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Alert

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Leveraged Finance Market Update

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"Private equity sponsors are envisioning creative solutions to structure and market leveraged buyout financings as investor appetite for risk has dropped and bank liquidity has dried up amid the macroeconomic volatility that has rattled the markets throughout the year."

- Gold Sheets (November 7, 2022)

It's not just the cost of Thanksgiving turkey that has increased in 2022. The U.S. leveraged loan market for the majority of 2022 has been shaped by three increases: (A) increased volatility, (B) increased borrowing costs and (C) increased risk-aversion.

The year started off strong in the early weeks, but following Russia's invasion of Ukraine in February, coupled with inflationary pressures, supply chain disruptions and high interest rates, market conditions quickly reversed course with U.S. leverage issuance remaining muted throughout the first three quarters of 2022. Total U.S. leveraged loan issuance in the third quarter of 2022 totaled $67.2 billion, representing the lowest quarterly amount since the fourth quarter of 2014 and a 86% decrease from the same period in 2021.[1] In the face of high interest rates, opportunistic transactions such as dividend recaps and refinancings also fizzled.

The broadly syndicated loan market felt the brunt of the pain following a number of widely reported hung syndications. Direct lenders, on the other hand, capitalized on market conditions by jumping into opportunities left open by institutional lenders who were focused on clearing deals underwritten earlier in 2022.

While these lower activity levels have thus far persisted into the fourth quarter of 2022, leveraged loans did gain a few points ahead of the U.S. Thanksgiving holiday.

When exactly the broadly syndicated leveraged loan market will see a full recovery is the million dollar question, but in the interim, market participants are likely to remain creative in their search for opportunities. The market has seen institutional lenders, eager for M&A fees, team up with direct lenders in certain instances to diversify risk. Meanwhile, some private equity sponsors have also taken the lead on arranging financing for deals including with direct lenders, as well as employing alternative structures, such as net-asset-value ("NAV") loans.[2]

[1] Tyler Udland, "US leveraged loan issuance plunges to lowest level in Q3 since 2009" (Oct. 3, 2022). Available here.

[2] Paola Aurisicchio and Michelle Sierra, "Blackstone combines banks, private debt lenders to finance Emerson buy", Gold Sheets (Nov. 7, 2022).

I. 2022 MARKET CONDITIONS

A. *Volatility and its Impact on the Syndicated vs. Direct Lending Market*

If there is one theme that the U.S. leveraged loan market will remember from 2022, it is the billions of dollars in losses that institutional banks incurred as a result of large syndicated LBO's that had been committed to, but not syndicated, prior to the market slowdown.

Institutional lenders spent the majority of 2022 focused on clearing backlogged financings through the U.S. leveraged loan market, in many cases offering steep discounts and requiring borrowers to accept tighter documentation terms in order to achieve a successful syndication. The tally of backlogged financings was estimated to be as high as $43 billion by some sources.[3]

The two most notable examples were:

- the $4.55 billion of loans backing Elliott Management's acquisition of Citrix, announced at the end of January 2022 and the largest LBO of 2022 to date, which priced at 91 OID on September 20, 2022, with banks facing losses of at least $100 million;[4] and

- the $1.4 billion term loan "B" backing Apollo's take-private acquisition of Tenneco, which launched on November 1, 2022 at 84-85 OID, representing the steepest discount on a first-lien term loan for an LBO in more than six years. As of the acquisition closing on November 17, 2022, syndication had not been completed.[5]

In some cases, arrangers opted against pre-closing syndication, choosing to hold the loans on their books until market conditions improved, rather than locking in steep losses in the current market.[6] This thereby constrained their ability to deploy capital for new syndicated financings.

Direct lenders, on the other hand, have continued to gain ground in the leveraged loan market, casting a wide net for funding and even looking to U.S. insurers as a source of funds.[7] Private credit comprised 23% of U.S. large corporate leveraged loan volume (i.e., borrowers with revenues or loan sizes of at least $500 million) in the third quarter of 2022. While traditionally direct lenders have been viewed as a source of competition for institutional lenders, the market slowdown created opportunities for collaboration between direct lenders and investment banks.

For example, on October 31, 2022, Blackstone agreed to purchase Emerson Electric's climate technologies business for $14 billion, which will include a $6.2 billion financing comprised of a $2.6 billion term loan "B" provided by direct lenders led by Sixth Street and Goldman Sachs Asset Management and a $3.6 billion term loan "A" provided by banks including RBC Capital Markets, Wells Fargo and Sumitomo Mitsui Banking Corp.[8]

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[3] Olivia Raimonde and Jill R. Shah, Wall Street's $38 Billion Loan Backlog Curbs New Bank Lending, Bloomberg (Nov. 15, 2022); Matt Wirz, "Raising Money on Wall Street Hasn't Been This Hard in a Decade", WSJ (Nov. 6, 2022). Availalbe here.

[4] Alexander Saeedy and Laura Cooper, "Citrix Debt Deal Prices With Large Losses for Banks", WSJ (Sept. 21, 2022). Availalbe here.

[5] LCD News Today: November 17, 2022.

[6] Kristen Haunss and Rhys Adams, "Banks bide time on Twitter loan syndication", Gold Sheets (Oct. 31, 2022).

[7] Refinitiv LPC Gold Sheets (Nov. 28, 2022).

[8] Paola Aurisicchio and Michelle Sierra, "Blackstone combines banks, private debt lenders to finance Emerson buy", Gold Sheets (Nov. 7, 2022).

