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European leveraged loans outlook: Embracing the unknown

Despite another challenging year for financial markets, European leveraged loans bucked the trend generating healthy double-digit returns. Here, we explore some of the key drivers behind the defensive nature of the loan universe and ask: through the many unknowns on the horizon, could European loans provide solace for investors in the year ahead?

Financial markets excel at pricing high probability, low impact events but they are invariably bad with high impact events, both before and after they occur. In contrast to the dominant, single major event that defined 2022, 2023 has been consistently upset by unanticipated occurrences: rampant, double-digit inflation, the collapse of reputable financial institutions like Credit Suisse and Silicon Valley Bank, the outbreak of a conflict between Israel and Hamas in Palestine, paralysing, polarised politics and the US sovereign debt ceiling debacle.

For many asset classes there was no way to outrun these risks. Amidst these challenges, European loans provided a rare bright spot, experiencing minimal impact. With year-to-date returns of over 12% at the time of writing, European loans have outperformed other credit asset classes, offering a more stable return path. Moreover, negative returns have been the exception (only one month) rather than the norm in the past 12 months, making it the third highest annual return to date[1]. This performance can be attributed to the defensive composition of the loan universe, its floating rate structure and no direct exposure to banks or conflict regions. Furthermore, borrowers have largely attended to their debt maturities, bolstering defences for the foreseeable future and mitigating default risk. In this article, we will delve deeper into the factors driving this defensiveness and provide our outlook for 2024.

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[1] Credit Suisse Western European Leveraged Loan Index EUR Hedged as of 20th December, 2023.

Demand and loan supply

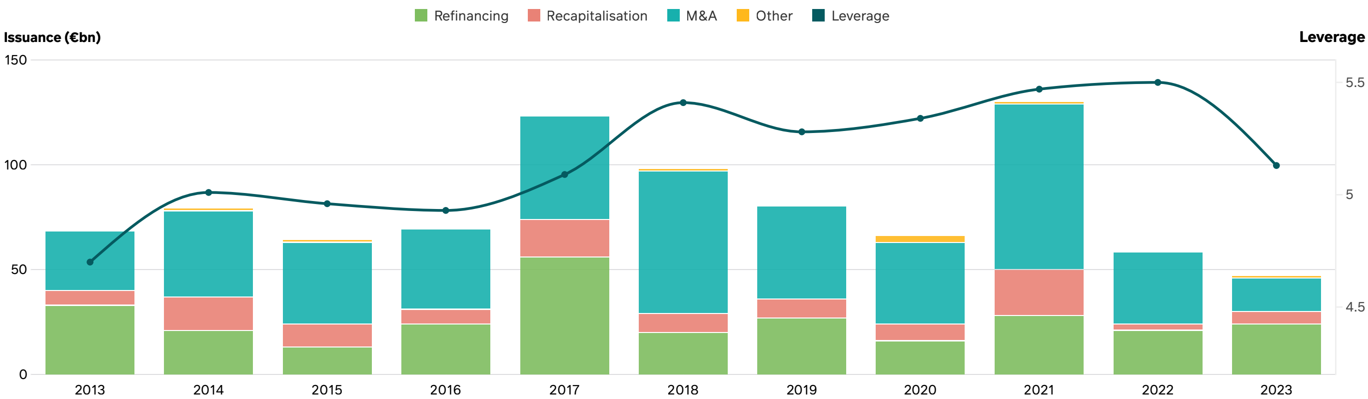
Q3 2022 marked the onset of the most hawkish period of central bank policy in the last decade, a trend that persisted throughout 2023. The European Central Bank (ECB) raised deposit rates to a peak of 4% and main rates to a peak of 4.5% to combat inflation. However, this tightening stance has not been without its casualties, GDP growth being one and corporate activity (ergo M&A) being another.

New issuance of loans is driven by M&A and thus has been relatively subdued. Furthermore, grappling with higher financing costs has created uncertainty in leveraged buy-outs. Consequently, companies have focused on stabilising their capital structures, prioritising funding solutions for any near-term due debt (2023-2025). Predominantly through amend and extend mechanisms, and value-additive tuck-in acquisitions. Unlike the high-yield market, which has struggled with pricing new deals as issuers have balked at call-protected, locked-in levels, the loan market has remained functional, owing to the inherent flexibility to prepay, preserving borrower options. The active refinancing activity has led to a significant reduction in the maturity wall for European loans that has decreased by 75% compared to 2021, with only 7% maturing in the next two years. In contrast, European high-yield bonds face a maturity wall closer to 20% of its population[2].

