VIEWPOINT

Syndicated Loans – Floating Rate Stability

March 2018

As base rates move towards more normalised levels, where can fixed income investors seek to gain protection from rising rates and source attractive returns?

Until 2009, senior secured syndicated loans were the dominant sub-investment grade asset class in Europe. In recent years the asset class has once again experienced significant growth and we expect that to continue. Within a changing environment for fixed income investors, we believe the asset class provides a number of features and benefits for investors looking to diversify their fixed income exposure.

Features

Floating Rate Returns

Loans are a floating rate asset class and, in our experience, typically offer mid-to-high single-digit returns through the cycle. They reset their underlying interest rates on a frequent basis – usually every three-to-six months at the discretion of the borrower.

As such, syndicated loans may provide investors with protection from rising rates and so tend to enjoy inflows in periods of rising rate expectations. Fund flow data is not available for Europe due to the absence of retail investors and mutual fund structures. However, looking at flows into US loans, it is clear that recent flows into syndicated loan mutual funds have been closely correlated to rising interest rate expectations. We believe this relationship will play out in the institutional European market as well when rates start to rise locally.

Diversification

The European syndicated loan market, as measured by the Credit Suisse Western European Leveraged Loan Index (CS WELLI), is €222 billion in size and made up of well-diversified corporate exposures from approximately 330 issuers.[1]

The main source of new issuance is private equity-backed leveraged buyout activity, with future supply likely to be driven by the approximate €1 trillion of "dry powder" that private equity firms have available for deployment (source: Prequin, as of 31 December 2017). Index issuer sizes range from €100 million up to €5.7 billion.

Sam McGairl

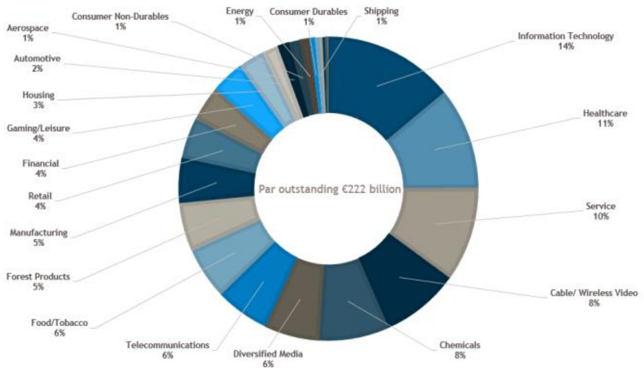
Director, Syndicated Loans

Sam joined Muzinich in November 2016 from ECM Asset Management Limited, where he was a Portfolio Manager responsible for loan and high yield investments in the firm's pooled loan programmes, as well as being responsible for loan trading across all ECM portfolios. Sam has 15 years of experience in leveraged finance and other credit products, having started his career at Bank of Scotland and BNP Paribas before ECM. Sam has a BA (Hons) in French from the University of Newcastle upon Tyne.

While the European syndicated loan market features a broad spread of industries, it has little exposure to financial services, property, energy and commodity firms (Fig. 1). Fluctuations in commodity prices in recent years have therefore not had a significant impact on European syndicated loan credit quality.

Country exposures are weighted towards the Northern European jurisdictions, with a recent feature being an increase in the number of issuers from North America who have issued euro-denominated tranches alongside their US dollar-denominated loans (source: CS WELLI). Issuers from the US now comprise 10% of the CS WELLI, the fifth-largest geography.

Fig. 1 – Sector Breakdown by Market Value



Source: CS WELLI. Totals depicted above may not equate to 100.00 due to the effects of rounding. Data as of February 28th, 2018.

Lower Volatility

In Europe, loans are predominantly an institutional asset class, as the current Undertakings for Collective Investment in Transferable Securities (UCITS) rules place some restrictions on investing in the European syndicated loan market.

This situation is not expected to change in the near future, so the investor base is made up of three main groupings:

Banks

Unlike the US loan market, and contrary to many of the predictions made post-crisis, banks are still an important part of the loan market investor base.

They are often politically motivated to undertake local lending in their own jurisdictions, and access to European Central Bank initiatives such as the long term refinancing operations, have come with the quid pro quo of growing their loan books.

Collateralised Loan Obligations (CLOs)

These have once again become an important part of the European investor base since the market reopened in 2013. The global hunt for yield in 2017 increased demand for the highest-rated CLO liabilities, which encouraged increased European CLO issuance to a post 2008 financial crisis high of €21bn. (Source: S&P Global Market Intelligence, as of 31 December 2017).

