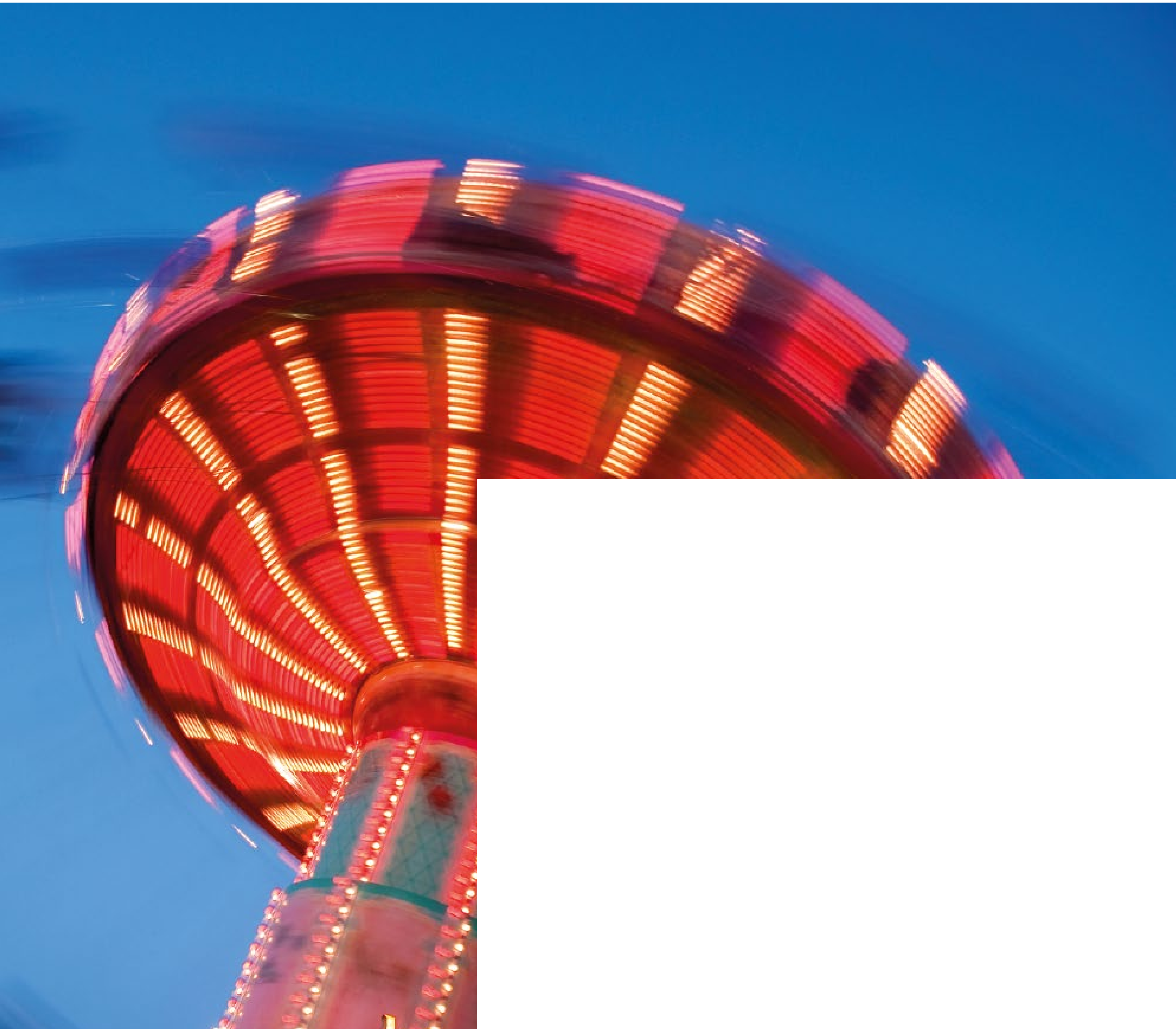
For Investment Professionals only

M&G Investments

2022 Leveraged loan market outlook

Favourable dynamics, but is it sustainable?



Introduction

For European loans, 2021 was a standout year in many ways. Record new-loan issuance was met with equally robust demand from traditional loan investors and asset allocators, looking for relatively high and stable yield, while the drive towards sustainability has been both prominent and purposeful. Here, we present our outlook for the key drivers in the European loan market in 2022.

What are the themes to watch in 2022?

Our base case view on European leveraged loans sees a continuation of strong fundamental drivers and positive technical tailwinds underpinning the asset class, loans serving as a source of high running-income and lower return-volatility in investors' search for positive real yields. We see another year of potentially positive risk-adjusted returns, with default rates likely to remain low in the near term, in our view, as market liquidity is ample and as existing companies delever while new buyouts should be numerous given the private equity dry powder. With many issuers having already refinanced, having extended maturities amid favourable financing conditions, there is also limited near-term refinancing pressure ahead.

For European loan issuers, credit fundamentals remain generally strong, but it is worth keeping a watchful eye on broader macro and policy risks, particularly should pandemic-related dislocations continue to influence yet more the inflation and economic growth trends, and associated responses. Stock-picking may become more necessary if specific risk were to rise in 2022. Name selection could prove to be beneficial, lending only to companies deemed to be of quality and substance, bolstered by strong sustainability. Furthermore, as dwindling asset purchases and central bank support-tapering begin to coincide with higher company cost-bases, markets may be vulnerable to confidence lapses, which reinforces the importance of choosing carefully. Modest rate rises will be a positive for floating-rate instruments, like loans and collateralised loan obligations (CLOs), as coupons adjust with changes in interest rates.

