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Leveraged Finance Market Update

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"While investors and bankers are optimistic that the market will remain open, they remain cautious as a potential recession is still possible."

– Refinitiv LPC Gold Sheets (January 30, 2023)

The proverbial "Dry January" was not entirely dry in the U.S. leveraged loan market where market participants remain thirsty for opportunities to deploy available capital. While lackluster, activity in the U.S. leveraged loan market in the fourth quarter of 2022 and January 2023 was bolstered by a strong private credit market and record-breaking amend-and-extend activity. We expect the first half of 2023 to continue these trends, with concentrations on: (a) continued growth in the private credit markets and alternative financing structures, including preferred equity financings, (b) amend-and-extend activity to continue pushing out maturities in 2023 and 2024 and (c) transitioning interest rate benchmarks away from LIBOR in existing leveraged loans. There are also signs that the syndicated leveraged loan market is beginning to re-open following the pricing in early February of syndicated term loans backing two large buyout transactions, contributing to an overall sentiment of guarded optimism for at least the first half of 2023.

I. JANUARY 2023 TRENDS AND Q4 2022 LOOKBACK

U.S. leveraged loan issuance in 2022 totaled $850 billion, which represents a 35% drop from the record volume set in 2021 and was shaped by increased volatility, increased borrowing costs and increased risk aversion.[i]

The U.S. leveraged loan market was slow to reopen in January 2023, during which $24 billion of U.S. leveraged loans were issued, representing a 50% decrease from the same period in 2021.[ii]

However, even in the midst of such subdued performance, the U.S. leveraged loan market has shown encouraging signs of reopening, including a return of dividend recapitalization transactions, which accounted for $735 million of January's volume, and the most seen in any month since February 2021.[iii] U.S. leveraged loan returns in January were the highest since May 2020, and the Morningstar LSTA U.S Leveraged Loan Index was up 2.73% in January, the strongest start to any year since 2009.[iv] Average discounts on leveraged loans improved in January, with the average original-issue-discount coming in at 97.43, compared to 96.5 in December.[v] The U.S. primary CLO market saw $10.48 billion of issuance through February 6, as compared to $7.54 billion in the same period in 2022.[vi] Finally, syndications priced the week of February 6, 2023 on (i) the $1.23 billion first lien term loan backing CD&R's purchase of a majority stake in Indicor (the newly named industrial businesses of Roper Technologies), pricing at Term SOFR + 4.50% (with a 0.50% Term SOFR floor) and 96.5% OID, and (ii) the $800 million term loan backing Apollo Global Management's buyout of Atlas Air, pricing at Term SOFR + 4.25% (with a 0.00% Term SOFR Floor) and 97.0% OID, perhaps signaling leveraged loan investors' cautiously positive outlook for early 2023.[vii]

A. *Continued Growth in Private Credit and Preferred Equity Financings*

Even in a muted year for leveraged loans, private credit providers gained considerable ground in 2022 as they moved to fill commitments left open by an anemic syndicated loan market. In the fourth quarter alone, private credit providers committed or funded leveraged loans backing buyouts over eight times more by volume than the syndicated market, including commitments to back (i) Advent International's $6.4 billion acquisition of Maxar Technologies announced in December, (ii) Thoma Bravo's $6.1 billion acquisition of Coupa announced in December and (iii) Blackstone's $14 billion acquisition of Emerson Electric's climate technologies business announced in November. Overall direct lending volume to sponsored companies reached a total of $109 billion for 2022, the second highest year on record, falling closely behind the record set in 2021 at $130 billion.[viii] As alternatives to the more traditional term loans offered by syndicated lenders, private credit providers are willing, and often eager, to provide alternatives, such as unitranche loans and structured preferred equity.

Structured preferred equity, in particular, is a popular financing option for private equity sponsors, issuers and investors, as it functions as an additional layer of the issuer's equity capital, without diluting existing investors in respect of ownership or governance control, while providing investors with an attractive dividend rate as compared to loans. In the midst of the challenging loan market in 2022, structured preferred equity presented a vital source of funds for leveraged buyouts, including Advent International's acquisition of Maxar Technologies and Blackstone's acquisition of Emerson Electric's climate technologies business.

