ICG

Credit Fund Management

September 2021

For institutional/professional/accredited investors only

Opportunities in senior secured loans remain as technical drivers diverge

Overview

- Senior secured loans offer attractive absolute value in both Europe and the US.
- Technical drivers have diverged in the European and US loan markets. Market technicals in Europe are enhancing absolute returns whilst technicals in the US are supporting further compression.
- European loans benefit from the structural pricing discipline of Collateralized Loan Obligation ("CLO") managers as CLO AAA spreads are widening, thereby requiring a wider spread on loans.
- US loans benefit from spread compression, supported by strong technical demand from robust CLO new issuance and retail inflows.
- Globally, rating agencies are unwinding the flood of pandemic-driven downgrades that left many loans mispriced. This positive rating migration unlocks demand for loans from rating-sensitive CLO buyers.

Peter Swanson
Senior Credit Trader,
Credit Fund Management

Nikolai Hartley
Credit Trader,
Credit Fund Management

Loans have continued to rally this year as the market has normalised, driven by vaccine deployment and economic reopening. Our base case remains that spreads will continue to compress over the remainder of the year, driven by improving corporate fundamentals and increased cash flow.

Although the opportunity set is evolving, senior secured loans continue to offer attractive absolute value. Both European and US loans stand to benefit from positive rating migration and market-specific factors. Temporary technical factors are aligning to enhance the return set for European loans, making them particularly attractive. By contrast, the US supply-demand dynamic has created a strong and persistent backdrop that should drive further compression.

Given the broad price appreciation over the last year, a selective alpha-led approach is best equipped to navigate the current environment.

icgam.com

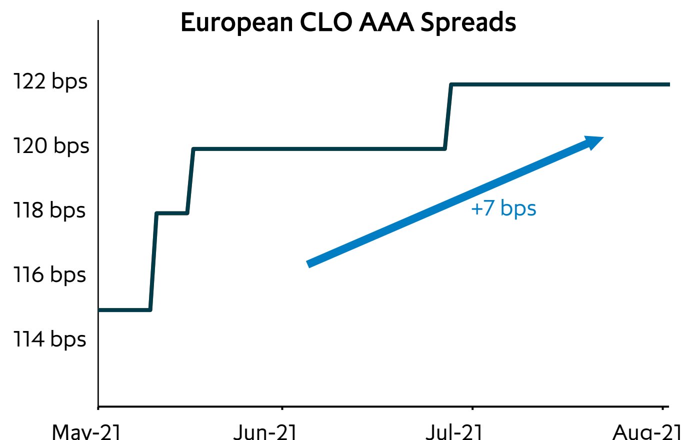
company/intermediate-capital-group

A tale of two markets: diverging technical drivers create opportunities on both sides of the Atlantic

CLOs have traditionally driven European loan demand. A CLO is a securitisation backed predominantly by a diversified portfolio of senior secured loans against which a series of debt obligations or "tranches" are issued. The cash flow generated from the portfolio of loans is used to pay principal and interest on the CLO's debt obligations. The difference between the interest generated by the portfolio and the interest cost of the CLO tranches is known as the "CLO arbitrage". The CLO AAA tranche is typically around 65% of the capital structure, and is therefore the most significant part of the debt cost.

European AAAs are widening

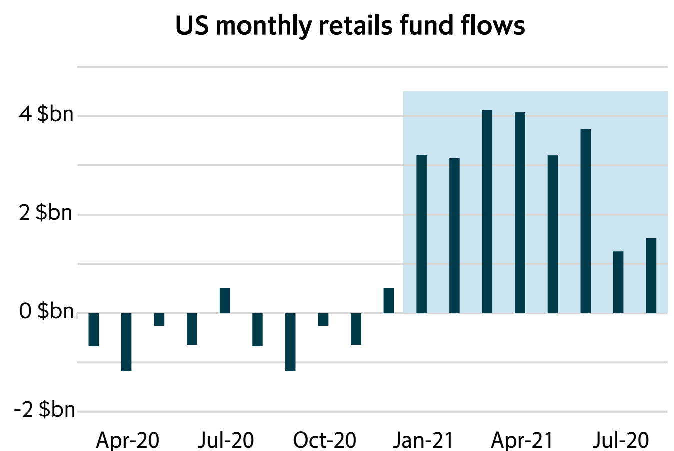
The recent widening of European CLO AAA spreads has made the CLO arbitrage more challenging and driven European investors to require wider spreads on loans. For example, the weighted average loan spread required to make the arbitrage work has increased over the last quarter from Euribor +350 to Euribor +375. The structural pricing discipline has made European loan spreads more attractive in the short term by reducing pricing competition.



