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European leveraged loans: Compelling entry point in an attractive asset class

MAM | MANDATUM ASSET MANAGEMENT

ABSTRACT

Leveraged Loans are an attractive asset class to include as a key component of a corporate credit portfolio, providing good diversification to a high yield ("HY") allocation. Loans are floating rate instruments with a low modified duration and are generally first lien senior secured, providing downside protection from a recovery perspective. The borrowers are typically large, stable and high-quality companies, and the lenders, primarily institutional investors, have sufficient time and information (vs. HY bonds) for their own credit analysis and credit selection processes.

2022 was a difficult year for credit investors due to rising rates, but leveraged loans outperformed bonds in this environment given their low modified duration. European leveraged loans (ELLI[1]) returned -3.3%, which is 8 percentage points higher than EUR HY bonds. Furthermore, ELLI's returns were 11 percentage points and 14 percentage points higher than EUR investment grade ("IG") and EUR government bonds, respectively. However, in line with other risk assets, 2022 still resulted in negative European leveraged loan returns for the first time since 2008, due to wider credit spreads driven by Russian invasion of Ukraine, European energy crisis, persistent inflation and recession fears.

The combination of widening credit spreads and rising base rates has resulted in discounted secondary market loan prices (ELLI at ~91px) and a hefty yield-to-maturity ("YTM") of 8.6% which, in our view, provides an attractive entry point into the European leveraged loan market. Since 2003, ELLI has delivered annual gross returns of 7.6% and 8.6% (median and average) over the next 3 years when the month-end YTM has been above 8%. In addition, every time the month-end YTM has been above 8%, the following 3-year period has had positive returns.

The current cash price and YTM levels of European leveraged loans also provide ample cushion and downside protection for potentially higher default rates over the next few years. Including the current Euribor forward curve, our illustrative scenario analysis indicates a gross return of more than 8% p.a. over the next 3 years, assuming a 3-4% annual default rate (in line with historical average default rates) and a long-term average first lien loan recovery rate of c. 70%.

Even with very pessimistic assumptions of an annual default rate of 6% (2009-2011 ELLI average) for 3 years and lower recovery rates (50-60%), the scenario analysis indicates an annual gross return of over 6% p.a., which is well above the average annual return (c. 5% p.a.) of European leveraged loans over the last 20 years.

While there might be further volatility ahead, we believe that the current prices and yields already provide a sufficient buffer for investors to expect meaningful returns over a longer time horizon. Skilful managers rely on rigorous credit underwriting processes to ensure that their portfolio is prepared for downturns, e.g. through defensive sector allocation, in order to outperform the market with a lower default rate. In addition, mark-to-market volatility creates opportunities for agile investors and managers to boost returns by buying solid credits at discounted prices.

Finally, liquidity is inclined to weaken when the market bottoms, and the following rally tends to happen rapidly. Therefore, we believe that the time to gradually put money to work in European leverage loans is today, instead of waiting and trying to time for the ultimate bottom.

1) Morningstar European Leveraged Loan Index

1. What are leveraged loans?

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

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

Large institutional market with hundreds of issuers

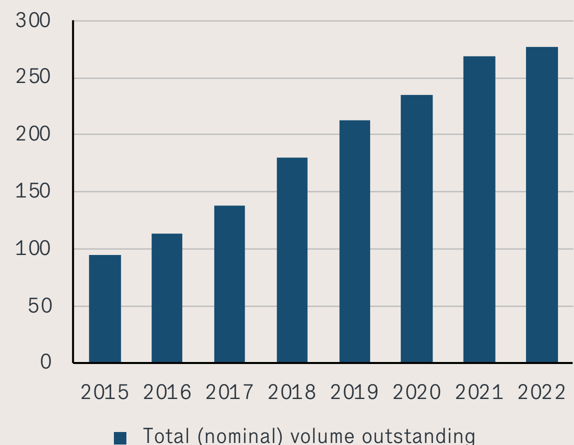
The European leveraged loan market grew and institutionalized in the early 2000s and has further accelerated within the last couple of years. The broadly syndicated market (ELLI index) includes c. 350 issuers with c. EUR 280bn of loans outstanding (by nominal value). The growth stalled somewhat in 2022 with limited new issuance but the volume outstanding remained at a record high level, after growing by 160% within the last 10 years.