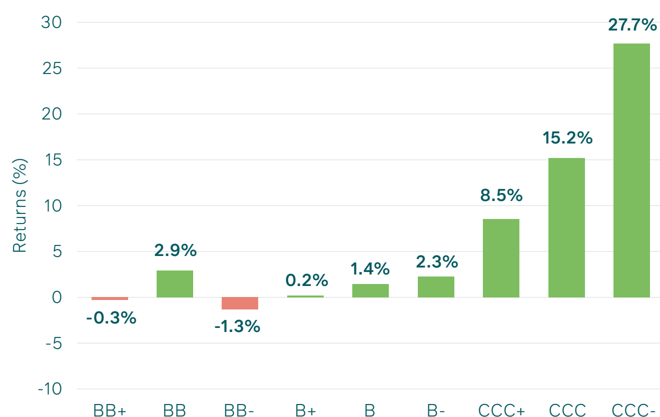
After significant advancement in ESG risk awareness and disclosure in 2021 – as well as 'labelled' loan issuance – we think momentum will pick up still more in 2022. We are therefore calling out Sustainability as a key theme for private companies and their stakeholders, including loan investors this year.

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.

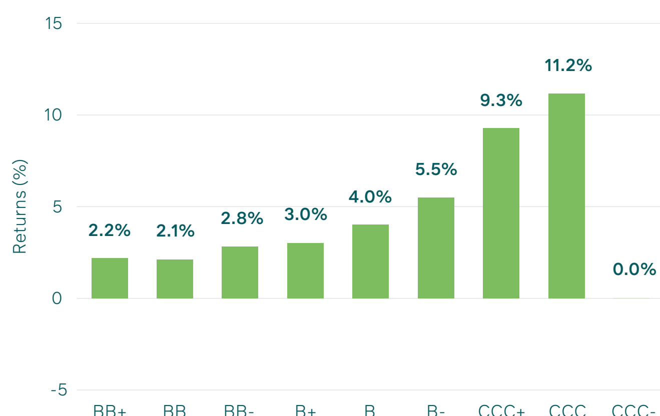
1. Loan market returns

Loan market returns by credit rating

FY 2020



FY 2021



Source: Credit Suisse Western European Leveraged Loan Index (CS WELLI) (hedged to Euros), as at 31 December 2021.
Past performance is no guarantee of future results.

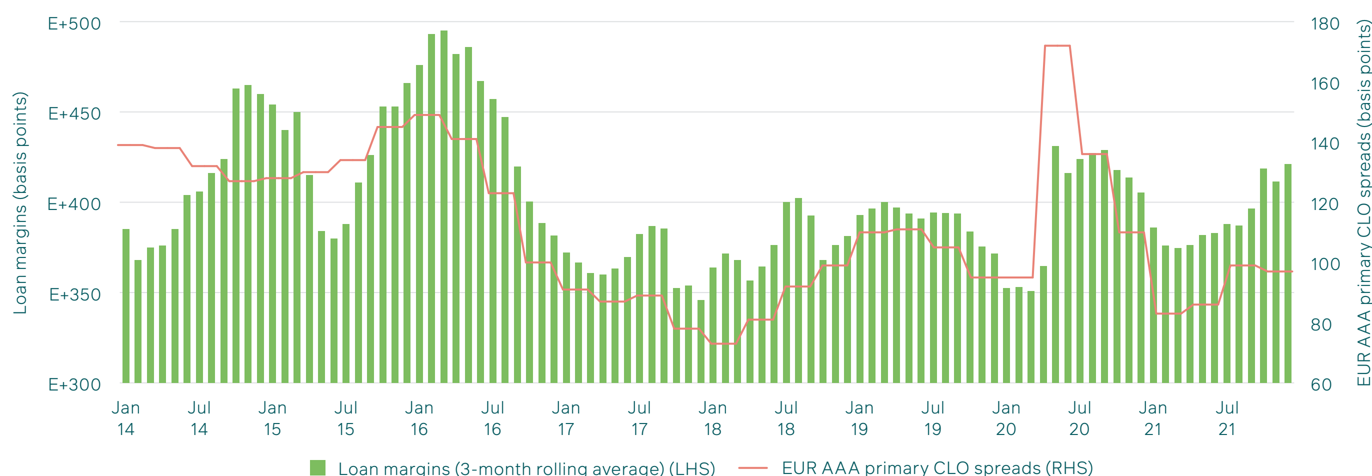
The Credit Suisse Western European Leveraged Loan Index (CS WELLI) returned 4.63% in Euro terms in 2021 – ahead of the US loan and bond markets' returns in comparable currency (4.53% and 4.45%, respectively) and substantially ahead of fixed-rate European (3.31%) high yield.

There was an element of capital gain in the 2021 returns given that 2020's positive out-turn had not seen prices fully normalise, but the majority of the return's attribution was from running income. Ultra-loose monetary and fiscal conditions; a gradual reopening of economies (at least during much of the summer and autumn months); and very low corporate default rates supported conditions for risk appetite. Consequently for most of 2020 and until July 2021, it was the lowest-rated assets, particularly in sectors most dependent on economic re-opening (travel and leisure) that led the market higher, albeit these sectors account for <5% of the WELLI. Much of the spread compression had concluded by the end of H1, with concerns around new Covid-19 variants and the associated impact of potential new lockdown restrictions across Europe limiting the extent to which credits in frontline sectors could compress in H2. CCC-rated cinema operator, Cineworld, is a good example of how the 're-opening' trade played out for stressed credits throughout the year, with the loan starting 2021 at c.69, before rising to a peak of c.89 in June and subsequently trading down to c.78 at year-end.

With market prices largely normalised now, return forecasts are for a 'coupon-clipping' c.4% in 2022 (in Euro terms). However, any monetary and fiscal policy errors, alongside pandemic developments could create modest levels of volatility along the way. However, this should be nothing like the potential upheaval that would affect wider fixed income, given tighter credit spreads and duration. This is not only owing to the senior secured and floating-rate nature of loans, but also to the lesser impact of monetary policy actions as the private loan market has remained beyond the reach of central bank purchase-programmes.

2. Pricing dynamics

European new-issue loan margins



Source: S&P LCD, as at 31 December 2021. Information is subject to change and is not a guarantee of future results.

Since the global financial crisis (GFC), loan pricing has been relatively stable, with new loans typically pricing in the EURIBOR +350-450 basis point (bp) range. 2021 was no exception and there is little reason to think that 2022 will deviate from the long-run trend. This is particularly the case given the context of CLO liability spreads, the difference between them and loan spreads creating the all-important arbitrage for the market to function.

