For Investment Professionals only

Leveraged loan market outlook

What will 2021 bring?

Summary

Key takeaways from our 2021 Outlook:

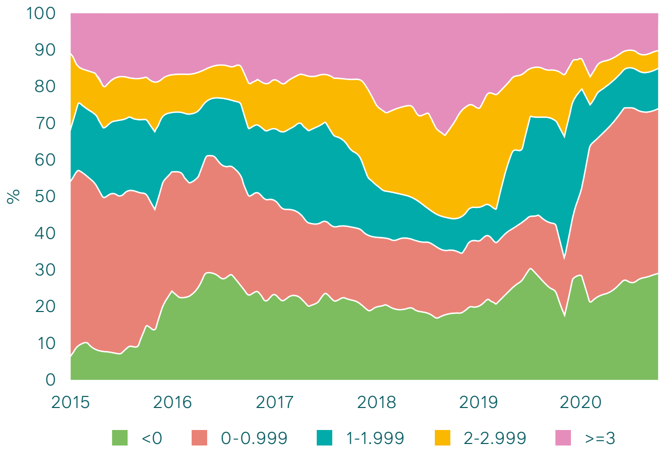
- The search for yield will likely persist in 2021, which should support further spread-tightening and boost investor appetite in the few higher-yielding asset classes that remain. We believe European loans offer attractive risk-adjusted returns for fixed income investors seeking yield and diversification.
- The case for cautious optimism hinges on successful vaccine rollouts in H1 as the pandemic rages. There is a reasonable expectation that the global economy will grow above-trend from the second half of the year, but there are numerous risks ahead, including policy mis-steps and virus mutations, so bouts of market volatility are possible.
- After a long period of very benign credit conditions and notwithstanding 2020's massive support from governments and company owners alike, elevated default risk must be navigated in 2021. Continued support; clear restoration of enterprise valuations and low refinancing needs could help but market forecasts coalesce around 4% and 5-6% for European and US loan markets respectively (higher for HY bonds but sectorally concentrated) putting recovery prospects (c. 70% historic average) in focus.
- Leveraged loans have proven risk-return and resilience through crises and over decades, and their higher yielding, senior-secured and low duration characteristics should help to mitigate against the risk of adverse scenarios like higher defaults.
- An ability to differentiate and exercise a high level of conservatism in selection will likely be important in 2021, reminding of the 2014-2015 alpha from stock-picking when default rates were last elevated, to deliver attractive risk-adjusted returns and high running income while minimising default losses.
- M&A back in full swing? With plenty of PE dry powder and restored and functioning capital markets, a renewed appetite for deal-making is expected, meaning annual loan issuance could increase materially. In Europe, companies and sponsors on the hunt for deals may be expected to look for opportunities in Value companies (vs. higher growth nature of US stocks), ahead of the anticipated rise of cyclical stocks. We anticipate a busy period of opportunistic take-privates, bolt-on acquisitions and secondary buyouts.
- CLO formation and financing costs remain important demand and pricing drivers, and our base case sees new CLO issuance volume increasing in 2021 as technicals improve though structured vehicle investors will need rating stability and demand robust portfolios from well-established managers.
- A big year for ESG? Regulation for investors and cohesive lobbying pressure on issuers – particularly for carbon target-setting and quantifiable emissions disclosure – could drive ESG and climate-change action forward in 2021. Diversity & Inclusion looks set to move up the corporate agenda too, with greater demonstration of equality being required from those purporting to be ESG leaders, including in the private corporate world.
- Regulatory change and reform remains in focus – IBOR transition will take place in earnest for GBP and USD-denominated loans in 2021 which may have some frictional side-effects for loan settlement times.

The value of investments will fluctuate, which will cause prices to fall as well as rise and you may not get back the original amount you invested. Where past performance is shown, please note that this is not a guide to future performance.

The charts that matter

Financial repression continues as quantum of negative yielding debt swells to $18 trillion.

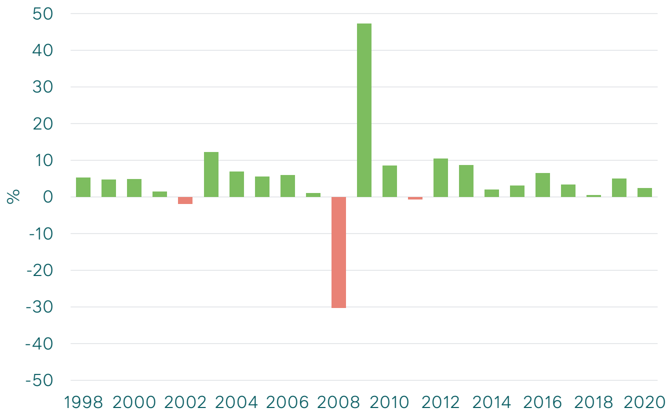
Figure 1. 90% of the world's bond market now yields 2% or less – Share of the $60 trillion global bond markets by their yields



Source: Bloomberg Finance LP, Deutsche Bank, as at 18 December 2020. Information is subject to change and is not a guarantee of future results.

After the most turbulent quarter since Q4 2008, the loan market ended 2020 with a positive return, preserving its strong relative track record for avoiding drawdown years.

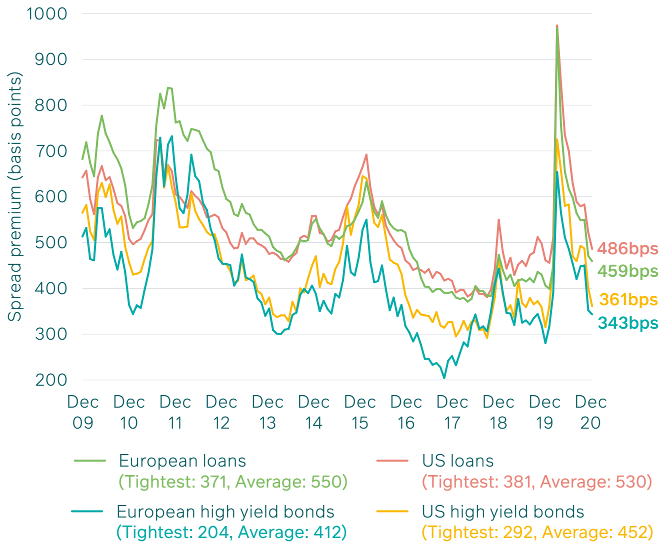
Figure 2. European loans performed well despite pandemic-driven volatility – European loan market returns: annual performance since 1998



Source: Credit Suisse (Western European leveraged loan index (CS WELLI)) (hedged to euros), as at 31 December 2020. Past performance is no guarantee of future results.

Sub-investment-grade spreads start 2021 wider than where they began 2020 and materially wider than their 2017 tights, but are tighter than their long-term averages. Any mis-steps by central banks or other nasty shocks could spark volatility.

Figure 3. Markets tighten on policy largesse – Loan and high yield bond spreads over past 10 years

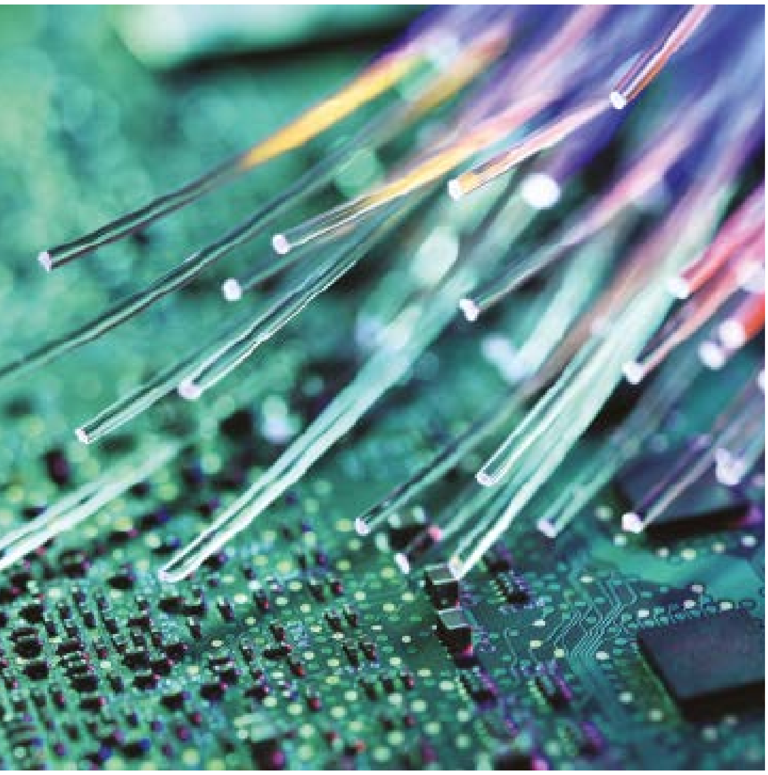


Source: M&G, CS WELLI, US leveraged loan index (LLI), three-year discount margin, Bloomberg (Merrill Lynch European HPIC high yield index swap spread, H0A0 index swap spread), as at 31 December 2020. Past performance is no guarantee of future results.