The broadly syndicated loan market is complemented by a large number of smaller syndicates, or so-called club-style loans. These loans have similar characteristics and use of proceeds as broadly syndicated leveraged loans; however, key differences include: i) the borrowers are somewhat smaller companies, hence smaller absolute debt amounts required and less lenders, ii) companies are typically unrated, iii) there is lower/limited secondary market liquidity, and iv) terms are typically better for lenders as compared to the broadly syndicated space, partly due to the stronger role of banks especially in the Nordics.

One of the factors behind the growth of the asset class is the increasing AUM of private equity funds, given loans remain the preferred way of financing leveraged buyouts. This is partly due to limited public reporting requirements (lenders receive quarterly / monthly updates and yearly budgets under NDA) and the fact that loan market investors are also specialists in acquisition financing. C. 70-80% of broadly syndicated loans are issued by private equity sponsor-backed companies.

2. Market size (2015-2022)

Broadly syndicated European leveraged loans, EUR bn



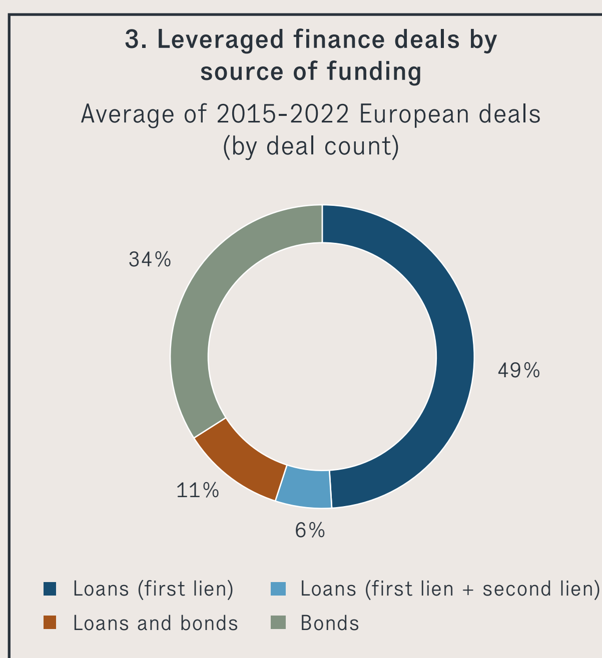
The syndicated loan market is a private market where only whitelisted institutions can operate. In addition, it requires a broad network of banks and sponsors, as well as sufficient resources to handle the more labour-intensive KYC, loan documentation and manual settlement process (vs. bonds). Due to this limited access, there is also less ‘retail’ money or funds with daily liquidity in the European market.

Source: PitchBook Data Inc.

Similar in size and limited overlap with HY bonds

European broadly syndicated leveraged finance new issuance (loans and bonds) averaged EUR 190bn in 2017-2021, before declining by 68% in 2022 from a record high in 2021 due to challenging market conditions. Leveraged loans averaged c. EUR 100bn of new issuance p.a. in 2017-2021, which is slightly above HY bond new issuance at c. EUR 90bn; however, total nominal value outstanding is still meaningfully larger for European HY bonds.

There is a very limited number of deals where both bonds and loans are issued, resulting in minimal overlap with HY bond issuers (or listed companies). As shown in graph 3, more than half of the new European leveraged deals were financed with loans only (first lien or first lien + second lien), one third were financed with only HY bonds, and just 11% of all deals included both loans and bonds. A combination of both loans and bonds are mostly used in the largest transactions in order to access the full market liquidity, and those deals also typically include both senior and junior tranches.



With a comparable size to the HY bond market and limited overlap in issuer base, European leveraged loans represent a meaningful and distinct market. By focusing only on HY bonds, investors would miss out on a large number of high-quality companies in their portfolios.

