For Investment Professionals only

M&G INSTITUTIONAL

Investment intelligence

European leveraged loans: finding risk-adjusted returns in an uncertain world

May 2018

Andrew Boughen, leveraged loans fund manager, explains why European loans have become popular with institutional investors over recent years, how the loan asset class is different from other asset classes and the reasons why it could be an opportune time to invest.

The value of investments will fluctuate, which will cause prices to fall as well as rise and you may not get back the original amount you invested. Wherever past performance is shown, please note that this is not a guide to future performance.

What's your role at M&G?

I am a fund manager on M&G's Leveraged Finance team and have 23 years of experience in the European leveraged finance market. M&G is one of the most established and largest European loan managers, being active in this market for almost 20 years and managing €9.4 billion* of assets on behalf of around 200 institutional clients of varying size.

By investing in this market, we aim to provide investors access to a secured, low duration asset class that offers high, stable income streams, limited correlation with other asset classes and defensive characteristics that can help to minimise credit losses.

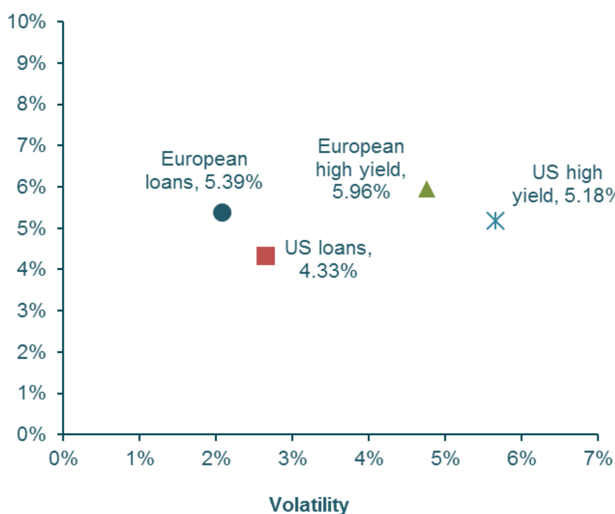
What are the attractions of leveraged loans compared to other asset classes?

European loans are proving very popular with institutional investors as they offer a range of benefits:

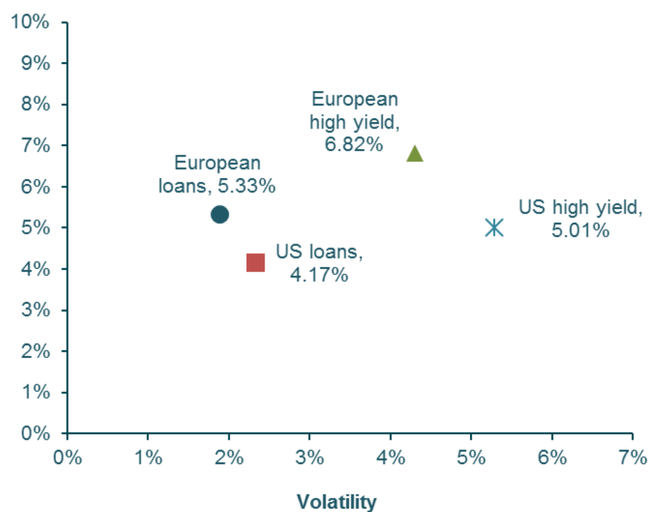
1. **High real and relatively stable returns:** Loans produce medium-term returns of Libor +350 to 400 basis points p.a. which are generated with significantly lower volatility than comparable asset classes.

European loans offer high risk-adjusted and stable returns over time

Reward for risk (three years annualised)



Reward for risk (five years annualised)



Sharpe ratio	European loans	US loans	European high yield	US high yield
Three years	2.16	1.30	1.06	0.75
Five years	2.47	1.52	1.43	0.82

Source: HPIC, EG00, H0A0, Credit Suisse hedged to US dollar and Credit Suisse US Index returns, as at 31 March 2018

*Source: M&G, as at end March 2018

2. **Senior ranking security over a borrower's shares and assets:** If the borrower defaults, senior lenders receive repayment ahead of junior creditors, significantly enhancing recovery rates and minimising credit losses.

3. **Low interest rate duration:** Loans are floating rate instruments with coupons linked to a short-term reference rate, such as three-month Libor, protecting investors against the impact of rising interest rates.