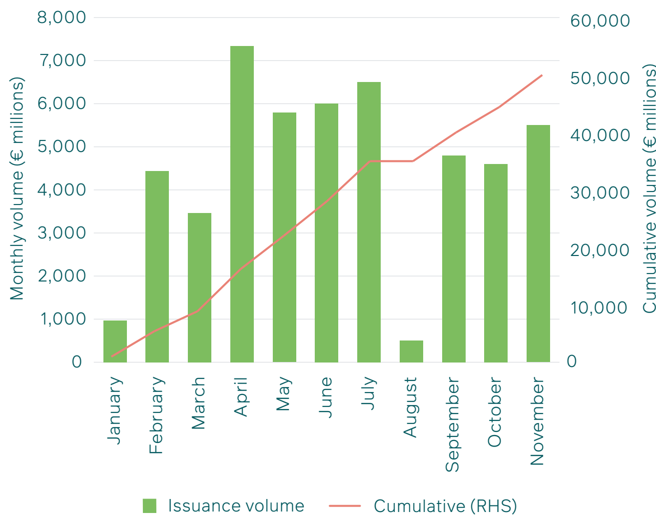
While loan demand marginally outweighed supply in the first half of 2021 in combination with a contraction in CLO AAA costs in response to a spike in demand, there was a brief period where loan margins edged towards E+350bps. However, July marked a clear turning-point. CLO AAA demand normalised again and ahead of the traditional summer holiday period in Europe; arrangers brought €13 billion of loan issuance to market in a single month which presented a great deal of choice, permitting selectivity and pushback. In the months following the summer break, supply and demand were well balanced but the indigestion of July's supply lingered on and new-issue pricing rarely dipped below E+400bps, as shown by the steady climb in the three-month rolling average margin in the above chart.

Pricing is mainly determined by the technical balance of supply and demand and – to a less pronounced extent – the prevailing trading levels within sub-investment grade (sub-IG) credit. While there are inherently many variables in forecasts, we believe the E+375-425bps range, with a 0% EURIBOR floor (worth an additional c.50bps) and a small new-issue discount, should persist given the aforementioned expectations for new loan issuance going forward.

That said, on the existing stock of loans in issue, monitoring the number of leverage ratchets (consisting of typically two or three 25bps margin step-downs, set at pre-determined levels of leverage) will be important. As corporate profitability improves, leverage may reduce if acquisitions are not made and so pricing ratchets will be triggered, thereby gradually reducing extant loan margins over time. This has the capacity to impact not only the level of carry within a loan portfolio, but also to suppress the mark-to-market (MTM) price, as yield on vintage secondary loans is adversely comparable to available primary loan opportunities. It is therefore important that loans are closely monitored and ratchets anticipated, supported by assiduous trading in order to maximise overall risk-adjusted target portfolio returns.

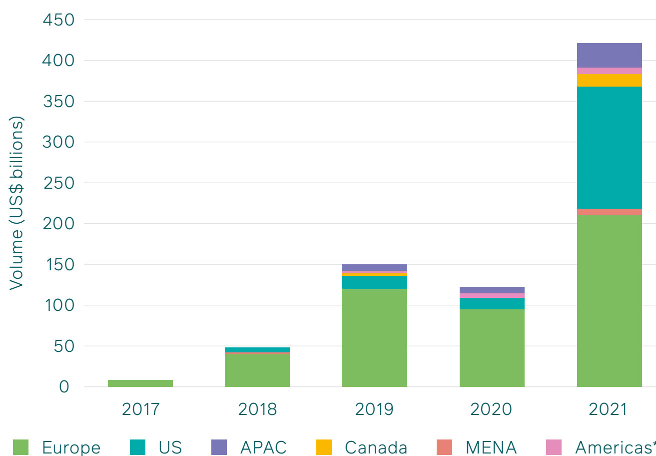
3. ESG and sustainability

Sustainability-linked loan issuance volumes in Europe



Source: 9fin.com, as at November 2021. Information is subject to change and is not a guarantee of future results.

Global sustainability-linked loan issuance since 2017



Source: Bloomberg, as at 31 December 2021. *Americas excluding the US and Canada. Information is subject to change and is not a guarantee of future results.

Significant progress was made in 2021 in sustainability in general, including in the wake of the COP26 climate conference, with 450 financial sector signatories – including M&G – representing US$130 trillion of collective assets under management (AUM), having now committed to delivering Net Zero across their portfolios by 2050 as well as to providing $100-150 trillion of finance necessary to create a net-zero economy over the next three decades.

Efforts to consolidate the various reporting frameworks into one (the International Sustainability Standards Board) will alleviate the fractured state of current disclosure too, it is hoped, notwithstanding the delay to the EU Commission's Sustainable Finance Disclosure Regulation by six months to 1 January 2023.

The private corporate world is no exception to the sustainability drive. The rise of labelled loans is emblematic of the change in attitude and disclosure. Almost 40% of 2021's European leveraged loan issuance contained explicit linkage of financing terms to key performance indicators through the use of margin ratchets, derived from Sustainability Performance Targets (SPTs) in company frameworks. Sustainability-linked loans (SLLs) are part of a suite of labelled instruments (including Green loans and Social loans) expected to swell in the sub-IG space in 2022.

In the wider loan markets, a global record was reached in 2021. Sustainability-linked loan issuance increased by 239% to $430 billion, 86 times the size of a market that began only four years ago. Europe is far and away the most dominant issuer base though the US is fast catching up.