While private equity deal flow and M&A driven issuance are at cyclical lows, Private Equity dry powder remains significant, hinting that rate stability will likely unlock powerful deal-making momentum. There are numerous company exits in the pipeline as sponsors face pressure to realise assets and redeploy capital. Historically, these exits would have been facilitated through public IPOs, but companies are increasingly choosing to stay private for longer, resulting in sales primarily to other sponsors or continuation funds. This trend should underpin public-to-private deals which we have already seen in 2023. Multi-billion take-privates concluded in the year include Adevinta, WorldPay, Dechra AG, Software AG, and Toshiba. This bodes well for the forward pipeline of private funding solutions, whether via Narrowly or Broadly Syndicated loans, the European Private Credit market being more symbiotic in this regard than the US.

Despite lower supply, demand for European loans has remained robust, driven by the anchor investor base of collateralized loan obligations (CLOs) and other investors seeking floating-rate, defensive assets. This has created a highly supportive dynamic of over-demand with a focus on sourcing in secondary markets where loan prices have rallied almost five points this year. Loan marks have been trading at a discount to par (c.96)[3] so there is more runway to go for potential gains. The primary supply has been dominated by refinancing and, in the face of higher rates, importantly there is evidence of some improvement in structures – both in headline leverage terms but also in EBITDA adjustment permissions.

European leveraged loan new issue supply and fundamentals



Source: Pitchbook LCD, Leverage as of Q3 2023.

[2] Barclays European Leveraged Loans 2023 Walking the tightrope.
[3] Credit Suisse Western European Leveraged Loan Index as of November 2023.

Affordability and defaults

Though elevated rates are a boon for floating rate returns, ultimately companies in the sub-investment grade space are faced with average all-in financing costs of 7-9%[4]. As hedges continue to roll off, weaker credits may struggle to withstand this. Having initially been more pessimistic, rating agencies revised forecasts for European loan default downwards as 2023 progressed, with expectations of approximately 4% in 2024[5]. However, with defaults currently standing at 1.4%, it is challenging to envision a near trebling of defaults within such a short timeframe. Nevertheless, we do agree that defaults are likely to peak in 2024 and we identify three main contributory factors.

Firstly, the maturity wall presents a risk for companies that are unable to refinance their near-term debts. However, as noted earlier only about 7% of the outstanding debt of the European Loan Universe falls due in the next two years, and a significant portion of that already has refinancing deals sitting in the pipeline.

Secondly, distressed credits are unlikely to find much respite and could face restructuring in the next year. However, these represent a relatively small portion of the European loan universe, with lower-rated CCC credits accounting for approximately 3.5%, and less than 3% of loans being priced at distressed levels (below 80). Furthermore, credit upgrades in 2023 have reached the third-highest level in the past decade, indicating relatively resilient performance. However, credit dispersion may increase in 2024 due to elevated volatility.

Lastly, companies with low (or no) cashflow may face a liquidity crunch and associated default. As financing costs have increased, interest coverage ratios (ICR) have naturally trended down, albeit remaining robust on average at approximately 3x[6], only about 1x lower than long-term norms. The active refinancing and capital structure rebalancing efforts, alongside successful cost pass-throughs and strong operational management could bolster cashflow from here.

Consequently, while the prognosis is for default rates to rise, there is more pessimism priced into the yield than is warranted, in our view, resulting in the potential for an attractive risk/reward profile for European Loans.

European loan annual default rates

Source: LCD Pitchbook ELLI Index, Fitch Ratings, M&G as of Q3 2023.

[6] M&G European Loan Fund as proxy of secondary market.
[4] European Loan and European High Yield All in Yields as of November 2023.
[5] Fitch Ratings.

Mind the performance gap

At the beginning of 2023, we anticipated double-digit returns in European Loans, posing the question: "Have European Loans been defensive against rising rates and uncertainty?" Given the subsequent performance, we can confidently answer with a resounding yes. European loans as a floating rate, senior secured defensive asset class have navigated the year's events with minimal impact, outperforming traditional credit asset classes – just as they have done over the past three years. Now, we might ask "Can Loans continue to deliver outsized returns in 2024?"

At the time of writing, European Loans are currently offering all in (EUR) yields of 8-9% per annum[7] over the medium term, a handsome risk-adjusted return in our opinion, versus the historic norm of the past decade. On the surface, this may not differentiate the asset class from High Yield bonds. However, there are positive differentiating structural factors at play.

Default levels are forecasted to be 4% in 2024 but the spread-implied default level of European Loans stands at approximately 14%. This implies that loans are currently mispriced, and that investors are being overcompensated for the level of credit risk at these yield levels.

The all-in yield of loans is predominantly driven by income rather than capital gain, which typically accounts for around 50% of the return stream for fixed credit.

