PGIM FIXED INCOME

PART FOUR

CREDIT SELECTION SUPPORTS THE ALLURE OF EUROPEAN LOANS

By PGIM Fixed Income's European Leveraged Finance Team

- **Households, pensioners, and investors across Europe are scrambling to keep up with inflation. Our previous posts showed that high-yield bonds can generate attractive inflation-adjusted returns amidst historically low default rates.**
- **European senior secured loans share some of high-yield bonds' qualities with additional features. Loans' floating-rate coupons rise as interest rates go up, they sit higher in a company's capital structure than unsecured bonds, and loan prices are historically less volatile than bond prices.**
- **However, benefitting from these attributes requires accurate credit selection as Europe approaches an expected economic contraction and issuer interest costs continue to rise in 2023. Hence, the following points—culminating with our views on how the asset class may perform under certain scenarios—pertain to asset allocation and credit selection considerations regarding European senior secured loans.**

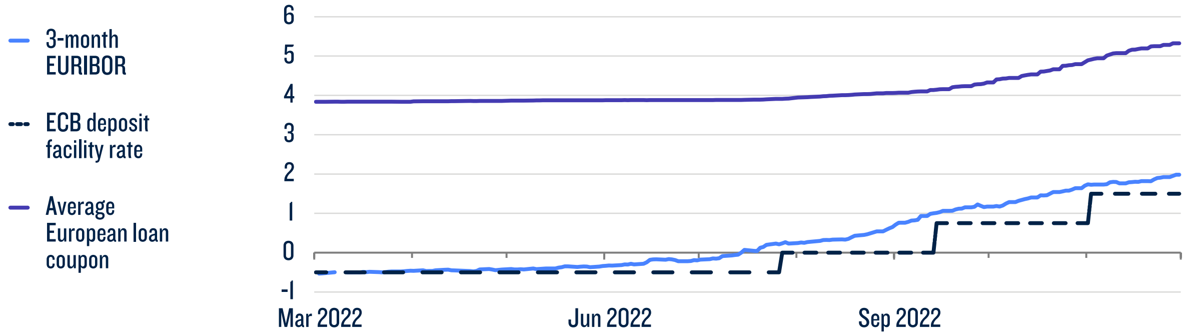
1. European loans pay a credit spread (or discount margin) over 3-month Euribor, a benchmark interest rate.

As the European Central Bank (ECB) hiked its main interest rate from -0.50% to 1.50% this year, Euribor rose from -0.57% to 1.97% by November-end. As a result, loan coupons climbed from 3.77% at the beginning of 2022 to 5.32% at the end of November (Figure 1). Additional increases may be forthcoming with the ECB's expected 50 bps rate hike in December. Subsequent 25 bps increases next year may bring the deposit rate to around 2.5-3.0% by the end of 2023.

While floating-rate coupons point to the potential for greater income generation, they also contribute to loans' minimal durations, which provide a defensive element for those seeking to limit interest-rate risk. For reference, the benchmark European high yield bond index had a duration of 3.2 years as of late November.

Figure 1: The ECB's rate hikes in 2022 have boosted loans' floating-rate coupons.

(%)



Source: PGIM Fixed Income, ECB, Credit Suisse as of November 30, 2022.