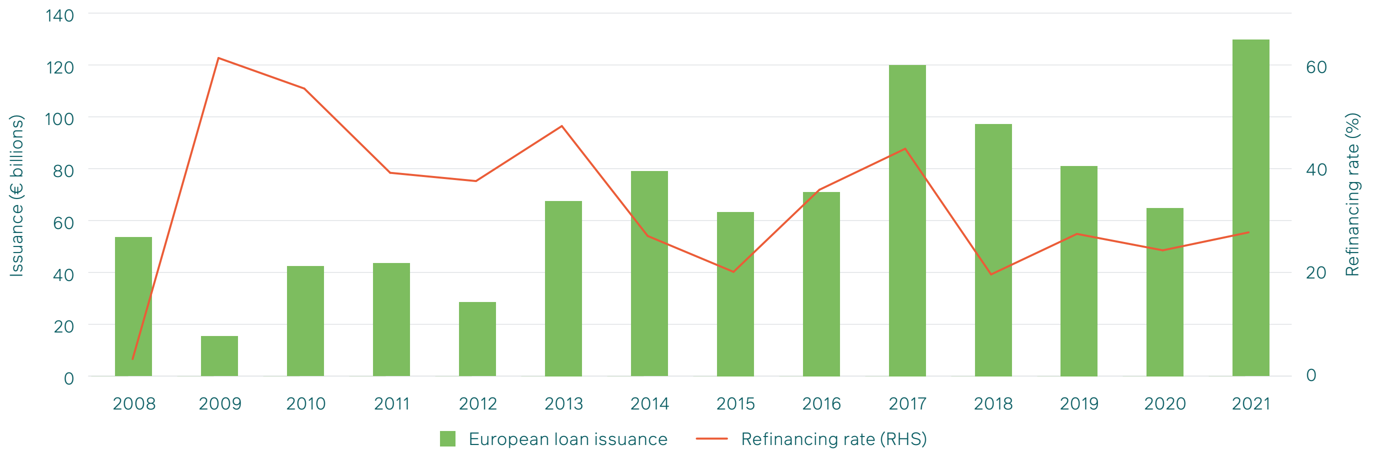
Sub-IG companies were an important component of overall sustainability issuance. From here, we expect focus to shift in company frameworks from Environmental to Social targets – particularly when these risks are significant in a company's sector of operation or geography. Generics drug-maker, Teva, is a case in point. For a company linked to opioid scandals, the worth of the SPTs in its massive, $5 billion sustainability-linked financing in November 2021 was somewhat undermined, referencing as it did various Environmental targets and nebulous Social ones which failed to tackle a real inherent ESG risk.

While some tolerance of the shorter history of sponsor-owned, private companies may be necessary at times, the standards being set by a private company's stakeholders are rising – especially in Europe.

One advantage of being a lender too – as opposed to a bondholder – is the greater opportunity to Engage that comes from a direct, contractual relationship. It is anticipated that the financing of harmful activities will prove tougher in 2022 too – the number of investors precluding fossil fuel-financing or refusing to support weapons, tobacco and gaming sectors grows steadily. Some PE sponsors are following pioneers like EQT, introducing firm-wide and pan-portfolio, science-based targets to attest to their commitment to moving the private corporate world forward. This is important given the influence and control of such owners that can be leveraged across multiple companies, simultaneously.

4. Loan supply

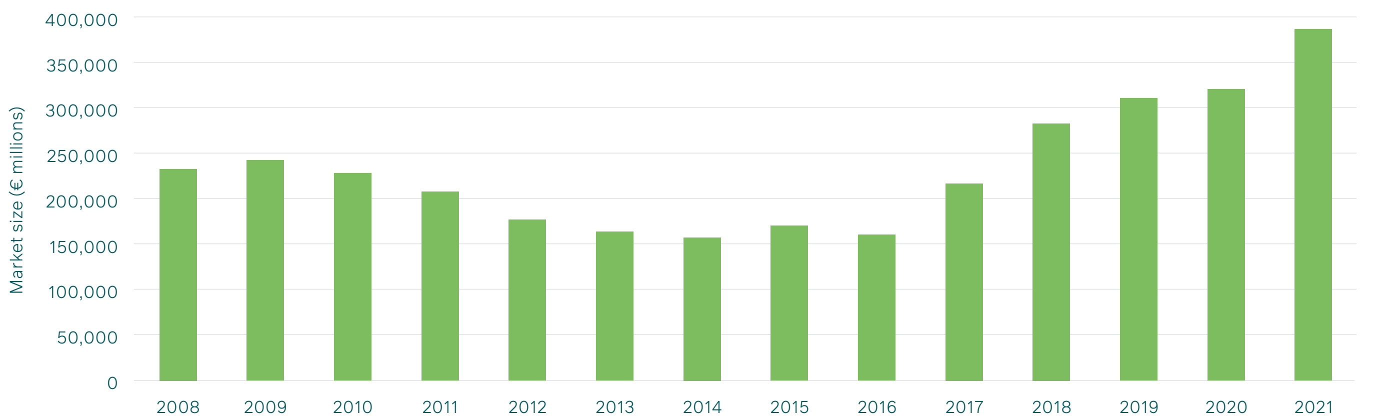
European leveraged loan issuance and refinancing rate



Source: S&P LCD, as at 31 December 2021. Information is subject to change and is not a guarantee of future results.

Following 2020's assessment and stabilisation of the impacts of Covid-19 on PE portfolios and corporate balance sheets, global demand for pent-up M&A activity was unleashed in 2021, with a record-breaking c.$6 trillion of activity being recorded. PE's share of the pie also increased as funds started to deploy the $2+ trillion of dry powder, amassed from fundraising efforts. These also continue at pace as global asset allocators continue their hunt for yield across private assets. The result of fervent deal-making for the European loan market, was a post-GFC record for new issuance at €130 billion; besting the €121 billion watermark set in 2017, and with c.60% arising from M&A-related activity (versus c.40% in 2017, bloated as it was by a significant amount of refinancing/repricing of existing transactions). Indeed, the European loan market expanded some 20% in 2021 to c.€400 billion.

Size of the European leveraged loan market



Source: Credit Suisse Western European Leveraged Loan Index (CS WELLI) par outstanding, as at 31 December 2021. Information is subject to change and is not a guarantee of future results.

