LEVERAGED FINANCE | JANUARY 2024

European leveraged loans posted the highest annual return since 2009, and still provide good value

MANDATUM ASSET MANAGEMENT

ABSTRACT

In last year's white paper, where we introduced the asset class itself, we provided our very optimistic view on the prospects of leveraged loans for 2023 and onwards, e.g. through several scenario analyses considering the convexity and yield levels at hand. This year, we will focus on a few select themes that were prevalent in 2023 in addition to providing our take on what the conditions look like for 2024.

As anticipated, 2023 proved to be a very strong year for European leveraged loans. ELLI[1] returned 13.5%, the highest return since 2009. This is the result of a strong 8% coupon return, supported by base rates not seen since 2008, and c. 5% appreciation of average loan prices from the start of 2023, when the market priced a great deal of uncertainty from rising rates, economic outlook and risk of rising defaults. Spreads remained wider compared to what the market required prior to 2022, but tightened eventually by c. 100bps during the year, corresponding to a move with the broader European HY credit market. Despite positive secondary market price action, a few smaller selloffs offered attractive entry points for agile investors in March, June and September-October.

Overall, European credit had a very favourable year across bonds and loans. For the third year in a row, returns for leveraged loans exceed that of HY bonds, despite the notable rally in bonds in Q4, driven by rapidly declining rates and tighter credit spreads. For three- and ten-year periods, European leveraged loans have outperformed HY bonds by 12.7 and 8.9 percentage points, respectively.

Primary loan issuance was characterized by lackluster new buyout activity and consequent lower new money supply but also by an ample flow of refinancings and extensions by existing issuers having their debts fall due in 2024-2026. These transactions offered investors opportunities to reprice loan margins to the current market context, collect extension fees as well as enter into new names, and for issuers, to reduce risks rising from upcoming maturity walls. In conjunction, we also saw more proactive use of equity from private equity sponsors to address capital structures and reduce leverage.

For 2023, banks and rating agencies expected a significant pick up in high yield credit defaults (to c. 3-5%). While the loan default rate did notch up by c. 1 percentage point from 2022 to 1.6%, the number remains materially below those adverse scenarios, for now. Rating actions (downgrades and upgrades) remained relatively balanced in the context of the overall macro environment as issuers have proven more resilient than the market initially feared.

As we look into 2024, the European leveraged loan market continues to look compelling, in our view. Supported by strong coupons, loans offer a 9.1% yield (or c. 7.5% when using the year-end Euribor forward curve), which is far above the historical average and well above that of HY bonds even when assuming the start of ECB rate cuts during 2024 (save for a severe hard landing scenario). While the economy and markets have shown more strength than expected, there are still multiple reasons to remain cautious. But as we argued last year, attractive yields, selective credit picking and senior secured positions provide ample cushion and downside protection, while market volatility may present even more favourable secondary market entry opportunities.

1) Morningstar European Leveraged Loan Index

RECAP: EUROPEAN LEVERAGED LOANS

1. What are leveraged loans?

A leveraged loan is a form of senior debt that is borrowed by a company that has a credit rating below investment grade, arranged by a group of banks and typically syndicated to a group of institutional investors.

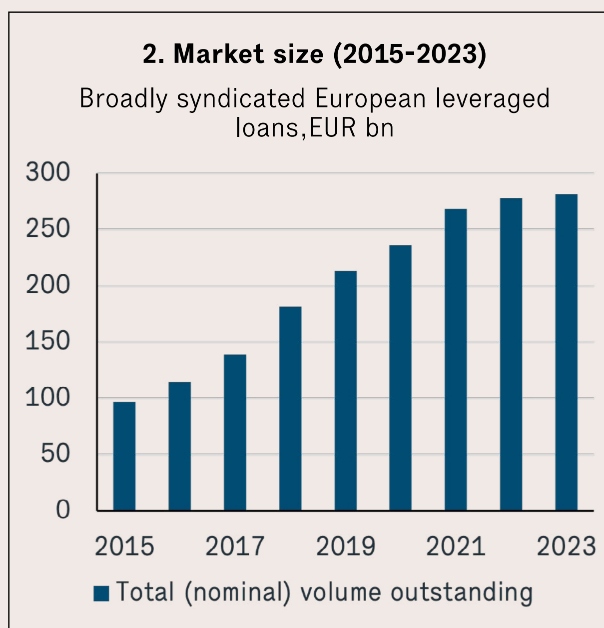
- Most often used to finance leveraged buyouts by private equity funds
- Mostly senior secured first lien instruments providing downside protection in terms of recovery
- Floating rate instruments with base rate floored to zero
- Non-listed instruments, but with secondary market liquidity through banks (broadly syndicated loans)
- Typical maturity 5-7 years (average lifetime shorter)