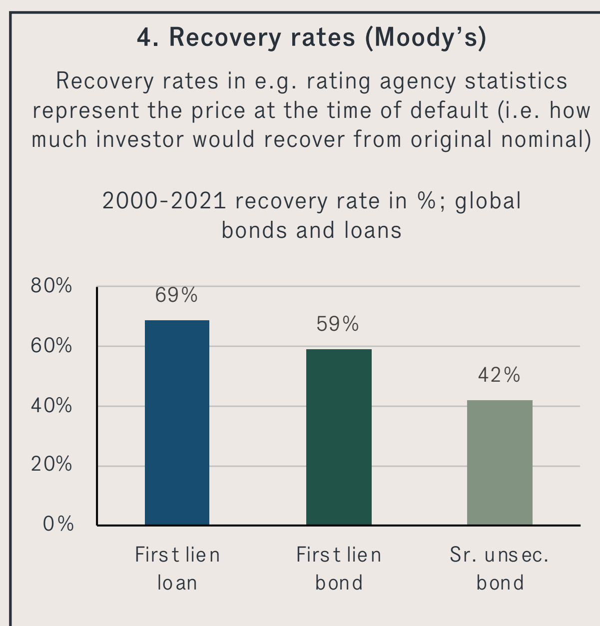
IMPROVING CREDIT PORTFOLIO CHARACTERISTICS BY INCLUDING LEVERAGE LOANS

Security and downside protection

99% of the broadly syndicated European leveraged loan index (ELLI) are first lien senior secured instruments with the highest seniority and priority claim on the security (borrower's shares and assets) in case of a default. This provides better downside protection compared to HY bonds, as illustrated in graph 4, where the majority of the European market is unsecured and recovery rates are lower.

Floating rate – limited interest rate risk

Loans have a low modified duration (c. 0.3 i.e., average interest rate period) and therefore, limited interest rate risk. Base rates are typically floored at 0%, and loan coupons grow as base rates rise, increasing investors' return expectations.



Source: PitchBook Data Inc.; Moody's

The low modified duration also explains most of the outperformance of loans vs. bonds in the rising rate environment of 2021-2022 (graph 5). Despite this significant outperformance, YTM of European leveraged loan index (8.6%) remains higher than the European HY bond index (7.7%) at the end of 2022 as rising base rates have increased coupons substantially.

High quality companies

Leveraged loan borrowers are typically large, diversified, stable and profitable companies with EBITDA ranging from c. EUR 100 million to over EUR 1 billion. Typically, EBITDA in the broadly syndicated market is in the hundreds of millions.

70-80% of issuers are owned by private equity sponsors that provide their prior operational and strategic expertise and can support issuers in times of stress. Private equity funds tend to favor, and hence overweight, defensive sectors such as pharma, software, healthcare and consumer staples, as well as companies with strong market positions, growth prospects and cash flow profiles.

Less price volatility

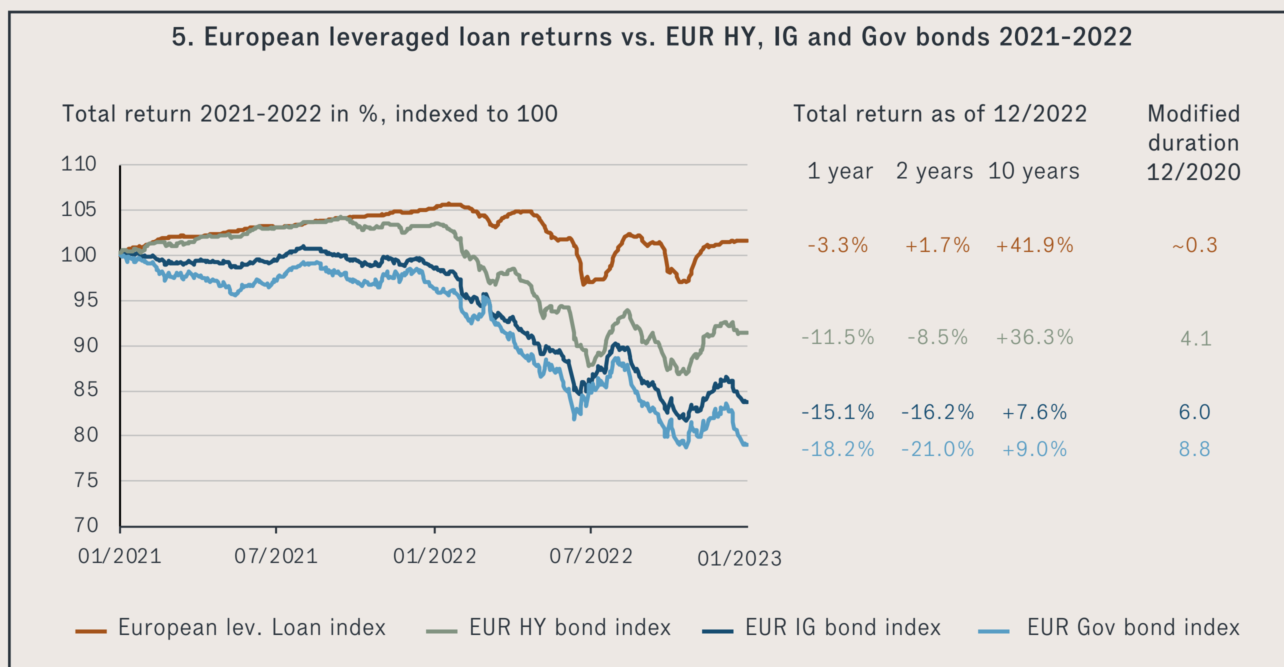
Leveraged loan prices are typically more stable comparedto bonds due to i) fewer retail funds and the absence of index funds and/or ETFs in Europe, ii) mostly long-term institutional capital, iii) lower sensitivity to interest rate fluctuations, and iv) prices "capped" to c. par due to prepayment provisions.

