# Investment Insights

European Senior Loan Market

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### 2021 review and 2022 outlook

We began our outlook a year ago commenting that the global economy and markets were sent into a COVID-induced tailspin. The calendar year 2021 has seen the "aircraft" return to level flight – not on all engines – but gaining altitude.

Vaccine developments enabled the lifting of mobility restrictions across Europe (and globally) and a return of confidence that the worst was over. There were periods of turbulence (new variants, for instance), nevertheless the European loan market performed strongly returning over 4%.[1]

The overall market grew during the year, with leveraged buyout (LBO) and M&A activity soaring as financial sponsors spotted opportunities, underpinned by a return of positive corporate earnings growth and outlooks. The supply and demand environment continues to be favourable as we enter the new year: both LBO and Collateralized Loan Obligation (CLO) momentum is healthy.

In Europe, both fiscal and monetary policy remain accommodative. While inflation has certainly increased during the latter quarters of the year, driven by reopening demand and shocked supply-chains, the European Central Bank (ECB) remains anchored to a conservative wait-and-see approach. Broad consensus is for Euro area (EA) GDP growth to normalise (to around 4%) and, therefore, the supply bottlenecks to open up. New COVID restrictions as a result of new strains remains a risk; however, ongoing medical developments are encouraging.

Therefore, the loan market is ideally placed in an environment where macroeconomic and credit conditions are in sympathy, moreover, given the focus of concern across broader assets classes is on higher inflation and higher yields. Loans may continue to provide high current income, upside price appreciation potential, and minimal duration risk. Furthermore, we see potential opportunities within sectors that remain affected by COVID.

### 2021 review

The Credit Suisse Western European Leveraged Loan Index's (CS WELLI or the Index) year-to-date returns are 4.20%.[2]

We were constructive on loans for 2021. Our core thesis materialised: continued monetary policy and fiscal support – at the national and EU levels – underpinned by rapid rollout of COVID vaccines, fueled the recovery and reopening thesis. While further lockdowns were possible in the earlier parts of the year (and did occur), we were optimistic that the challenges of further waves would be manageable.

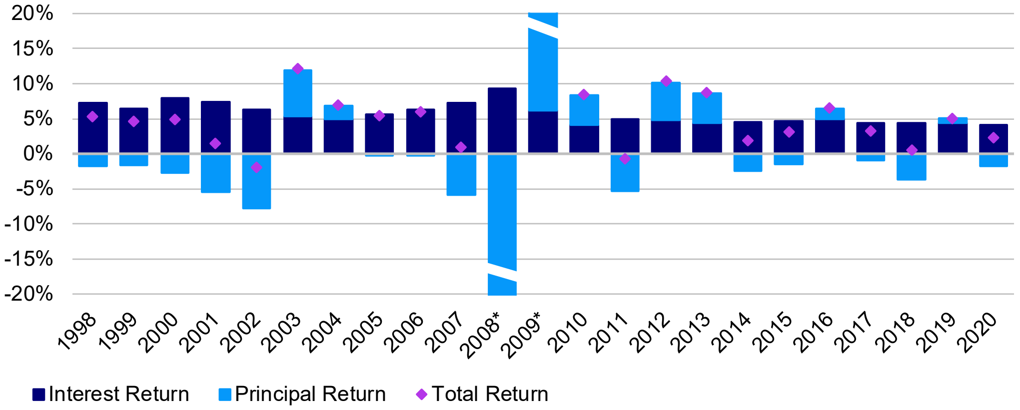
Total returns exhibited steady, low volatility gains throughout the year. In March, returns were muted due to further lockdowns and, in contrast, in July when primary issuance was strong leading to prices coming under downward pressure. Towards the latter parts of the year, when inflationary concerns (a risk that we did not envision would occur as quickly) affected the rates and high-yield markets, loans with their low-duration profile continued to perform strongly.