Large institutional market

The European leveraged loan market formed in the early 2000s and accelerated during the 2010s in the wake of private equity funds' buyout activity, where loans provided by a pool of large institutional investors were used as debt to leverage these acquisitions.

The broadly syndicated loan market includes over 300 issuers (ELLI) with c. EUR 280bn of loans outstanding (by nominal value). Even during 2022-2023, the outstanding volume remained steady despite a limited number of new private equity buyouts and respective new loan issuance.

The liquid syndicated market is complemented by smaller syndicates, or so-called club-style loans.



Attractive characteristics

Including leveraged loans in a credit portfolio improves its characteristics for five key reasons.

Firstly, 99% of the broadly syndicated European leveraged loan index (ELLI) are first lien senior secured instruments with the highest seniority and priority claim on the security. Average historical recovery rate for 1st lien loans is c. 70%.

Secondly, loans have a low modified duration (c. 0.3) and therefore limited interest rate risk. This resulted in considerable outperformance vs. bonds in 2022.

Thirdly, leveraged loan borrowers are of high quality: typically large, diversified, stable and profitable businesses, backed predominantly by private equity sponsors providing expertise and support.

Finally, investors also benefit from a longer syndication process and broader information vs. bonds (that allow thorough credit analysis) as well as from lower price volatility compared to bonds, (e.g. due to fewer retail funds) despite being increasingly liquid in secondary markets.

Read more about the market and its attractive characteristics from our *2023 white paper* [1].

1) https://www.mandatumam.com/490947/globalassets/mam/pdf/mam_leveraged-loans_en_2023.pdf
Source: PitchBook Data Inc., Moody's

Best returns for the asset class since 2009

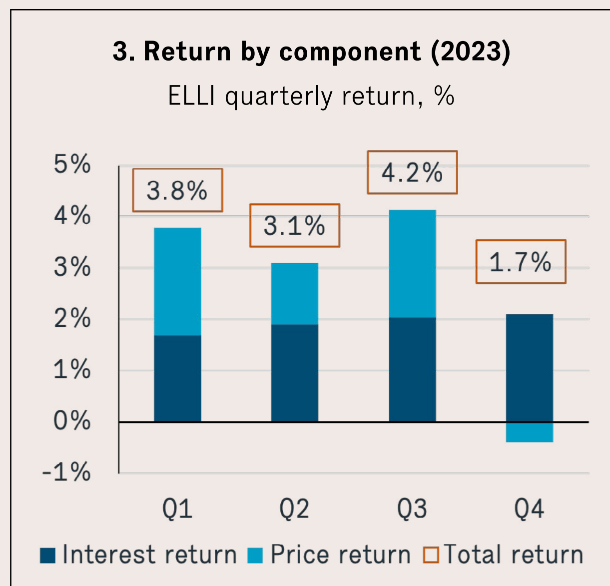
After a rough year for credit overall in 2022, when loans performed relatively well, ELLI started 2023 at an average price of 91.3, with a yield of 8.6% at a 3-month Euribor rate of 2.1% and a default rate of 0.4% over the last 12 months. At a 618bps total risk spread (discount margin), the market was discounting a considerable amount of uncertainty and credit losses ahead.

