rating trends or the share of deeply discounted secondary, these do not suggest adverse trends or immediate concerns for now. Maturity profile of the ELLI index is also well addressed with only 4% due in 2025-2026 or 12% until 2027 (vs 36% in 2023). This compares nicely against c 27% for EUR HY.







*) Liability management exercise. Source: Bloomberg, Pitchbook Data Inc

OUR MAIN THOUGHTS AS WE LOOK INTO 2025

Market in need of more new money supply

In terms of deal activity for 2025, expectations among market participants suggest a decent increase in volumes. We believe that supportive market conditions (availability and cost of debt including bonds, loans and private credit) should pose no obstacle for M&A to pick up. Ultimately however, such improvement largely depends on a recovery in sponsor asset rotation, new LBOs and closing the widely discussed valuation gap.

Until new LBO led supply picks up materially and the 2028 maturity wall approaches (currently representing 37% of loans outstanding), borrower led opportunistic transactions such as repricings have taken the spotlight, benefitting from the constructive market conditions. Dividend recapitalisations have remained lesser of a focus for now however one consideration for next year could be increased efforts towards capital distributions back to LPs amid lower sponsor asset rotation, on well performing assets at least.

Coupon return to drive above average carry also in 2025?

In terms of market returns, the current yield stands at 7.3% (6.7% with curve) with most of this derived from the coupon return rate as average price (~98) has climbed closer to its technical cap (~99–100). There is some potential upside left in the event of further spread compression, while downside risk from wider spreads and secondary volatility is more dependent on broader market dislocations rather than loan market specifics for now – except for a return to a zero or negative rate environment in Europe, which we still consider a low probability scenario in near term.

With respect to coupon return estimates for 2025: 1) base rate contribution (3-month Euribor) based on the year-end curve suggests an average of c 2.2% for 2025. However, as seen in 2024, it is reasonable to expect some volatility around these expectations, 2) both the current index level and new issue margins of around 4.0% with some additional fee contribution in the primary market.

This results in an estimated coupon return of c 6.3% including the curve. Such remains well above the historical context of actual coupon returns outlined in Table 5, which covers three periods: 1) pre-negative rates, 2) last 10 years and 3) full history since 2002.

5. ELLI historical coupon returns

ELLI index coupon	2002-2015	2015-2024	2002-2024
Average	5.3%	5.0%	5.2%
Median	5.0%	4.4%	4.7%
Max	8.4%	8.2%	8.4%
Min	3.7%	3.8%	3.7%

Around this broader market “base case” for next year, some gradual widening or tightening of spreads (+/- 20bps for index and +/- 40bps for primary) or slightly fewer or more of ECB rate cuts (ranging from 1.5 to 2.0%) would result in approximately +/- 10–20bps of delta for each. A faster pace of rate cuts to say 1.0%, would keep the coupon return still close to 6% with current spreads.

Whilst the above addresses market averages, average spread metrics can be improved through portfolio construction and credit selection.

Hypothetically, looking a few more years down the road, the forward curve suggests slightly above 2% Euribor rate (3 month) for 2026 and 2027, close to levels observed at the end of last year. Notwithstanding shifts in spreads during this period, a similar coupon assumption would likely remain valid beyond 2025, though this is understandably subject to a range of uncertainties.

Source: Bloomberg, Pitchbook Data Inc.

OUR MAIN THOUGHTS AS WE LOOK INTO 2025 (continued)

Other potential risks or reservations

Following two incredibly strong years of returns for loans, we believe the favourable market conditions provide good prospects extending into 2025. Nevertheless, it is worthwhile to address some reservations as we look ahead.