Material overperformance was evident in the "CCC" rated cohort, one concentrated with borrowers characterised by more "pandemic risk," namely those in the Travel and Leisure/Entertainment sectors, etc., all which benefited from easing of mobility restrictions. Overall, cyclical sectors returned 5.2% versus 3.4% for defensive sectors in 2021.[3]

While agencies started to upgrade corporate ratings throughout the year, incorporating a recovery in earnings, improved credit metrics (i.e., leverage) and outlooks, the pace has been conservative. The average rating for the CS WELLI improved to 'Split BB' in late spring, beginning the year at a 'B' rating.[4] Indeed, the proportion of 'B' credits decreased by 7% over the year to 57%, with an offsetting increase into higher, improved, rated categories observed.[5] The CCC proportion has remained around 4% throughout the year,[6] as a result of the Travel and Leisure borrowers which, in general, have not benefited from upgrades – a theme we expect to improve by summer 2022.

Furthermore, upgrades (or lack thereof) are in stark contrast to the number of distressed credits – as measured by those loans trading below 80 – which have decreased steadily and is currently at 0.5% of the Index.[7] Those credits trading below 90 has decreased from 5.5% to 1.3%[8] as sentiment and profitability has returned. Likewise, defaults rates have continued to moderate from pandemic highs and remain below 1%.[9] This level is better than our expectations, supported by the healthy macroeconomic tailwinds and liquidity profiles obtained throughout 2020.

**Figure 1: European loan market experienced three years of negative returns over the past 23 years**



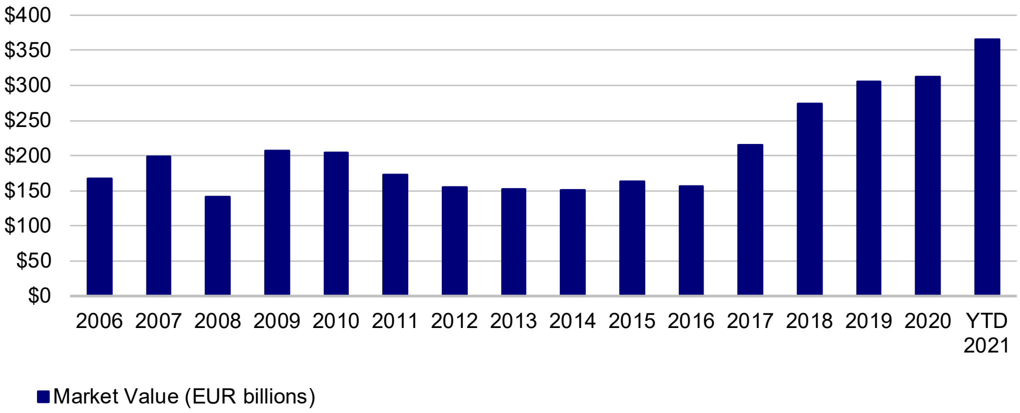

Source: Credit Suisse Western European Leveraged Loan Index data through December 31, 2020, updated annually. *Denotes returns in excess of the axis. 2008 returns were –30.24%, 2009 returns were 47.24%. **Past performance does not predict future returns**.

Alongside a strong economic recovery has been steady positive loan supply throughout 2021 – more than €110 billion (bn) of new issuance has been recorded, the greatest since the Global Financial Crisis. The primary factor has been LBO financing, which has almost doubled in 2021 to €70bn, more than our estimated €45bn levels for the year.

In parallel, demand has matched supply with the CLO market printing its highest annual new issue volume on record (€36bn). CLO demand continues to underpin secondary loans, with the average price for the CS WELLI close to yearly highs again, closing at 98.85.[10]

Overall, the CS WELLI has grown by 16% this year to over €370bn in size.[11] Average prices have appreciated by approximately 1.3% and coupon income generating 3.1%, for a total return of 4.4%.[12]

**Figure 2: European loan market size growth**




Source: Credit Suisse Western European Leveraged Loan Index (EUR hedged) data as of November 30, 2021. An investment cannot be made in an index.

### 2022 outlook

Positive macroeconomic and technical drivers leave us confident that loans can perform strongly in 2022.