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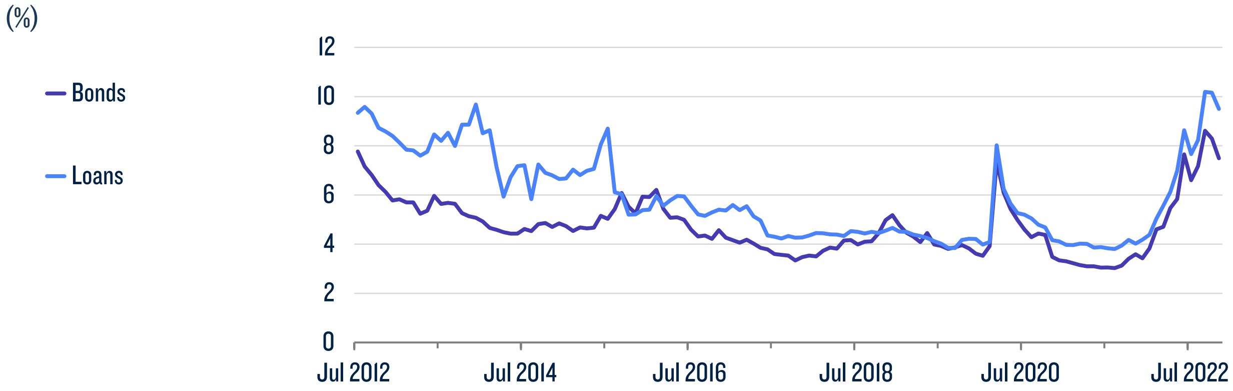
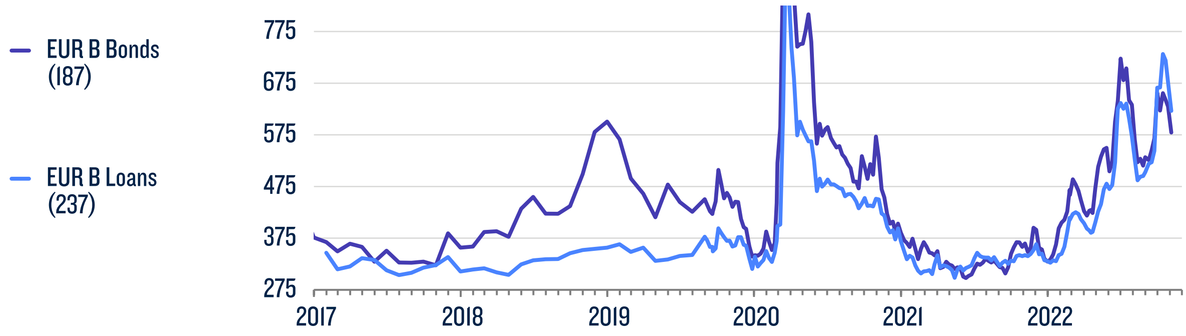
Figure 2: European loans offer higher yields than European high-yield bonds.



Source: PGIM Fixed Income, ICE BofA European High Yield Index, and Credit Suisse Western Europe Leveraged Loan Index as of November 30, 2022.

Figure 3: Loans trade with a wider spread than similarly rated secured bonds.



Source: PGIM Fixed Income as of November 4, 2022.

2. Loans are secured by creditors' assets and sit near the top of the capital structure. This may be viewed as another defensive attribute as the European economy slows and impacts highly levered companies.

Recovery rates depend on an issuer's degree of asset coverage, which fluctuates depending on leverage levels and assets available for collateral. Thus, asset coverage levels may decline during a recession, but, in Europe, they are starting from a healthy spot as they are currently higher than they were heading into the COVID pandemic. With that context, the historical recovery rate (2011-2022) on defaulted European loans is 66%. By contrast, over half of European high-yield bonds are "unsecured" or "senior subordinated" debt. Therefore, their historical recovery rate is lower at around 50%.

While the loan market's average credit rating is lower than high yield bonds', we believe loan issuers have adequate cushion heading into 2023. As a rule of thumb, a loss in the event of default typically occurs once the enterprise value of a company deteriorates below the value of its outstanding debt, i.e., a loan-to-value (LTV) ratio of more than 100%. Yet, the market's average LTV currently stands at 55%. Furthermore, the pace at which these companies have refinanced in 2021-22 means that few are likely to exhaust liquidity in the near future. Hence, our benign default outlook for senior loans (see the following section) and high yield bonds in 2023.

Although we expect a recession in Europe as well as declining corporate EBITDA and earnings, which will lead to an increase in LTV ratios and defaults over time, we believe current loan prices and credit spreads more than compensate for the cooler economic climate.

3. European loan yields are higher than those on European high-yield bonds.

The average yield-to-maturity on European senior secured loans was 9.5%, around 2 percentage points higher than European high-yield bonds as of late November (Figure 2). That differential could expand further with the ECB's additional rate hikes.

That relationship is logical given that around 76% of European loans are rated "B" while 69% of European high-yield bonds are rated "BB." When viewed on the

Outlook: PGIM Fixed Income's three scenarios for 2023

1
MODERATION

Inflation moderates towards pre-pandemic levels. Economic growth stabilises around 1%-2%. Issuers' revenues continue to grow.

Loan yields moderate from current levels into 2023. The default rate picks up only modestly.

2
RECESSION

Inflation falls back to trend or below. But the economy shrinks in a mild recession. Issuers' revenues suffer, but central banks moderate their rate hikes.