CLOs can drive demand for loans and tend to be long term, stable holders of the loan assets which they buy.

Institutional Investors

Usually buying via a specialist manager, investors such as pension funds, insurance companies and family offices take a long-term approach to investing in corporates via the loan market.

Liquidity

European syndicated loans are a well-established asset class, and tend to benefit from a secondary market which trades actively over the counter. Documentation and trading conventions are standardised by the Loan Market Association.

Secondary market activity is seen as a necessary and complementary activity for banks involved in syndicated loan and CLO origination.

Banks and brokers act as intermediaries to facilitate the market liquidity that investors require when investing in European syndicated loans.

Seniority and Security

The European syndicated loan market for institutional investors grew out of the bank lending market in the 1980s and 1990s. As such, it has many features which were initially designed for bank lending.

Most important among these is the position which loans occupy in the capital structure.

As a senior-secured, first-lien lender, loans are the first to get repaid by a borrower. In the event that the borrower defaults, loans enjoy a first-lien claim over substantially all of the assets of that borrower.

On a global basis, first-lien loans have been shown by Moody's to recover 67% in the event of default.[2] Today, senior secured first-lien loans make up 98% of the CS WELLI (as of 31 December 2017).[3]

Why Consider an Allocation?

Attractive Returns

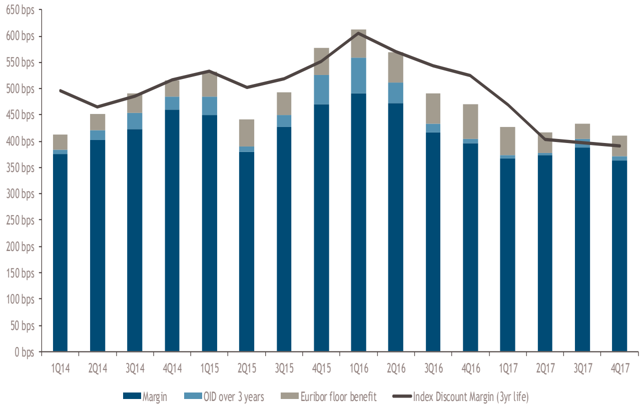
The European syndicated loan market has been a provider of steady mid-single-digit returns through an economic cycle (source: CS WELLI). In today's low yield environment, a relatively stable return of 3.5-4.5% for 2018, in our view, looks particularly attractive.

Returns are driven primarily by the interest margin which borrowers pay over the base rate. Protection from low rates is provided by the near ubiquitous Euribor floors, which almost all syndicated loans have featured in the post-crisis period.

Fig. 2 shows how investors are compensated for the risk taken in new issuance.

Given the supply demand dynamic as it stands, and the prices at which loans are currently trading in the secondary market, access to the primary market is critical for returns, as a way to monetise the new issue premium.

Fig. 2 – Average all-in TLB Spread of New Issue European B-rated Loans Compared to Index Spread (bps)



Sources: New issuance spread data S&P Global Market Intelligence, European Quarterly Review. Index data: CS WELLI Discount Margin (3yr life) average for quarter. Data updated as of December 31st 2017.

Volatility and Correlation

With rising inflationary expectations (notably in the US) and therefore the prospects of higher rates, we have witnessed a broad based increase in volatility in 2018 across most asset classes, apart from loans.

With that in mind, it is worth further examining the performance of European syndicated loans in the context of their volatility and correlation with other credit asset classes.

Syndicated loans tend to exhibit considerably less return volatility than other asset classes (Fig. 3). In fact, for a similar return over the last five years, investors would have had to expect close to double the return volatility.

Similarly, the correlation to other asset classes is limited. Whilst Fig. 4 shows a high correlation to high yield over a five-year period as there is a significant minority of issuers which issue in both markets, the volatility numbers show that, despite the correlation, loans tend to fall less far and more slowly than high yield in periods of volatility.

The lower volatility of returns in the syndicated loan market is due to the make-up of the investor base as we have already discussed. The lack of mutual fund flows differentiate it both from high yield globally, and US syndicated loans.

Fig. 4 - Syndicated Loans' Correlation to Other Asset Classes

5 Year Correlation	CS WELLI	EUR HY (HP4N)
EUR HY (HP4N)	0.7	
Euro Stoxx 50 (ER02)	0.4	0.7
Euro Corp IG 3-5 yr (EN40)	0.3	0.7
German Fed Govt 3-5 yrs (G2D0)	-0.1	0.1

Source: Credit Suisse Western European Leveraged Loans Index (CS WELLI), BofA Merrill Lynch BB-B Euro Currency Non-Financial HY Constrained (HP4N), German Federal Government 3-5yr Index (G2D0), DJ Euro Stoxx 50 (ER02), European Investment Grade (EN40). Data in Table as of December 31st, 2017 - updated quarterly. Calculated based on index returns.