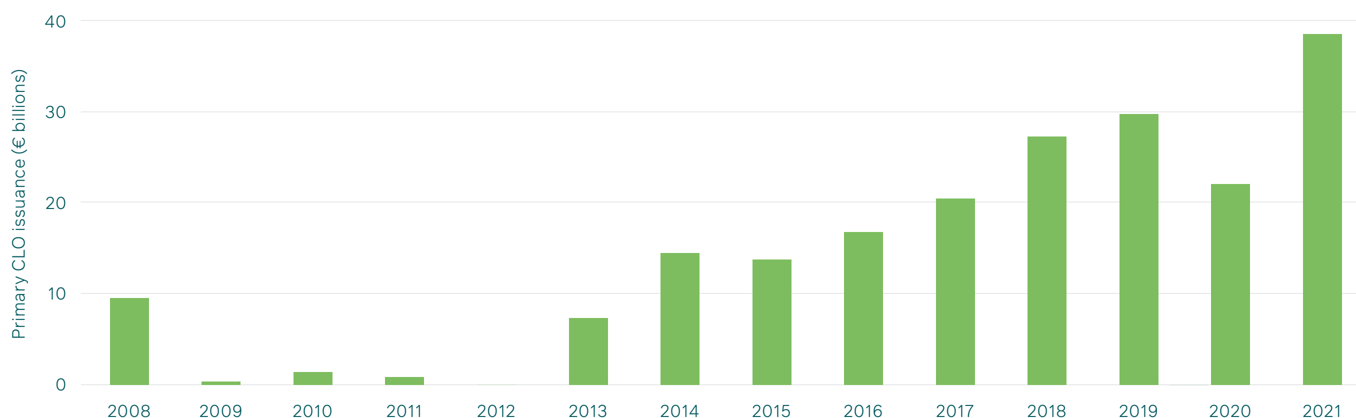
Given the ever-larger nature of buyout funds, a notable supply theme in 2021 was deal-size. Jumbo issuance, including the $30 billion buyout of US medical supplies business, Medline, by Blackstone, H&F and Carlyle; and the €4.84 billion takeover of T-Mobile Netherlands by Apax and Warburg Pincus, were among the headline deals of the year. Despite the post-Brexit ramifications for some sectors, UK transactions – particularly public-to-private takeovers (P2Ps) were seen, including UK supermarket chain Morrisons; pharmaceuticals group, UDG; and defence components-maker, Ultra Electronics.

Given the tailwinds from continued demand for private assets – both equity and debt – supply expectations for 2022 are also high albeit likely to fall short of 2021 given the year's super-normal activity from pent-up demand following a disruptive 2020. European loan issuance for 2022 is expected to be in the range of €75-100 billion, including the £6.6 billion financing package to support the announced buyouts of Morrisons; wealth services firm, Intertrust; pharmaceuticals group, Clinigen; Unilever's tea business, ekaterra; and a more speculative, c.€30 billion KKR-sponsored takeover of Telecom Italia.

Existing borrowers are also expected to remain active with add-on issuance to fund bolt-on acquisitions or, in some cases, to recapitalise. It will be particularly important to pay close attention to opportunistic issuance from companies that have been pandemic beneficiaries – those who may attempt to raise debt, based on an unsustainably-inflated level of EBITDA. Healthcare was an active sector in 2021, thanks to the 'opportunity' presented by the pandemic. The sector may not be as attractive in 2022 if sponsors are tempted to recapitalise. It may also be the source of prepayments given that it remains a good time to sell at high valuations viz the €5 billion exit from Unilabs achieved by Nordic Capital upon sale of the company to the AP Møller family at the end of 2021.

5. Loan demand

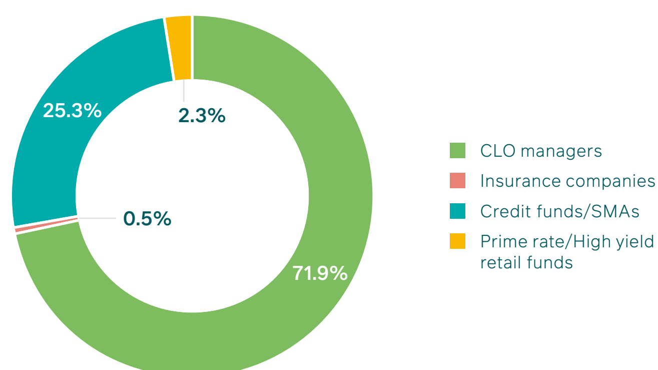
European primary CLO issuance



Source: S&P LCD, as at 31 December 2021. Information is subject to change and is not a guarantee of future results.

Demand in the European loan market typically arises from: CLOs; institutional investors, insurance companies and pension funds – via managed accounts or funds and, to a modest extent, multi-asset credit funds. There is also the internally-generated demand from loan repayments. The private nature of the European loan market means data accurately showing flows and market-share by investor type is approximate only:

European primary market by institutional investor type, 2021



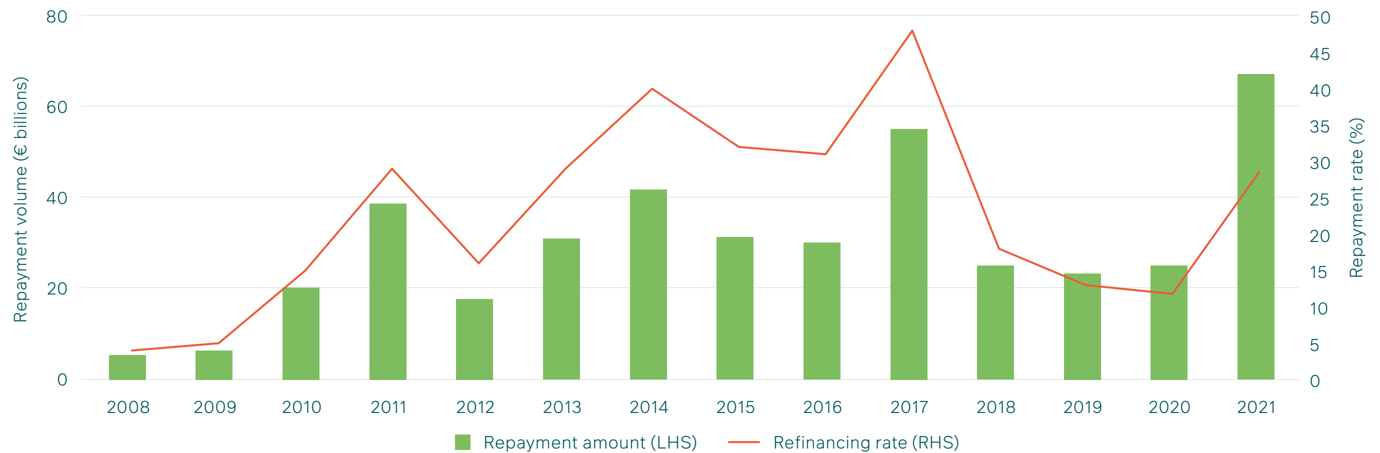
Source: S&P LCD, as at 31 December 2021. Information is subject to change and is not a guarantee of future results.

