Weil

October 31, 2023

Leveraged Finance Market Update

By: Andrew Colao, Jacqueline Oveissi, Angel Torres and Angela Estrada

The U.S. leveraged finance market had plenty to celebrate in Q3'23. We saw the U.S. syndicated loan market rise from the dead with a post-Labor Day flurry of activity, including a handful of large LBO issuances and a steady pipeline of refinancings. Nevertheless, investors and borrowers have reason to be spooked this Halloween season, between ongoing recessionary fears, macro-economic and political instability, regulatory expansion and whispers of "systemic financial issues . . . lurking in the market"[i]. These "Spooky" developments are leaving investors wondering whether they're in for a "trick" or a "treat" in Q4'23.

In this article, we will highlight some of the "Good" of 2023, as well as a few "Spooky" developments that create uncertainty for Q4'23 and beyond.

Looking forward, although we expect the outlook to cool for Q4'23, we anticipate refinancings will continue to drive loan volumes as borrowers and issuers seek to address upcoming maturities by extending their credit facilities. We also expect private credit to continue to play a key role in the loan market by expanding into other asset classes and bringing competition to the leveraged loan market, including by serving as a refinancing avenue for existing broadly syndicated loans nearing their maturities.

A. THE GOOD

1. Q3'23: A Howling Good Time

By all measures, Q3'23 represented a welcome improvement in the U.S. loan market. After a lackluster start to the summer, conditions were "eerie-sistible" for investors who were ready to put their cash to work.

In total, there was $70 billion of institutional volume in Q3'23, representing the highest quarterly level since the Federal Reserve began raising interest rates in Q1'22.[ii] September alone accounted for $38 billion of new-issue volume, being the only month of the year in excess of $30 billion.[iii] As a promising sign, the uptick was largely driven by LBO and acquisition-related financing transactions. According to Bloomberg, new money financings accounted for 27% of monthly volume for September, of which 83% was for M&A issuances.[iv] The buyout loans for Worldpay ($5.2 billion/€500 million), Simon & Schuster ($1 billion) and Syneos ($2.7 billion) comprised a significant portion of the new-money issuances.[v]

The uptick in LBO loan volume in September was supported by an increase in CLO issuance. More than $83 billion of U.S. CLO's were raised through September 29, 2023,[vi] and overall, CLO issuance for Q3'23 surpassed Q2'23.[vii]

Similarly, the secondary market has shown its backbone with conditions meaningfully improving in 2H'23. The most liquid loans measured by Refinitiv in the LPC 100 were quoted at 95.83 cents on the dollar as of September 2023, as compared to June 1, when the LPC 100 quoted at below the 92 level.[viii]

Finally, amend-and-extend loan volume went into overdrive and topped $130 billion, which marks a record-breaking year, as companies face punitive refinancing costs and the possibility of a prolonged period of higher interest rates.[ix] The increased amend-and-extend loan volume (which allows borrowers to push out maturities of debt arrangements without incurring new debt) made a dent in the "wall of maturities", which as of September 30, 2023, had decreased to $143 billion, of which only $18.8 billion is due by the end of 2024.[x]

2. Credit Documentation Terms: If you've got it, Haunt it!

In light of a busy Q3'23, documentation terms and pricing started to tilt in favor of borrowers, who took advantage of this window of opportunity to refinance and extend maturities, and with many arrangers exercising reverse flex to lower pricing for borrowers.

Nevertheless, ongoing recessionary fears and concerns over interest coverage capabilities have contributed to more conservative underwriting standards overall when viewed historically. Average total leverage across the board remained low. Total leverage for large corporate U.S. LBOs declined to 5.8x, representing the lowest level since 2011[xi]. The share of LBO deals levered 7x or higher also decreased to only 6% this year.[xii] In addition, according to LCDNews, the average LBO equity contribution has exceeded 50% this year, up from 45% last year.[xiii]

That said, these figures are skewed somewhat by the fact that many of the borrowers that came to market during this window tended to be stronger credit story companies to begin with, thereby requiring less leverage.

To the extent current market conditions persist, leverage levels are expected to remain low and lenders are expected to continue to require significant sponsor equity checks in LBO deals.