The EA economy, while returning to a steadier growth path, is expected to expand by around four percent in 2022. Supply chain snags should clear as growth moderates, while a catch-up in services spending is likely. Favorable ECB and fiscal policies are expected to continue. Accordingly, defaults should remain low across the asset class. We believe that private equity, which is the heart of loan origination, can remain healthy as sponsors invest, continuing to fuel growth in the loan market (as measured by the Index size). Demand to fund M&A and LBO activity are anticipated to be underpinned by a continued search for yield against a backdrop of low (but rising) interest rates, enhanced by leveraged loans' low duration characteristics, and robust CLO formation.

We expect the loan market to maintain growth in 2022, driven by continued strong M&A and LBO activity. Pitchbook estimates that 2021 (at the end of September) European private equity transactions were close to €550bn, above the previous high of around €490bn set in 2018.[13] Private equity fundraising continues. Given the macroeconomic background, as detailed above, heightened M&A and LBO activity/momentum – at €70bn at the end of November, just below the 2007 record – may continue into the new year as sponsors deploy 'dry powder' financed via loans (advantageous call structures) vis-à-vis the bond market in a rising yield environment. Thus, continued M&A/LBO related supply of order €65-75bn is probable, although jumbo transactions could skew issuance to the upside. The quantum of loans above par, around 15% (below trend),[14] is reflecting the strong repricing activity of €26bn (annualised) in 2021, the second highest on record. Refinancings volumes should normalise at around €20bn in 2022. Overall, we see the net growth of the market at around €15-20bn, after incorporating around €60bn of repayments and €10-15bn of issuance for recapitalisations.

The average price of the Index is around 99.[15] COVID-related risks will continue to oscillate. Increasing access to vaccinations and booster shots globally will support the recovery in sectors such as (international) Travel and Leisure – several loans in these sectors remain in the low 90s (with no change to their pandemic hit ratings). On the downside, given the macroeconomic backdrop, we expect a relatively small proportion of the market to experience pricing pressure, led by weaker operational performance and then rating downgrades.

An important factor helping to drive supply is CLO demand. 2021 European CLO issuance of €31bn is the most on record. We expect these themes to continue throughout 2022, driven by the aforementioned market growth, primarily from a buoyant M&A/LBO (and thus new issuance) environment. CLO vehicles remain the dominant buyer of loans, and their arbitrage strategy enforces a technical floor on loan pricings. Issuers need CLOs to purchase loans (be it new issuance, or repricings) and, thus, appropriate pricing is needed to ensure CLO equity returns are appropriate for their risk profile. A strong CLO issuance may ultimately support loan spreads/margins, thus defending the Index's average coupon of 3.72%.[16]

Throughout 2021, borrower leverage, cash flow generation, and balance sheet liquidity, have, for the most part, improved. Corporate and macroeconomic fundamentals are healthy as we enter 2022. Therefore, we are expecting a default rate of around 1.5% in 2022, above the current 12-month trailing levels of approximately 1% (recall that defaults rates during the pandemic peaked at just 2.6%),[17] a quasi-nominalisation as the pandemic pulled forward some defaults. While not all companies would fare equally in the above downside scenario, given the low proportion of issuers trading at distressed levels, we would expect the benign default environment to continue and rise to 2% in this bear case, remaining below the long-term average of approximately 3.2%.[18]

Over a longer time horizon, an eventual rising rate environment could add further demand for loans, away from high yield bonds, even though ECB policy rates are expected to remain below EURIBOR floors (typically set a 0%). In our view, this suggests that loan coupons are unlikely to increase for some time.

**Conclusion**

The general assumptions behind this outlook are based on activity further normalising. What could go wrong to this constructive outlook? At the forefront, is likely new COVID-related restrictions, particularly from the emergence of new strains which the current vaccinations provide little or no protection. However, given the positive ongoing medical developments, including the antivirals from Pfizer and Merck, the largest risk has most likely shifted towards a sharper and more persistent rise in inflation, globally. This could lead to a slowdown in growth over coming quarters and would trigger the ECB to tighten quicker. Earlier hiking would unsettle risk markets and should the US Federal Reserve normalise US monetary policy much faster than currently anticipated, financial conditions and sentiment in the EA would also likely suffer further. Increased negative developments in China could also affect the EA negatively, similar to 2014 and 2017.

