Allspring

MARKETING COMMUNICATION

Five Reasons to Buy European Loans

In a world where interest rates may remain higher for longer and geopolitical risks are elevated, investors are torn between seeking yield and preserving capital. European loans stand out as an asset class that can help investors pursue both goals in this challenging environment.

Key benefits of European loans

01 European loans offer **high levels of income**

02 Senior-secured status provides **strong creditor protection**

03 European loans provide investors with **diversification benefits**

04 Fundamental and technical factors support **strong expected risk-adjusted returns**

05 European loans offer an attractive **alternative to direct lending**

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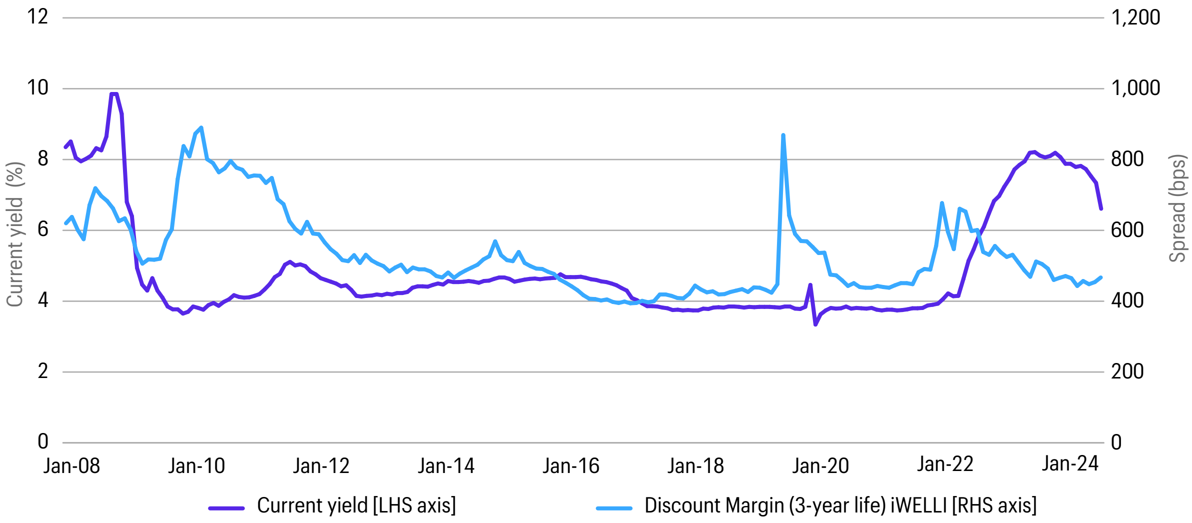
01 European loans offer high levels of income

Following their steep sell-off in 2022, European loans continue to offer attractive yields. Loans provide an approximate 4.35% margin over the Euro Interbank Offered Rate (EURIBOR) and a current yield of 6.6%, as shown in Figure 1.

