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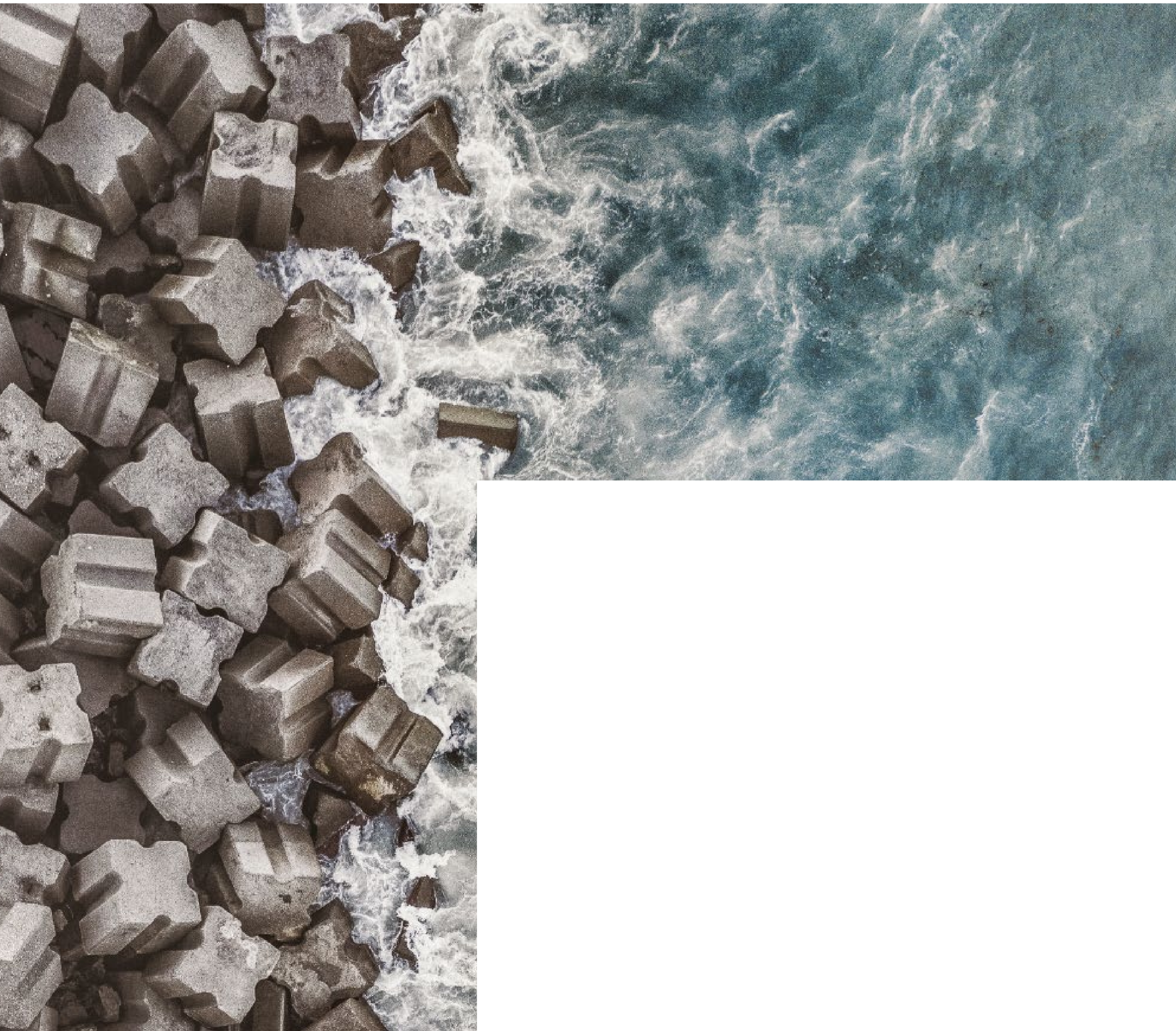
M&G Investments

2023 European leveraged loans outlook

Defensive against rising rates and uncertainty?