4. **Liquidity and short ramp-up periods:** Loans offer an active secondary market and therefore provide greater liquidity than most forms of private debt.

5. **Diversification:** With over 300 different issuers, the European leveraged loan market – which is similar in size to the high yield bond market at circa €300 billion – gives investors exposure to a diverse range of industries with limited crossover to other markets.

What are the investment risks and how can lenders mitigate them?

As with all asset classes, leveraged loans feature some potential investment risks, including:

- **Credit and default risk** – this is sub-investment grade lending to leveraged companies, so over time some credit deterioration leading to downgrades and even defaults are likely to occur. This risk, however, is partly mitigated by the senior secured nature of the loans, which ensures the lenders receive priority repayment in the event of a default.

  While these risks shouldn't be underestimated, our experienced teams make the most of their rigorous research and analytical skills to identify – and mitigate – potential risks before investing. It is important to note that European loans, unlike high yield bonds and to a far greater extent than US loans, are private debt instruments and lenders receive information on borrowers that is not available in the public domain. This helps well-resourced managers with dedicated private loan analysts and access to a large range of lending opportunities, to deeply analyse borrowers before investing and therefore to be highly selective, minimising defaults and losses.

  Selectivity on which loans make it into a portfolio is very important – M&G has declined around 60% of all the deals it has been shown, enabling it to demonstrate a much lower level of defaults than the overall market.

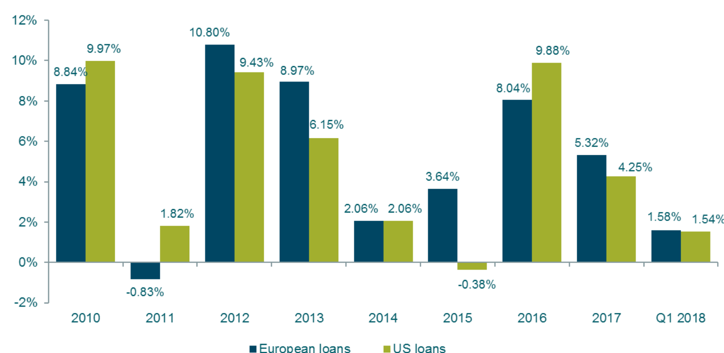
- **Prepayment risk** – loans are generally prepayable on demand without penalty, so investors face re-investment risk where a borrower chooses to repay their debt early. The annual prepayment rate in Europe is currently at around 30%. To counter this, it is important to invest in the asset class through a manager with strong access to loan assets.

- **Liquidity risk** – while loans are more liquid than other forms of private debt, they are less liquid than the mainstream bond and equity markets so do come with a degree of liquidity risk, created both by longer settlement periods and by times of market stress – which can make it harder to trade or sell loans. Large pooled funds offering regular dealing dates can partially lessen this risk.

How do the European and US leveraged loan markets differ?

European leveraged loans have similar characteristics to the larger US loans market, but have a more stable, institutional-only investor base, which has resulted in higher returns and lower volatility over a long period of time.

European loan returns traditionally exceed those of the US



Annualised total return	European loan index*	US loan index	Differential
Last three years	5.39%	4.33%	106bps
Last five years	5.33%	4.17%	116bps

Source: Credit Suisse, as at 31 March 2018. *Hedged to US dollar

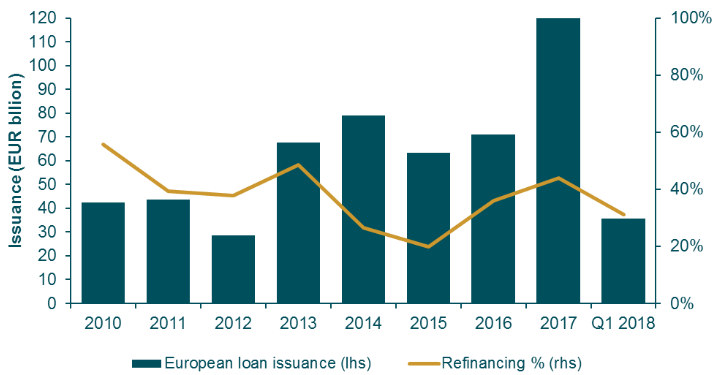
There is no retail investor base in Europe because of regulatory restrictions – the main lenders are banks, collateralised loan obligations (CLOs), and long-term, unlevered investors like pension funds and insurers. Therefore, demand is more stable than in the US loans market where daily dealing mutual funds and indeed exchange-traded funds (ETFs) are significant participants, adding a greater level of volatility to market flows and stability.