2020 Review

Overview

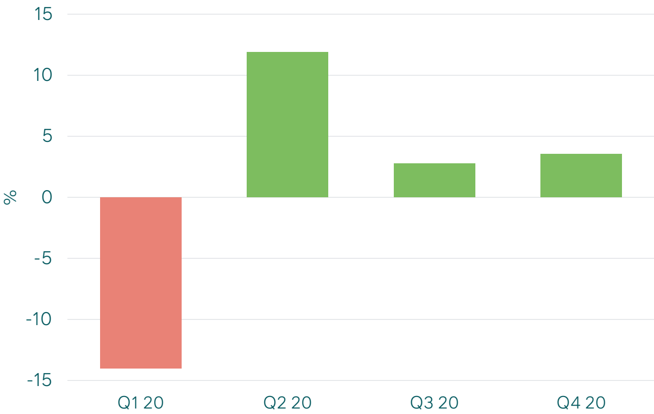
Neither the COVID-19 pandemic nor the market's reaction to it could have been predicted. And, even if the pandemic had been foreseen, the speed of bounce-back would not have been. In some assets and single stocks, we have potentially seen both a crash and a bubble in the space of a year. Nor is the meteoric rise entirely related to the massive fiscal and monetary stimulus that was swiftly given: there have been behavioural and technological changes too – not least the rapid adaptation by the global population to remote working and the permanent digitising of many activities. There has also been huge speculative fervour from new retail investors, contributing to the rise of US growth stocks and less mainstream assets like Bitcoin, the latter quadrupling in value in 2020. After experiencing a recession not seen since World War II (WW2) and with the pandemic still raging, are there already signs of irrational exuberance?



Loan market performance

The European loan market (as represented by the Credit Suisse Western European Loan Index (CS WELLI)) ended the year with a positive return of 2.38% (in euro terms) – a remarkable outcome given it was down c.20% at its nadir in March and after registering a -14% decline for Q1.

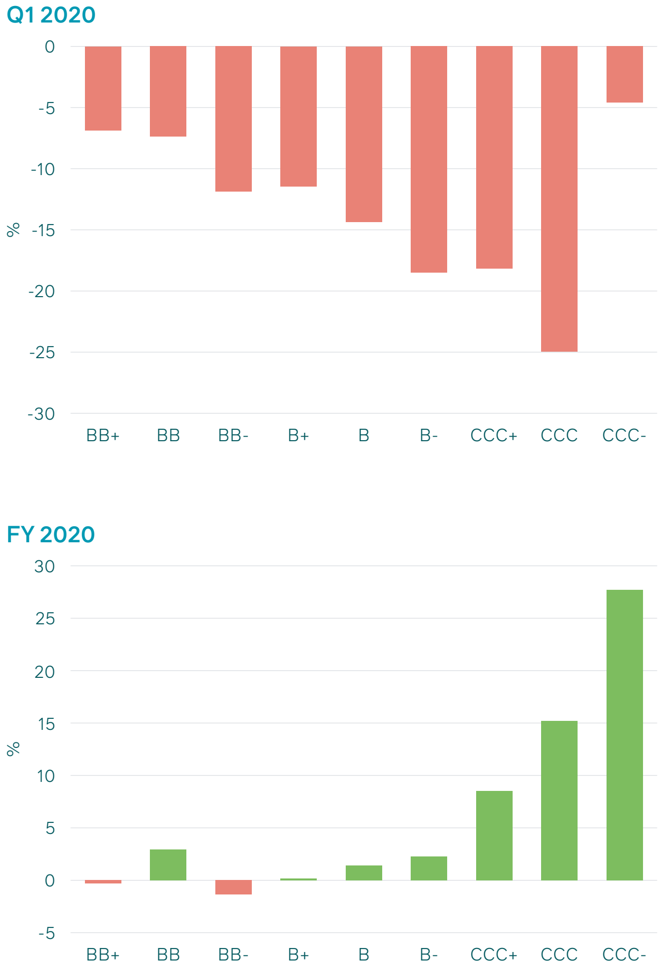
Figure 4. European quarterly loan market returns 2020



Source: CS WELLI (hedged to euros), as at 31 December 2020.
Past performance is no guarantee of future results.

In terms of loan market volatility, the biggest moves were seen in the weakest names, with the CCC-rated cohort – accounting for c. 4% of the whole index – bouncing back remarkably strongly after falling so dramatically in the first quarter. With so much uncertainty still prevalent in the economy and society, it was surprising that the performance of the very weakest component of the CCC-rated constituency amounted to c.50% from its nadir point and c. 25% for the year as a whole. (That said, this is performance is somewhat theoretical as far as the real world was concerned given its tiny population and the inability to trade this portion of the market fully or in size).

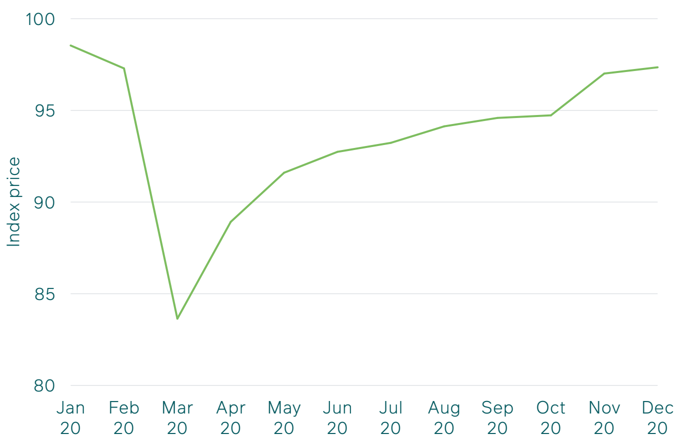
Figure 5. European loan market returns – by credit ratings



Source: M&G, CS WELLI (hedged to euros), as at 31 December 2020.
Past performance is no guarantee of future results.

The crisis of 2020 has proven, in our view, the resilience of the loan market, with the index price closing at 97.35, only a point below its start.

Figure 6. European loan market index price dynamics



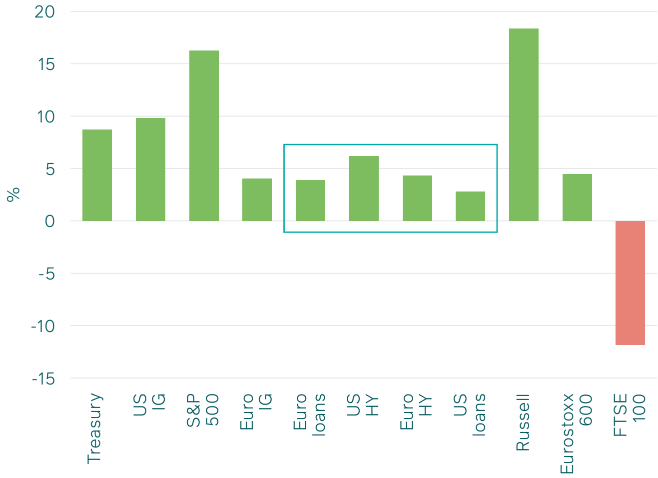
Source: CS WELLI, as at 31 December 2020.
Information is subject to change and is not a guarantee of future results.

How did the performance of European loans fare against other asset classes in 2020? Remarkably, in the face of double-digit declines at the end of Q1, only crude oil and some European stock markets (notably the UK's FTSE 100) ended 2020 in the red (in US dollar terms) – see Figure 7 on **page 6**. Despite big, volatile moves in-between, most risk assets delivered positive returns, including loans and high yield bonds.

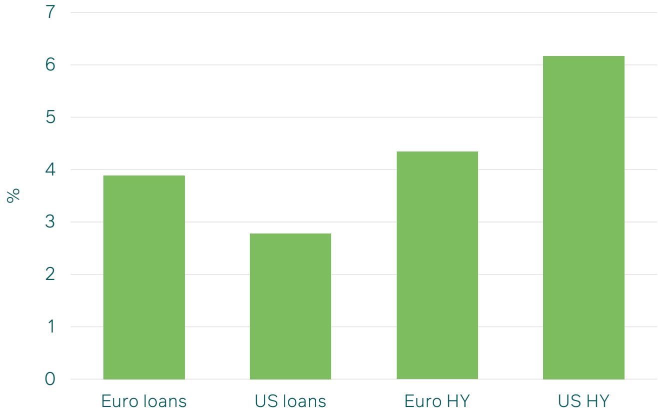
Drilling into the sub-investment-grade detail, returns of European loans and high yield bonds were similar but there was some divergence in the US, with bonds benefiting from rate-falls as well as spread compression from high demand – both from net fund inflows as well as the US Federal Reserve's (Fed) first foray into (newly) non-investment grade issues. By contrast, US loan returns lagged, beleaguered by persistent mutual fund outflows as interest rates got ever lower. Investors in mutual funds and exchange-traded funds that buy US loans had dwindled to just 8% of the US investor-base by year-end.

Figure 7. Contextualising European loan market performance across asset classes

2020 returns across asset classes (in US dollar terms)



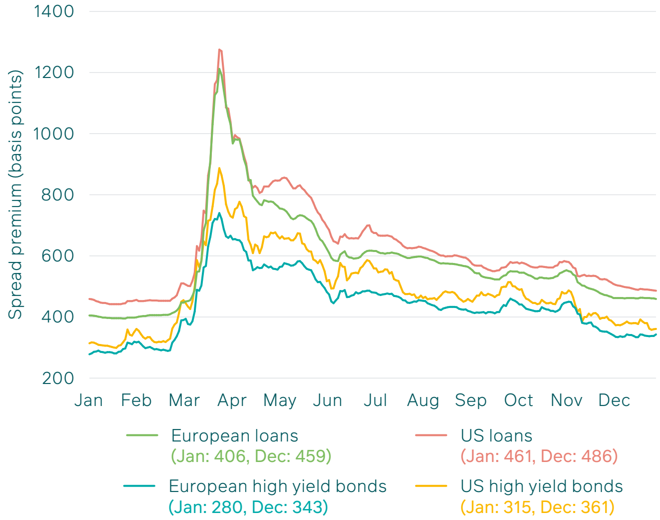
2020 returns across sub-IG markets



Source: Bloomberg, Credit Suisse, as at 31 December 2020. Returns hedged to USD for comparability. Past performance is no guarantee of future results.