Key takeaways

- The direction of the global economy is uncertain with scope for further gyration in yield curves, therefore positioning for duration protection is important at this point in the cycle. European loans as a floating rate asset class provide a compelling solution, in our view.
- Fundamentals within the universe are generally healthy enough to absorb significant levels of rate rises, with many companies having adequate pass-through mechanisms.
- As a result, defaults are expected to only increase to 3-4% which is marginally above long-term levels, but there could be an increase in dispersion in company performance, so rigorous defensive credit selection rather than broad asset allocation is crucial to navigating this environment.
- The spread dislocation implied default rate is in the mid-teens vs. a forecast 3-4%, suggesting that today's wide spreads are fundamentally mispriced. Even factoring default loss, we think the yields on offer should provide considerable risk-adjusted premia.
- Issuance will be subdued as borrowers and sponsors assess the length and depth of the downturn but Amend & Extends will continue as borrowers proactively address near-term maturities.
- Despite a challenging 2022, ESG issuance soldiered on – we expect this momentum to continue in 2023 with more regulatory focus around ESG labelling.

A review of 2022 performance

For the traditional '60/40' investment portfolio, 2022 was a tough year – it was down 17%[1] given the myriad of volatile events through the year including the Russia/Ukraine conflict, double-digit inflation and the UK LDI crisis flows, to name a few. This was exacerbated by an upward trend in correlation between equities and traditional fixed income.

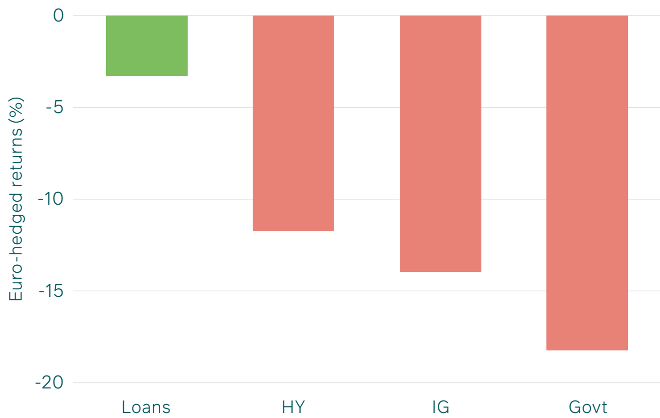
However, there are pockets within fixed income such as private credit which provide much-needed volatility dampening relative to equities. European loans, while not immune to the pressures, demonstrated this relative resilience and lower volatility, with returns of -3.3% vs -11.7% for European high yield (HY) bonds and -18.2% for European government bonds, shown in the chart below. The senior secured nature, defensive sector positioning, shorter life and floating-rate characteristics of loans have insulated against the duration drag of the year. The institutional investor base of the asset class also contributes to the lower volatility as there is less irrational retail sentiment-driven flows.

European loans sit in a unique middle-ground space, being able to provide the benefits of private investments, such as being closer to the borrower with better alignment and representation of interests, whilst also providing liquidity. Loans are tradeable daily with transparent pricing, so there wasn't a liquidity crunch during the UK LDI meltdown in September. Trading remained two-way and its performance during that period was still resilient relative to traditional liquid credit.

> **"In the current inflationary, rising rate environment, we believe European loans are well-placed to steer through the various challenges ahead due to their largely floating-rate nature, as well as other attractive structurally robust features."**