Amid still-favourable funding conditions, another post-GFC record for CLO issuance was set in 2021 with close to €39 billion of newly-created vehicles (not to mention c.€42 billion in refinancing/resetting of the existing population to re-energise investment activity). The CLO share of the investor base has grown c.15% compared to previous years. While demand for managed accounts remained robust, CLOs were the notable driver of demand in 2021.

In 2022, we expect floating-rate, senior secured, private lending to flourish with institutional investors generally. An attractive level of carry ought to be in high demand as fixed income investors fret over tight spreads; the impact of inflation; and remedial rate-hikes. CLO formation maybe fractionally lower than 2021 – around €30-37 billion – but should still be strong compared to recent years.

Away from CLOs, and acknowledging that Europe lacks public flow data, we think a positive steer can be seen from observable fund flows in the US. These showed a reversal of 2020's outflows and a c.$33 billion net inflow in 2021. By contrast, US high-yield funds saw outflows of c.$12 billion in 2021, reversing their net inflow seen in 2020. We expect 2022 to be directionally similar to 2021.

European loan market repayments and repayment rate



Source: S&P LCD, as at 31 December 2021. Information is subject to change and is not a guarantee of future results.

At around 30%, the level of repayments in 2021 was also relatively high in 2021 and so contributed to absorbing the record level of supply. Repayments came in various forms, ranging from true market exits to trade buyers, such as the sale of financial data platform, Refinitiv, by Blackstone to the LSE; or the sale of Nordic payments group, Nets, to Italian trade buyer, Nexi. There were also so-called pass-the-parcel deals, involving sale of a company from one sponsor to another, like Carlyle's €1.7 billion purchase of Swiss auto software concern, Autoform, from Astorg. Listings via Special Purpose Acquisition Companies (SPACs) were less common than anticipated but included a sizeable, $9 billion exit-route of Paysafe for Blackstone and CVC.

In the first half of the year, repricing and refinancing was the prepayment trigger, including the transfer of attractive assets into longer-dated, PE continuation vehicles. H&F maintained control of security business, Verisure, this way, by transferring its holding to a newer fund and instigating a refinancing of debt. Regardless of their trigger, repayments restored liquidity to investors, at par, from assets that were, in many cases, still marked lower, following the well-documented March 2020 market sell-off. Proceeds could then be redeployed into higher-margin, fresh issuance.

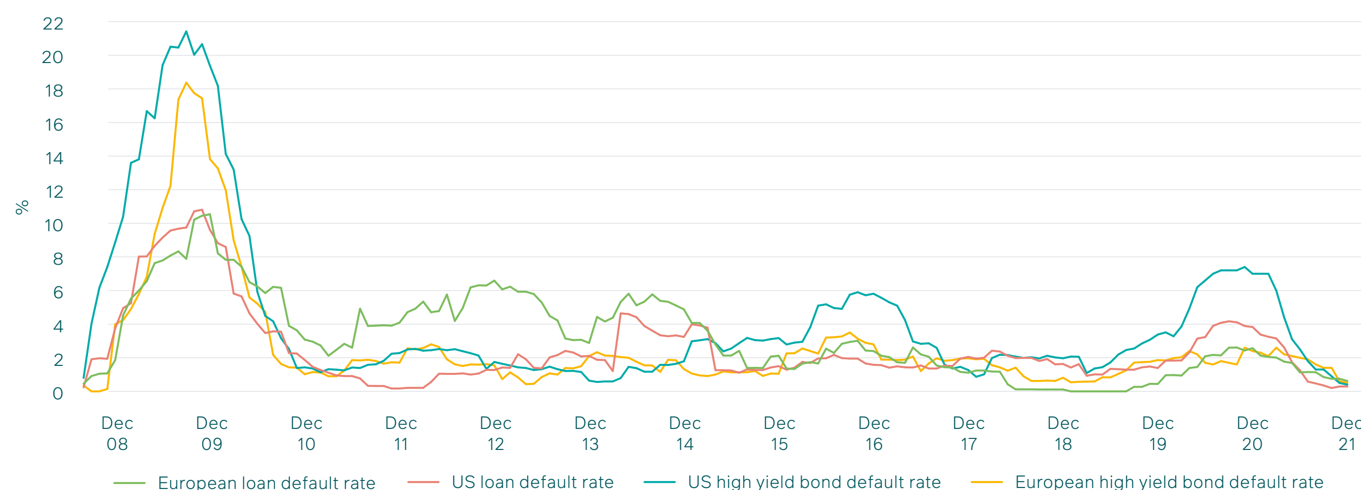
With sponsors needing continually to prove valuations via exits from funds of earlier vintages in order to raise fresh firepower, we expect a healthy, and normal c.20%-25% level of repayments to prevail in 2022. Without much in the way of near-term maturity pressure in the borrower population (only 13% of the loan market falls due in the next two years) and with most pandemic issuance already having been repriced, we would expect repayments to be skewed towards change-of-control, be that IPOs (should equity markets continue to be receptive), trade-sales or secondary buyout activity among the sponsor community.