Despite lower volatility, broadly syndicated loans are increasingly liquid due to secondary trading through banks' trading desks. European leveraged loan trading volumes have tripled within last 5 years, while the total volume outstanding has doubled in the same time period.

Ideal market for credit picking

The syndication process for leveraged loans is normally 1-3 weeks per deal (vs. a few days in HY bond transactions), which provides sufficient time to conduct proprietary credit research and address key questions. There is also more information available, as compared to bond deals, with access to broad due diligence material and detailed company financials under NDAs.

5. European leveraged loan returns vs. EUR HY, IG and Gov bonds 2021-2022



	Total return as of 12/2022: 1 year	2 years	10 years	Modified duration 12/2020
European lev. Loan index	-3.3%	+1.7%	+41.9%	~0.3
EUR HY bond index	-11.5%	-8.5%	+36.3%	4.1
EUR IG bond index	-15.1%	-16.2%	+7.6%	6.0
EUR Gov bond index	-18.2%	-21.0%	+9.0%	8.8

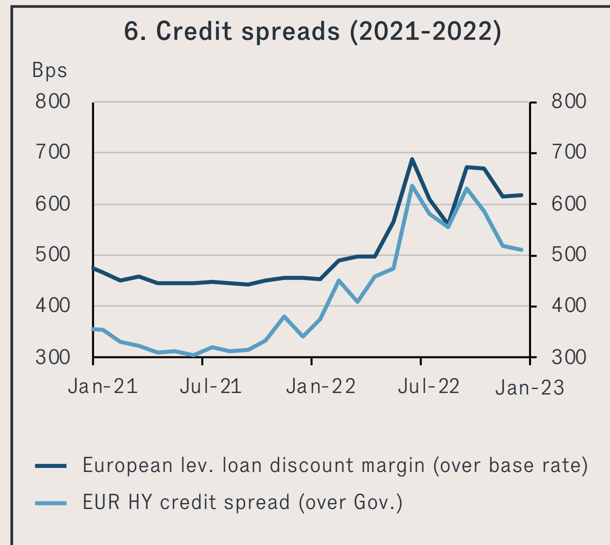
Source: PitchBook Data Inc.; Bloomberg; ICE BofA; LMA

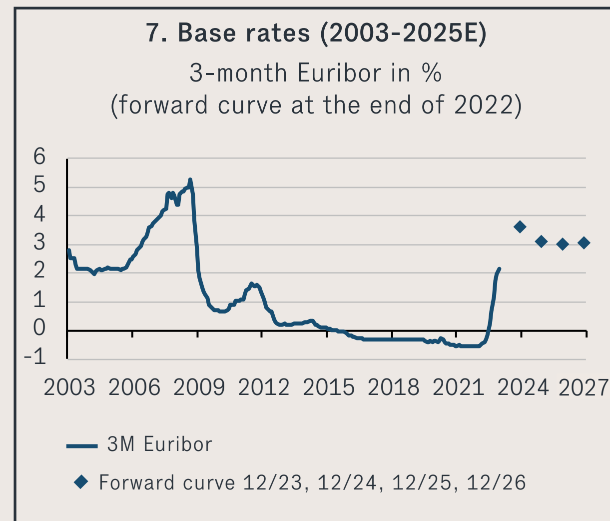
2022 PRICE DECLINE AND YIELD EXPANSION OFFERING AN ENTRY POINT?