2022 was a tough year

Euro-hedged returns of European fixed income asset classes



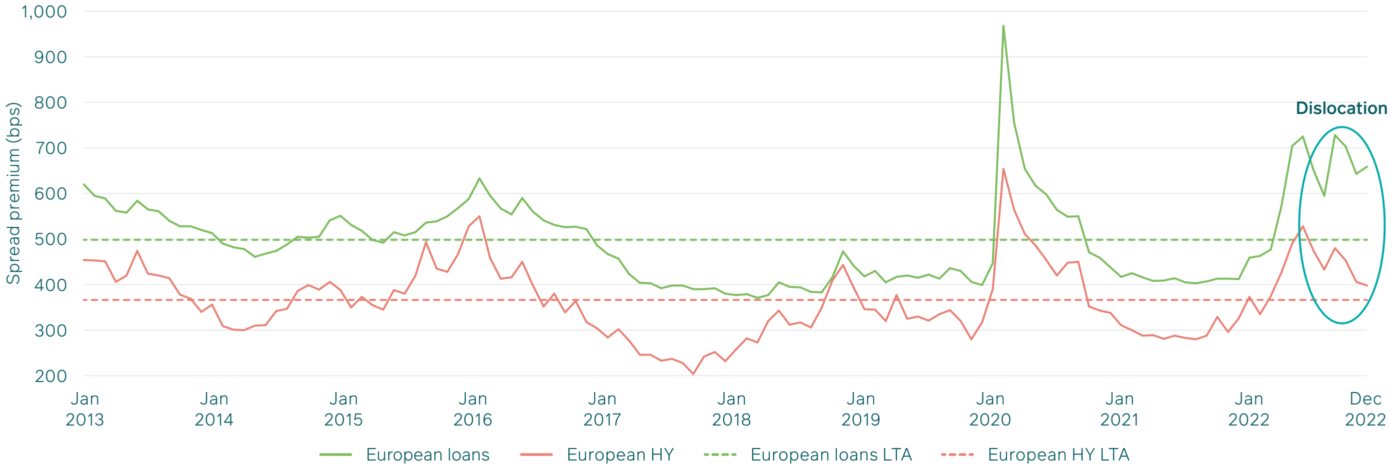
Source: European loans: Credit Suisse Western European Leveraged Loan Index; High Yield: ICE BofA European Currency Non-Financial High Yield 2% Constrained Index; Investment Grade: ICE BofA Euro Corporate Index; Government: ICE BofA Euro Government Index, as at 31 December 2022.

Past performance is not a guide to future performance.

[1]Financial Times, "Battered 60-40 portfolios face another challenging year", (FT.com), 11 January 2023.

Dislocation of spreads to above average levels

European loans and HY 10-year spread premium (basis points)



Source: European loans: Credit Suisse Western European Leveraged Loan Index 3 year DM; European HY: ICE BofA European Currency Non-Financial High Yield 2% Constrained Index Asset Spread, as at 31 December 2022. LTA =Long-term average.

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Dislocation outpaces potential default loss

Given the more challenged backdrop, it came as no surprise that the 3-year discount margin (DM) dislocated to 650-700 basis points (bps), close to levels seen during the Covid-19 pandemic, but far from the crisis level of 2000 bps in 2009, shown below. These levels are higher than the long-term average of c.500 bps providing an implied all-in-yield of c.10%. Even factoring a bear case scenario with 7.5% default and 50% recovery, the all-in yield is still healthy at over 6%. We believe this means that today's wide spreads, even factoring default loss, should provide considerable risk-adjusted premia, and therefore offer an interesting entry point for a senior secured, defensive asset class.

Much of this value is driven by performing loans (BB and Single B tranches), which are dislocated to their long-term levels. We do not see the same dislocation within CCC or lower rated names which, though wider, are in-line with their typical risk premia and more susceptible to default risk and capital erosion. There are also pockets of value within bonds, but we see a stronger credit dislocation within loans compared to high yield.

Despite ending the year at a relatively benign default level of 0.4%, distress is not expected to be materially higher than the long-term default rate of 3% for European loans. Base case consensus has converged around a 4% default rate for 2023, with most defaults being distressed exchanges or missed coupons rather than bankruptcies, and first lien recoveries in line with long term averages of 70%. In contrast, the implied default rate from the spread dislocation is in the mid-teens vs a forecast 3-4%. This means that today's wide spreads are fundamentally mispriced. Even with that in mind and yields of 10% on offer, we believe careful credit selection remains key to facilitate sustainable value creation over the long term in an uncertain environment.

Not a yield buffet but back to basics

Negative headlines dominated investment content in 2022, with particular emphasis on falling markets and performance. Whilst the macro environment is certainly not a bed of roses, we are also not expected to experience an extended period of sustained global contraction, save for any further unforeseen shocks. The International Monetary Fund (IMF) forecast global growth to slow from 6.0% in 2021 to 2.9% in 2023, but crucially growth is still positive. Specifically, within Europe growth is forecast to be flat, with a recovery to c.2% growth in 2024, signalling that there is light at the end of the tunnel.

History does not repeat but it certainly rhymes. Some of the economic factors at play now are not so different to the bull market period of the 1990s to the mid-2000s, punctuated by the GFC: a tech boom (90s) plus low interest rates (00s) contributing to unsustainable growth. Technology unicorns have dominated the cultural zeitgeist in the 2010s and the sector has grown to be the dominant area of deployment for private equity (PE).