Notwithstanding their rally, we believe loans continue to look attractive and, while index spreads tightened sharply in the final two months of the year, European loans still ended 2020 at 459 basis points (bps) (assuming a three-year average life) – comfortably over the 406bps offered at the start of the year.

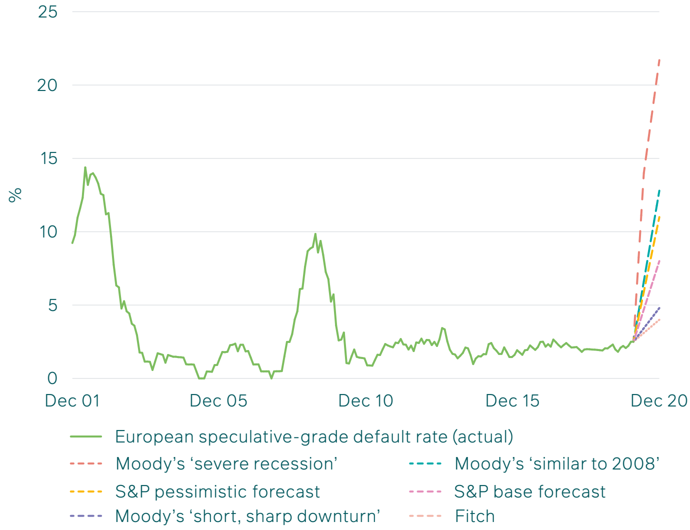
Figure 8. Loan and high yield bond spreads over past 12 months



Source: M&G, Credit Suisse (CS WELLI, CS LLI, three-year discount margin), Bloomberg (Merrill Lynch European HPIC high yield index swap spread, H0A0 index swap spread), as at 31 December 2020. Past performance is no guarantee of future results.

In the eye of the pandemic storm, predictions for corporate defaults varied wildly with some predicting a 2008-2009 redux.

Figure 9. European sub-IG default rate and credit rating agency predictions in the eye of the pandemic



Source: M&G, S&P Global Ratings, Moody's, Fitch Ratings, as at March 2020. Information is subject to change and is not a guarantee of future results.

In the event, such was the swift support from private equity (PE) owners and various state-support schemes, only US bond default rates spiked (to 7%) with European loan and bond rates rising only modestly, ending 2020 below 3%. It was a year of focusing on liquidity, with debt-bloated balance-sheets being now in focus for 2021 and beyond, depending on the speed of economic recovery.

Indeed, in the first year of a crisis, it is always a 'liquidity problem, not a solvency problem'. The solution to the shock of the pandemic's impact was mainly provided by debt rather than grants or equity (drawing down on all manner of available credit lines for survival and cash), creating potential future solvency risks. Although it is worth pointing out that the debt came largely from tolerant and supportive bank and non-bank lenders, PE owners and/or state support schemes – and in response to a universal health crisis. Unlike the last crisis, retribution is not likely to be a post-pandemic characteristic.

The plight of indebted corporates is akin to that of sovereigns whose debt-to-GDP has risen markedly in 2020 – to 100% in the US and 110% in the Euro area. However, artificially low interest rates – that have prevailed for the last decade – together with extensive liquidity support could have ensured that a bare minimum of debtors will be pushed to the point of having to restructure, at country and corporate level, assuming confidence is assured. What that means for companies is observable, robust Enterprise Valuations (EVs) since what pays creditors back in the end is growth and profitability. Only growth can protect a stakeholder from elevated debt and faith in it can sustain a company even if its deleveraging is slow-going to begin with. That said, a persistent debt overhang can create a vicious cycle, limiting and discouraging the involvement of new investors. But, analogous to the sovereign's situation, high debt is only a problem if its size deters voluntary new lending and investment.

What has been the corporate take-up for state-support schemes across Europe?

In Europe, state support came in the form of short-term loans as well as tax holidays and furlough schemes. According to S&P, Spain, Italy and France were the countries whose corporates availed themselves most of loan guarantee schemes, with corporate debt rising, on average, by 6%-12% across the three countries:

Figure 10. Loan guarantee schemes across Europe

	France	Germany	Italy	Spain	UK
Number of corporates ('000)	607.8	97.7	1,257.10	880.9	1,942.30
Requested/committed (€/£ billions)	128.7/125.0	56.2/44.6	118.4/0	0/108.0	0/65.6
Outstanding NFC debt (%)	5.7	2.5	10.1	11.9	4.9
Programme envelope (€/£ billions)	300	120	510	152	330
Envelope used (%)	42	37	23	71	20
Government guarantee (%)	70-90	80-90	90	60-80	80-100
Latest data	6 Nov 2020	19 Nov 2020	11 Nov 2020	15 Nov 2020	15 Nov 2020
Programme end date	30 Jun 2021	31 Dec 2020	31 Jan 2021	–	31 Jan 2021

Source: S&P Global Ratings, as at 25 November 2020. NFC = Non-financial corporate. Information is subject to change and is not a guarantee of future results.

Empirically, in the leveraged finance universe, it appeared as though French LBO corporates were the most active in raising state-backed loans.

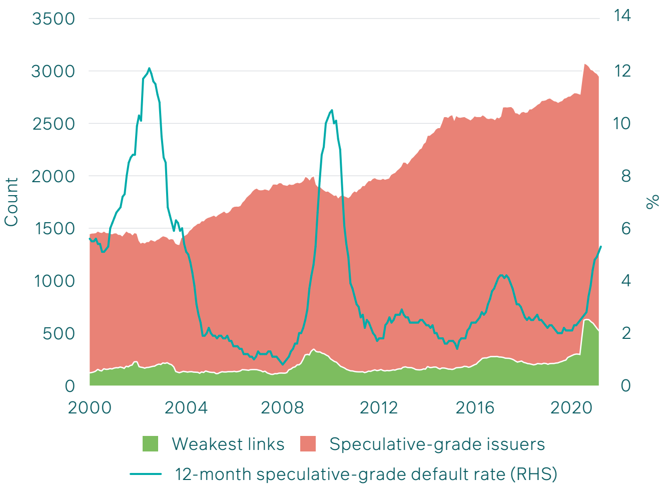
Zombies aka ‘weakest links’

Loans were made to companies at a time of macro distress in 2020 on the basis of preventing their collapse and stabilising their situations. In this way, capital, the company and its stakeholders were protected. So far, more heavily indebted companies have performed better than feared, having managed cash and costs well, focused on survival and tapped all available liquidity and credit support lines. Massive support should mean an avoidance of the dire widespread solvency situation experienced after the Global Financial Crisis.

However, if the loans given only serve to prop up a company for the short term, merely postponing an inevitable collapse over a longer period – and even crowding-out the emergence of a viable competitor, offering better productivity and employment prospects – then they were pointless and ultimately destructive. This is the road to discovery on which some companies now embark.

While the suppressive effect of support and stimulus has reduced the expectations for global, speculative-grade (sub-IG) defaults, some indebted companies will be zombies or, as ratings agency, S&P Global, more tactfully puts it, ‘weakest links’[1] and their numbers have grown in 2020:

Figure 11. Share of weakest links among total speculative-grade issuers remains elevated

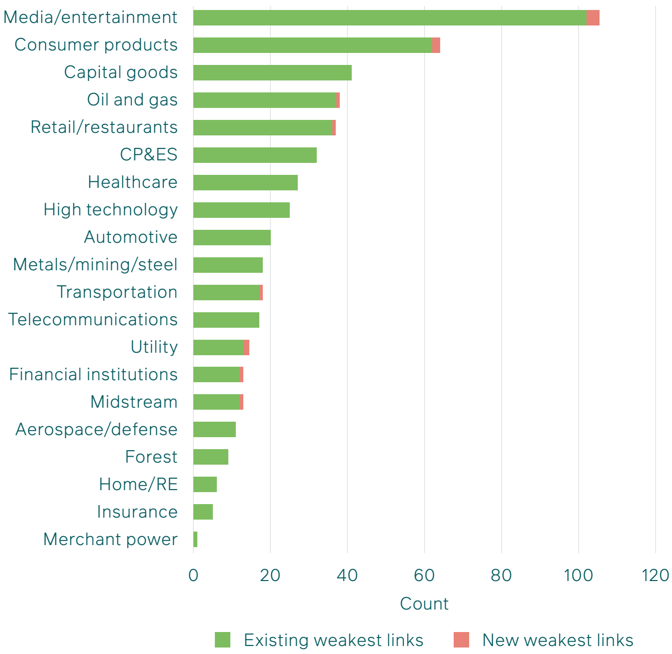


Source: S&P Global Ratings Research and S&P Global Market Intelligence’s CreditPro, “Default, Transition and Recovery: Weakest Links Fall Amid Improved Funding Conditions”, 16 December 2020. Data as at 19 November 2020. Default data as at 31 October 2020. Information is subject to change and is not a guarantee of future results.

[1]S&P Global Ratings Research. ‘Weakest links’ refers to issuers rated B- or lower by S&P Global Ratings with negative outlooks or ratings on CreditWatch with negative implications.

The greatest proportion of weakest links by region are found in the US (representing c.71% of the total weakest links tally) compared with Europe’s 17% share. At sector level, the risk is concentrated with entertainment and consumer goods accounting for almost a third of the total:

Figure 12. Weakest link tally increases in 2020 – sectors and industries most at risk for defaults



Source: S&P Global Ratings Research, “Default, Transition and Recovery: Weakest Links Fall Amid Improved Funding Conditions”, 16 December 2020. Notes: CP&ES = Chemicals, packaging and environmental services. Home/RE = Homebuilders and real estate companies. Forest = Forest products and building materials. Data as at 19 November 2020. Information is subject to change and is not a guarantee of future results.