FIGURE 1: EUROPEAN LOAN ALL-IN YIELDS ARE NEAR 10-YEAR HIGHS



Sources: Allspring, S&P UBS as at 31 December 2024

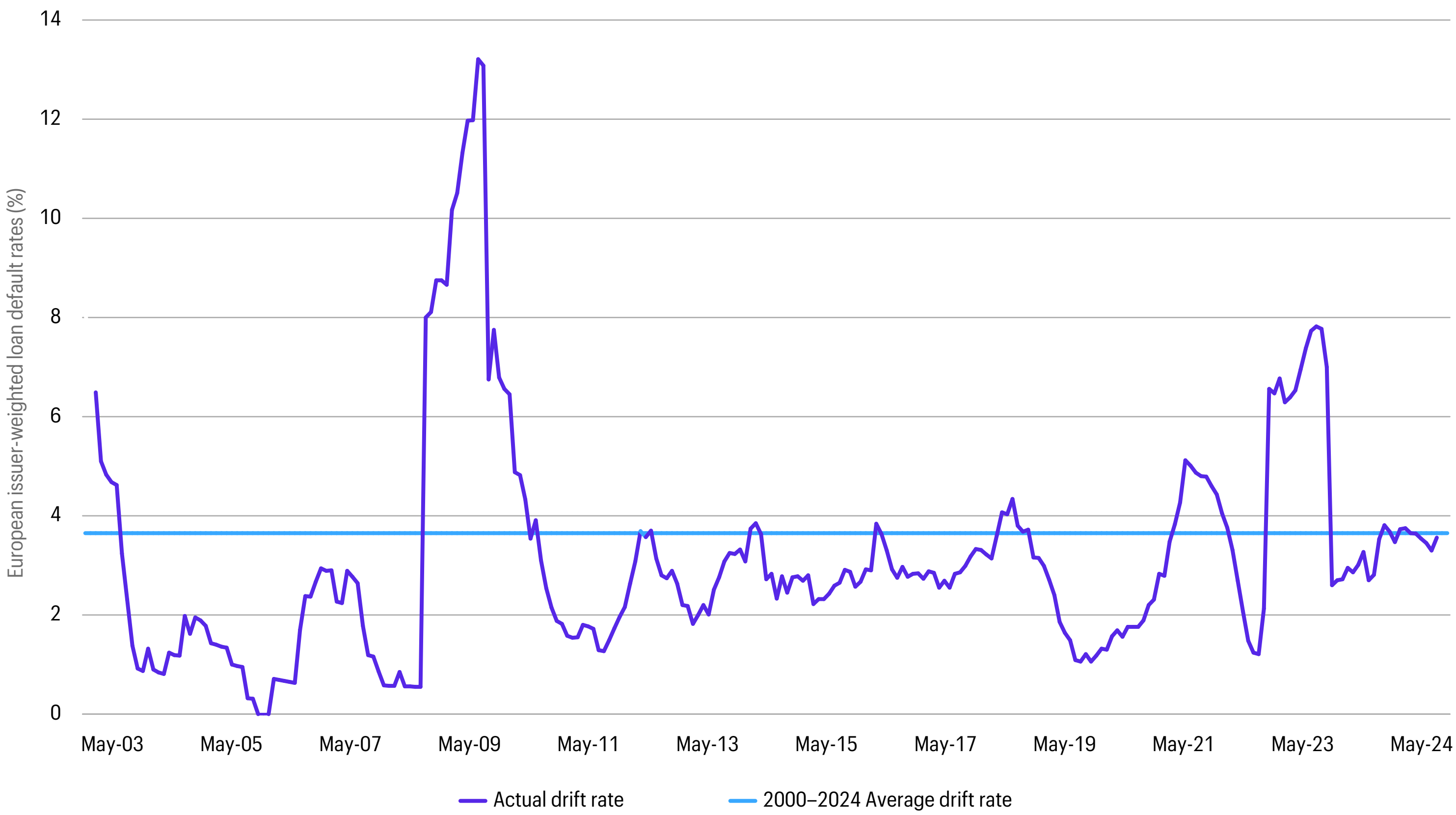
02 Senior-secured status provides strong creditor protection

The senior-secured status of European loans offers investors the following advantages:

- **Stronger legal documentation.** Loan documentation in Europe has traditionally been drafted by banks that often seek to protect their interests at the expense of bondholders subordinated to them. As a result, loan documentation typically offers more protection than bond indentures.
- **The credit rating of a loan is typically one to two notches higher** than that of an unsecured or subordinated high yield bond.
- **Stronger recovery rates.** The recovery rate on European senior-secured loans has historically been about 60% versus 30% for subordinated high yield bondholders.

Although the impact of the move towards covenant-lite documentation may result in a reduction of recovery rates going forward, these protections continue to provide important protection to investors. Despite the impact of higher interest rates, loan defaults continue to hover near all-time lows, as shown in Figure 2. The past monetary environment has allowed many companies to push out their maturity profile of loan repayments to 2027 and 2028. As a result, the amount of loans maturing in 2025 and 2026 remains very low by historical standards, and we expect defaults to stay modest.

