Banking & Finance Alert

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Leveraged Finance Market Update

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It has been a cruel summer, not just for Taylor Swift fans navigating Ticketmaster, but also for the leveraged finance market, as borrowers and lenders alike faced a challenging economic climate and tight credit conditions. However, cooling inflation and signs of a reopening of the syndicated loan market suggest we may soon be out of the woods.

In a hopeful sign for the leveraged finance market for the second half of 2023, on July 6, 2023, GTCR announced that it agreed to acquire a 55% stake in Worldpay, backed by $8.4 billion of leveraged loans and high yield bonds committed by a group of banks led by JPMorgan Chase and Goldman Sachs—the largest syndicated debt financing since Elon Musk's takeover of Twitter in 2022.[i]

Looking ahead to the second half of 2023, we expect borrowers to take advantage of a reopening syndicated loan market to refinance and extend maturities on existing debt, while exploring alternative financing structures to maximize liquidity and manage capital costs. If interest rates continue to rise, some borrowers may need to explore liability management solutions, as rising interest expenses put strain on their balance sheets.

I. 1H 2023 BY THE NUMBERS[ii]

1H 2023 US Institutional Leveraged Loan Issuance:	1H 2023 US Institutional Leveraged Loan Issuance – New Money:	1H 2023 US CLO Issuance Volume:
$112 billion (down 35% from the comparable period in 2022)	$32.1 billion (down 75% from the comparable period in 2022)	$55.3 billion (down 24% from the comparable period in 2022)

II. Q2 2023 AND 1H 2023 TRENDS

Overall, US institutional leveraged loan activity in the first half of 2023 was muted, resulting from a seeming parade of horribles: regional bank turmoil resulting from SVB's collapse in March, followed by Signature Bank a few days later and First Republic Bank in May, debt ceiling concerns in June, rapid Federal Reserve interest rate hikes, alongside high borrowing costs, low asset valuations and lackluster M&A activity. In the midst of this uncertainty, lenders were more selective, favoring more highly rated borrowers and demanding higher spreads, lower leverage, increased equity contributions and tighter covenants. For borrowers looking to finance add-on acquisitions or refinance and extend maturities of existing debt, private credit provided a valuable (and sometimes the sole available) source of liquidity.

A. *M&A Financing: Smaller Deals and Add-On Acquisitions*

Rising inflation and interest rates, coupled with low asset valuations, made it difficult for private equity firms to exit existing investments and to achieve high leverage multiples on new large acquisitions in the first half of 2023. According to Covenant Review, the average pro forma adjusted debt to EBITDA ratio for syndicated

leveraged loans backing M&A issued in Q2 2023 fell to 4.2x—the lowest read since Covenant Review began tracking this metric in 2017.[iii] Many private equity firms chose instead to deploy capital for new platform acquisitions in smaller companies or add-on acquisitions. In the second quarter through June 20, LCD reported 25 add-on transactions, up from 14 in the first quarter.[iv] Nevertheless, even inclusive of add-ons, new M&A transactions accounted for only 18.5% of all institutional loan activity in the first half of 2023, representing the lowest first-half reading since 2009 based on LCD data.[v]

B. *Refinancings and Maturity Extensions*

Given the shortage of M&A activity, refinancings and amend-to-extend transactions took center stage, representing 74% of 1H 2023 US institutional loan volume on a combined basis. As a result, near term maturities in 2024 were reduced by more than 50% and 2025 maturities were reduced by more 26%.[vi]

C. *Private Credit Wants to Be Your End Game*

While the traditional private equity LBO financing pipeline remained weak during the first half of 2023, private credit providers continued to expand their financing role across the capital structure, via investment grade lending, asset-based lending and preferred equity investments. According to PitchBook/LCD, the number of non-LBO transactions in the US that were financed by private credit, by count, exceeded the number of those transactions financed in the broadly syndicated loan market for each of the last five quarters through June 20, 2023.[vii]

The size of deals financed by private credit has also increased alongside the asset class. Recent examples include (i) Advent International's $6.4 billion acquisition of Maxar Technologies that closed in early May, (ii) Blackstone's $14 billion acquisition of Copeland (Emerson Electric's climate technologies business) that closed in late May, and (iii) KKR's $1.7 billion acquisition of Circor International announced in June.

In a show of continued faith in the growth of the private credit market, TPG announced in May that it plans to acquire the alternative investment firm Angelo Gordon for $2.7 billion. And, in one example of private credit stepping directly into the shoes of commercial banks, Ares Management recently acquired a $3.5 billion specialty finance loan portfolio from PacWest Bancorp.

D. *Secured Bonds Hit Different*

Borrowers increasingly looked to issue secured bonds in place of term loans, given the dislocation in price between the cost of funds for secured bonds and institutional loans. The rolling 90-day new-issue clearing yield for single-B loans as of July 13, 2023 was 10.44%, as compared to 9.90% for single-B bonds, based on data from LCD.[viii] In one particularly striking example, MoneyGram's $500 million of 9.00% senior secured notes partially backing its buyout by Madison Dearborn had a yield of 12.742% at pricing on June 1, 2023, as compared to their $400 million term loan B, which had a yield to maturity of 15.43%.[ix] Borrowers also looked to issue secured bonds to refinance institutional loans, as "bond-for-loan" transactions increased nearly six-fold in the first half of 2023 compared to the same period in 2022 (at $31.9 billion versus $5.5 billion).[x]

E. *Should've Said SOFR*

Amendments transitioning from LIBOR to SOFR picked up in the second quarter of 2023 ahead of LIBOR's final publication on June 30, 2023, with many borrowers waiting until the last few days of June to transition pursuant to existing credit documentation that provided for hardwired SOFR transitions with negative lender consent or no lender consent.