2021 Outlook: Measure for Measure

In the next sections, we outline our expectations for the loan markets in the year ahead; the key considerations and risks to watch; and our thoughts on some of the key themes in 2021 and beyond.

Loan market yield – is it sustainable?

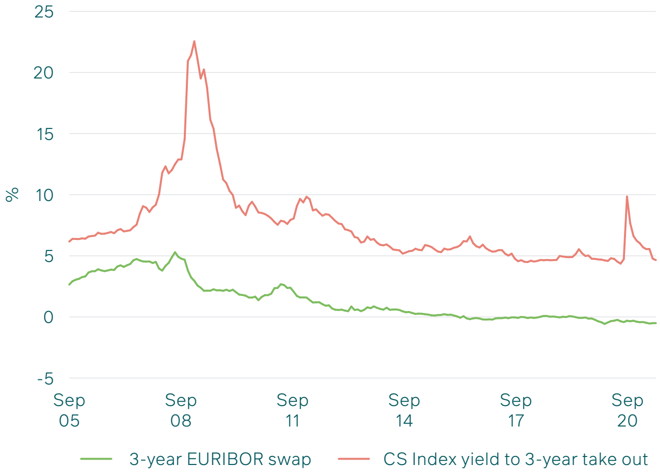
We start 2021 with almost all of the $60 trillion global bond market at a yield of 2% or lower. Within that, almost a third of government debt and over 40% of investment grade (IG) credit are negative-yielding – a total of $18 trillion. It is fair to assume that the search for yield will persist in 2021. Greater certainty of yield will also remain important for fixed income investors, which augurs well for institutionally-dominated, first lien, floating-rate European loans.

The unquenchable thirst for yield could support further credit spread tightening. However, that is not to say that there will not be bouts of volatility. The race between rising (and mutating) infections and vaccine rollouts may dictate sentiment for the first months of 2021 and, even with steady and effective vaccination programmes, if policy support is withdrawn too quickly or if tussles in the EU stop stimulus from the Recovery Fund from being disseminated swiftly, then there is scope for renewed disruption and market instability. Furthermore, the heavily-indebted state of most sovereigns may create political issues and populist disruptions, with Southern European debt-to-GDP ratios in particular, reminding all of the EU's North-South divide and echoing 2011.

Married with concerns over corporate survivorship, 2021 could be a year for alpha delivery via stock-picking to the greatest extent seen in the loan asset class since 2014-2015, the last time when the combination of higher volatility and elevated default rates (c.5%) was evident, with conservative, careful selection proving return-enhancing.

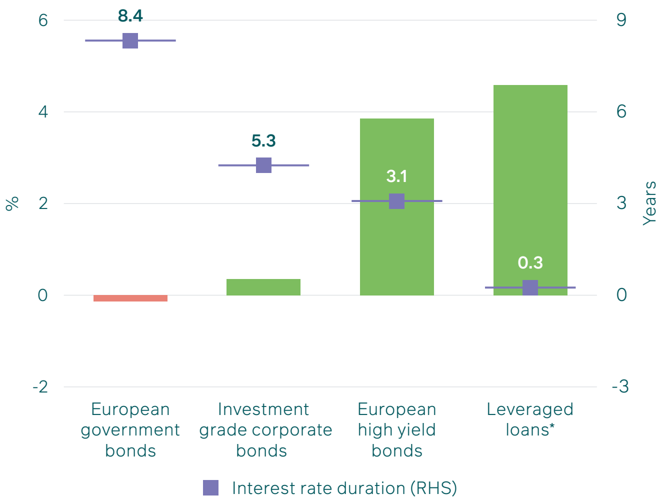
Figure 13. European loan yields – versus Euribor rates and versus other fixed income asset classes

Market yield versus Euribor rates



Source: Bloomberg, CS WELLI three-year yield, as at 31 December 2020. Information is subject to change and is not a guarantee of future results.

European fixed income yields

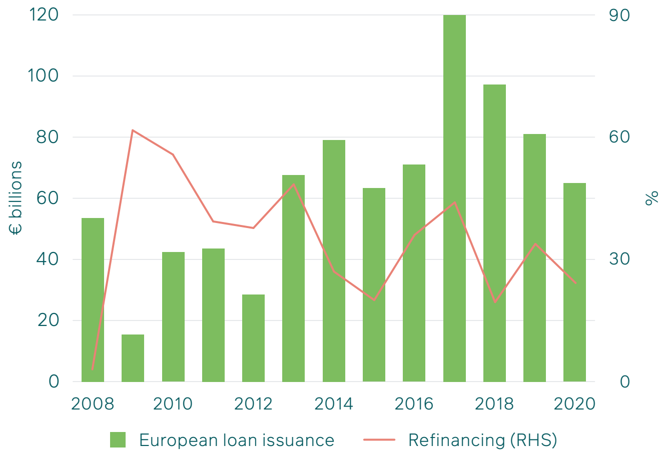


Source: Bloomberg and Merrill Lynch (EG00, ER00, HEAD), as at 31 December 2020. Fixed bond returns and modified duration on a 'worst' basis. *Leveraged loan yield is current spread of CS WELLI assuming zero Euribor rate and four year pull-to-par. Information is subject to change and is not a guarantee of future results.

Loan supply

In 2020, European loan issuance was 20% down on 2019, at €65 billion, with the new-issue loan market suffering from a lack of new buyouts and suppressed deal-making. The proportion of refinancings (24% vs. 34%) was naturally lower than 2019's level with the spike in primary market pricing at the height of the crisis deterring opportunistic transactions. Understandably, dividend recaps accounted for just 12% of activity. It was a similar supply picture in the US, with loan issuance also down by a fifth and reduced refinancing (26% vs. 37%).

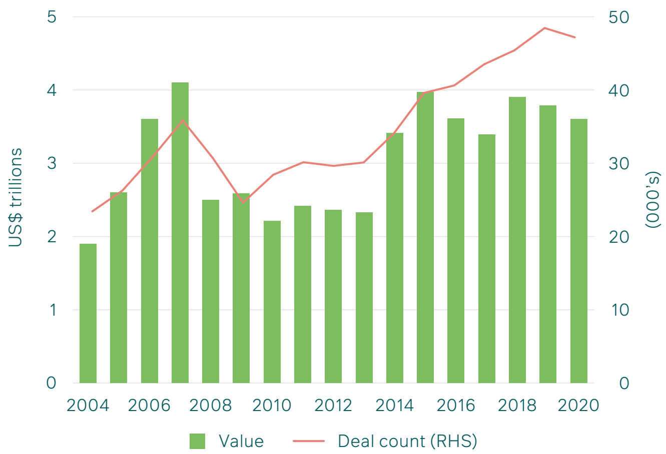
Figure 14. European leveraged loan issuance and refinancing



Source: S&P LCD, as at 31 December 2020. Information is subject to change and is not a guarantee of future results.

M&A activity leads new loan issuance (usually with a 6-to-12 month lag). M&A volume ended 2020 at US$3.6 trillion, only 5% down from 2019, making for encouraging 2021 loan issuance prospects given its back-ended nature:

Figure 15. Global M&A annual volume and number of transactions



Source: Bloomberg, as at 31 December 2020. Information is subject to change and is not a guarantee of future results.

With the momentum in European M&A picking up from the second half of 2020 and into 2021, we anticipate a busy period of opportunistic take-privates (particularly in the beaten-up UK equity market, cf. G4S and William Hill in 2020); bolt-on acquisitions; and secondary buyouts to create subsequent loan issuance of size. There is $1.6 trillion in unspent PE capital – so sponsors will not be shy about getting back to work, boding well for leveraged loan supply. The early M&A pipeline in 2021 is significant too, and all else being equal, predictions are for annual issuance to increase materially over the course of the year.

Indeed, available PE capital may be augmented by the rise of NAV loans – the gearing-up of sponsors' funds, via loan-to-value facilities from specialist providers, to unleash the extra value perceived across portfolios. Price discovery is key to unlocking this though, meaning reliable public market valuations – made difficult by volatility.

'Pass the parcel' or so-called continuation deals are also anticipated, where one sponsor sells a company to a new vehicle that it controls. We might see more of this in 2021, a trend that was on the rise in 2020, when $35 billion worth of such deals were effected (eg CapVest's French pharmaceutical company, Curium; EQT's enterprise software business, IFS). Larger European loan issuers, Springer Nature (BCP) and Verisure (H&F) are reportedly considering similar deals, all of which depend on robust, observable valuations.

SPACs surge in popularity

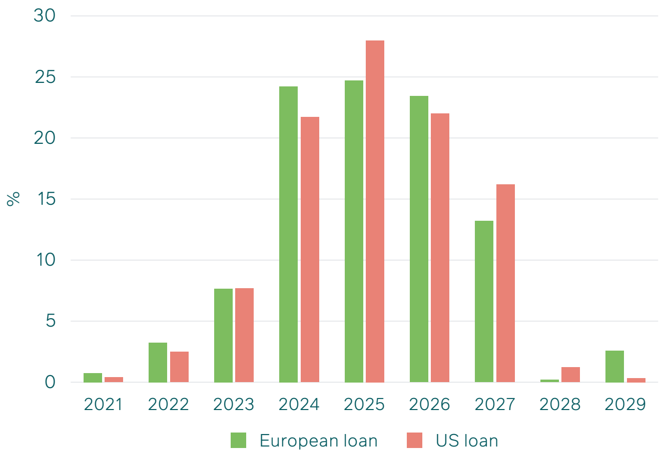
SPACs, or Special Purpose Acquisition Vehicles, is another trend worth highlighting as we think about sponsor exits in the year ahead, given their advent and explosion in 2020. SPACs are a regulatory arbitrage and largely a US phenomenon. Since direct listings are not a route open to everyone, SPACs are not 'acquisition vehicles' in essence, but rather a means of listing for high-growth companies. In the main, hyper-growth companies use them and, unlike a direct listing, management may use projections to tell its story. They also offer deal and price certainty and can cut 7-8 months from the timetable versus a direct listing – hence their appeal in a time of volatility.