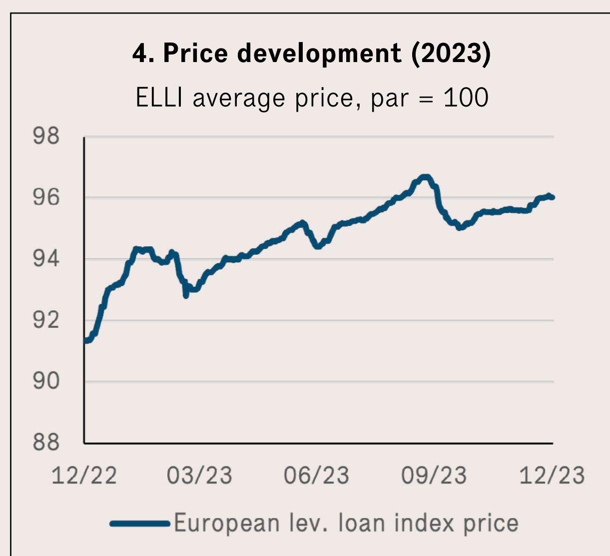
A year later at the end of 2023, ELLI ended at a 96.0 average price (i.e. 5% price appreciation in a year), a yield of 9.1% with a 3-month Euribor rate of 3.9%, a discount margin of 502bps, and an LTM default rate of 1.6%. This translates into a 13.5% return for European leveraged loans for 2023, the highest outcome since 2009 in the wake of the GFC.

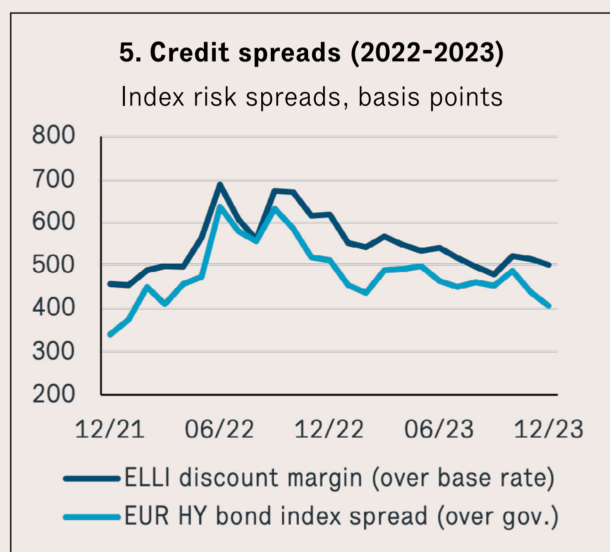
Given the floating rate nature of loans, coupon return grew throughout the year to around 8%, enabled by base rates not seen since 2008. The majority (c. 60%) of 2023's return was driven by coupons of c. 2% per quarter (see graph 3).

Amid favourable market dynamics, loans appreciated by 1.8% on average per quarter during Q1-Q3, followed by a small decline in Q4. Overall, price action was resilient despite the March banking crisis in the US (ELLI -1.5%), a smaller correction in June (-0.8%) and a broader correction in September-October (-1.7%). These selloffs provided healthy breathers for a well bid market (supported by CLO issuance in the face of more limited supply) and offered more attractive entry points for investors in the secondary markets at better price discounts and with a more balanced supply-demand.

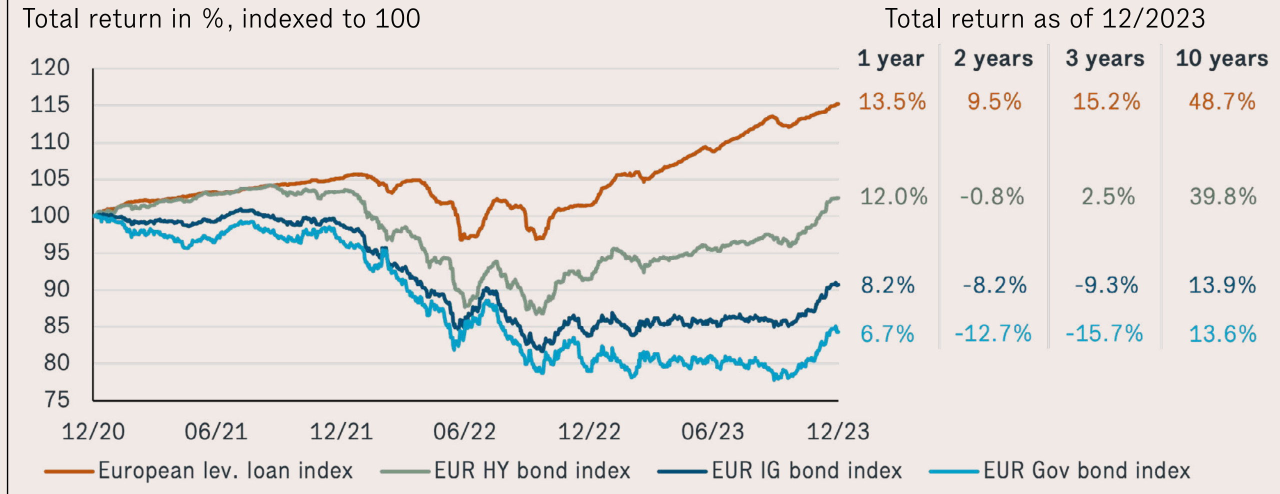
Albeit average spreads tightened from last year by c. 100bps, they remained above pre-2022 levels which together with base rates allowed investors to deploy capital at unusually high yields of c. 9%. Year's end spreads still indicate fair amount of uncertainty and above average defaults, but no longer a hard landing scenario necessarily.