- Spreads are now tighter compared to last year, with excess risk pricing having shifted toward more normal market conditions. As a result, downside risk (higher spreads) is more pronounced compared to last year should conditions worsen. However, spread tightening could continue further, and price differentiation may narrow as tolerance for risk increases. This would support higher market prices, but underscores the need for investor discipline.
- A continued or even increasing flow of opportunistic transactions is possible should demand pressures persist and supply not pick up equally. This could lead to more repricings and/or dividend recapitalisations, the latter of which, however, provides a source of "new money" supply.
- Adverse lender behaviour with respect to distressed assets has recently been observed in Europe, stemming from trends in the US market, albeit still in small numbers. This is a risk that should be assessed early, with a cognisant and proactive approach.
- Should a weaker macroeconomic trend continue in Europe or broader recessionary outcomes potentially materialise, such would hamper company performance across sectors. Similarly, geopolitical uncertainties remain elevated and as always, other unforeseen external shocks cannot be ruled out.

On the other hand, as base rates continue to fall and spreads tighten, interest costs for borrowers have already started to ease in floating rate structures with the belly of interest coverage ratios most likely behind us. Economic conditions will then play a larger role in guiding company revenue generation and profitability. Against this backdrop, a balanced approach can be maintained without excluding any macro scenario and rather focus on credit selection, leveraging broader market opportunities and ensuring diversification across variables.

We updated the illustrative scenario analysis (Table 6) of the 3-year annual returns for a loan portfolio on the basis of ELLI-index current yield with curve and varying default and recovery rates. In short, annual returns would result to c 5.7–6.0% in the "base case", and even with more adverse outcomes returns remain around ELLI's 2002–2024 average annual return of 5.1%.

6. Three-year annualised return scenarios* as a function of default and recovery rates (with forward curve)

Recovery rate 2025-2027 \ Annual default rate 2025-2027	0.0%	1.0%	2.0%	3.0%	4.0%
90%	6.7%	6.6%	6.5%	6.4%	6.2%
80%	6.7%	6.5%	6.3%	6.1%	5.8%
70%	6.7%	6.4%	6.1%	5.7%	5.4%
60%	6.7%	6.3%	5.9%	5.4%	5.0%
50%	6.7%	6.2%	5.7%	5.1%	4.6%

*) Illustrative return for an investment into a loan portfolio with ELLI's price (98.0), margin (398bps) and maturity (4.3 years). Assuming par repayment and linear price increase towards maturity excluding defaults that are exited at recovery value. Assuming forward curve for 3m Euribor as of 12/2024.

Lastly, while harvesting running coupon return, market dislocations and secondary volatility can provide very attractive opportunities and returns for long term agile investors as in 2020 and 2022. Thus, one can remain alert and ready for opportunistic actions in case of larger market movements or company specific situations.

For long-term perspective, we carried out an analysis of the performance metrics of leveraged loans as an asset class in our most recent white paper published in September. We found the results to be quite favourable for leveraged loans as part of a broader portfolio. Please see the link below for further information.

https://www.mandatumam.com/4a8437/globalassets/mam/pdf/9-2024/mam_leveragedfinance_whitepaper_0924_eng_v7.pdf

Mandatum Asset Management

Mandatum Asset Management (MAM) is part of Mandatum Group, a major financial services provider that combines expertise in wealth management and life insurance. Mandatum offers services to corporate, retail, institutional and wealth management clients. At the centre of Mandatum's success are highly skilled personnel, a strong brand as well as a proven investment track record.

MAM offers discretionary and consultative asset management for institutional and other professional investors and manages a variety of investment products within its core areas of credit, private equity, real estate and equity selection.

Investing both client money as well as the Group's own balance sheet capital, MAM has extensive investment experience in European leveraged finance including high yield bonds and leveraged loans. MAM currently offers two different client loan strategies focused on broadly syndicated European first lien leveraged loans, with the ability to also invest in club-style European leveraged loans (including second lien leveraged loans) as well as European high yield bonds.

AUTHORS

ALEXANDER GALLOTTI

Director | Head of Leveraged Finance
alexander.gallotti@mandatumam.com

KIMMO SALOKOSKI

Senior Portfolio Manager | Leveraged Finance
kimmo.salokoski@mandatumam.com

ILKKA LAMPIO

Senior Portfolio Manager | Leveraged Finance
ilkka.lampio@mandatumam.com

MANDATUM
ASSET MANAGEMENT

Mandatum Asset Management Ltd
Bulevardi 56, P.O Box 1221,
FI-00101 Helsinki, FINLAND

www.mandatumam.com

DISCLAIMER

This document is being provided to you for marketing and informational purposes only and does not constitute investment advice or a solicitation to invest or to participate in any trading, investment strategy or an offer to buy or sell any security or other financial instrument. The presented information is based on the information available at the time the article was created as well as on the views and estimates of Mandatum Asset Management Ltd and Mandatum Group ("Mandatum") at that time. The information may change without notice and Mandatum is under no obligation to ensure that such updates are brought to your attention.