We also experienced an era of record-breaking expansionary monetary policy with negative to zero base rates across major central banks. The cheap money 'party' was always going to come to an end. Now that global governments and central banks are reversing those loose polices, we are seeing a return to yield for many asset classes which had been squeezed from quantitative easing (QE). Fixed income investing is returning to basics, in our view; ie, an asset class whose primary function is to provide stable sustainable income alongside lower volatility rather than mark-to-market capital gains.

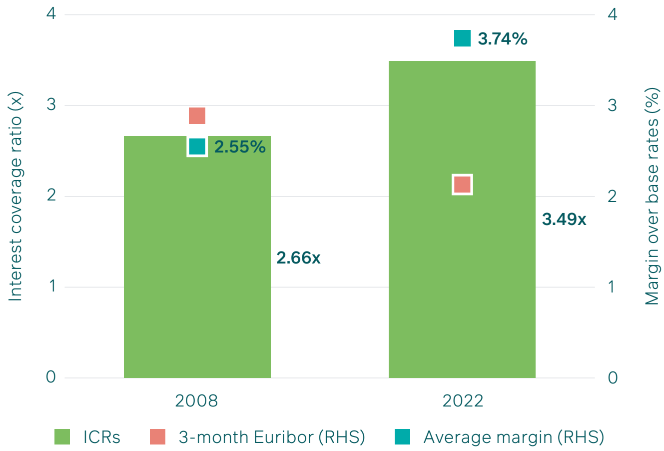
Robust fundamentals

Despite this, we believe the fundamentals for loans are in healthier shape. Average senior leverage sits at c.5x whilst average equity contribution from PE sponsors has increased to the 40% range vs c.30% prior to the GFC, meaning there is a thicker 'first-loss' buffer in the event of default. We have also seen the behaviour of PE sponsors improve since the GFC with a willingness and track record of making cash injections when needed, such as during liquidity crunches or the Covid-crisis, which may well come into play in the coming year.

Interest coverage ratios (ICRs) are also still strong at 4.2x with significant room to absorb base rate rises, functioning as a floating rate investment should, demonstrated in the below chart. Currently, 3-month Euribor is not far off from 2008 levels, but ICRs are still robust, with firms able to provide higher margins (on average 374 bps vs 255 bps; a 121bps premium) for a better quality, more transparent portfolio, in our view. Many companies within the population also have adequate pass-through mechanisms for input costs rises, further shoring up the robustness of cash flows and 'money-goodness' of these companies.

Improved fundamentals plus higher potential income

Interest coverage ratio and margin over base rates



Source: Interest Cover Ratios (ICRs): LCD Comps European Quarterly Review Q3 2022; Average Margin: Credit Suisse Western European Leveraged Loan Index; 3-month Euribor (RHS): Year End 3-month Euribor. Data as at December 2008, December 2022.

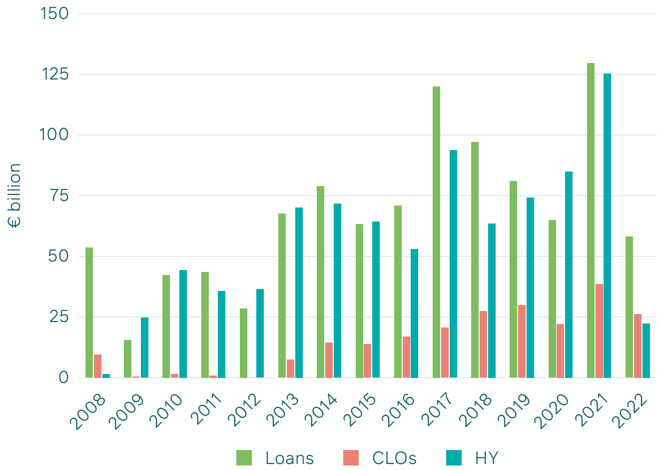
Past performance is not a guide to future performance.

Subdued issuance

Naturally, with wider spreads comes lower near-term issuance while borrowers assess the length and depth of the downturn. This was no different in 2022 where issuance at €58.1 billion was up to half the level of a normalised scenario of €80-100 billion, but still functioning and well ahead of HY bond issuance at €22.3 billion, which dropped by approximately 70%. Issuance of collateralized loan obligations (CLOs) also fell, but by proportionally less, about a third, which provided a much-needed asymmetric undersupply over-demand base aiding in the partial recovery of loans, highlighted in the following chart.