Source: Citi as at 9th September 2021

Robust and persistent retail inflows

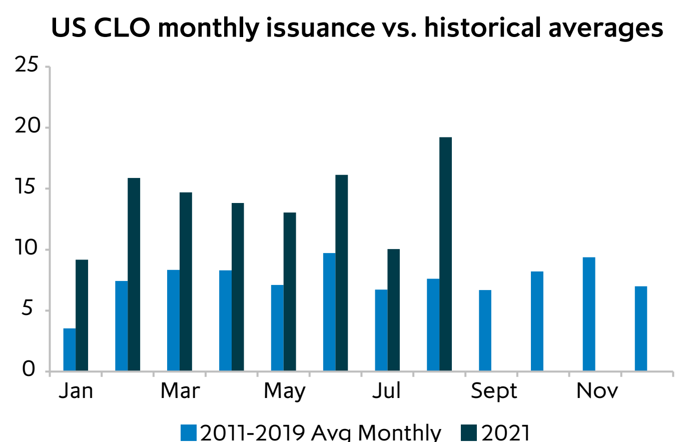
By contrast, US retail appetite for the senior secured loan asset class remains relentless, with a year-to-date net inflow totalling $31.7bn through the end of August. This is in stark contrast to the outflows we have witnessed recently from high yield bond funds. This year's rate volatility and lingering inflation concerns combined with attractive absolute yields should sustain retail investors' demand for loans.



Source: JP Morgan, Lipper as at 31st August 2021

Strong US CLO formation

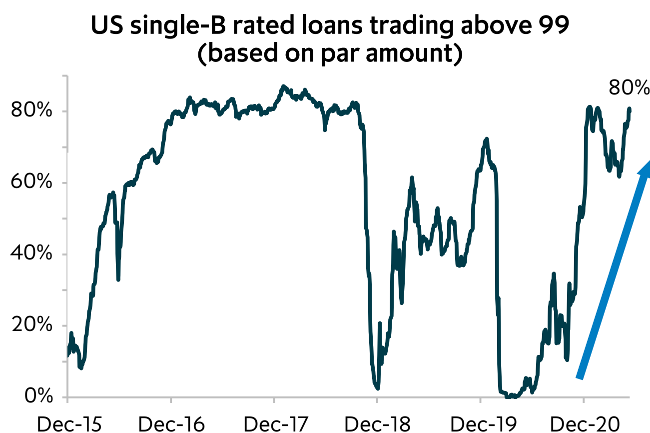
New CLO issuance is an additional driver of demand with a monthly record $19bn created in August alone, bringing the year-to-date total to $112bn, up 126% compared to 2020 and up 36% compared to 2019. The continued attractive economics of the US CLO arbitrage, along with insatiable demand for high-grade credit, means CLO formation activity is likely to remain busy. These dynamics could persist and drive further spread compression and resulting price appreciation.



Source: S&P LCD as at 31st August 2021

Reprice risks increase as US loans trade higher

As US loan prices have risen, the greater portion of loans trading near or above par has increased the potential risk of spread compression due to refinancings and repricings given loans' lack of hard call protection. In this environment, careful asset selection is key to capture spread compression from price appreciation and avoid exposure to refinancing/repricing driven spread compression.



Source: Credit Suisse as at 31st August 2021

European issuance pricing is cheap versus US issuance

Substantial new issue supply generated through financial sponsor activity and corporate M&A have globally provided the chance to make differentiated credit decisions and drive pricing. Primary issuance has been strong with issuance at +113% year-over-year (€107bn versus €50bn) in Europe and +149% year-over-year in the US ($390bn versus $157bn). Primary issuance in Europe is relatively attractive compared to the US with the value of the 0% Euribor floor being larger than the value of the US Libor floor, particularly when we take into account the forward structure of rates. For example, in both the recent Anticimex and Apex deals, the EUR transaction not only priced wider due to the previously mentioned demand technical, but additionally benefitted from its 0% Euribor floor.