Comparison with Other Asset Classes

What are some pros and cons of syndicated loans versus comparable asset classes? We believe that the two closest asset classes are high yield and private debt.

High Yield

A key difference between the two markets is that high yield bonds are usually fixed rate, while loans are floating rate.

Whilst senior secured high yield issuance has become more common in recent years, the syndicated loan market as a whole contains more first-lien debt than the high yield market, as evidenced by the 98% senior secured makeup of the CS WELLI.

High yield was compensated for this risk, as the five-year annualised return of 5.98% in Fig. 3 shows, but with higher volatility and lower recoveries through a default cycle as Moody's have shown.

Private Debt

Investments in private debt typically enjoy the same senior secured position in the capital structure as syndicated loans, and often with better documentary protection.

The size of the transactions also mean a better headline return and this is delivered on a floating rate basis, as with syndicated loans.

What syndicated loans can offer which private debt cannot, is liquidity. Private debt investments are typically closed end, while loan funds usually offer liquidity to investors.

Fig. 3 Attractive Low Volatility of Returns (Annualised)

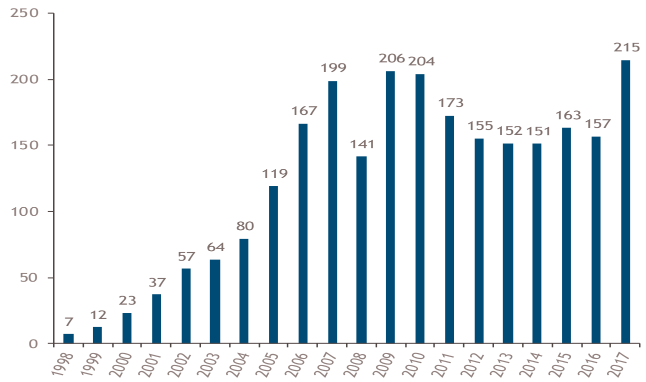
	1 year (%)		3 years (%)		5 years (%)	
	Return	Volatility	Return	Volatility	Return	Volatility
Credit Suisse WELLI (CS WELLI)	2.60	0.94	4.07	2.02	4.53	1.88
Euro High Yield (HP4N)	3.76	1.91	4.35	4.70	5.98	4.24
Euro Corp IG 3-5 Yr (ER02)	1.09	1.17	1.65	1.59	2.77	1.70
German Federal Govt 3-5yr (G2D0)	-1.80	1.40	0.09	1.49	0.73	1.58
Euro Stoxx (SX5E)	3.60	11.22	-1.50	14.87	5.48	14.20

Source: Muzinich analysis, Bloomberg, ICE BofA Merrill Lynch and Credit Suisse Western European Leveraged Loans Index (CS WELLI). Data as of January 2013 to February 28th, 2018. ICE BofA BB-B Euro Currency Non-Financial HY Constrained Index (HP4N), ICE BofA European Corporate 3-5 year Index (ER02), ICE BofA German Federal Government 3-5years Index (G2D0), Euro Stoxx Index (SX5E). Past performance does not guarantee future results.

Positive Technicals

In 2017 the European syndicated loan market saw significant net new issuance (Fig. 5) and we expect this to continue, both from M&A and refinancings from other markets.

Fig. 5 – Growth of European Syndicated Loan Market (EUR bn)

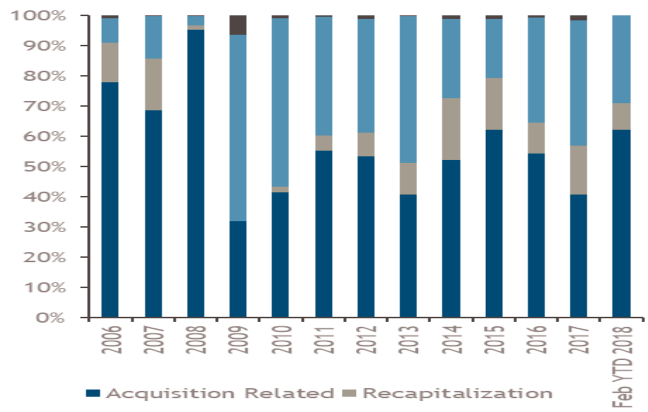


Source: CS WELLI & Leveraged Loan Index as of December 31st, 2017.