We expect PE sponsors to exit investments via sales to SPACs in 2021 though this is likely to be only in certain, high-growth sectors, technology and sports rights, for example.

Refinancing picture

For European and US loans, near-term maturities are of little concern with the lion's share of maturities being in four-to-six years' time. Any refinancing activity is thus likely to be opportunistic only.

Figure 16. Maturity breakdown of the European and US loan markets (% of total)



Source: S&P Global Market Intelligence, CS WELLI and US LLI, as at 31 December 2020. Information is subject to change and is not a guarantee of future results.

Loan demand

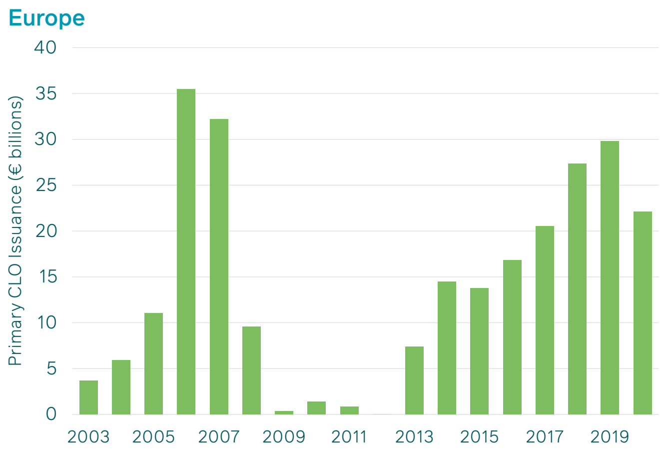
Loan spreads have been relatively insulated historically, owing to avoidance of excessive demand thanks to the very nature of loans, their non-UCITS status plus their ineligibility for central bank asset buying programmes.

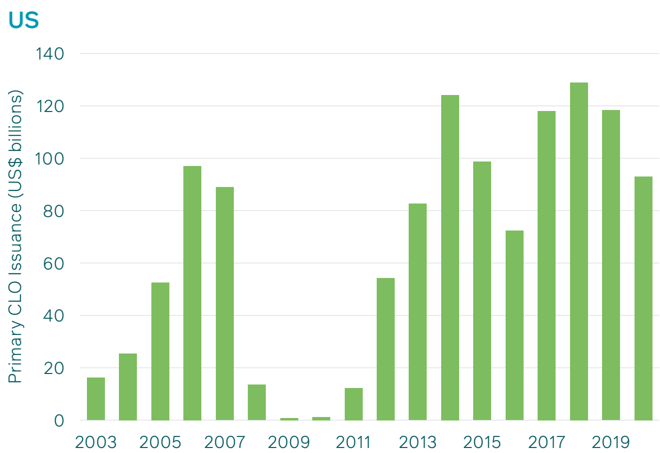
Collateralised loan obligations (CLOs) remain an important demand-driver particularly in the US where they account for two-thirds of the buying base at least versus c. 50% in Europe. However, institutional loan funds and separately-managed accounts, which were joined by the raising of new 'credit opportunity' funds in 2020, are important too. Anecdotally, there have been reports that global funds are buying into Europe once again, with Asian investors also investing directly in the market, further extending demand for the asset class.

While CLO formation was reduced in 2020 amid concerns around rating migration and lack of new primary loan supply, it picked up in the fourth quarter. CLOs are vulnerable to rating agencies so this will remain the determinant of new issuance in 2021. The number of COVID-inspired downgrades in Spring 2020 created a vicious circle – failing the quality tests that govern the CLOs' ability to keep investing freely (and, ultimately, if they persist, their coupon payments to investors on lower-stack notes to be suspended).

CLO creation has picked up strongly of late as a result of loan rating stability and significant tightening in their liability costs, with average AAA spreads now back to their pre-pandemic levels. For as long as markets are calm, this situation should persist. New CLO issuance volume is expected to increase this year, with 26 new-issue European CLOs already scheduled for Q1.

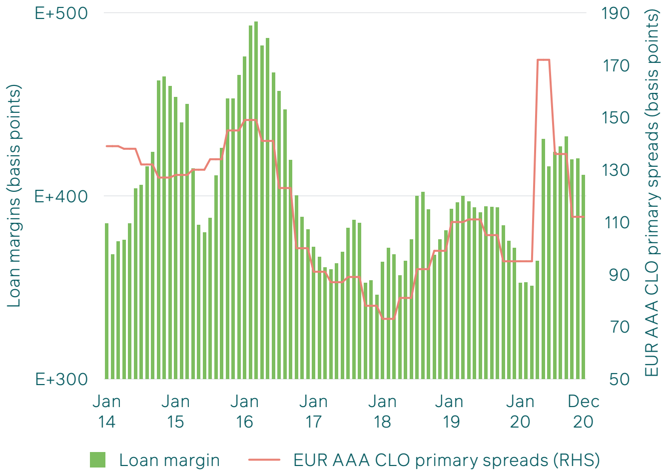
Figure 17. European primary CLO issuance and US primary CLO issuance





Source: S&P LCD, as at 31 December 2020. Information is subject to change and is not a guarantee of future results.

Figure 18. European new-issue loan margins



Source: M&G, S&P LCD, as at 31 December 2020. Information is subject to change and is not a guarantee of future results.

Historically, relative equilibrium between supply and demand has protected loan pricing. In the year ahead too, new-issue loan spreads are expected to remain in their medium-term range of 3.75%-4.25%. In our view, European loans offer attractive risk-adjusted returns and high running income, but is it enough to compensate investors for the risks ahead? We take a closer look in the next sections.

Macro risk

Absenting the unique circumstances of the pandemic in 2020 and volatility not seen since the Global Financial Crisis, markets were last choppy in 2018, when political uncertainty and macro growth concerns saw all risk assets end the year in the red (apart from European loans which delivered a small, positive return). However, back then corporate default rates were abnormally low, meaning that snapback was rapid. In 2021, while the COVID-19 crisis could abate, its effects will last.

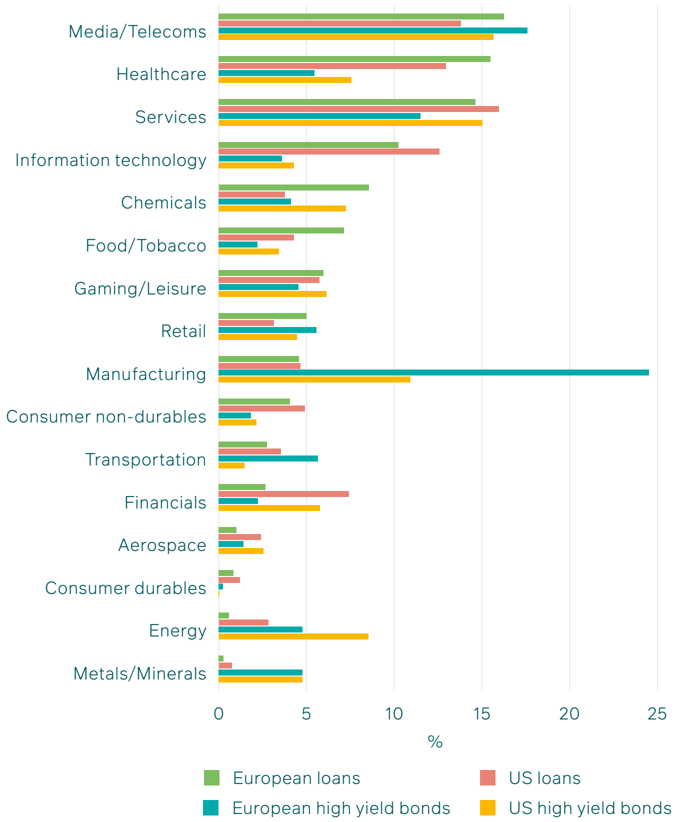
Almost no-one expects a return to economic 'normality' by the end of 2021 and the Eurozone may not recover to pre-pandemic GDP growth until mid-2022 or even 2023. The persistence of the virus-outbreak and its lingering effects pose threats to economic recovery and human health. And, there remains the prospect of recurring lockdowns until there is sufficient vaccine coverage to protect large swathes of the population. The risks stemming from high unemployment rates, changing consumer habits and behaviours and the consequences of heavy corporate and government debt burdens cannot be discounted.

Rise of indebtedness

With global government debt-to-GDP at levels not seen since WW2 and pandemic support having been provided mostly in loan form, higher indebtedness is the status quo for sovereigns, companies and individuals alike. That said, this is unlikely to be exposed as a big worry in 2021 such is the relatively widespread liquidity comfort.

The European loan market is sectorally weighted towards the defensive sectors of media and telecoms, healthcare, services and information technology (representing over half the market), with small exposures only to the front-line sectors of leisure and retail, and the longer-term declining industries of manufacturing (auto). Unlike the US high yield bond market, it also has near-negligible exposure to the energy sector. Therefore, the European loan market's natural sectoral distribution should help to insulate the asset class somewhat.