Source: PitchBook Data Inc.; Bloomberg; ICE BofA



6. European leveraged loans vs. EUR HY, IG and Government bonds (2021-2023)

Outperformance vs. bonds continued

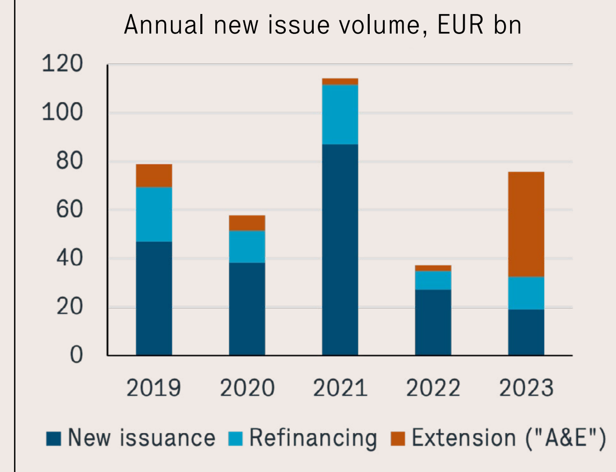
Altogether, European credit had a strong year across bonds and loans. For the most part of the year, when loans enjoyed tailwind from higher base rates and longer-term rates kept trending gradually higher, it seemed bonds would end the year with "coupon clipping" returns until the swift change of direction in Q4 (as seen in graph 6). Despite this notable rally in bonds, driven by rapidly declining rates and tighter credit spreads, European leveraged loans outperformed HY bonds for the third year in a row.

For a three-year period, mainly driven by low duration and higher coupon return, leveraged loans have now outperformed HY bonds by 12.7 percentage points, and EUR IG and government bonds by 24.5 and 30.9 percentage points, respectively. For a ten-year period, leveraged loans have returned c. 9 percentage points more compared to HY bonds.

New LBO issuance still muted, 2023 year of the Amend & Extend ("A&E")

2023 annual new money loan issuance volume reached only EUR 19 bn, which is down 30% vs. 2022 and 80% below 2021. The main reason for the continued decline was the persistent drought of new buyouts ("LBOs"), and a large part of new money issuance therefore consisted of add-on loans to fund bolt-on M&A. Alongside syndicated loans and bonds, private debt structures also continued to offer an alternative for LBO financing during these more turbulent times (with less market risk but higher cost). However, it is only a matter of time when private equity sponsors find new common ground for valuations for deal activity to pick up again. From market size perspective, loan market managed to push volume up by 0.3%, despite limited new supply. This contrasts with the EUR HY market, which saw volume decline for the second year in a row.

While the new money issue volumes discussed above suggest even lower activity compared to 2022, these exclude the considerable maturity extension (A&E) and refinancing activity that characterized 2023, as seen in graph 7.



7. New issues[1] by purpose (2019-2023)

1) New issue syndicated European leveraged loans
Source: PitchBook Data Inc.; Bloomberg; ICE BofA

The benefit from maturity extensions is two-fold: I) lenders get to reprice loan margins wider to current market context and collect extension fees, and II) issuers get to reduce refinancing risk by pushing maturities out by 2-4 years. In addition, in a number of cases, sponsors have addressed capital structures by injecting new equity to complete the transaction, reducing net leverage and therefore credit risk from lenders' perspective. A&Es also enable lenders to resize existing positions as well as provide an opportunity to invest in new names.

New issue pricing has remained attractive

Despite low volumes, new transactions offered good opportunities to deploy cash at attractive terms. Margins were mostly set at a 4-5-handle (up from 3-4-handle), with 85% of the issued first lien loans having a margin of 400bps or higher and 40% a margin of 500bps or higher. In 2019-2021, these shares were only c. 50% and c. 10%, respectively.