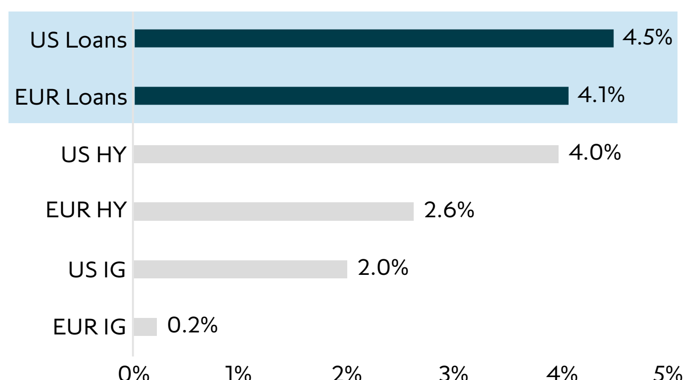
ANTICIMEX	
EUR: 447 3Y-spread (bps)	**USD: 408** 3Y-spread (bps)
Tranche: TLB2 7Y €685M	Tranche: TLB1 7Y $815M
Margin: E+375	Margin: L+350
Floor: 0.00% (3M Euribor -0.54%)	Floor: 0.50% (3M Libor 0.13%)
OID: 99.5	OID: 99.5

APEX	
EUR: 470 3Y-spread (bps)	**USD: 425** 3Y-spread (bps)
Tranche: TLB2 7Y €435M	Tranche: TLB1 7Y $900M
Margin: E+400	Margin: L+375
Floor: 0.00% (3M Euribor -0.54%)	Floor: 0.50% (3M Libor 0.13%)
OID: 99.5	OID: 99.75

Attractive relative value

Globally, the case for senior secured loans remains supported by their attractive return profile and from positive rating migration. Both in Europe and the US, loans continue to offer an attractive absolute return and offer better relative value compared to high yield bonds.

Cross asset yield terrain as of August 2021

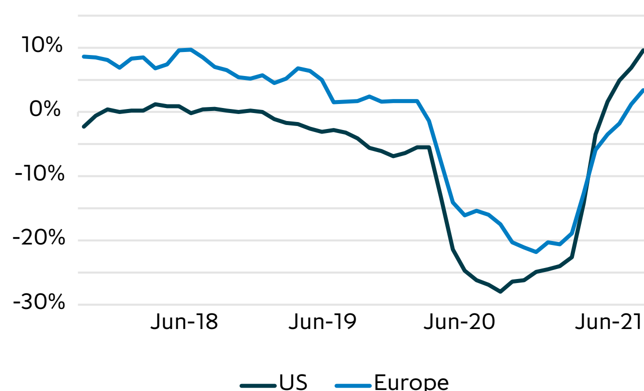


Source: Credit Suisse, ICE BofA as at 31st August 2021

Ratings tailwinds

As discussed in our white paper published in May 2021 , rating agencies aggressively downgraded credits in the early phases of the pandemic. With default rates remaining benign, we see this as too pessimistic, particularly for senior secured loans, where sponsors have been supportive and loan-to-values remain low. Globally, CLO demand is highly sensitive to ratings. COVID-19 driven downgrades have created an opportunity for rating-agnostic credit investors to capitalise on forced selling. Detailed bottom-up credit analysis combined with rising public and private equity valuations provide comfort to those taking advantage of these pricing dislocations.

Ratings drift LTM



Source: Moody's as at 31st August 2021. Rolling 12 month rating drift defined as (notches up-notches down)/issuers

Opportunities remain with credit selection paramount

The differing global technical factors provide an opportunity to exploit loan mispricings arising from a rating and arbitrage constrained CLO investor base. We continue to believe that these factors provide an opportunity to return more than just the coupon. In the US, the sustained CLO bid and retail inflows could drive further compression providing the opportunity to capitalise on price appreciation. In Europe, the challenged CLO arbitrage has reduced pricing competition for loans enhancing the returns available in the region. Broadly, opportunities still remain to buy discounted assets that should benefit from the ongoing positive rating migration driven by the global economic reopening. Diligent portfolio construction and careful credit selection across the globe is needed to navigate these technicals. Ultimately, loan spreads remain too wide relative to the fundamental risk of loss, given security, seniority and private equity support. Investors need a manager with in-depth research capabilities, careful portfolio construction and a global reach to best position for these dynamics.

ICG

Disclaimer

This is a marketing material. For institutional/professional/accredited investors only. This document is being provided to you by the subsidiaries or affiliates of Intermediate Capital Group plc ("ICG", and together with their respective directors, officers, employees, partners, members, shareholders, advisers and agents, as the context requires, "the ICG Parties") on a strictly confidential basis and no part may be reproduced or redistributed in any form, by any means without the prior express written consent of ICG. This document is intended only for information purposes and convenient reference and does not create any legally binding obligation on any of the ICG Parties. The ICG Parties expressly disclaim any liability for the use, misuse, or distribution of this information to unauthorised recipients. Past performance is not necessarily indicative of future results, and there can be no assurance that the Fund will achieve comparable results or that the Fund will be able to implement its investment strategy, achieve its investment objectives or avoid substantial losses

This document: (i) is not intended as an offer or solicitation with respect to the purchase or sale of any security or financial instrument; (ii) is not to be relied upon in evaluating the merits of investing in any securities; and (iii) is provided solely as reference material for background purposes. You should be aware that investing in a fund sponsored by ICG (an "ICG Fund") involves a high degree of risk, and there can be no assurance that an ICG Fund's investment objective will be achieved or that you will receive a return on your capital. The possibility of partial or total loss of capital from an investment in an ICG Fund will exist and you must be prepared to bear such losses. You should refrain from investing in an ICG Fund unless you fully understand all the risks involved and you independently determine that the investment is suitable for you. ICG is not your designated investment advisor.