Despite their recent market prominence, direct lenders have not been entirely immune to the impact of the volatile market conditions. Direct lenders, too, are becoming increasingly more conservative in deal underwriting, including cutting down the size of their commitments in order to diversify their portfolios.[9]

B. *Steep Borrowing Costs*

Another key theme that 2022 will be remembered for is the steep cost of capital. On November 2, 2022, the Federal Reserve announced a 0.75% hike to the federal funds rate, bringing the target to 3.75%-4%.[10] This was the sixth interest rate increase for 2022, which has been mirrored by 12-month Term SOFR, which increased from under 0.50% in 2021 to over 4.9% in 2022.[11]

As a result, the average new-issue yield to maturity for U.S. leveraged loans increased to 10.1% in October 2022 up from 9.4% in September and the highest all-in spread seen since July 2009.[12] The average new-issue spread to maturity increased to 475 bps above the applicable base rate, the highest level since May 2020.[13] According to one estimate, North American companies will need to come up with at least $155 billion to cover rising interest expenses in 2022 and 2023.[14]

With more loans trading below par, we may see more sponsors and borrowers beginning to explore debt buybacks.

C. *Risk Aversion and Recessionary Jitters*

Lower-rated borrowers have been disproportionately impacted by challenging financing conditions as a result of lenders shifting their focus in 2022 to credit quality and positioning their portfolios for a recessionary environment.

According to the results of the October 2022 Senior Loan Officer Opinion Survey conducted by the Federal Reserve, over 40% of respondents said their bank's credit standards for approving commercial and industrial loans or lines of credit to large and middle-market firms had tightened in the last three months.[15] In the same survey, 94.1% of respondents said that their bank assessed the probability of a recession happening at any time in the next 12 months at 40% or higher, with 19.1% of respondents reporting an assessed probability of 80% or higher.[16]

As a mitigating factor, many borrowers have a longer runway to maturity following robust refinancing and amend-and-extend activity in 2020 and 2021. According to the Morningstar LSTA US Leveraged Loan Index, only 9% of outstanding sponsor loans will come due prior to the end of 2024.[17] The runway provided by the vast majority of loans coming due in 2025 and beyond may soften the impact of an economic downturn on borrowers.[18]

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[9] Refinitiv LPC Gold Sheets (Nov. 28, 2022).

[10] Tanza Loudenback, "What the Fed's Rate Hike means for Savings Rates, Mortgages and More" (Nov. 2, 2022). Available here.

[11] 12-month CME Term SOFR for November 10, 2022 is 4.90852%. Available here.

[12] Refinitiv LPC Gold Sheets (Nov. 21, 2022).

[13] "Leveraged loan break prices rise in October with higher-rated deals in focus", LCDNews (Nov. 11, 2022).

[14] Matt Wirz, "Raising Money on Wall Street Hasn't Been This Hard in a Decade", WSJ (Nov. 6, 2022). Available here.

[15] Available here.

[16] Available here.

[17] Rachelle Kakounis, "Private equity and risk in the Morningstar LSTA US Leveraged Loan Index", LCD (Oct. 26, 2022).

[18] Tyler Udland, "US leveraged loan issuance plunges to lowest level in Q3 since 2009" (Oct. 3, 2022). Available here.

II. OUTLOOK

Lower activity levels have overall persisted into the fourth quarter of 2022. According to Lev Fin Insights, leveraged loan issuance was $16 billion in October, down 67% month-over-month since September 2022.[19] However, there are some glimmers of hope.

Although CLO issuance is low when compared with a record-setting year in 2021, the total $115.9 billion of CLOs issued year-to-date through November 8, 2022 has already surpassed the total amount issued in 2020, and could still outstrip the amount issued in 2019 and 2018 – a promising sign given CLOs have historically been the largest buyer of leveraged loans.[20]

In addition, leveraged loans gained a few points in advance of the U.S. Thanksgiving holiday in response to news that inflation may have already reached peak levels.[21]

Odds are that the "wait and see" approach taken by lenders and borrowers alike will continue through the remaining weeks of 2022. Some market participants believe the risk-averse market approach will prevail until the Fed reverses course on interest rate hikes to fight inflation or the backlogged or tabled syndications have cleared (or both).

In such an environment, we expect sponsors and borrowers will continue to look to the private credit market to provide a much-needed financing source, though lenders likely will continue to be selective about where they deploy their funds and the size of their respective commitments.

Sponsors are also looking to explore alternative financing structures, including in the form of NAV loans – born out of the European market – in which firms borrow against a pool of portfolio companies within a fund.[22] One source predicts the market for NAV loans will increase from $100 billion today to $700 billion by the end of the decade.[23]

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[19] Refinitiv LPC Gold Sheets (Nov. 21, 2022); Becky Quan, "U.S. Loans October 2022 Wrap-Up: New Issue U.S. Leveraged Loan Market Remains in Autumn Doldrums, but LMEs Strike Back", Covenant Review (Nov. 3, 2022).

[20] "Refinancings dominate issuance as M&A dries up", Gold Sheets (Nov. 14, 2022).

[21] Refinitiv LPC Gold Sheets (Nov. 21, 2022).

[22] Allison McNeely, Private Equity Funds Tap Exotic Loans for Liquidity as Deals Ebb, Bloomberg (Nov. 15, 2022).

[23] Allison McNeely, Private Equity Funds Tap Exotic Loans for Liquidity as Deals Ebb, Bloomberg (Nov. 15, 2022).

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