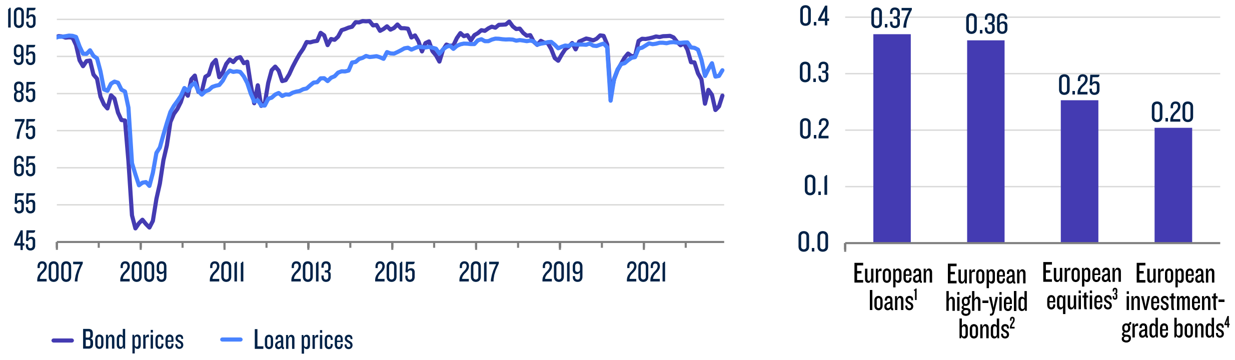
Loan yields rise and defaults increase. But most companies cope as corporate balance sheets are strong, and few maturities are due in coming years.

3
STAGFLATION

Inflation remains fairly high and the economy is sluggish for a sustained period of time, perhaps due to the European energy crisis. Issuers' revenues struggle. Central banks have to keep raising interest rates to subdue inflation.

Loan yields rise significantly and defaults pick up.

Figure 4: When interest rates rise, loans and their limited durations hold their value better than bonds. Loans also present attractive Sharpe ratios relative to other European asset classes.
(left graph: bond prices and loan prices (indexed, 29 Dec 2006 = 100); right graph: market-representative Sharpe ratios)



Source: PGIM Fixed Income, ICE BofA, Credit Suisse, and Bloomberg as of November 30, 2022. [1] Credit Suisse Western Europe Leveraged Loan Index. [2] Ice BofA European Currency High Yield index. [3] Stoxx Europe 600 Index. [4] Ice BofA Euro Corporate Index.

basis of credit spreads on B rated loans and secured bonds, loans also provide 50 bps in additional spread (Figure 3).

The combination of these factors—including loans' minimal durations—contributes to relatively stable prices, particularly when interest rates rise, as well as compelling Sharpe ratios compared to high yield bonds (Figure 4).

Against that background, in our accompanying moderation and recession scenarios, our analysis foresees a benign loan default forecast of only 2% to 3% per annum, before recovery, between now and 2028. Only in severe stagflation, with a collapse in corporate valuations, do we foresee higher default rates.

Conclusion

Today may not be the trough of prices on European senior secured loans. However, the current environment presents an attractive entry point into the asset class for those drawn by its floating-rate coupons, minimal durations, and seniority in the capital structure. That said, these are loans to highly levered companies, and accurate credit selection is key to benefitting from their attributes as a European recession lies on the horizon.

With that backdrop, we're generally avoiding cyclical and consumer discretionary names, while finding opportunities in non-cyclical credits. Yet, as the credit and economic cycle progresses, we may actively adjust that positioning to continuing benefitting from loans' alluring characteristics.

SPOTLIGHT

THE VALUE OF ACTIVE LOAN PORTFOLIO MANAGEMENT

Rising yields have started to impinge on free cash flows in the senior secured loan and the bond markets. It's another factor that underscores the importance of credit research and active management in order to avoid companies that will suffer most from rising interest costs.

Credit research remains paramount given our forecast that the Eurozone economy will shrink by 0.9% in 2023. B3 and CCC-rated companies will likely suffer the most credit stress from higher interest rates and a slowing economy, which may force them to raise additional capital, e.g., senior debt, subordinated securities (including preferred shares), or equity via a rights issue. However, that stress is unlikely to emerge before 2024 given that most of this cohort refinanced in 2021-22.

Credit analysts' assessment of downside and worst-case scenarios allows portfolio managers to avoid issuers and industries in secular decline. Remember, for instance, the collapse of Yellow Pages businesses across Europe in the late 2000s as consumers turned to internet searches.

Credit research also allows managers to avoid businesses that are likely to suffer from idiosyncratic problems. In the current climate, we're focused on avoiding many consumer discretionary and cyclical businesses, which may suffer from Europe's weakening economic environment.

The "death of the high street," for example, has been on people's minds for a while. We have been keen to avoid many bricks-and-mortar retailers given the online competition and consumers' cost of living crisis. Chemicals firms, travel operators, as well as hotels and restaurants are also high on our list of industries of concern.

On the bright side, our credit research has identified non-cyclical sectors that can perform well even in a downturn. These include business services, telecommunications, and consumer staples, such as food and healthcare firms.

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Source(s) of data (unless otherwise noted): PGIM Fixed Income, as of 30 November 2022.

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