The ascendency of private credit as a key player in the U.S. leveraged loan market (as discussed in the next section) is expected to provide for continued competition vis-à-vis the broadly syndicated loan market, which will bode well for sponsors and borrowers looking to improve credit documentation terms. This competition has already resulted in the erosion of the number of larger private credit deals requiring a permanent financial maintenance covenant. In a recent Moody's report, 38% of deals sized $250 million to $500 million included a springing covenant rather than a financial maintenance covenant. This trend is likely to continue and may expand to other credit documentation terms as well, as private credit itself continues to expand.

3. Private Credit Markets: In it for the Mummy

Private credit continues to dominate headlines, and for good reason. The "New Kings of Wall Street"[xiv] seized increasing market share during the first half of 2023 as the traditional private equity LBO financing pipeline remained weak, and are expected to continue to look for opportunities, including by targeting currently syndicated loans in the Morningstar LSTA U.S. Leveraged Loan Index that are nearing their maturities[xv]. According to PitchBook/LCD, the number of non-LBO transactions in the U.S. 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.[xvi] Looking back more broadly, according to Institutional Investor, the private credit industry has grown nearly 25% per year over the last 20 years, and the asset class is now three times as large as it was in 2015.[xvii]

Private credit providers have also turned their attention to other asset classes, including investment grade lending, asset-based lending and preferred equity investments. Other big players are joining the party as well: Bain Capital announced its new asset-based lending arm in May 2023, and Blackstone reorganized its asset-based finance unit in September 2023 and announced that private credit is coming for asset-based debt.[xviii]

Privately placed financings can have a number of benefits for private equity sponsors, namely (i) improved deal certainty from a debt financing perspective in LBO transactions due to the absence of a marketing process and ability to close without a formal marketing period and (ii) certainty regarding terms due to the absence of market flex provisions; though this typically comes at the cost of higher interest rate margins and more conservative terms. For more details on the rise of private credit and its impact on LBOs, please refer to the following article, which was published by our colleagues in September 2023: *M&A, Professional Perspective – The Rise of Private Credit & Its Impact on Acquisition Dynamics*.[xix]

4. Syndicated Loan Market: It's Boo-gie Time!

The syndicated loan market, too, started to re-open in Q3'23, although syndicated loan volume is still down 32% year over year.[xx]

Investor confidence in the syndicated loan market has been bolstered by a few large LBO syndications that cleared the market in Q3'23, including: (1) the LBO financing for Worldpay (BB/Ba3/BB), which included a $2.7 billion leveraged loan that was upsized to $5.2 billion while in market and (2) the $2.7 billion term loan B for Syneos Health (B/B1/B+).[xxi] The success of these deals helped bolster the resurgence of the syndicated market in Q3'23, though LBO volume for the first 9 months of 2023 is still down more than 60% compared to the same period in 2022.[xxii]

To combat ongoing market volatility on syndicated financings, arrangers have reported spending more time pre-marketing and hitting the market quickly to offload risk.

B. THE SPOOKY

1. Government Regulations: Like vampires, they can be deadly

Lengthening regulatory approval timelines and more aggressive enforcement by the FTC and DOJ have been one contributing factor to the overall tepid state of the loan market in 2023. In addition to creating deal uncertainty, these heightened regulatory schemes can also have economic implications for underwritten debt financings with long commitment periods in the form of ticking fees and/or duration-based pricing, fee step-ups or price flex rights.

The general consensus is that the heightened regulatory environment is here to stay for the foreseeable future. For example, the FTC recently focused in on "roll-up" transactions led by private equity firms as potentially resulting in market consolidation and anti-competitive behavior.[xxiii] In another recent example, the FTC submitted a second request for information in connection with the $2.33 billion acquisition of Sovos Brands by Campbell Soup, which has pushed closing of the deal to mid-2024.[xxiv]

Similarly, there are several new regulatory proposals from various government agencies, including with respect to safeguarding proposed rulemaking, conflicts of interest in securitizations, private fund adviser rules and liquidity risk management proposed amendments.[xxv] Some of these rules could have a direct impact on the loan market, which may result in higher pricing to access capital for companies.

Despite more active enforcement, regulators have faced some notable defeats this year. The FTC lost its case against Microsoft, who recently completed its acquisition of Activision Blizzard for $69 billion, and the SEC lost its case in Millennium Health, in which the appellate court affirmed the Southern District of New York's holding that leveraged loans do <u>not</u> qualify as securities[xxvi].

Investors should keep the regulatory backdrop in mind on transactions and may need to adjust investment plans as needed to account for this continually evolving area.