However, in our view, solid economic growth and easy monetary policy are supportive of risky assets. The global economy is transitioning from the recovery phase of the economic cycle to a period of more stable growth. Thus, we believe that the loan market is ideally placed in an environment where macroeconomic and credit conditions are favourable, and the main threat across broader assets classes comes from higher yields. With average loans prices capped, we expect defaults to remain low, and all-in coupons that will be supported by the demand/supply dynamic inherent in the asset class.

## Topics in loans: Growth of ESG

Environmental, social, and governance considerations remain a major discussion point within the loan market and continue to gain influence over how investors allocate capital. Investors increasingly require better ESG disclosure, and issuers have responded with better communication on these important topics (and in some cases, more thoughtful ESG strategy).

While the loan market broadly lags other asset classes in terms of ESG adoption/sophistication, Invesco remains a market leader in this area. Invesco introduced first-of-their-kind ESG loan strategies during 2019 and 2020 and we continue to build an ESG-centric investment platform utilizing our proprietary process for evaluating loan issuers' ESG profiles.

In Europe, ESG margin ratchets are often included in new issuance, incentivizing borrowers to reduce their interest costs upon achieving pre-defined ESG goals/KPIs (such as meeting carbon emissions targets). A shift to independent third-party assessment of borrower ESG KPI targets is gaining momentum, a trend that Invesco is actively supporting in the market. Invesco is a member of several influential associations that aim to improve disclosure and lender-must-haves regarding ESG matters.

CLOs represent another frontier of ESG adoption within the loan space. Managers have begun issuing ESG-compliant CLOs which implement negative screening criteria in their indentures. Here again, Invesco is at the forefront of industry change; we manage our ESG-compliant CLO strategy leveraging the same proprietary ESG ratings database utilized by our retail and institutional strategies,[19] extending our ESG commitments deeper into our investment enterprise.

### Investment risks

*The value of investments and any income will fluctuate (this may partly be the result of exchange rate fluctuations) and investors may not get back the full amount invested.*

*Most senior loans are made to corporations with the below investment-grade credit ratings and are subject to significant credit, valuation and liquidity risk. The value of the collateral securing a loan may not be sufficient to cover the amount owed, may be found invalid or may be used to pay other outstanding obligations of the borrower under applicable law. There is also the risk that the collateral may be difficult to liquidate, or that a majority of the collateral may be illiquid. Compared to investment grade bonds, junk bonds involve greater risk of default or price changes due to changes in the issuer's credit quality. Diversification does not guarantee of profit or eliminate the risk of loss.*



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[1] Credit Suisse Western European Leveraged Loan Index (hedged to EUR) as of November 30, 2021.
[2] Credit Suisse Western European Leveraged Loan Index (hedged to EUR) as of November 30, 2021.
[3] Credit Suisse Western European Leveraged Loan Index (hedged to EUR) as of November 30, 2021.
[4] Credit Suisse Western European Leveraged Loan Index as of November 30, 2021.
[5] Credit Suisse Western European Leveraged Loan Index as of November 30, 2021.
[6] Credit Suisse Western European Leveraged Loan Index as of November 30, 2021.
[7] Credit Suisse Western European Leveraged Loan Index as of November 30, 2021.
[8] Credit Suisse Western European Leveraged Loan Index as of November 30, 2021.
[9] S&P European Leveraged Loan Index, through November 30, 2021.
[10] Credit Suisse Western European Leveraged Loan Index (hedged to EUR) as of November 24, 2021.
[11] Credit Suisse Western European Leveraged Loan Index (hedged to EUR) as of November 30, 2021.
[12] Credit Suisse Western European Leveraged Loan Index (hedged to EUR) as of November 30, 2021.
[13] JP Morgan as of November 17, 2021.
[14] S&P LCD Research as of November 30, 2021.
[15] Credit Suisse Western European Leveraged Loan Index as of November 30, 2021.
[16] Credit Suisse Western European Leveraged Loan Index as of November 30, 2021.
[17] S&P LSTA Index / LCD Research as of November 30, 2021.
[18] S&P LSTA Index / LCD Research as of November 30, 2021.
[19] Not all products are available in all regions. Please consult your local Invesco representative for more information.