FIGURE 2: EUROPEAN ISSUER-WEIGHTED LOAN DEFAULT RATES

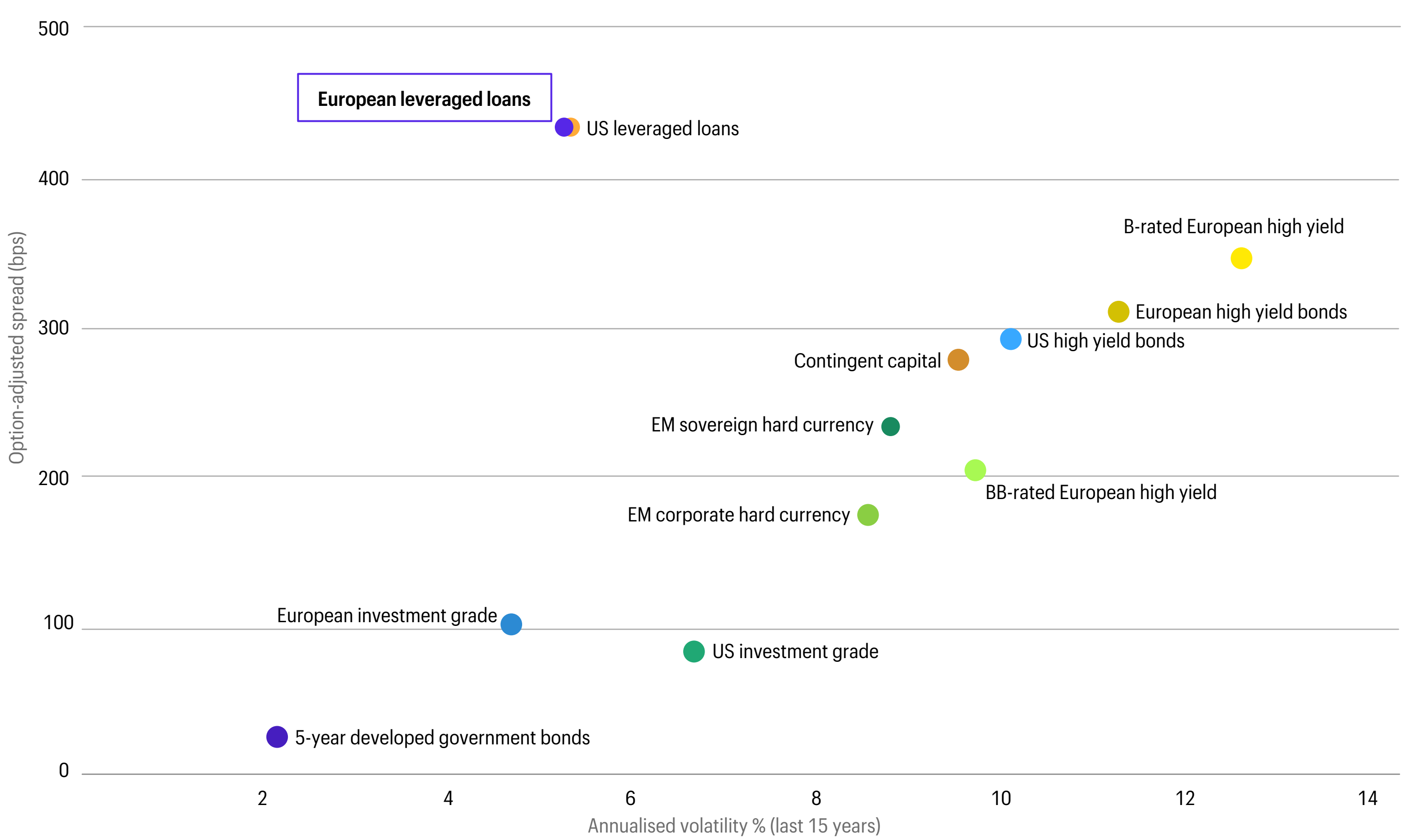


Sources: Allspring and Moody's, as at 31 November 2024

03 European loans provide investors with diversification benefits

European loans have historically provided investors with attractive expected risk-adjusted returns. We believe bottom-up considerations are often more important drivers of returns for this asset class than top-down macro considerations, such as interest rate levels. This makes European loans a good portfolio diversifier. Figure 3 shows how European loans offer attractive spreads per unit of volatility in comparison to competing fixed income asset classes.