Over the past decade, private credit has built itself into a $1.4 trillion industry, with Preqin expecting private credit assets under management to increase to $2.3 trillion by 2028.[ix] Some larger banks have recently sought to reclaim some of the direct-lending pie, including JPMorgan who recently set aside a minimum of $10 billion to fund a move into private credit.[x]

According to a survey conducted in early December, market participants expect the shift to private credit to be permanent, with 73% of respondents expecting pricing in the private credit markets to be competitive with terms available in the syndicated loan markets over the next six months, citing "speed and certainty of execution relative to public markets, direct lending's dry powder and a lack of appetite at banks to underwrite risk".[xi]

B. *Record-Breaking Amend-and-Extend Activity in 2022 and Ahead*

Amend-and-extend volume broke a record in 2022, nearing a total volume of $109 billion and surpassing the previous record of $107.9 billion set in 2019.[xii] Borrowers extended a combined $27.7 billion of debt due in 2025 and 2026, with the volume of loans coming due in 2028 or later growing by $625.11 billion since the end of 2020.[xiii] We expect the heightened amend-and-extend activity observed in 2022 to account for a large share of leveraged loan activity in the first half of 2023, which should provide leveraged loan borrowers with more breathing room to service their debts amidst, and ahead of, uncertain markets.

C. *Transition from LIBOR*

According to Barclays PLC, roughly 78% of the $1.09 trillion U.S. leveraged loan deals remain tied to LIBOR, which is set to cease publication on June 30, 2023.[xiv] Although the announcement of such date was made on March 5, 2021, the U.S. leveraged loan market has been slow to transition. While Term SOFR, a rate based on the Secured Overnight Funding Rate (SOFR), emerged as the market leader for the LIBOR replacement in late 2021, the leveraged loan market slowdown in 2022 chilled the transition to Term SOFR, as many borrowers waited for an opportunistic financing transaction that did not present itself. Further, CLOs and investment banks remain at odds on the amount of spread adjustment offered. While some CLOs are inclined to push for a higher credit spread adjustment to account for the difference between LIBOR and Term SOFR, some investment banks are motivated to accelerate the pace of Term SOFR transition amendments, irrespective of spread adjustment, as a means to avoid a logjam in June.[xv] As we move toward the final few months of LIBOR, we expect increased focus by both borrowers, lenders and other market participants (including CLO investors) on an orderly transition to Term SOFR.

II. OUTLOOK

While market observers predict M&A activity will remain low in the first few months of 2023, due at least in part to a perceived mismatch in price expectations between buyers and sellers, leveraged loan market participants remain occupied with amend-and-extend activity, LIBOR transition amendments and clearing the backlog of syndicated deals from 2022. Borrowers with existing credit facilities may turn to their revolving credit facilities to fund smaller add-on acquisitions, rather than attempting to navigate the leveraged loan market for an incremental facility in the face of high borrowing costs and potential MFN issues. As high inflation, geopolitical turmoil and recessionary worries still hang in the air, we expect borrowers and lenders alike will continue taking a “wait and see” approach at least with respect to large M&A until one or more of these pressures stabilizes and the bid/ask spread between buyers and sellers narrows. As in years past, we anticipate private equity sponsors and borrowers will continue to turn to private credit providers to fund capital and to engage in creative financing solutions.

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ENDNOTES

[i] Refinitiv LPC's Leveraged Loan Monthly (Year End 2022).

[ii] Refinitiv LPC's Leveraged Loan Monthly (January 2023).

[iii] LCD News Today (February 3, 2023).

[iv] Marina Lukatsky, "January Wrap: Leveraged loans jumps 2.73% in strongest start to year since 2009", Leveraged Commentary & Data (February 1, 2023).

[v] Refinitiv LPC Gold Sheets (January 30, 2023).

[vi] Pitchbook/LCD, "CLO market rejuvenated as investor base diversifies" (February 7, 2023).

[vii] Michelle Serra and Maria Gallagher, "Banks may return to dealmaking as Atlas, Indicor hit market", Refinitiv LPC Gold Sheets (February 6, 2023).

[viii] Refinitiv LPC Gold Sheets (January 30, 2023).

[ix] Shannon D. Harrington, "The Big Banks Want Their Lucrative Lending Back: Credit Weekly", Bloomberg (January 21, 2023).

[x] Shannon D. Harrington, "The Big Banks Want Their Lucrative Lending Back: Credit Weekly", Bloomberg (January 21, 2023).

[xi] Rachelle Kakouris, "2023 US Leveraged Finance Survey: Stress may be less severe, but longer-lasting", PitchBook (January 11, 2023).

[xii] Richard Kellerhals, "Amend-and-extend volume breaks record in 2022, at nearly $109B", Leveraged Commentary & Data (January 19, 2023).

[xiii] Richard Kellerhals, "Amend-and-extend volume breaks record in 2022, at nearly $109B", Leveraged Commentary & Data (January 19, 2023).

[xiv] Mark Maurer, "Companies, Lenders Clash Over Loan Spreads in Switch from Libor", The Wall Street Journal (January 13, 2023).

[xv] Refinitiv LPC Gold Sheets (February 13, 2023).

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