6. Loan default outlook and macro risks

Huge fiscal and monetary support has helped ease funding pressures for households and companies alike though it is worth reflecting on the sobering level of global debt which has mushroomed to an estimated $300 trillion[1] (over three times the world's GDP). Then, there is the extraordinary fiscal stimulus (to the tune of $12.7 trillion[2]) that was deployed during the pandemic, accompanied by bond-buying of equal magnitude. Reportedly, central banks have injected a staggering $32 trillion into markets globally since the pandemic began[3].

Against a backdrop of ample market liquidity, companies raised a record $12 trillion[4] via the global capital markets in 2021 in the form of equity, debt and new loan issuance amid favourable financing conditions. In European loans in particular, PE sponsors have remained an anchor of support for portfolio companies. Consequently, against expectations in Q1 2020, default rates have declined and there has been a surge in upgrades relative to downgrades too, as credit fundamentals have improved and as borrowers took the opportunity to refinance.

European and US speculative grade 12-month trailing default rates



Source: S&P LCD, S&P Ratings Direct, BofA Merrill Lynch (BofAML), Credit Suisse European Credit Trades & Themes, as at 31 December 2021. Information is subject to change and is not a guarantee of future results.

[1]Financial Times, "The liquidity threat looming over markets in 2022.", 17 December 2021.

[2]UN "Monthly briefing on the world economic situation and prospects – No. 146, 5 February 2021".

[3]Financial Times citing Bank of America, "The big market questions for 2022.", 18 December 2021.

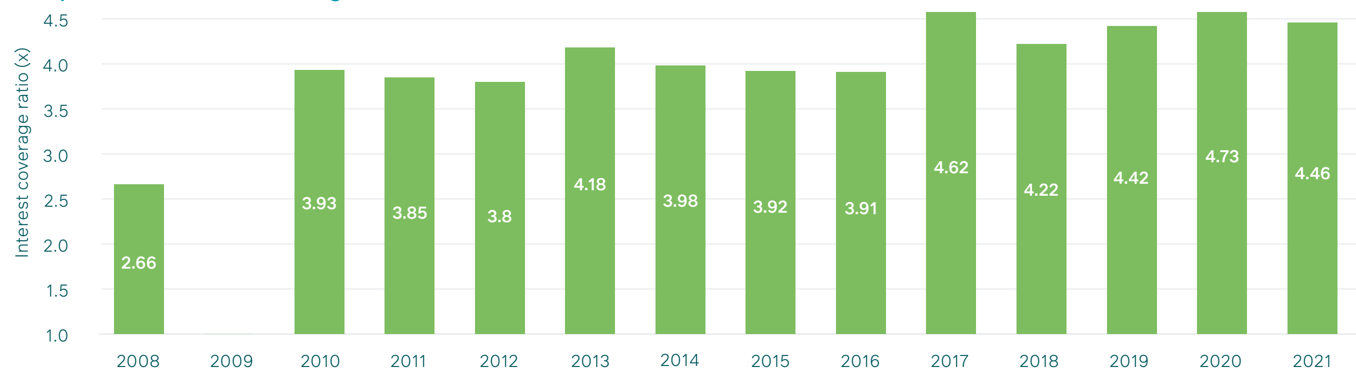
[4]Financial Times, "Companies raise over $12tn in 'blockbuster' year for global capital markets.", 28 December 2021.

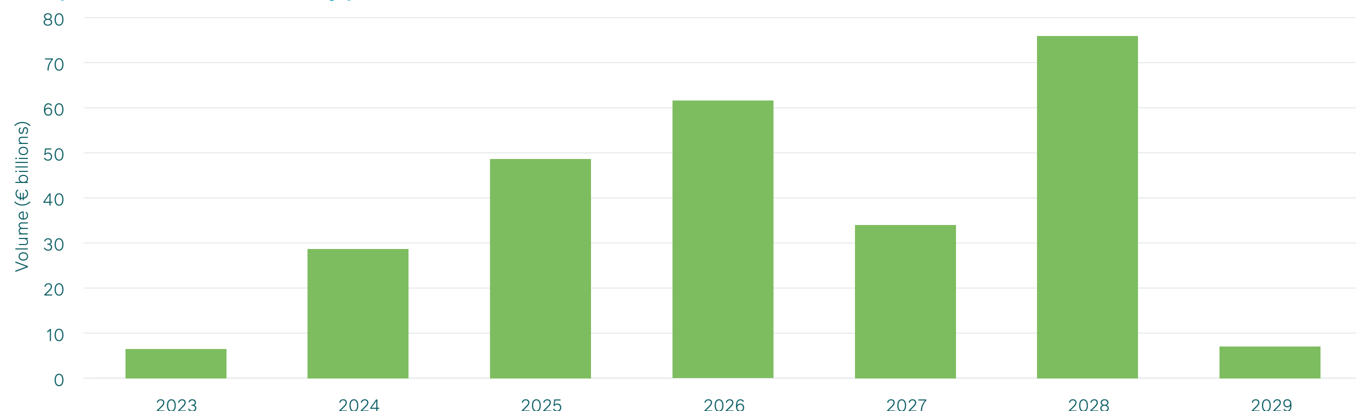
This year, we expect the focus to be on deleveraging, with loan defaults being expected to remain low. Market forecasts coalesce around a trailing-12-month default rate of 1.5%-2.5% for European loans by year-end. However, risks remain on the horizon. The quandary facing monetary and fiscal policymakers is acute as indebtedness (government and corporate) is significant while inflation is spiralling. Disorderly tapering of support given gigantic indebtedness poses a risk of policy-induced panic.

The European loan market is well-placed to be somewhat insulated though given its constituency of large, steady, cash-generating businesses, mostly in 'defensive' sectors (eg telecommunications, technology and contracted services) which can support leverage and with supportive owners. Noting total leverage for new issuance remained relatively flat throughout 2021 – at around 5.4x – it was good to see supporting equity cheques mostly remaining high at c.45%. There is also not much of a near-term maturity wall. With loan fixing-rates floored at 0%, several rate rises will likely be required by the ECB before companies' debt-servicing costs start to rise and it is expected that this can be easily absorbed given current interest cover ratios.