2022 returns and set up for 2023

Despite outperformance vs. bonds in 2022, European leveraged loans (ELLI) posted negative returns (-3.3%) for the first time since 2008 as loans were not fully shielded from the broader negative risk sentiment driven by Russia's invasion of Ukraine, persistent inflation and European energy crisis as well as emerging recession fears. This led to widening credit spreads, and the discount margin of ELLI expanded c. 160bps in 2022, which compares to c. 170bps in EUR HY spreads.

At the same time, underlying base rates have seen an aggressive advance from sub-zero territory to 3.3% (12M Euribor) and 2.2% (3M Euribor). This has boosted the YTM of ELLI to an attractive 8.6% (or c. 9.6% when using Euribor forward curve) at the end of 2022.

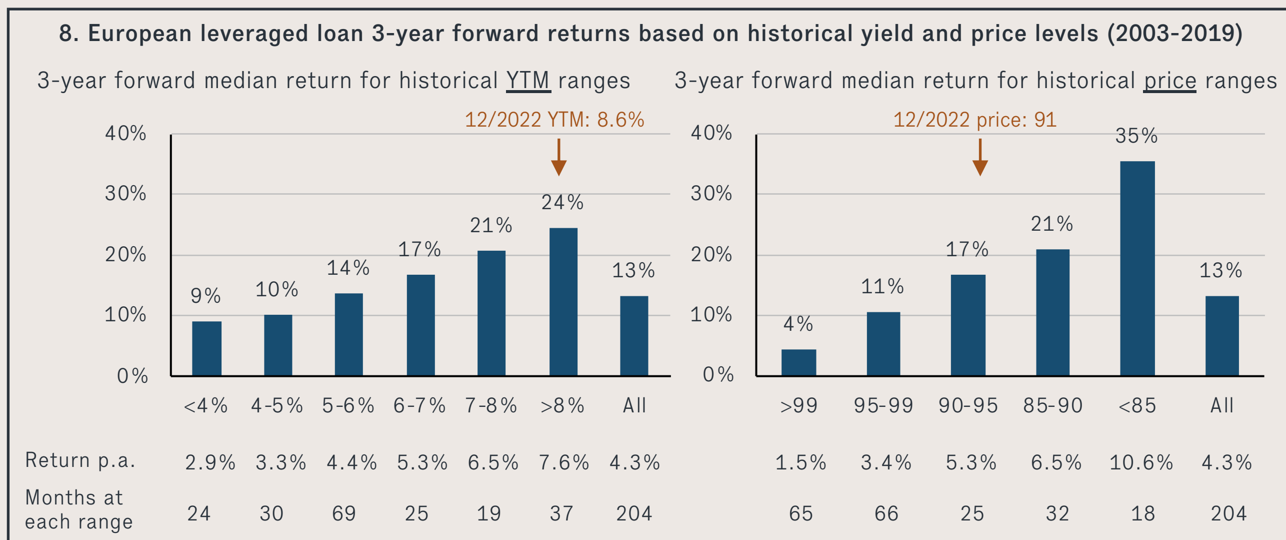




Time to put money to work?

What kind of returns would investors have historically received if they invested in European leveraged loans at the current cash price and yield levels? We analysed the 3-year forward returns of ELLI since the beginning of 2003 (graph 8).