This is a differentiating characteristic of the European loan market and one that is likely to remain for the foreseeable future to the benefit of those investors who can participate in the market.

Is this a good time to invest?

We think the investment case for European loans persists, underpinned by solid market fundamentals. Corporate performance is strong, loan defaults are very low, and boosted by strong European corporate activity and a significant level of private equity fundraising, the outlook for M&A-related leveraged loan issuance remains very supportive.

European loan issuance, 2010 to Q1 2018



Source: S&P Capital IQ LCD, as at 31 March 2018

The level of M&A is particularly important because corporate deal-making Is the biggest driver of our market. The first quarter of this year saw €35 billion of new loans issued – far higher than average – and notably including some jumbo deals with the promise of more to come. Big, divisional sales like Flora – Unilever's €7 billion spreads business – sold to KKR in Q1, will soon be joined by the €10 billion spin-out of the Specialty Chemicals division of Akzo Nobel, creating the largest deal the European loan market has seen since Alliance Boots, a decade ago.

Healthy supply keeps the market in balance, helping to ensure that returns and terms remain attractive for investors.

What are the benefits of including loans in an investment portfolio?

European leveraged loans offer investors high risk-adjusted and stable returns. Due to favourable asset and investor characteristics, loans have been less volatile than the public high yield and US loan markets, respectively, for a long period of time.

While benefiting from the advantages of private debt asset classes, loans offer significantly more liquidity than other private debt asset classes. There is an established secondary loan market and many managers, including M&G, can offer immediate investment through open-ended pooled funds with no ramp-up period, and regular (at least monthly) dealing dates.

As the asset class sits at the crossroads between the public debt markets and the less-liquid private debt markets that operate in Europe, we consider it to be a logical starting point to invest in high yielding European credit.

Contact

Benelux

Stefan Cornelissen
+31 (0)20 799 7680
stefan.cornelissen@mandg.co.uk

Sjoerd Hoogeveen
+31 (0)20 799 7682
sjoerd.hoogeveen@mandg.co.uk

Luuk Veenstra
+31 (0)20 799 7685
luuk.veenstra@mandg.co.uk

Katya De Graaf
+31 (0)20 799 7791
katya.degraaf@mandg.co.uk

Nordics

Billyana Kuncheva
+358 (0)9 4159 0488
billyana.kuncheva@mandg.co.uk

Anna Louise Klintman
+44 (0)203 790 1127
anna.louise.klintman@mandg.co.uk

Robert Heaney
+46 (0)8 5025 6529
robert.heaney@mandg.co.uk

Switzerland

Manuele De Gennaro
+41 (0)43 443 8206
manuele.degennaro@mandg.co.uk

Mersiha Markovic
+41 (0) 43 443 8217
mersiha.markovic@mandg.co.uk

www.mandg.com/institutions
institutional.investors@mandg.co.uk

The value of investments will fluctuate, which will cause prices to fall as well as rise and you may not get back the original amount you invested.

For Investment Professionals only.

This guide reflects M&G's present opinions reflecting current market conditions. They are subject to change without notice and involve a number of assumptions which may not prove valid. Past performance is not a guide to future performance. The distribution of this guide does not constitute an offer or solicitation. It has been written for informational and educational purposes only and should not be considered as investment advice or as a recommendation of any security, strategy or investment product. Reference in this document to individual companies is included solely for the purpose of illustration and should not be construed as a recommendation to buy or sell the same. Information given in this document has been obtained from, or based upon, sources believed by us to be reliable and accurate although M&G does not accept liability for the accuracy of the contents.

The services and products provided by M&G Investment Management Limited are available only to investors who come within the category of the Professional Client as defined in the Financial Conduct Authority's Handbook.

M&G Investments is a business name of M&G Investment Management Limited and is used by other companies within the Prudential Group. M&G Investment Management Limited is registered in England and Wales under number 936683 with its registered office at Laurence Pountney Hill, London EC4R 0HH. M&G Investment Management Limited is authorised and regulated by the Financial Conduct Authority. **MAY 2018 / IM-1748_EU (C)**