ICG may encounter potential conflicts of interest in connection with the activities of an ICG Fund. Please see the applicable ICG Fund's offering memorandum or any other such similar documents for additional information. A private offering of interests in an ICG Fund may only be made pursuant to the final confidential private placement memorandum for the fund and any supplements (or any other such similar documents) thereto (the "Memorandum") and the fund's governing and subscription documents (together, the "Offering Documents"), which may be furnished to qualified investors on a confidential basis at their request for their consideration in connection with such offering. The information contained herein will be superseded by and is qualified in its entirety by reference to the Offering Documents, which contains additional information about the investment objective, terms and conditions of an investment in the fund and also contains tax information and risk and conflict of interest disclosures that are important to any investment decision regarding the fund. No person has been authorized to give any information or make any representations other than as contained in the Memorandum and, if given or made, any such information or representation must not be relied upon as having been authorized by the fund or any of the ICG Parties. A prospective investor should not invest in any fund interests unless satisfied that it (alone or together with its investment representative) has asked for and received all information that would enable the investor (or both of them) to evaluate the merits and risks of the proposed investment.

Although certain information has been obtained from, and is based upon sources that we consider reliable, none of the ICG Parties guarantee its accuracy, and it may be incomplete or condensed. All opinions, projections and estimates constitute the judgement of the ICG Parties, as of the date of the document and are subject to change without notice. The ICG Parties make no representation or warranty, express or implied as to the fairness, correctness, accuracy or completeness of this document. The ICG Parties accept no responsibility for any loss arising for any action taken or not taken by anyone using the information contained herein. This document is not to be relied upon in substitution for the exercise of independent judgment. ICG may have issued, and may in the future issue, other communications that are inconsistent with, and reach different conclusions from, the information contained herein. This document reflects the different assumptions, views and analytical methods of the analysts who prepared them and ICG is under no obligation to ensure that such communications are brought to the attention of any recipient of this document. Past performance should not be taken as an indication or guarantee regarding future performance, and no representation or warranty, express or implied is made regarding future performance. Moreover, certain information contained herein constitute "forward-looking statements," which may be identified by the use of forward-looking terminology such as "may," "will", "should," "expect," "anticipate," "target," "project," "forecast," "estimate," "intend," "continue" or "believe," or the negatives thereof or other variations thereon or comparable terminology. Any forward-looking statements or results in this presentation are based upon current assumptions, may be simplified and may depend on events outside ICG's control. Due to various risks and uncertainties actual events or results or the actual performance of the fund may differ materially from those reflected or contemplated in such forward-looking statements. Statements herein are made as of the date hereof unless stated otherwise herein

This document has been issued and approved for distribution by ICG Europe SARL, a wholly- owned subsidiary of ICG PLC and authorised and regulated by the Luxembourg Commission de Surveillance du Secteur Financier, with delegated management to Alternative Investment Limited (ICG AIL) also a wholly- owned subsidiary of ICG PLC and authorised and regulated by the UK Financial Conduct Authority [FRN:606186]. Both IGC Europe SARL and ICG AIL has filed certain portions of Form ADV with the US Securities and Exchange Commission (SEC) as an exempt reporting adviser and have certain limited reporting obligations to, and may be subject to examination by, the SEC, but is not registered as an investment adviser under the US Investment Advisers Act 1940. This document is not intended to provide, and should not be relied upon, for accounting, legal, tax advice or investment recommendations. You should consult your tax, legal, accounting or other advisors about the issues discussed herein. This document is neither investment research nor a research recommendation as defined by the FCA.

For the avoidance of doubt, this document will not be issued to or directed at, and any investment in an ICG Fund will not be available to, persons in any country where such actions would be contrary to local laws or regulations in that relevant country. This document is not intended for distribution to or use by any person or entity in any jurisdiction or country where such distribution or use would be contrary to local law or regulation.

icgam.com

company/intermediate-capital-group

Intermediate Capital Group plc
Procession House,
55 Ludgate Hill,
London, EC4M 7JW
Tel. +44 20 3545 2000 icgam.com