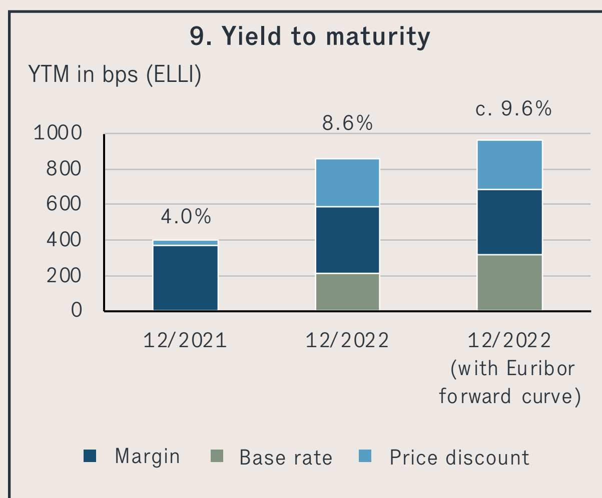
Historically, entry into European leveraged loans at current yield levels has resulted in attractive returns over a 3-year holding period. When month-end YTM has been above 8%, the median return has been 24% (7.6% p.a.) and the average return



Source: PitchBook Data Inc.; Bloomberg; ICE BofA

has been 28% (8.6% p.a.) over the next three years. In addition, every time the month-end YTM has been above 8%, the following 3-year period has had positive returns, with only 3 out of 37 periods resulting in a total return below 10% (3.2% p.a.). Further, analysing 3-year historical returns at different entry prices gives similar consistent results: the lower the entry price, the higher the following 3-year returns (e.g. 5.3% p.a. return with entry price of 90-95 and 6.5% p.a. at 85-90).

As the yield is boosted in today's market by a combination of discounted secondary market prices as well as positive base rates, both historical data sets presented are relevant to note, in our view. Graph 9 illustrates how the yield has expanded vs. the end of 2021 by underlying component. The price discount reflects increased risk premia required by market participants whereas in new issues, the price discount would typically be smaller but compensated by wider margins.



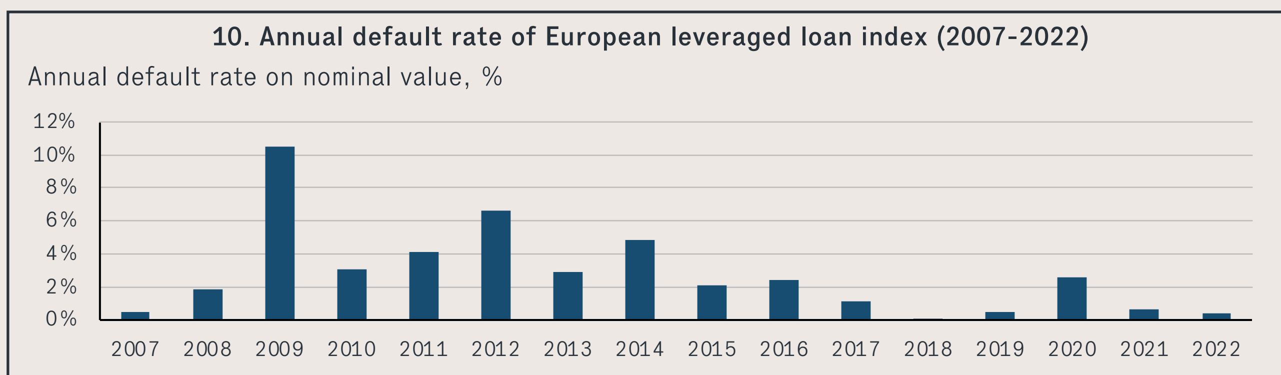
WHAT ABOUT DEFAULTS?

Historical default rates

European leveraged loan defaults have been at low levels in recent years, even with the impact of COVID-19 in 2020, as shown in graph 10. The average default rate from 2007-2022 was 2.8% and only 0.8% in 2018-2022. Additionally, it is worth reminding that the default rate does not equal credit loss, and loans have historically had high recovery rates, as shown earlier in graph 4.

Given the current macro picture, rating agencies and banks expect default rates to rise in 2023. The latest base case estimates vary from slightly above 3% to 4-4.5% for global or European HY bonds and loans, which would bring them close to historical averages (Moody's global issuer-weighted HY corporate defaults averaged 3.5% in 2003-2022).