Figure 19. Sectoral distribution of European and US speculative-grade loan and bond markets

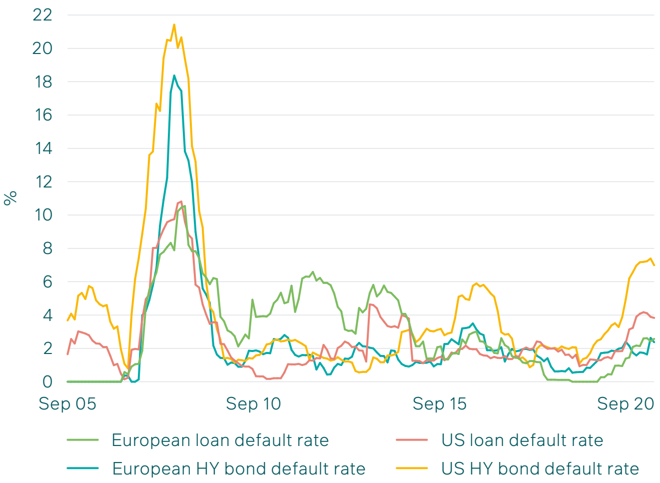


Source: M&G, Bloomberg, Credit Suisse, as at 31 December 2020. Information is subject to change and is not a guarantee of future results.

Default and recovery outlook

Default rates, though rising, entered the pandemic – for Europe in particular – from a low base.

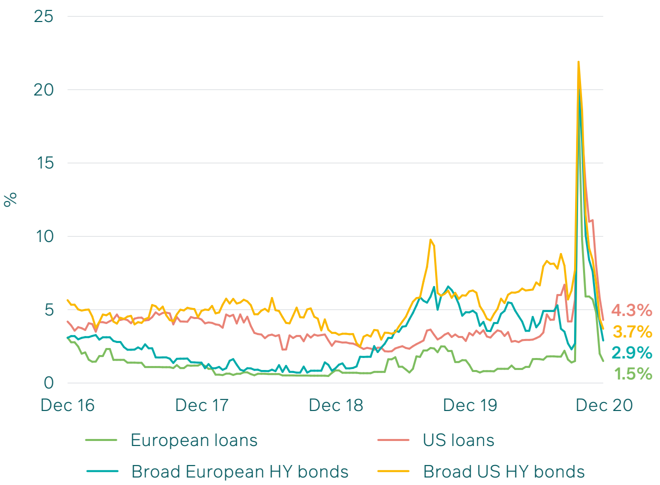
Figure 20. European and US speculative grade annual default rates



Source: S&P LCD, S&P Ratings Direct, BofA Merrill Lynch (BofAML), as at 31 December 2020. Loan specific figures not given pre 2007 for Europe and pre-2005 for US. Information is subject to change and is not a guarantee of future results.

And, market prices would imply very low default-rates from here:

Figure 21. European and US distress ratios

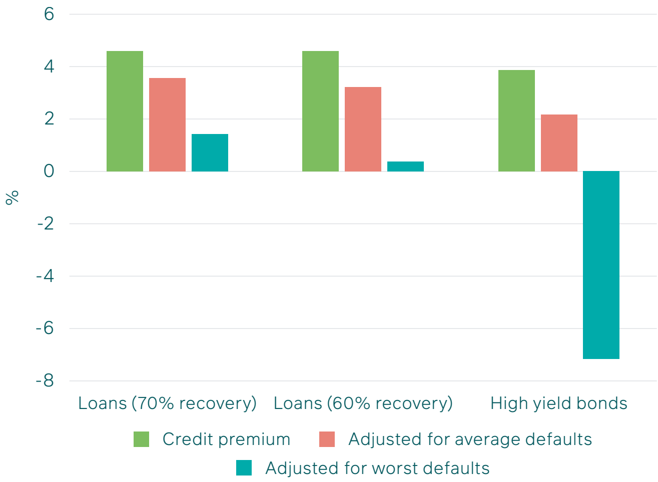


Source: Credit Suisse European Credit Trades & Themes. Percentage of securities trading at a price below 80 in the secondary market, as at 31 December 2020. Information is subject to change and is not a guarantee of future results.

However, loan market participant polls, conducted in December 2020, suggest market consensus of 4% and 5%-6% for European and US loan markets[2].

While sub-IG spreads start 2021 wider than where they began 2020, additional compensation is warranted for elevated default risk. The senior-secured nature of loans tends to provide strong downside protection to the lender, while the better loss-adjusted spread of loans is down to historically higher recoveries compared to (largely unsecured) high yield bonds.

Figure 22. European loan and high yield bond spreads and default spread premia



Source: M&G, Bloomberg (BofA Merrill Lynch High Yield (HPIC) asset swap spread), CS WELLI Index three-year DM, as at 31 December 2020. S&P, Moody's default data for loans and bonds, 2008-2020. Estimated recovery rate 40% for bonds, 70%/60% loans based on data from S&P, Moody's and M&G. Past performance is not an indication of future performance.

In loans, if the 70% recovery-rate historical average persists, that would mean a required premium of at least 20bps, assuming the base case assumption of a rise to 4% in European loan default rates is accurate versus its historic average. That said, S&P's wider forecasts[3] for the whole sub-IG universe (ie including bonds) would suggest a US default rate of 9% by September 2021 and 8% in Europe, hinting at potentially higher default rates ahead for bonds.

[2]Source: S&P LCD. Survey data through 15 December 2020.

[3]S&P Global Ratings, "Default, Transition and Recovery: Weakest Links Fall Amid Improved Funding Conditions", 16 December 2020.

Default predictions vary considerably but there is universal agreement that they will be less dramatically elevated than those forecasted in the eye of the pandemic last Spring. With loan spreads over 50bps wider in Europe, there would appear to be appropriate additional premium to cover the reasonable default scenario. The case is less compelling in US loans – which ended the year only 20bps higher in spread terms than where they began it – although it should be noted that the US loan market has a higher composition of BB-rated loans (c.30%) than Europe.

While there is no denying the current state of elevated leverage, cashflow and still-high EV multiples help to mitigate this. Pro-forma interest coverage has held up, remaining at historic highs in Europe (4.7x in European loans), given the all-in cost of debt-servicing is low, whereas PE sponsors are maintaining their high equity stakes in new buyouts (c.50%) while preserving plenty of cash to support existing companies.

Key themes for loan markets – Brave New World

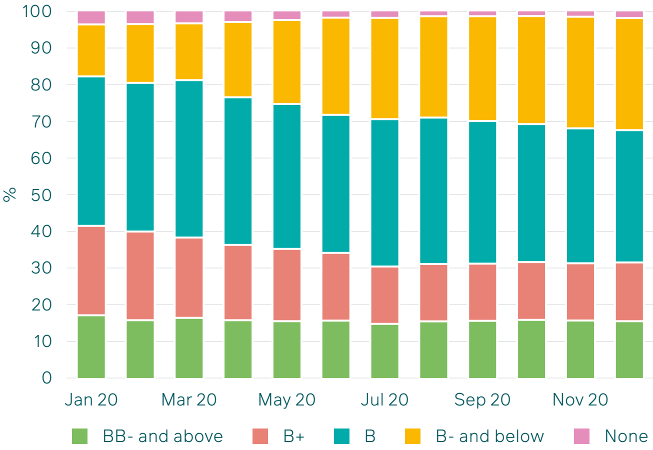
Here, we take a closer look at some of the key factors of significance to the post-pandemic loan market.

Ratings migration

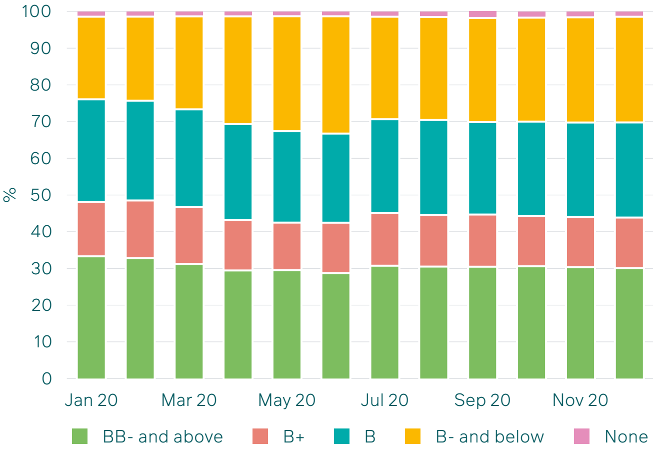
While the pace of downgrades in the European leveraged loan market slowed heading into the fourth quarter, according to S&P LCD data, the ratio of downgrades-to-upgrades remains high. Perhaps the biggest change in terms of ratings distribution in 2020 was seen in the single B- cohort, which grew to c.30% of the European loan market (from 14% at the start of 2020) – on par with the share of the US loan market. While the incidence of front-line sectors is low in Europe, as we highlighted in the previous section, the 'pro-forma' EBITDA to which many new-issue ratings were modelled by the agencies saw some hasty rating revisions made.

Figure 23. European and US loan market composition by credit ratings

European loan market



US loan market



Source: M&G, S&P ELLI, LSTA, as at 31 December 2020. Based on market value. Information is subject to change and is not a guarantee of future results.

From here, we think sectoral positioning and individual stock selection matter more to loan performance and returns than ratings.

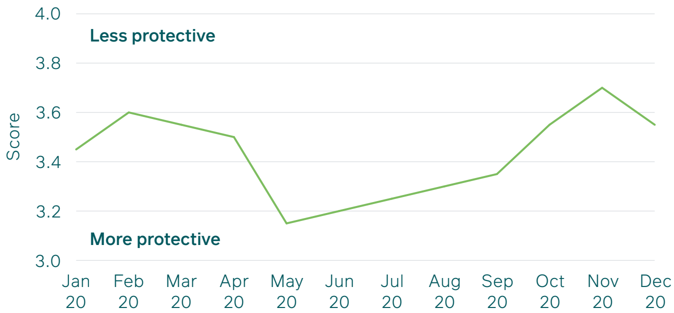
Documentation

Lender scrutiny of deal structures and terms will remain as important as it has in previous years, and we highlight some of the (newer) documentation trends and behaviours we have observed in the loan markets since the crisis (see 'Special focus: Loan documentation trends post-COVID – new risks and twists' overleaf).