While credit fundamentals generally remain strong, investors should continue to monitor the impact of cost-push inflation and supply chain disruptions in 2022. Portfolio-level observations show that, so far, credits have managed to navigate these issues relatively well and companies have been able to pass through raw material price rises. However, if such issues persist, they could challenge the cashflows of those with weak pricing-power.

European loan market interest cover and maturity breakdown





Source: S&P LCD, as at 31 December 2021. Information is subject to change and is not a guarantee of future results.

Final word

Our constructive view on loans is supported by strong observed market fundamentals and anticipated positive technical drivers, while the inherent strengths and defensive characteristics of the asset class should be in high demand in a world of some economic, inflationary and interest rate uncertainty.

With the outlook being finely balanced, we would be wary of chasing risk in 2022, deeming it unnecessary when the stock of fresh issuance is set to be significant and appropriately priced.

Furthermore, companies with attention to sustainability bolster mitigation against downside risk. Loans are set fair to be a source of repeatable, sustainable returns, in our view. □

www.mandg.com/institutional

Please note that this website has not been reviewed by the SFC and will contain information about funds that are not registered with the SFC.

For Investment Professionals only. Not for onward distribution. No other persons should rely on any information contained within. This piece reflects M&G's present opinions reflecting current market conditions. They are subject to change without notice and involve a number of assumptions which may not prove valid. The distribution of this piece does not constitute an offer of, or solicitation for, a purchase or sale of any investment product or class of investment products, or to provide discretionary investment management services. These materials are not, and under no circumstances are to be construed as, an advertisement or a public offering of any securities or a solicitation of any offer to buy securities. It has been written for informational and educational purposes only and should not be considered as investment advice, a forecast or guarantee of future results, or as a recommendation of any security, strategy or investment product. Reference in this document to individual companies is included solely for the purpose of illustration and should not be construed as a recommendation to buy or sell the same. Information is derived from proprietary and non-proprietary sources which have not been independently verified for accuracy or completeness. While M&G Investments believes the information to be accurate and reliable, we do not claim or have responsibility for its completeness, accuracy, or reliability. Statements of future expectations, estimates, projections, and other forward-looking statements are based on available information and management's view as of the time of these statements. Accordingly, such statements are inherently speculative as they are based on assumptions which may involve known and unknown risks and uncertainties. Actual results, performance or events may differ materially from those expressed or implied in such statements. All forms of investments carry risks. Such investments may not be suitable for everyone. **United States:** M&G Investment Management Limited is registered as an investment adviser with the Securities and Exchange Commission of the United States of America under US laws, which differ from UK and FCA laws. **Canada:** Upon receipt of these materials, each Canadian recipient will be deemed to have represented to M&G Investment Management Limited, that the investor is a 'permitted client' as such term is defined in National Instrument 31-103 Registration Requirements, Exemptions and Ongoing Registrant Obligations. **Australia:** M&G Investment Management Limited (MAGIM) and M&G Alternatives Investment Management Limited (MAGAIM) have received notification from the Australian Securities & Investments Commission that they can rely on the ASIC Class Order [CO 03/1099] exemption and are therefore permitted to market their investment strategies (including the offering and provision of discretionary investment management services) to wholesale clients in Australia without the requirement to hold an Australian financial services licence under the Corporations Act 2001 (Cth). MAGIM and MAGAIM are authorised and regulated by the Financial Conduct Authority under laws of the United Kingdom, which differ from Australian laws. **Singapore:** For Institutional Investors and Accredited Investors only. In Singapore, this financial promotion is issued by M&G Real Estate Asia Pte. Ltd. (Co. Reg. No. 200610218G) and/or M&G Investments (Singapore) Pte. Ltd. (Co. Reg. No. 201131425R), both regulated by the Monetary Authority of Singapore. **Hong Kong**: For Professional Investors only. In Hong Kong, this financial promotion is issued by M&G Investments (Hong Kong) Limited. Office: Unit 1002, LHT Tower, 31 Queen's Road Central, Central, Hong Kong. **South Korea:** For Qualified Professional Investors. **China:** On a cross-border basis only. **Notice to investors in Taiwan:** Nothing herein shall constitute an offer to sell or provide, or recommendation of, any financial products or services. **Japan: M&G Investments Japan Co., Ltd., Investment Management Business Operator, Investment Advisory and Agency Business Operator, Type II Financial Instruments Business Operator, Director-General of the Kanto Local Finance Bureau (Kinsho) No. 2942, Membership to Associations:** Japan Investment Advisers Association, Type II Financial Instruments Firms Association. This document is provided to you for the purpose of providing information with respect to investment management by Company's offshore group affiliates and neither provided for the purpose of solicitation of any securities nor intended for such solicitation of any securities. Pursuant to such the registrations above, the Company may: (1) provide agency and intermediary services for clients to enter into a discretionary investment management agreement or investment advisory agreement with any of the Offshore Group Affiliates; (2) directly enter into a discretionary investment management agreement with clients; or (3) solicit clients for investment into offshore collective investment scheme(s) managed by the Offshore Group Affiliate. Please refer to materials separately provided to you for specific risks and any fees relating to the discretionary investment management agreement and the investment into the offshore collective investment scheme(s). The Company will not charge any fees to clients with respect to '(1) and '(3) above. M&G Investments is a direct subsidiary of M&G plc, a company incorporated in the United Kingdom. M&G plc and its affiliated companies are not affiliated in any manner with Prudential Financial, Inc, a company whose principal place of business is in the United States of America or Prudential plc, an international group incorporated in the United Kingdom. This financial promotion is issued by M&G International Investments S.A. in the EU and M&G Investment Management Limited elsewhere (unless otherwise stated). The registered office of M&G International Investments S.A. is 16, boulevard Royal, L-2449, Luxembourg. M&G Investment Management Limited is registered in England and Wales under number 936683, registered office 10 Fenchurch Avenue, London EC3M 5AG. M&G Investment Management Limited is authorised and regulated by the Financial Conduct Authority. M&G Real Estate Limited is registered in England and Wales under number 3852763 and is not authorised or regulated by the Financial Conduct Authority. M&G Real Estate Limited forms part of the M&G Group of companies. **JAN 22 / 666706**