Fig. 6 shows the reasons for which new issuance has taken place over the course of the last cycle. In the post-crisis years, from 2010 onwards, acquisition-related issuance made up between 40% and 60% of total new issuance, adding diversity to the market. To the end of February, 2018 has started with 62% of issuance being acquisition related.

We believe this is likely to be driven going forwards by the (already mentioned) €1 trillion of "dry powder" which private equity firms currently have at their disposal.

Fig. 6 – New Issuance Deal Purpose (%)



Source: S&P Global Market Intelligence. Data as of February 28th, 2018.

Solid Fundamentals

The fundamental outlook for European syndicated loans is relatively benign. As mentioned previously, the composition of the market means that the volatility related to commodity-exposed borrowers, which have impacted other similar asset classes, has been largely avoided in the European syndicated loan space.

Leverage levels are close to their long-term average (as assessed by S&P LCD) and interest coverage ratios have improved significantly post crisis. (Source: S&P Global Market Intelligence, as of 28 February 2018.)

Clearly, rising rates could be seen as a headwind for weaker borrowers, but we believe rising rates in Europe should come with an improving macro picture, so Moody's expects baseline default rates for the entire European speculative grade corporate universe to remain low for the next 12 months (Fig. 7).

Defaults in loans will be mitigated by likely strong, first-lien loan recovery rates, shown by Moody's to average 67% on a global basis for the period 1983 to 2017. (Source: Moody's Annual Default Study, as of 15 February 2018.)

Conclusion

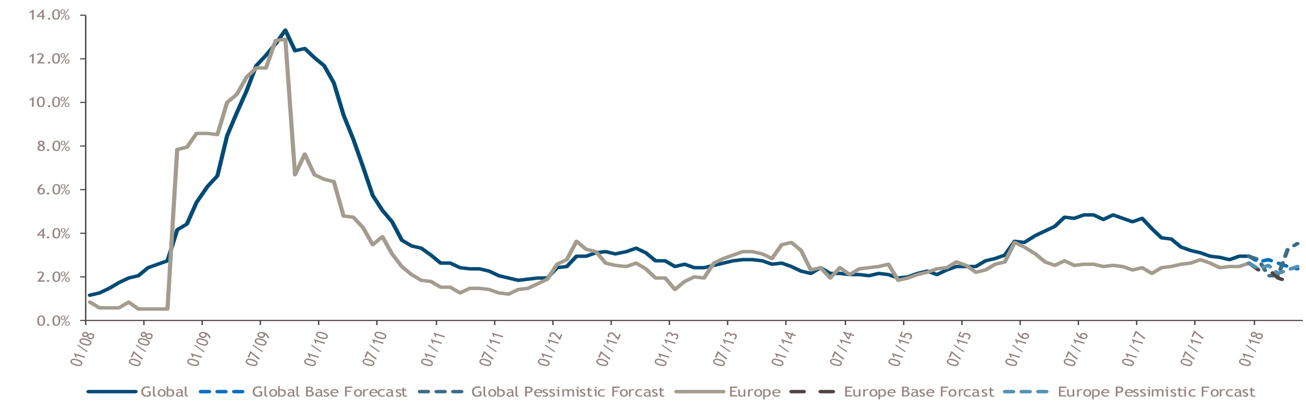
Following years of low to negative base rates and monetary policy easing, central banks globally are now moving towards higher interest rate policies and the gradual removal of quantitative easing.

In such an environment, we believe European syndicated loans can offer investors relatively stable income and protection from rising rates, with floating rate returns expected to be in the mid-to-high single digits through the cycle.

In addition, with abundant dry powder in the hands of private equity investors, we expect the European syndicated loan market to grow in the coming years and become an increasingly important diversifier in the portfolios of investors searching for duration-neutral income.

1. CS WELLI, data as at 28th February 2018
2. Moody's Annual Default study, published February 15th, 2018
3. CS WELLI, data as at 31st December 2017

Fig. 7 – Sub-Investment Grade Default Trends and Forecasts



Source: Moody's Investors Service. Default and Recovery Rates of European Financial and Non- Financial Corporate Issuers. Europe Trailing 12-Month Issuer -Weighted Spec-Grade Default Rate Forecast and Global Trailing 12-Month Issuer-Weighted Spec-Grade Default Rate Forecast. Data as of December 31st, 2017. Updated quarterly. * Moody's Annual Default study, published February 15th, 2018.