Special focus: Loan documentation trends post-COVID – new risks and twists

Though there was evidence of some pushback from lenders in 2020 in direct response to the pandemic, the improvement in loan documentation has proved short-lived:

Figure 24. European loans: Composite documentation score



Source: Fitch Ratings, Covenant Review, as at 31 December 2020. Composite documentation scores are three-month rolling averages. Information is subject to change and is not a guarantee of future results.

The only exception was in EBITDA-adjustments where caps – ie the capping of synergies and other cost savings to either an agreed specified amount or a percentage of EBITDA – (as opposed to uncapped) remained commonplace. Furthermore, the ability to include revenue synergies was largely confined to 'committed actions', meaning only known acquisitions or steps taken could be counted in this respect.

Priming risk

In 2020, there were worrying examples of debt being raised by ailing companies – at super senior level – from a self-selecting group of lenders who, in exchange for exclusive rights to sell their first lien debt back at a discount, were able to swap their exposure – in a cashless exchange – for super senior debt, thereby leapfrogging themselves to a priority level ahead of other first lien lenders in the event of a default. In this way, they violated the 'sacred right' of pro-rata sharing – the traditional requirement to allow all first lien lenders the option of participating in super senior rescue-financing. Such examples of 'up-tiering' transactions (Serta Simmons, Boardriders, Trimark) were all seen in the US loan market.

As yet, the European loan market has not seen such 'lender on lender violence', as the Financial Times delicately described the practice.

Indeed, this is trickier to do in Europe since the majority of Senior Facilities Agreements require debt repurchases to be undertaken via a solicitation process, involving all lenders. Acceptances of multiple offers at the same price are typically required to be dealt with on a pro-rata basis too. Only after that, may participations in loans be purchased bilaterally. And even then, they are subject to restrictions, including that terms are no more favourable to some than to other lenders in the same facility.

Furthermore, European loan documents typically restrict the source of funding such an exchange to an 'acceptable' one, meaning 1) new equity; 2) subordinated loans; 3) retained cash or; 4) payments permitted to be made to investors. That said, some deals may permit any form of permitted debt to be used, making debt exchange feasible.

The Intercreditor Agreement (IA) is equally important since it sets out the relative ranking and priority of different creditor classes. It would be tripped if a company sought to introduce an additional super senior-ranking debt class. An amendment to an IA would likely require all lenders to give their consent too. In other words, most European loan documentation is fundamentally different to that found in the US.

However, it is important to be vigilant. Some recent transactions have provided for 'hollow tranches' within the IA, effectively baking in the future potential to issue super senior tranches not envisaged at the time the transaction occurs.

DIY restructurings

Thus far, the flexibility to incur debt at non-guarantor subsidiary level, secured by liens on non-collateral assets, has been used only to allow European companies to address urgent liquidity needs and shore up cash reserves. However, going forward, potential 'long-term liability management transactions,' may be attempted as some companies seek permanently to reduce debt without going through formal restructuring processes.

Opportunities to capture value via aggressive actions could follow 'the liquidity phase' that defined 2020 if companies get into solvency problems from here. Re-cutting debt may come to owners and management's minds too. It may be less interesting for management to work for an underwater Management Incentive Plan (MIP).

How to spot priming risk

Pre-requisites in documentation are:

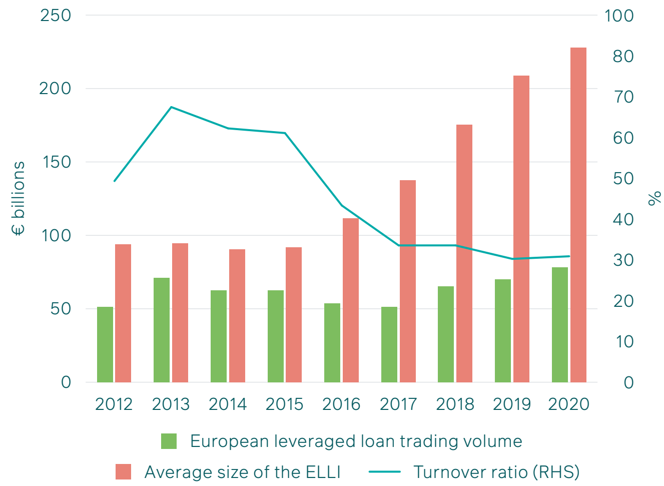
- Scope for significant incremental debt capacity
- Omission of non-guarantor caps for permitted incremental debt and limited requirements to tie it to IAs
- Weak transaction security and;
- Overly expansive permitted liens.

Market liquidity

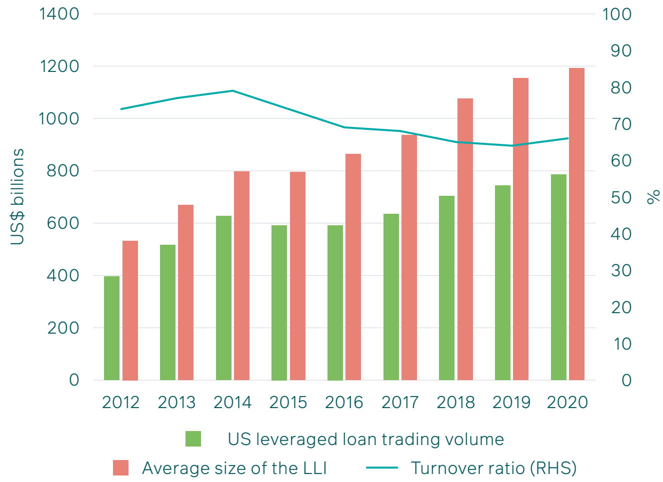
Loan bid-offer spreads are still wide of their long-term averages, having spiked to a greater extent than high yield bonds in Q1 2020 – at one point briefly exceeding their peak seen in the Global Financial Crisis – before news of co-ordinated fiscal and monetary response restored functionality to all markets. Unlike other credit markets though, forced selling was not a feature of loan investors during those early, panic-driven weeks and, despite the price-widening for a period, turnover ratios for the year were broadly in line with their long-term averages of 40% and 60% for European and US loan markets, respectively.

Figure 25. European and US secondary leveraged loan market liquidity

European leveraged trading volume



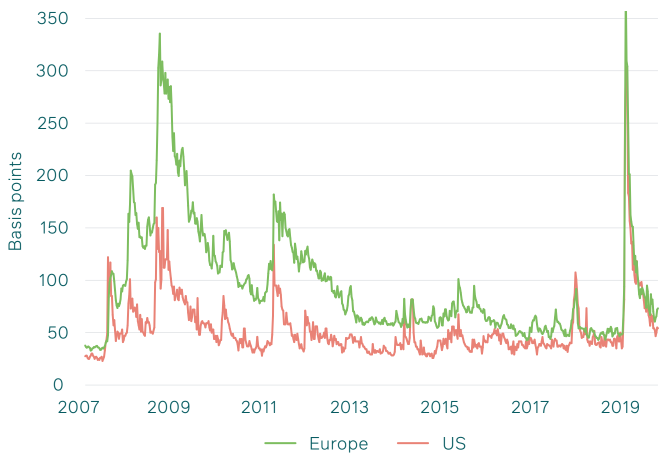
US leveraged trading volume



Source: S&P Capital IQ LCD, Thomson Reuters LPC, Loan Market Association, LSTA Trade Data Study, as at 31 December 2020. Note European market Q4 and US Dec 2020 data not yet available so annualised. Information is subject to change and is not a guarantee of future results.

From here, and notwithstanding renewed bouts of market volatility, we see bid-offer spreads resolving to their norm of 60bps, in turn preserving turnover ratios.

Figure 26. European and US liquid loans: bid-ask spreads

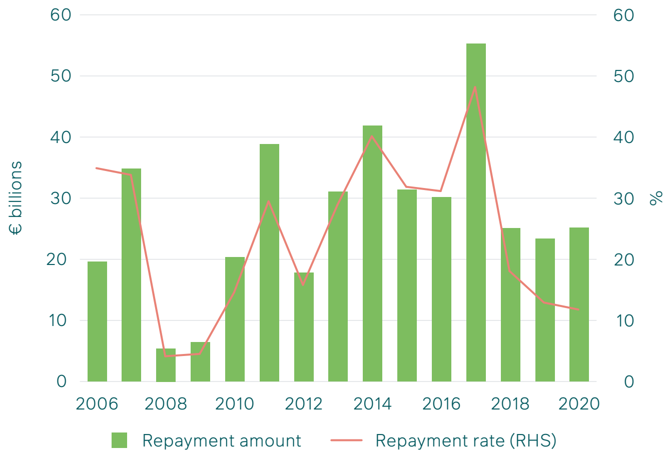


Source: S&P LCD, as at 31 December 2020. Information is subject to change and is not a guarantee of future results.

Repayments

The rate of repayment in 2020 was 12% (vs. 13% in 2019) – lower than the medium-term average of 25% pa. With loan prices still discounted below par in the secondary market – the CS WELLI closed out the year at 97.4 – we think there is scope for further upside from the asset class, as a material increase in M&A activity from here should see loan prepayments pick up upon sponsor exits – including via IPOs – that crystallise capital gains. Even absenting the pandemic's effect on deal-making, repayment rates have been below the norm for a couple of years, reflecting the sizeable M&A activity of 2017. Those buyouts are now of a vintage to be recycled in PE portfolios, contributing to the expectation of a meaningful pick-up in prepayments in 2021.