FIGURE 3: SPREAD AND VOLATILITY (HEDGED TO €) FOR MAJOR FIXED INCOME ASSET CLASSES



Sources: Bloomberg, JPMorgan, S&P UBS and Allspring, as at 31 December 2024

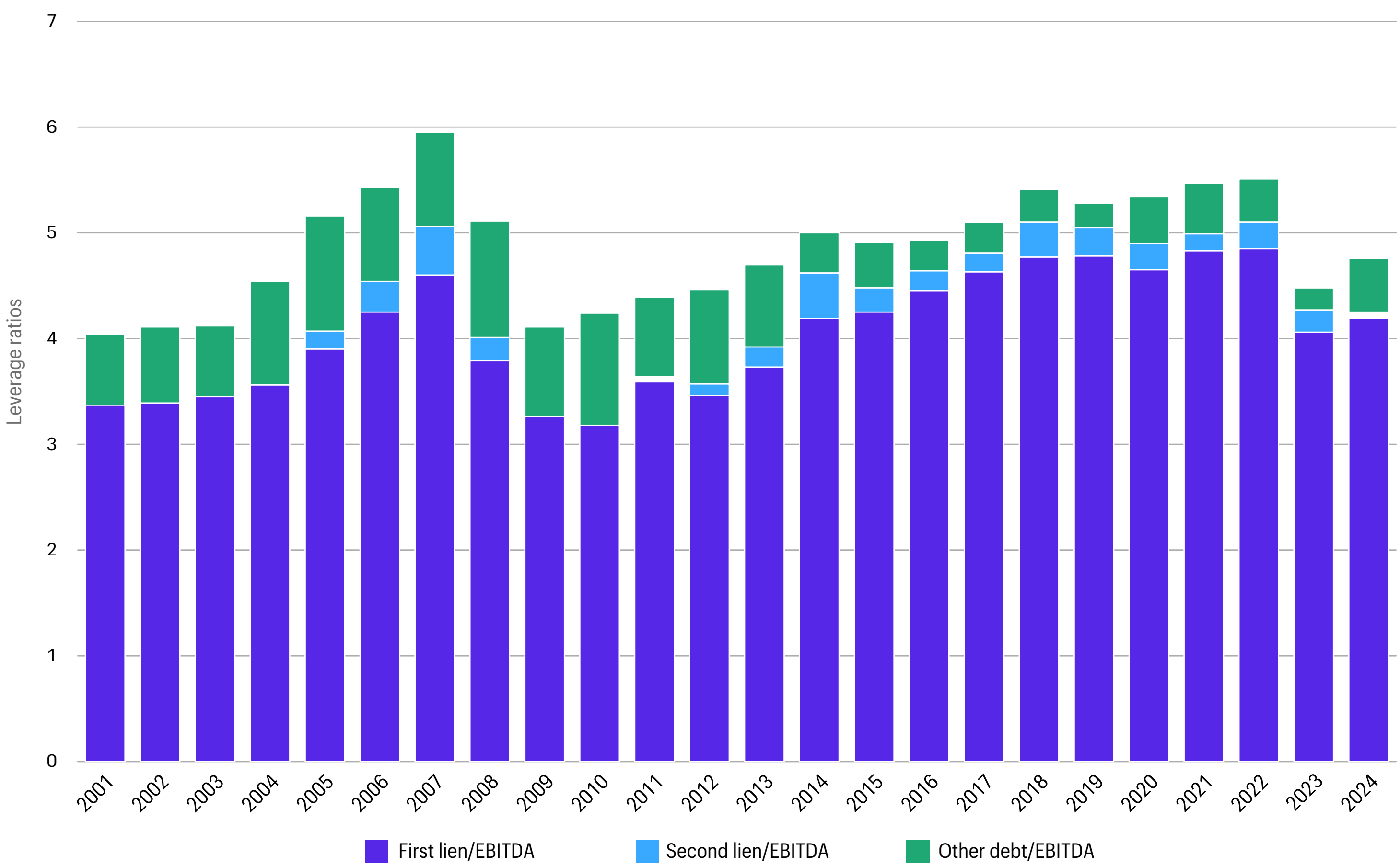
04 Fundamental and technical factors support strong expected risk-adjusted returns

European borrowers continue to display strong fundamentals. A key measure we look at is the leverage ratio, calculated as total company debt divided by earnings before interest, taxes, depreciation and amortisation (EBITDA). Figure 4 shows how this metric, in aggregate, has evolved in recent years for new deals brought to the primary market and how, as a result of rising interest rates, the leverage multiple actually started to drop in 2023.

Volatility has also been kept low as a result of collateralised loan obligation (CLO) vehicles in the market. CLOs have grown over the years to become the largest buyers of leveraged loans, mopping up the overall majority of all new issue supply—the remaining loans are bought by funds and separate accounts. In 2024, the situation became even more pronounced, as the euro CLO market saw €45 billion in new issue supply versus just €40 billion of new lending opportunities, broken down equally in three parts between new LBOs, new M&A and private credit refinancings.

