European Syndicated Loans - Three Reasons to Consider an Allocation

June 2023

A rising interest rate environment, limited new issue supply and improving lending standards are likely to prove beneficial for the asset class, offering investors a potentially compelling entry point

The value of investments and the income from them may fall as well as rise and is not guaranteed. Investors may not get back the full amount invested

1. Floating Rate Feature Seeks to Enhance Return Potential

Syndicated loans are floating rate credit products. Since the end of July 2022, this feature has enhanced their coupon payments. 3-month Euribor is the most used base rate for European syndicated loans, and borrowers fix this rate every 3 months for the following 3 months. As of 31 May 2023, 3-month Euribor was 3.46%. In addition, the borrower will pay an average margin over this base rate of 3.86%. This takes the average all-in annual coupon above 7.5%. Therefore, in a market without any price volatility or base rate changes, there is the potential to earn 7.5% for the next year. If the European Central Bank (ECB) keeps policy rates elevated for an extended period, this floating rate feature could underpin the performance of European syndicated loans for some time.

Past performance is not a reliable indicator of current or future results Risk: Index performance is for illustrative purposes only. You cannot invest directly in the index.

Fig. 1 - 3-Month Euribor + Margin

Source: Bloomberg and Credit Suisse. Euribor 3 Month ACT/360 Index and Credit Suisse Western European Leveraged Loan Index, as of 31 May 2023. Muzinich views and opinions, for illustrative purposes only. You cannot invest directly in the index.

1 Bloomberg, Euribor 3 Month ACT/360 Index as of 31 May 2023
2 Credit Suisse PLUS. Credit Suisse Western European Leveraged Loan Index, hedged to Euro, and constituents, as of 31 May 2023
Such a level of coupon has not been on offer in the European syndicated loan market since late 2008 when Euribor was more than 5.0%3. The current coupon (7.5%) available provides a substantial buffer to withstand market price volatility in the actively traded secondary loan market and against any potential losses arising from future defaults. Should an investor decide to enter the market today, there would be an additional benefit of buying below par because the weighted average price of the Credit Suisse Western European Loan Index was 94.31 as of 31 May 20232 (the entry price for a strategy incorporating borrowers with higher-than-average credit ratings would be higher but still below par2). Assuming the weighted average price of 94.31 moves closer to par in the future, an investors’ return could be even better than the carry.

A price appreciation of index constituents to par assumes that all businesses/borrowers in the European syndicated loan market will perform well and pay back their loans in full. Whilst the vast majority could be expected to do so, businesses today are facing a challenging economic environment which makes this perfect outcome unrealistic. However, given the carry available in the asset class today to absorb credit losses, significant further price appreciation is not a pre-requisite to make an investment in European syndicated loans an attractive opportunity.

2. Default Rates Expected to be Contained

Default rates are likely to rise above the ultra-low levels of recent years. We believe the driver of this development could come from borrowers struggling with too much debt in over-leveraged capital structures, where the cost of the debt absorbs more than the free cashflow generated by the borrower in any given period.

Absent support from these borrowers’ shareholders (although most European syndicated loan borrowers are owned by private equity funds4 who have demonstrated a willingness in the past to be active and supportive owners), such borrowers would struggle to service unsustainable debt levels.

A second source of potential defaults is term loans maturing during a challenging refinancing environment. In this regard, the European syndicated loans market has a limited number of facilities maturing in 2023 (0.4%) and 2024 (3.2%), whilst that proportion of today’s loan index maturing in 2025 rises to 11.8%2.

3 Bloomberg, Euribor 3 Month ACT/360 Index as of 17 October 2008
4 Pitchbook Leveraged Commentary & Data (LCD), Morningstar European Leveraged Loan Index Factsheet as of 31 May 2023
However, prudent borrowers are already addressing these near-to-mid-term maturity profiles, either by refinancing debt with longer-dated instruments or by amending the terms of their existing facilities to extend maturities through Amend and Extend transactions (A&Es). Arranging banks are helping borrowers to obtain syndicate approval for maturity extensions of 3 to 3.5 years in exchange for enhanced economics such as an increased margin on top of the Euribor base rate and upfront fees known as original issue discounts (OIDs).

The trailing last twelve-month default rate for the European syndicated loan market is currently 1.9%, but the default rate for the wider European speculative grade universe is estimated by Moody’s Investors Service to rise to 3.5% to 4.0% over the next twelve months. However, this forecast remains well below the peak European speculative grade default rate experienced during the global financial crisis of 2008-2009 of approx. 14%.

We expect that the negative impact of credit losses from defaults will be constrained by the seniority of syndicated loans in a borrower’s capital structure and the security that syndicated lenders hold over a borrower’s assets. Historically, recovery rates for first-lien syndicated loans have been 65.7% therefore the potential negative impact on European syndicated loan returns in the next twelve months given the forecast default rate above could be -1.2% to -1.4% compared with the current all-in average coupon for the European syndicated loan market of 7.5%.

3. Limited Supply Likely to Underpin Prices

New issuance in the European syndicated loan market has been limited so far in 2023, totalling approx. €16 billion to 31 May 2023 compared to approx. €25 billion for the same period in 2022 and approx. €64 billion for the first 5 months in 2021. As a result, the focus of loan investors has been firmly on the secondary market, leading to an improvement in the weighted average market price to 94.31 as of 31 May 2023, up from an average of 91.56 as of 31 December 2022.

Whilst banks are accommodating A&E transactions, arranging bank appetite for underwriting new issue syndicated loans in Europe is currently uncertain. Merger & acquisition activity is generally down given the uncertain/challenging global macroeconomic outlook. However, when the new issue market reopens, we expect that lending standards will have improved from the looser terms which dominated new issue loan documentation in 2021 and early 2022. We expect that new issue capital structures will be less aggressive and could offer more attractive pricing to reflect the yields available in the secondary loan market.

A Positive Outlook

The price appreciation of European syndicated loans, combined with the elevated level of carry, have led to a strong performance for the asset class already in 2023. We do not expect a significant uplift in new issue supply in the second half of 2023 and, with syndicated loan coupons at current levels, even an increase in default losses for the market this year could be absorbed without a marked impact on overall returns. Depending on the future policy rate actions of the European Central Bank, the current level of interest income for Euro-denominated syndicated loans could even increase from current levels and may persist well beyond the end of 2023. For these reasons, we believe that European syndicated loans currently provide a compelling investment opportunity.

Risk: Reference to the names of each company mentioned in this communication is merely for explaining the investment strategy and should not be construed as investment advice or investment recommendation of those companies.

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5 Credit Suisse Credit Strategy Default Statistics report, as of 6 June 2023
6 Moody’s Investors Service, Default Trends - Global, April 2023 Default Report and Excel data, as of 14 May 2023
7 Moody’s Investors Service, Default Trends - Global, Annual default study as of 13 March 2023
8 Pitchbook Leveraged Commentary & Data (LCD), European Playbook as of 1 June 2023 and LCD European Playbook as of 1 June 2022
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