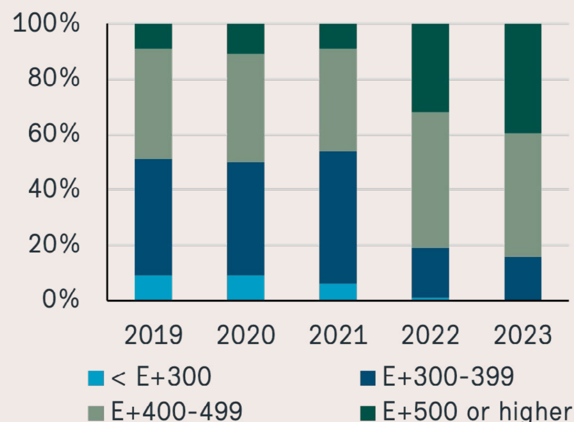
In addition, original issue discounts ("OID") averaged at c. 2.5% in 2023, vs. c. 4% in 2022 but only c. 0.5% in 2019 and 2021. Total new issue spread, including margin and OID, averaged at c. 550bps in 2023, which is slightly below 2022 but over 100bps above 2019-2021 average.

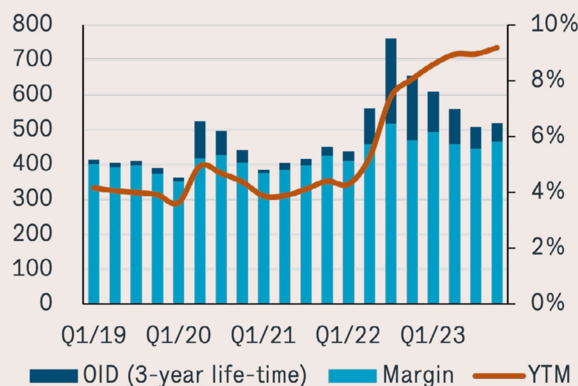
With an average 3.4% 3-month Euribor rate in 2023, the resulting average euro-denominated new issue yield increased to c. 8.9%, a level not seen since 2008-2009.

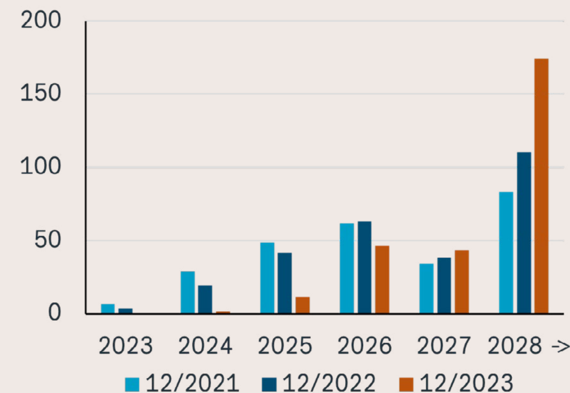
Maturity wall successfully pushed forward

The loan market was largely open throughout the year for issuers to refinance or extend their debt packages despite the interest rate environment and aforementioned market volatility. Issuers indeed were proactive in utilising this window of opportunity instead of waiting for more favourable market conditions.

As a result, only EUR 13bn of loans (4.7% of ELLI) falling due prior to 2026 remain currently outstanding. This compares to EUR 23bn of 2023-2024 maturities at the end of 2022 (8.2% of the index). Thus, a majority of the near to mid-term maturity wall within European leveraged loans has already been addressed.







1) New issue syndicated European leveraged loans
Source: PitchBook Data Inc.

Defaults picked up, but less than feared

Going into 2023, the European leveraged loan market had a very low default rate for 2022 (0.4%), which was comparable to the previous 4 years, except for 2020 (2.6%) at the breakout of the pandemic. Banks and rating agencies expected a significant increase in high yield credit defaults to c. 3-5% in 2023, and whilst loan default rates did notch up somewhat from the lows to 1.6% in H2/2023, the outcome was far less adverse than feared.

More favourable conditions are partly explained by the economy remaining stronger than feared, especially in the US, but we believe there are also other underlying factors, highlighting the resilience of the asset class.