For existing loans transitioning to SOFR, a credit spread adjustment (or CSA) seemed difficult to avoid given the mismatch in benchmark rates. While the market was mixed on the applicable CSA, an increasing majority of hardwired SOFR amendments applied the ARRC-recommended CSA of 11.448 / 26.161 / 42.826 bps for 1-, 3- and 6-month interest periods, respectively, as the June 30 LIBOR cessation date grew closer.

On the other hand, new deals originated in SOFR have started to move away from credit spread adjustments altogether. 64% of US first-lien institutional term loans in Q2 2023 as of June 14, 2023 did not have a CSA. For new deals that did have a CSA, the majority had a flat 10 bps CSA, followed by the ARRC-recommended CSA, then by a 10 / 15 / 25 bps CSA.[xi]

Several borrowers that did not make the SOFR switch before June 30 instead selected longer-dated LIBOR contracts to get them through the end of the year. Other borrowers lacking LIBOR fallback mechanics in their existing credit documentation have opted to use “synthetic US LIBOR”, which will be published until September 30, 2024 as an “unrepresentative” synthetic methodology in 1-, 3- and 6-month tenors. “Synthetic LIBOR” is calculated as the relevant CME Term SOFR reference rate *plus* the relevant ISDA fixed spread adjustment.

Loans that do not transition to SOFR prior to expiration of their existing LIBOR contracts and for which synthetic LIBOR is not viable under the language of the existing loan documentation may be required to fall back on the prime rate, which is 8.25% as of the date of this publication, as compared to 1-month Term SOFR, which is 5.230% as of the date of this publication, further increasing the interest expense burden on these borrowers.

III. 2H 2023 OUTLOOK

The syndicated lending market has shown positive signs of reopening in the last few weeks, which would present a welcome source of liquidity (and competition for private credit) to borrowers looking to refinance or extend maturities of existing debt. As of June 30, 2023, the volume of US institutional leveraged loans due to mature in 2024 was $30.5 billion (down more than 50% year-over-year) and in 2025 was $149.6 billion (down 26% year-over-year).[xii] We expect borrowers will move to seize the window of opportunity that has opened at the beginning of the third quarter of 2023 to refinance or extend the maturity on these loans, rather than wait to refinance under unknown circumstances.

In anticipation of a reopening syndicated lending market, borrowers and private equity firms are more frequently running dual-track processes with syndicated and private credit options to land the most favorable terms possible. In addition to keeping the source of liquidity options open, borrowers and private equity firms are continuing to explore all forms of financing at various levels of the capital stack to raise additional liquidity, including through secured bonds, fund-level NAV facilities, structured preferred equity, “holdco” financing and junior and mezzanine debt.

Still, as borrowers look to manage tighter operating conditions and higher interest rates, there are signs of an uptick in covenant relief and liability management transactions. The trailing 12-month default rate has risen at the fastest pace so far this year since the beginning of the COVID-19 pandemic to 1.71%, just slightly below the 10-year average of 1.87% based on data from the Morningstar LSTA US Leveraged Loan Index. LCD tracked 24 covenant-relief transactions in the first half of 2023, more than the comparable periods for each of 2022 and 2021.[xiii] As another indicator of company stress, the rolling-three-month ratio of downgrade to upgrade activity for US leveraged loans was 2.37x in June 2023, marking the 13th consecutive month where downgrades outpaced upgrades, though cooling off from 2.85x in May.[xiv] Depending on their existing credit documentation, borrowers may have an increasing number of potential

liability management maneuvers at their disposal, including priming debt issuances (often coupled with entry consents by the priming lenders) and “double dip” and “drop-down” financing transactions.

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ENDNOTES

[i] Claire Ruckin, Gowri Gurumurthy, and Jeannine Amodeo, "Banks Line Up $9.4 Billion of Debt for GTCR's Worldpay Takeover", July 6, 2023 (available here).

[ii] Refinitiv LPC's Leveraged Loan Monthly, June 2023.

[iii] Covenant Review, "M&A Debt Multiples Remain Below Trend in Q2 as Highly Leveraged Deals Go Missing", July 10, 2023 (available here).

[iv] Abby Latour, "Q2 US Private Credit Wrap: Direct lending slows but outpaces syndicated loans," Pitchbook/LCD, June 27, 2023 (available here).

[v] Marina Lukatsky, "June Wrap: Loan returns soar as rates rise, though market trouble spots abound," Pitchbook/LCD, July 5, 2023 (available here).

[vi] Marina Lukatsky, "June Wrap: Loan returns soar as rates rise, though market trouble spots abound," Pitchbook/LCD, July 5, 2023 (available here).

[vii] Abby Latour, "Q2 US Private Credit Wrap: Direct lending slows but outpaces syndicated loans," Pitchbook/LCD, June 27, 2023 available (here).

[viii] John Atkins, "Quick Take: Funding efforts migrate to secured bonds as loan costs soar", PitchBook/LCD, June 7, 2023 (available here).

[ix] "Weekly clearing yields for bonds, leveraged loans", LCD, July 14, 2023 (available here).

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[xi] Diana Diquez, "Daily Analytic: Share of US institutional deals done without a CSA increases in 2Q23", Refinitiv, June 14, 2023 (available here).

[xii] Marina Lukatsky, "June US Leveraged Loan Market Wrap: Returns soar as rates rise, though trouble spots abound", PitchBook/LCD, July 11, 2023 (available here).

[xiii] Richard Kellerhals, "Leveraged loan amend-and-extend activity heats up, maturities pushed out", PitchBook/LCD, July 14, 2023 (available here).

[xiv] Rachelle Kakouris, "After sharp rise, US leveraged loan default rate finally nears historical average", PitchBook/LCD, July 9, 2023 (available here).

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