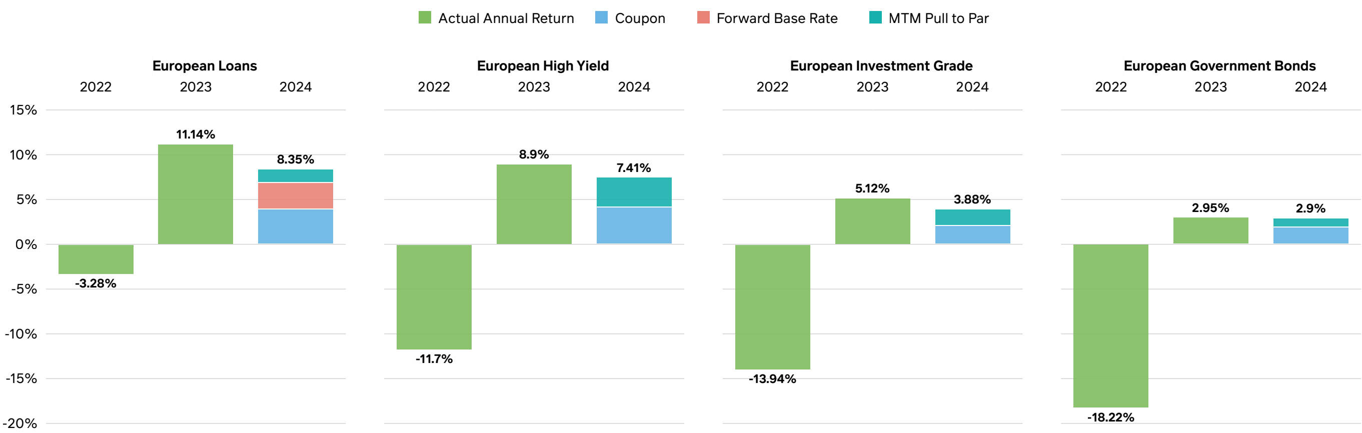
Consequently, return streams from loans are not only more stable, given their lower susceptibility to sentiment-driven flows, but also less reliant on positive economic growth, which tends to drive price rallies. Additionally, the pull-to-par component in loans is likely to be realised more quickly as corporate finance activity picks up. Sponsor-backed LBO loans actively repay every 2-3 years, whereas the average life span of fixed credit is 4+ years.

Assuming defaults and recoveries remain in line with historical averages of 3% and 70% per annum over the next three years, the risk-adjusted base-case yield could still be approximately 8%. Even with a default-rate higher than the agencies predict – at 5% – and lower recoveries – at 60% – the all-in yield could exceed 6%, a real return in our opinion, and still over 2% above risk-free rates.

European Leveraged Loans involve secured lending to sub-investment-grade companies – typically those owned by Private Equity sponsors. Consequently, the risk of default and non-payment is higher than for investment-grade debt. Coupons consist of a credit spread above short-term interest rates, meaning that financing costs for companies rise immediately upon the resetting higher of the base-rate by Central Banks.

Therefore, the principal risk to consider when investing is the risk of default and associated loss from debt write-off. Loans trade in a secondary market albeit not on an exchange. Consequently, while trading liquidity is comparable to High Yield bonds, settlement liquidity can be lengthy – c. 30-40 days. Although investing in loans may not be risk free, it has proved out its risk efficiency.

Actual returns 2022, 2023 and current yields



Source: Credit Suisse Western European Leveraged Loan Index, ICE BofA European Currency Non-Financial High Yield 2% Constrained Index, ICE BofA Euro Corporate Index, ICE BofA Euro Government Index as of November 2023.

[7] M&G as of December 2023.

Default recovery adjusted yield to 3 years

	60% pa Recovery	70% pa Recovery	100% pa Recovery
2.5% pa Default	7.34%	7.59%	8.35%
5% pa Default	6.34%	6.84%	8.35%
	Upside Case	Base Case	Downside Case

Source: M&G November 2023.

Duration the salve for geopolitics?

As we look ahead, a peaceful resolution to the Russian-Ukrainian conflict remains elusive, and the Israel-Hamas conflict has only added fresh fuel to the geopolitical risks. In 2024, over half the global population is expected to participate in elections, the largest proportion in history. Potential flashpoints for global markets abound, making solidity and bottom-up fundamental analysis an important feature of investing again. While making duration-based investments could feature in an investor's asset allocation, we believe there remains a role for asset classes whose return is linked to short-rates and driven predominantly by spread.

The final word

European loans have proven their worth as a strategic and tactical allocation this year and could do the same in 2024. With potential all-in yields of 8-9% (in euro terms) and discounted entry points in the mid-90s, investors have not missed the opportunity. The outlook for 2024 remains uncertain, with continued risks to the economy in the medium term. Investors will have to embrace the unknown. Navigating this winding road requires a stable approach, and from our front seat, we believe that real yields, achieved sustainably through robust credit selection, hold value for investors during periods of volatility in the broader public markets.

[8] BlackRock Investment Institute 2024.

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