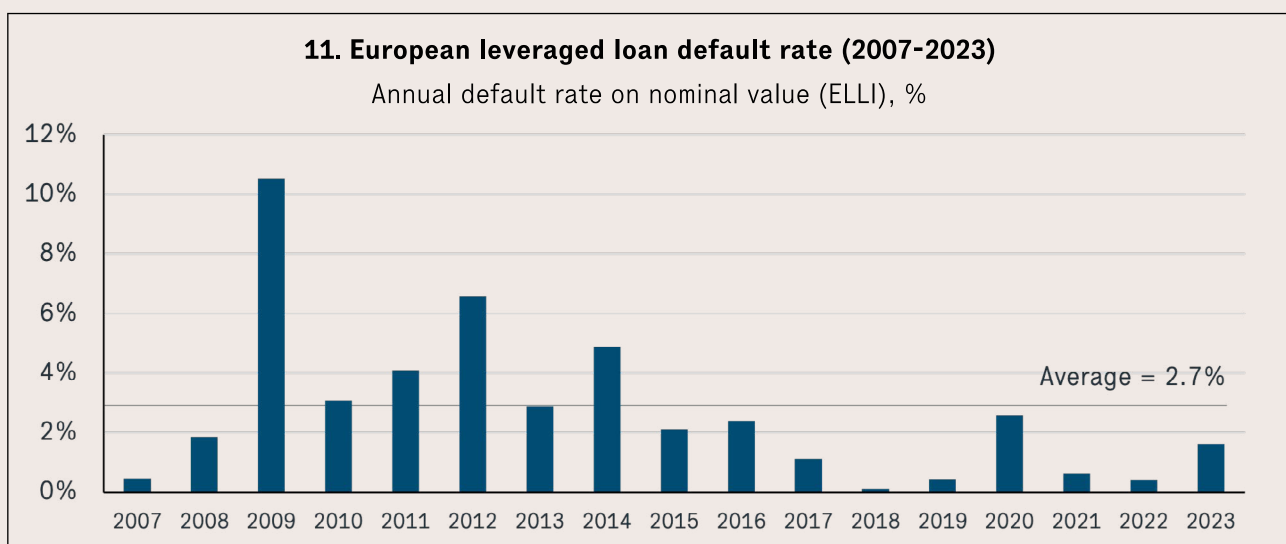
As we noted in last year's white paper, leveraged loan issuers today are well positioned compared to the 2008-2009 GFC era when default rates peaked. Loan issuers are larger companies than those of 2005-2007, have lower loan-to-value ratios (LTVs) as well as lower net leverages.

In fact, first lien new issue net leverage level further moderated in 2023 to 4.5× vs. 4.8× in 2018-2022, driven by higher cost of debt and general market uncertainty. There is yet limited evidence of today's enterprise valuations and respective LTVs; however, we remain constructive on sponsor equity and junior debt cushions.

Furthermore, I) leveraged loan issuers are largely from resilient industries – many issuers were still witnessing earnings growth in 2023, II) management and sponsors have proactively engaged in cost cutting measures as well as hedged part of their floating interest loans, and III) private equity sponsors have recently been more active than usual in injecting equity to reduce leverage, cash interest costs as well as supporting liquidity and capex programs.

In addition to economic woes, it was anticipated that loans would see faster transmission of higher rates into higher cash interest expenses and thus lower interest coverages. While that is true and ratios have weakened from the zero rates environment, they remain fair on average (2.9× in new issues of 2023). This does however entail a different split on the use of free cash flows (e.g. for M&A and growth capex), and underlines more proactive use of equity injections by the sponsors.

Lastly, it is worth mentioning that while funding cost remains elevated, a majority of the increased cost of debt for loan structures has already been incurred via higher base rates. The remaining pick-up in interest cost is mainly attributable to those who need to refinance to higher margin, in addition to varying degrees of interest rate hedges having to be reset over the coming years.



Source: PitchBook Data Inc.