Figure 27. European loan market repayments and repayment rate



Source: S&P LCD, as at 31 December 2020. Information is subject to change and is not a guarantee of future results.

The role and trajectory of ESG

The key to success in lending is investment in durable, sustainable businesses with robust market presence in their fields and visible, long-term high valuations while being well-protected by a first lien secured position that is inviolable.

On the topic of governance, the 'G' in ESG, lenders need to remain vigilant by ensuring that their portfolio companies continue to exercise ethical financial management with responsibility and regard to all stakeholders and aligned with the ESG philosophies they espouse. This includes calling out any questionable behaviour including in financial practice. The European buyside community has had some successes on this front, via lobbying body, the European Leveraged Finance Association (ELFA) – publicising the unacceptable use of excessive, COVID-inspired earnings adjustments (dubbed 'EBITDAC') to pass covenant tests that would otherwise have necessitated engagement with investors, for example. With near-universal evaporation of top-line revenues in some sectors, EBITDA may be unknowable, but using EBITDAC adjustments is fantastical.

In its all-encompassing impact, COVID-19 must raise regard for all stakeholders. Can the private equity playbook be unaffected in the post-COVID era? Can companies cut costs in the same way as before or will there need to be a greater consideration of employees?

Post-COVID, the 'S' in ESG has become more important. Amid a universal health crisis, the focus has fallen on employee safety (and the risk of endangering the workforce in a whole new, viral way), security (of people and data) amid office closures and the almost-overnight move to remote working practices. Equality, trust and resilience too are all more pronounced considerations, following this unique experience. 'Trust' was always – and remains – a very important 'soft' feature of lending. Consequently, excessive interpretation of grey areas being used to protect one stakeholders' interests over another's will not go unnoticed, unchallenged or unrecorded.

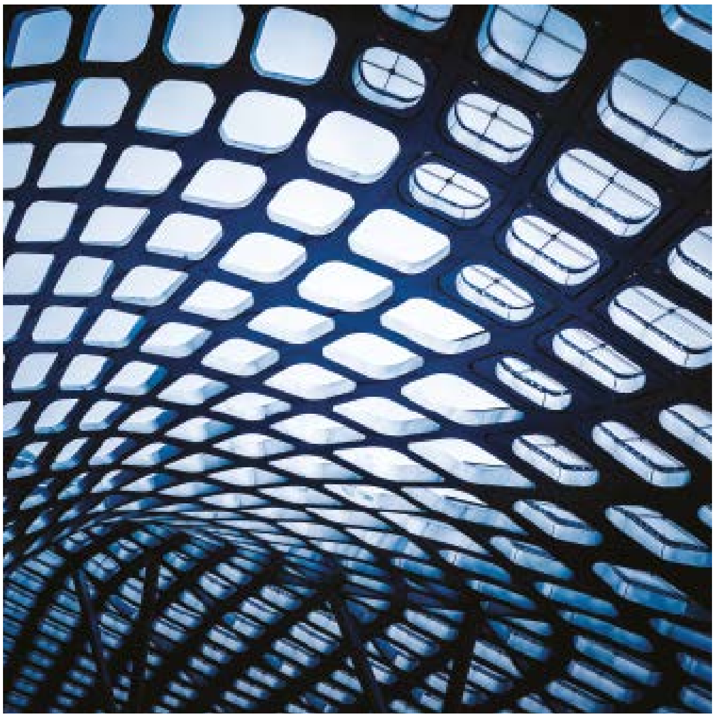
Equality in all its forms has been brought to the fore during the crisis. Reporting on gender pay gaps as one example, has been relaxed yet calculations suggest that the COVID crisis might have set women back by another 30 years[4]. The reality being that thousands of working mothers have had to take unpaid leave or voluntarily go on furlough to look after their families since women still bear the brunt of care duties for children and older parents.

Then there is the Climate agenda which has received renewed emphasis in response to the pandemic. It is here that we hope momentum has increased – in target-setting, disclosure and action. Lobbying initiatives to advance the 'E' in ESG pervade markets, including loans.

Company-owners and boards who navigate the new world well are the ones that could find the most supportive, empathetic stakeholders.

UK Stewardship Code

The new UK Stewardship Code, which came into effect at the start of 2020, involved the stepping-up of stewardship activities and more granular reporting about voting decision-making. Companies also have to provide further information on material ESG issues that impact their businesses. While voluntary, it requires those asset managers and asset owners that sign up to explain how they have exercised stewardship and engagement across all asset classes, including equity; fixed Income; infrastructure – whether public or private. The UK Pensions Regulator encourages adherence to the Code as guidance for trustees of pension schemes.



[4]Source: The Fawcett Society.

Special focus: ESG and sustainability – what's new and what's to come?

From here and after such an all-pervading health crisis, there will likely be a heightened focus on natural and human capital, meaning Climate and Diversity & Inclusion will move up the agenda. On climate change, can we look forward to big commitments from companies, financial institutions and governments alike in 2021 – as many submit new and improved climate commitments, mindful inter alia of milestones like the COP26 summit in November? Regulation for investors (the Sustainable Finance Disclosure Regulation (SFDR), for example –see 'A big year for EU regulation' box) and cohesive lobbying pressure – particularly for carbon target-setting and quantifiable emissions disclosure – could drive ESG forward in 2021.

The hastening of automation has been a consequence of the pandemic which has the potential to exacerbate inequality in society. We expect more demonstration of inclusion and equality from those purporting to be ESG leaders, including in the private corporate world.

Equally, we note the beginnings of a trend to link margins to ESG metrics in the loan market. It is hoped that this will be indicative of a wider commitment on the part of a borrower/sponsor to disclosure rather than a ploy to gain a financing advantage based on hand-selected measures that add little to material risk-changing.

ESG continues to play an increasing role in the high yield market too, with greater data disclosure and engagement from issuers. However, private lenders have a closer nexus with companies than bond investors, improving their opportunities to engage on ESG-related matters.

A big year for EU regulation

The SFDR comes into force in March and requires investment managers to disclose how they have integrated ESG in their processes and to publish details on the sustainability of their investments. The technical standards underpinning the regulations will not come into force until 2022 and there are issues that need clarifying, including around additional disclosure requirements for funds with an explicit impact investment strategy (Article 9) or those with sustainable characteristics (Article 8).

The European Commission is also expected to release the next update of its 'ambitious and comprehensive' sustainable finance agenda in March – which seeks to mobilise the private investment needed to meet the EU's climate targets. While the first phase of the green taxonomy is due to come into force this year, in addition to new rules around sustainability disclosures, the update is expected to cover new topics.

Around the same time, the EU is also expected to detail its plans to overhaul the Non-Financial Reporting Directive (NFDR) which will impose a stricter set of rules on ESG disclosure for bigger companies in Europe. Watch this space.

The regulatory landscape

Changing insolvency regime – moving to a Chapter 11-style Europe but some way to go

In the UK, what is known as a 'cross-class cramdown' is now possible, thanks to the new Super Scheme introduced by insolvency legislation reforms, supplanting the need to obtain the required consent from each impacted class in restructuring and permitting senior classes to impose terms on junior classes to expedite an agreed outcome.

The 2019 EU Directive on preventative restructuring frameworks came in too, requiring all EU countries to include new features like debtor-in-possession (DIP), moratorium and cross-class cramdown. The aim is to provide a minimum standard that looks more like US-style Chapter 11 bankruptcy proceedings ie more debtor and senior creditor friendly. But, the reality is that each country will implement the Directive differently. The UK leads the way with its long legal, case-law history and established judiciary with finance and insolvency experience. The UK Scheme of Arrangement and Restructuring Plan are very flexible, preserving the UK as the restructuring destination of choice for lenders where outcomes are relatively reliable and predictable.

While 2020 saw some distressed businesses restructured, we think 2021 will be about dealing with stressed businesses which doesn't have to be in the form of a debt-for-equity swap – it could be via M&A or other means. Troubled sectors, with increased leverage and facing ongoing structural changes in their end-markets, are arguably the most imperilled. A sharp and deep contraction followed by a swift economic recovery was largely the view shared by market forecasters when the pandemic hit in March 2020. Now, there are indications that the crisis will likely be protracted, exposing dated business models as unviable.

Libor transition

The end of Libor remains a global challenge. Banks and investors will have to ensure that they have done all they can to prepare for the end of Libor, which is due to be phased out by the end of 2021. Tackling the transition of the mass of existing GBP and USD-denominated loans in issue will dominate 2021, which could have some frictional side-effects for loan settlement times. There has been an improvement in the transition language embedded in GBP and USD loan documentation such that an automatic ('hard-wired') switch to a new risk-free rate, of pre-specified type, can occur upon trigger event (cessation of Libor or even before). However, there is still the morass of older deals to deal with that, while discontinuation of Libor is contemplated, make only an inadequate attempt to describe and prescribe 'fall-backs' in their documentation. There is commonly no detail on the precise replacement rate therein nor its method of calculation. Such loans, which are vast in number, will still require the Agent – acting on the instructions of majority lenders – and the company to enter into 'good faith negotiations' in 2021 to agree case-by-case transition details before being capable of reincarnation.

Fortunately, for the majority of the European loan market, Euribor (in reformulated form) will persist. While term-rates derived from SONIA (GBP) and SOFR (USD) will exist, the working assumption for the traded loan market is for IBORs to be replaced by rates based on backward-looking, in arrears methodology, together with a spread adjustment to account for any historic differential. □

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