The highest 3-year average default rate in European leveraged loans was 5.9%, which occurred in 2009-2011. Such levels are not our (nor rating agencies' and banks') expectation for the coming years, as European leveraged loans are currently better positioned to weather possible downturns vs. pre-GFC. Key factors behind this assumption include: i) issuers now being larger (<15% of new issues in recent years were less than EUR 250 million vs. c. 70% pre-GFC) and ii) interest coverage ratios of the 2019-2021 issues (bulk of current loans) were at 4.2× compared to only 2.7× in 2005-2007. Additionally, loan-to-values have been lower in 2019-2021 than 2005-2007 at 46% and 59%, respectively, while net leverage has also been slightly lower at 5.4× and 5.5× for the same time periods.



Source: PitchBook Data Inc.; Moody's

Impact to future returns

We conducted an illustrative scenario analysis (graph 11) of the 3-year returns for an investor who invests in a portfolio with similar characteristics (margin, price and yield) as ELLI at the end of 2022. The results indicate that the current price and yield are sufficient to compensate for extremely gloomy default and credit loss outcomes:

1. Assuming a 3-4% default rate for the next three years (in line with historical averages) and a historical recovery rate for first lien loans of c. 70%, investors would be looking at an annual return of c. 8.2-8.5% for the next three years. Price discount and wider all-in-spreads compensate for potential credit losses, while returns are further boosted by higher expected base rates (in a 0% default scenario, returns are one percentage point above current YTM due to an expected further rise in 3M Euribor, as shown in graphs 7 and 9).

2. Pessimistically using ELLI's default rate from 2009-2011 (6%) and assuming a lower recovery rate of 50-60%, the investor would still see 6.2-6.8% p.a. returns, which are well above the average annual return (c. 5% p.a.) of European leveraged loans over the last 20 years.

Despite the cushion, credit managers should rely on rigorous underwriting process and credit picking. With the correct approach, this can lead to meaningful outperformance, which is even more important in the current environment. Furthermore, mark-to-market volatility creates additional opportunities for agile investors and managers to boost returns by buying solid credits at discounted prices.

11. Three-year annualised return scenarios* as a function of default rate and recovery rate

Recovery rate 2023-2025	Annual default rate 2023-2025						
	0.0%	1.0 %	2.0%	3.0%	4.0%	5.0%	6.0%
90%	9.6%	9.5%	9.3%	9.2%	9.0%	8.9%	8.7%
80%	9.6%	9.3%	9.1%	8.9%	8.6%	8.4%	8.1%
70%	9.6%	9.2%	8.9%	8.5%	8.2% (1)	7.8%	7.5%
60%	9.6%	9.1%	8.7%	8.2%	7.7%	7.3%	6.8%
50%	9.6%	9.0%	8.5%	7.9%	7.3%	6.8%	6.2% (2)

*) Illustrative return for an investment into a portfolio with the same characteristics with European leveraged loan index: avg. price: 91, average margin: 372bps; average YTM: 8.6% (9.6% with Euribor forward curve), average maturity: 4.2 years. Assuming par repayment for loans, excl. defaulted loans and reinvestment of interests and default recovery proceeds. Assuming current forward curve for 3 month Euribor (graph 7)

Source: PitchBook Data Inc.

Mandatum Asset Management

Mandatum Asset Management is the asset management arm of Sampo Group, a significant insurance group in the Nordics. As part of Sampo Group, we leverage its investment heritage, expertise and broad resources as one of the most successful institutional investors in the Nordics to provide investment solutions and products to our clients.

We offer discretionary and consultative asset management and manage a variety of investment products within our core areas of credit, alternatives and equity selection. Our philosophy of managing clients' assets is characterized by jointly investing in products with Sampo Group's balance sheet assets, and we manage EUR 29 billion in client and balance sheet assets. Our clients include pension funds, insurance companies, foundations, family offices, UHNW investors and other financial institutions across the Nordics and Central Europe.

MAM manages roughly EUR 5 billion in high yield credit (high yield bonds and leveraged loans), including client money as well as the Group's own balance sheet capital and has 15 years of experience of investing in the asset class. MAM currently offers two different client loan strategies focused on broadly syndicated European first lien leveraged loans, with the ability to also invest in club-style European leveraged loans (including second lien leveraged loans) as well as European high yield bonds.

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