OUTLOOK FOR 2024

Spread and yield still attractive, in our view

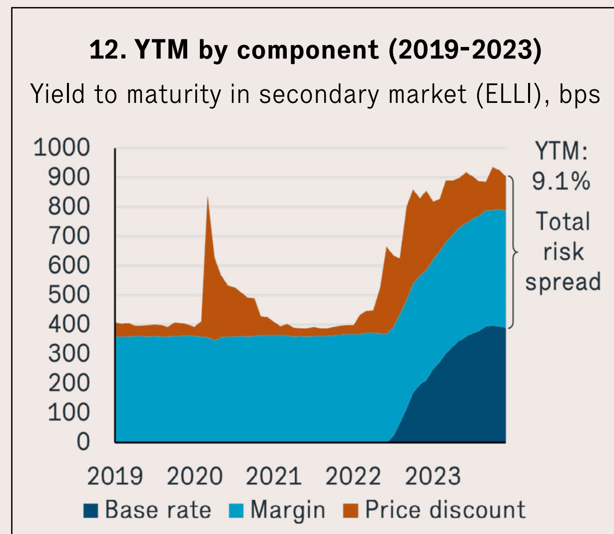
Despite a strong 2023, the European leveraged loan market continues to look compelling in our view. Total risk spread (discount margin) remains at c. 500bps, which is also illustrated in graph 12 as the sum of margin and price discount components. For example, in 2019 and 2021 the spread was c. 400bps due to lower margins and limited price discount.

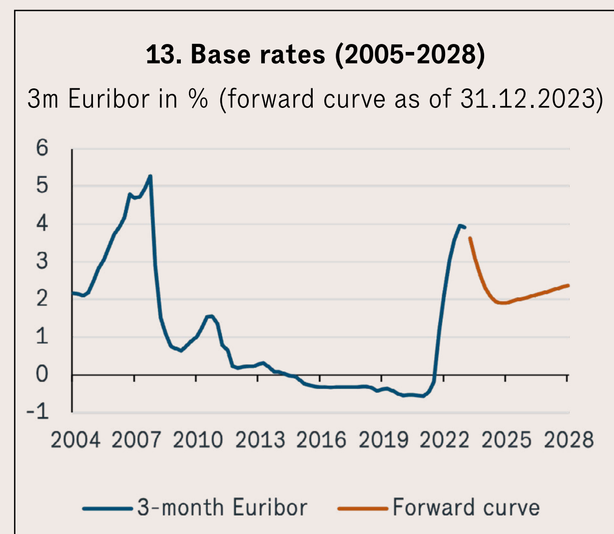
Yield-wise, leveraged loans started 2023 with a YTM of 8.6% vs. HY bonds at 7.7%, moving to 9.1% and 6.5% by year's end, respectively. The differential has only widened as a result of Q4 market movements, and even with market expectations for Euribor (graph 13), leveraged loan yield (c. 7.5% with forward curve) exceeds that of HY bonds by one percentage point.

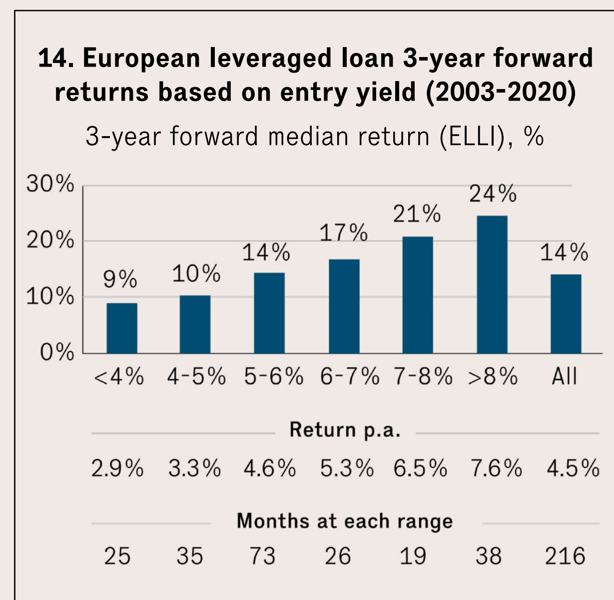
While the expectations for ECB actions continue to fluctuate, the initiation of rate cuts is likely in the cards from 2024 onwards. Nevertheless, we take comfort in the loan coupon return component, which, all else equal, should remain on average above 7% for 2024 even with lower base rates towards the end of the year, save for a hard landing scenario and even more aggressive easing. This can be compared, for example, to the 2016-2021 period, when the average coupon rate was around 3.8%, set above zero floor when Euribor rates were negative.

We updated the analysis of the 3-year forward returns of ELLI since 2003, presented in the 2023 white paper. There were very small changes in the results (graph 14), but it is still worth highlighting how the outcome for investors has been favourable when entering the market with current yield levels.