Wider spreads in 2022 saw issuance decline

European loan, CLO and HY issuance in 2022



Source: LCD Comps CLO, Leveraged Loans and Bonds Volume reports 2022, 31 December 2022.

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The path to this level was certainly not straightforward with pockets of almost no issuance such as in the aftermath of the Russian invasion of Ukraine and the seasonally low summer months. At the start of the year the forward pipeline began at €3.9 billion swelling to a peak of €19.4 billion in June, before tailing off to just under €2 billion by year-end as several large hung deals finally came to market prior to the war in Ukraine.

Arranging banks did have to give up some economies with Q4 deals printing with generous Original Issue Discount (OIDs) – some as low as the 80s – as they focused on clearing their books before year-end, but crucially these deals got done.

Nevertheless, the ability of the loan market to remain functional through the year points to an asset class that, in our opinion, has developed from past mistakes and is structurally sounder than it was in previous downturns. Unlike in the aftermath of the GFC, bank balance sheets are in better shape. They have played a part in providing a liquidity backstop in the face of c.30% lower M&A volumes (albeit in-line with pre-Covid levels), given increased cost of acquisition financing and economic uncertainty. Consequently, bank-driven pro-rata volume finished at the highest level for 5 years[2]. There are other structural underpinnings for supply; clubs deals are plentiful again, with direct lenders and more tenured syndicate members able to collaborate to get deals done where smaller loan investors may already be overweight.

Looking forward, the expectation for 2023 issuance is somewhat mixed, ranging from a pessimistic €34 billion to a flatter €60 billion. What issuance there is will likely be driven by refinancing should spreads compress as borrowers aim to reprint wider deals placed in the prior year and/or extend existing maturities – a dynamic we saw in the record-breaking issuance year of 2021. Similarly, CLO refi/reset volumes are expected to be elevated in the coming year as 60% of the deals issued in 2022 (by count) have non-call periods ending in 2023; and CLO managers seek to refinance at tighter levels from AAA spreads at 200 bps vs a long-term average of c.100 bps.

Maturity wall is well tempered

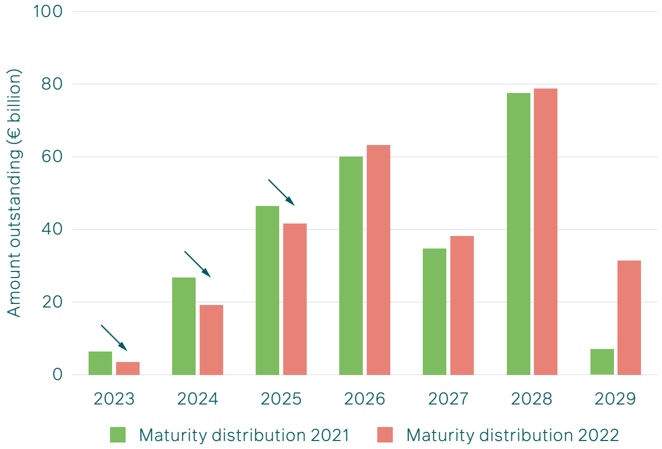
At the start of the year, roughly 13% of loans were set to mature by 2024. By the end of the year, this was closer to 8% and continuing to trend down (shown in the chart below). Through the year we saw companies proactively address near term maturities (2023-2025), either

[2]LCD Comps Leveraged Loans Volume reports as of December 2022.

through 'amend & extends' or new tranches. The result is the maturity wall for European loans won't likely begin to peak until about 2026 and 2028, so the near-term refinancing need is not pressing.

Active refinancing of nearer term maturities

Maturity distribution of loans in 2021 vs 2022



Source: Morningstar European Leveraged Loan Index (ELLI), December 2021 and December 2022.

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The hawkish pace of base rate increases has rightly led to concerns around the maturity wall of credit asset classes, the health of ICRs, and in turn creditworthiness and hence defaults. Digging into the fundamentals, average ICRs at 4.2x is still healthy and well above the 2.6x levels of 2008, as the chart titled "Interest coverage ratio and margin over base rates" shows, so there is significant room for deterioration before any stress. In addition, many borrowers apply hedging to at least a portion of their debt, tempering the pace of deterioration.