The presence of CLO warehouses as major buyers of loans acts as a shock absorber: if spreads become too tight, underwriting banks may lose more than half of their buyer base for the deals they are trying to syndicate. Conversely, if spreads move too wide, CLO warehouses will quickly step in to purchase excess supply.

FIGURE 4: THE EVOLUTION OF LEVERAGE (TOTAL DEBT/EBITDA) IN EUROPEAN LOAN MARKETS



Sources: Allspring and Morningstar LCD, as at 30 September 2024

05 European loans offer an attractive alternative to direct lending

The European sub-investment-grade market includes high yield bonds, loans and direct lending. With relative value and supply varying over time, a case can be made for investing in each part of the market.

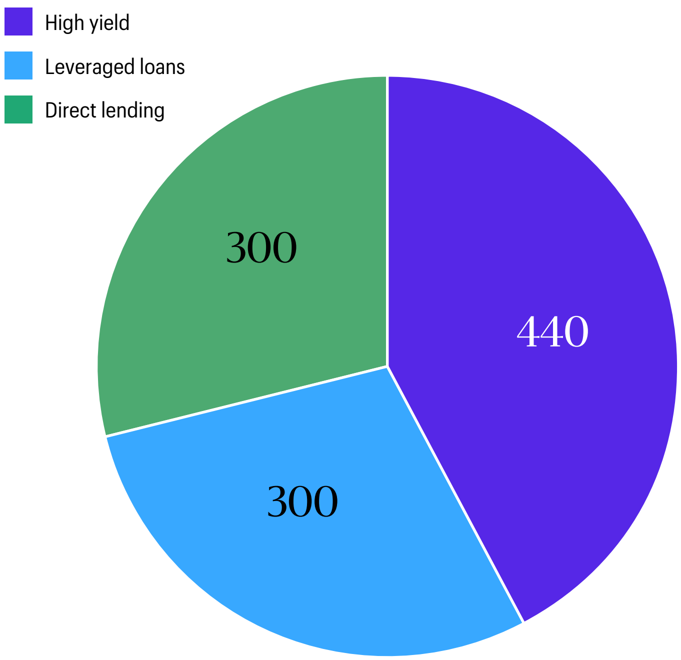
Specifically, for those investors worried about some aspects of their direct lending investments, we see European loans as an attractive alternative.

For example, the closed-end nature of direct lending vehicles and the absence of a secondary market in the notes issued by these vehicles mean that a direct lending allocation is less liquid than an investment in European loans, which is typically accessed via open-ended fund structures. The added return received in direct lending versus leveraged loans of 1.5% to 2.0% per annum—the so-called illiquidity premium—may not be enough to compensate for the risk in the eyes of some investors.

Second, investors may be concerned that direct lenders have had to make many borrower-friendly concessions, including weaker loan covenants to deploy capital during the last two to three years, and that this may affect future investment returns as the default cycle accelerates. Whereas the European loan managers have worked through two default cycles during the last 15 years (the 2008–2009 Global Financial Crisis and the European sovereign debt and banking crisis in 2011–2012), we do not know whether direct lenders' investment and restructuring teams are strong and experienced enough to come through the next default cycle unscathed.

In both these instances, an allocation to the more liquid and mature European leveraged loan asset class at current yield-to-maturity levels of 8% offers a sound alternative and a great way to diversify the overall portfolio.

FIGURE 5: EUROPEAN SUB-INVESTMENT-GRADE MARKET (EUR BILLION)



Sources: Allspring, Bloomberg, S&P UBS as at 31 December 2024

Conclusion

Against a backdrop of higher rates and wider spreads, investors continue to search for opportunities to add attractive risk adjusted returns. An allocation to European loans may meet this need. Evidence has shown that this asset class has experienced compelling risk-adjusted returns, helped in part by continued robust fundamentals, despite the impact of the COVID-19 crisis and the Ukraine war. Looking ahead, we expect this thesis to remain intact over the next two to three years.

European loans offer investors several advantages aside from their high level of income. From a credit risk perspective, they have the advantage of being senior in the capital structure. In terms of diversification, they have shown less correlation with other asset classes. Market technical factors such as supply and demand trends are also supportive of this asset class. Finally, they offer a more liquid alternative to direct lending.

For further information

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