When month-end yield to maturity has been above 8%, the median return has been 24% (7.6% p.a.) and the average return has been 28% (8.6% p.a.) over the next three years. In addition, every time the month-end YTM has been above 8%, the following 3-year period has had positive returns, with only 3 out of 38 periods resulting in a total return below 10% (all just prior to the GFC).







Source: PitchBook Data Inc.; Bloomberg

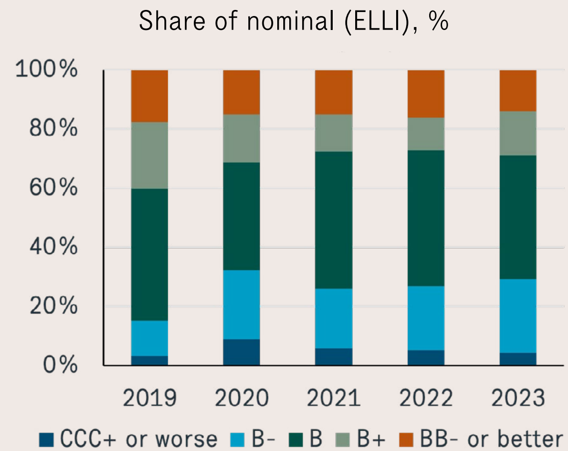
Need for caution

The rating profiles of loan issuers (graph 15) did not materially worsen in 2023: the share of B- or worse grew but remains below 2020, while the share of B+ or higher grew as well, resulting in the same overall weighted average rating as in 2022. In addition, rating actions were fairly balanced in light of the earlier expectations (upgrades 10%, downgrades 19%).

Although defaults did not pick up in 2023 as projected by many, and credit ratings remained relatively resilient for now, there are still reasons to remain cautious, including a weakening macro picture, recession concerns and geopolitical tensions, as well as a continued higher cost of debt leading to tighter cash flows and interest coverage ratios.

In case of another round of material market weakness, spreads are likely to widen temporarily via lower loan prices. However, prices tend to rally rapidly after a bottom has been reached once forced sellers disappear, making timing difficult. The more important factor regarding long term returns are spreads and yields at which to invest initially and secondly defaults that lead to potential credit losses over time.

As we argued in the previous pages, a recession was already expected in 2023 and many companies prepared by cutting costs, preserving cash, and extending their loan maturities in time. A more defensive sector tilt also continues to limit the overall damage to loan issuers' earnings. We also believe that sponsors continue to be supportive of defending their equity stakes.



16. Three-year annualised return scenarios* as a function of default and recovery rates (reflecting current base rate forward curve)

Annual default rate 2024-2026

Recovery rate 2024-2026	0.0%	1.0%	2.0%	3.0%	4.0%	5.0%	6.0%
90%	7.6%	7.5%	7.4%	7.3%	7.2%	7.1%	6.9%
80%	7.6%	7.4%	7.2%	7.0%	6.8%	6.5%	6.3%
70%	7.6%	7.3%	7.0%	6.7%	6.3%	6.0%	5.7%
60%	7.6%	7.2%	6.8%	6.3%	5.9%	5.5%	5.1%
50%	7.6%	7.1%	6.6%	6.0%	5.5%	5.0%	4.5%

*) Illustrative return for an investment into a loan portfolio with ELLI's price (96.0), margin (399bps) and maturity (4.1 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 12/2023 (graph 13).

Price discount and yields as cushion

Finally, we updated the illustrative scenario analysis (graph 16) of the 3-year returns for a loan portfolio with same characteristics as the European leveraged loan index (ELLI). As in last year's analysis, the results indicate that current price and yield compensate well for different default and credit loss outcomes.

With the historical average default rate (2-3% p.a.) and average recovery rate (c. 70%), investors would be looking at a 6.7-7.0% annual return over the next three years.

Using the worst historical 3-year default rate including both the GFC and Euro crisis (6% p.a.) and lower recovery rate (60-70%), annual returns would be c. 5.1-5.7% - still above ELLI's 2003-2023 average annual return of 5.0%.

As we argued last year, attractive yields, selective credit picking and senior secured positions provide ample cushion and downside protection, while market volatility may present even more favourable secondary market entry opportunities for agile investors.

Source: PitchBook Data Inc.

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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.

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