The investments discussed on this article may not be suitable for all investors. Investors should make their own investment decisions based upon their own financial objectives and financial resources and, if in any doubt, should seek advice from investment, legal and tax advisers.

Investment involves risk. The value of investments and the income from them can go down as well as up and you may not get back the amount originally invested. Past performance does not guarantee future returns. If an investment is denominated in a currency other than your base currency, changes in the rate of exchange may have an adverse effect on value, price or income.

This document has been prepared from sources Mandatum believes to be reliable, but we do not guarantee its accuracy or completeness and do not accept liability for any loss arising from its use. Mandatum reserves the right to remedy any errors that may be present in this document.

THE MORNINGSTAR ENTITIES DO NOT GUARANTEE THE ACCURACY AND/OR THE COMPLETENESS OF THE MORNINGSTAR EUROPEAN LEVERAGED LOAN INDEX OR ANY DATA INCLUDED THEREIN AND MORNINGSTAR ENTITIES SHALL HAVE NO LIABILITY FOR ANY ERRORS, OMISSIONS OR INTERRUPTIONS THEREIN.

SOURCE ICE DATA INDICES, LLC ("ICE DATA"), IS USED WITH PERMISSION. ICE® IS A REGISTERED TRADEMARK OF ICE DATA OR ITS AFFILIATES, AND BOFA® IS A REGISTERED TRADEMARK OF BANK OF AMERICA CORPORATION LICENSED BY BANK OF AMERICA CORPORATION AND ITS AFFILIATES ("BOFA") AND MAY NOT BE USED WITHOUT BOFA'S PRIOR WRITTEN APPROVAL. ICE DATA, ITS AFFILIATES AND THEIR RESPECTIVE THIRD PARTY SUPPLIERS DISCLAIM ANY AND ALL WARRANTIES AND REPRESENTATIONS, EXPRESS AND/OR IMPLIED, INCLUDING ANY WARRANTIES OF MERCHANTABILITY OR FITNESS FOR A PARTICULAR PURPOSE OR USE, INCLUDING THE INDICES, INDEX DATA AND ANY DATA INCLUDED IN, RELATED TO, OR DERIVED THEREFROM. NEITHER V.6 071320 ICE DATA, ITS AFFILIATES NOR THEIR RESPECTIVE THIRD PARTY SUPPLIERS SHALL BE SUBJECT TO ANY DAMAGES OR LIABILITY WITH RESPECT TO THE ADEQUACY, ACCURACY, TIMELINESS OR COMPLETENESS OF THE INDICES OR THE INDEX DATA OR ANY COMPONENT THEREOF, AND THE INDICES AND INDEX DATA AND ALL COMPONENTS THEREOF ARE PROVIDED ON AN "AS IS" BASIS AND YOUR USE IS AT YOUR OWN RISK. ICE DATA, ITS AFFILIATES AND THEIR RESPECTIVE THIRD PARTY SUPPLIERS DO NOT SPONSOR, ENDORSE, OR RECOMMEND MANDATUM, OR ANY OF ITS PRODUCTS OR SERVICES

STOXX Limited ("STOXX") is the source of the indices and the data comprised therein. STOXX has not been involved in any way in the creation of any reported information and does not give any warranty and excludes any liability whatsoever (whether in negligence or otherwise) - including without limitation for the accuracy, adequateness, correctness, completeness, timeliness, and fitness for any purpose - with respect to any reported information or in relation to any errors, omissions or interruptions in the indices or its data. Any dissemination or further distribution of any such information pertaining to STOXX is prohibited.