Arguably, the maturity wall is broadly a positive dynamic given the 'pull-to-par' effect from average pricing in the low 90s, plus higher all-in rates (wider margins plus higher base rate) and OIDs on replacement new issuance more than offset potential average default loss, in our view.

Carbon clean and sustainability

With most investors looking beyond simply integrating ESG factors into their portfolios, the focus on carbon and sustainability continues to rise in importance. 2022 continued the positive momentum of ESG-linked issuance. According to LCD Morningstar, €26 billion worth of global sub-investment grade ESG loans printed, of which more than half were specifically sustainability linked. The majority of these were US deals given there wasn't a drop off in overall issuance levels in the region, albeit this was due to an all-time high level of pro-rata bank debt volumes – institutional loan volumes were similarly depressed as Europe.

There was limited public disclosure, but margin ratchets were in the typical range of 7.5 bps to 10 bps. With the current spreads on offer, and higher new issue margins, we believe these ratchets can comfortably be absorbed without a significant impact on returns, so investors will likely push for even further carbon reduction and sustainability key performance indicators.

Regulatory oversight is increasing with the rise of ESG-oriented and labelled funds where standardised definitions have been somewhat lacking. This has been spearheaded by the EU's Sustainable Finance Disclosure Regulation (SFDR) driving more transparent reporting, with other regulators following suit. 2023 may yet be another year with a further slowdown in the pace of ESG-labelled/marketed funds as investment funds rationalise their marketing to meet the rapidly changing and tightening regulations.

In response to the growing demand for benchmarks that consider climate factors, ICE launched six climate variants across 23 corporate parent indices ranging from US and European corporates to emerging market and Asia Pacific corporates. The variants seek to achieve net zero carbon emissions by 2050 based on Paris Aligned, Net Zero and Climate transition frameworks. Given the 20% overlap of bond and loan issuers within the universe (by count), this is a further positive step for the loan market in which only c.10% of climate/carbon data is currently available from third-party providers.

Positive outlook for loans in 2023

2023 has the potential to be more geopolitically stable than recent years as it will be the first year of the 21st century without a general or presidential election in any G7 country, notwithstanding the possibility of snap elections or China/US chip-war escalations. The outcome is that leaders will potentially be able to spend more of their time addressing current challenges rather than re-election campaign promises. This points to the potential for a more stable economic environment for companies to operate in, but the broad economic outlook remains uncertain nonetheless, in our view.

While fixed income is generally seen as more favourable than equities (which we believe have further room to fall) at this point in the cycle, there is certainly further scope for yield curves to gyrate, so we think remaining duration agnostic is preferable. In our view, European loans as a floating rate asset class provide a compelling solution.

Since its inception, European loans has never experienced two consecutive years of negative returns and has had the longest bull run in the past decade versus comparable risk asset classes, Investment Grade, HY or Equities. 2022 was the only year to have generated negative returns over the last decade within the asset class. Even its close relative US loans has only had a maximum of 3 years of consecutive positive returns (EUR Hedged) during this period.

Its positive mean reversion should be accretive to total returns for loans. Despite wide ranging forecasts for the asset class, most wash out in positive territory given the implied higher base rates for the coming year. JP Morgan forecasts a 5% total return, and Barclays a 5.5% return, which would be the highest returns for five-years. Uncertainty abounds but at current price levels and with the coupons already on offer, we believe a return in the range of 4-6% could be achievable in 2023 with further upside available providing the general economic and geopolitical climate improve faster than expected, which could include a potential resolution to the Russia/Ukraine conflict.

CLOs represent c.70% of the loan buyer base so they will be a large driver of this potential return dynamic. The CLO market has grown by 20% over 2022, while the loan market is net flat[3], so we see a strong forward demand momentum to support this.

Loans well-placed in current environment

In the current inflationary, rising rate environment, we believe European loans are well-placed to steer through the various challenges ahead due to their largely floating-rate nature, as well as other attractive structurally robust features. With an uncertain economic outlook and the expected uptick in defaults, defensive positioning combined with careful credit selection remains key to sustainable value creation. ☐

[3]Barclays European Loan Research, "Papering over the cracks", December 2022.

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