2. Recessionary Fears

Although recessionary fears remain, they may be waning. In a recent Refinitiv LPC Survey, 61.5% of respondents indicated that they do not anticipate a recession before 2024, 77% believe any recession will be shallow, and the balance say any recession will be moderate.[xxvii] Similarly, top U.S. economists are predicting that the chances of the U.S. economy avoiding a recession are improving, with the odds, at 46%, being the lowest since Q1'22.[xxviii] However, continued inflation, high interest rates, political discord and geopolitical tensions could function to tilt the scale towards a recession at any time.

3. Potential Government Shutdown

The drawn out battle to elect a new speaker of the House has left Washington in disarray. Although a new Speaker was elected last week, the House now has limited time to negotiate and approve a funding deal to keep the government open, as the current funding deal will expire on November 17, 2023. In addition to creating broader instability, a government shutdown could have implications for M&A deals in the market. In the event of a government shutdown, the FTC would likely only have enough funding to get through a few weeks before it would be limited to operating with just "essential" staff. This could result in further delays for deals seeking HSR approvals.

4. Conflict in the Middle East

It remains to be seen what impact the devastating Israel/Hamas conflict and ensuing war will have on the loan market. The impact will likely depend, at least in part, on whether the conflict remains focused in Gaza and Israel or whether it spreads more broadly throughout the Middle East.[xxix] The potential for this conflict to disrupt the world economy or tilt the scale towards a recession is certainly real.

C. Q4 2023 / 2024 OUTLOOK – TRICK OR TREAT?

The loan market has already softened in Q4'23 due to concerns around some of the "spooky" developments we highlighted above. The softening of the market from the second half of September through the end of October demonstrates the continued fragility of the overall leveraged loan market.

Market participants are expecting that the U.S. Federal Reserve will keep interest rates higher for longer. If this is true, since borrowing costs would by extension also remain higher for longer, this would suggest we may be in for "more of the same" at least for the beginning of 2024. Further, the valuation gap between buyers and sellers remains wide and is expected to have the continued effect of hampering LBO activity until it starts to narrow.

Despite various challenges and setbacks in 2023, loan market participants showed up strong at the end of Q3'23. With amend-to-extend activity expected to continue, the decline in private credit defaults and the ever-expanding role of private credit providers driving competition, there are still reasons to be optimistic as we close out 2023 and look ahead to the new year.

ENDNOTES

[i] Commissioner Carolina A. Crenshaw, “In-securities: What Happens When Investors in an Important Market are not Protected? Remarks to the Center for American Progress”, October 11, 2023.

[ii] Marina Lukatsky, “September Wrap: Loans continue to rally despite losses in other asset classes”, October 2, 2023.

[iii] Marina Lukatsky, “September Wrap: Loans continue to rally despite losses in other asset classes”, October 2, 2023.

[iv] Bloomberg, “Leveraged Finance Chartbook”.

[v] Jessica Hamlin, “KKR builds historic foothold in publishing with Simon & Schuster deal”, August 8, 2023; Claire Ruckin, “Price Transparency on Junk Debt Deals Smoothes the Way for More”, September 22, 2023.

[vi] Refinitiv LPC’s Gold Sheets, October 16, 2023.

[vii] Refinitiv LPC’s Gold Sheets, October 16, 2023.

[viii] Refinitiv LPC’s Daily Analytic: LPC 100 has gained 4% since beginning of June, September 19, 2023.

[ix] Richard Kellerhals and Rachelle Kakouris, “Amend-and-extend loan volume tops $130B in record-breaking year”, October 19, 2023.

[x] Richard Kellerhals and Rachelle Kakouris, “Amend-and-extend loan volume tops $130B in record-breaking year”, October 19, 2023.

[xi] Refinitiv LPC’s Gold Sheets, October 30, 2023.

[xii] Credit Insights, “CR TrendLines Topical Report: M&A Debt Multiples Remained Low in Q3; Highly Levered Deals Again Missing”, October 5, 2023.

[xiii] Rachelle Kakouris, “Quick Take: LBO equity contributions top 50%; yields hit record highs”, October 17, 2023.

[xiv] Matt Wirz, “The New Kings of Wall Street Aren’t Banks. Private Funds Fuel Corporate America”, October 8, 2023.

[xv] Abby Latour, “Private Credit, hungry for deals, feasts on near-term loans in syndicated market”, May 30, 2023.

[xvi] Abby Latour, “Private Credit: It’s not just for LBOs, LCD data show”, May 5, 2023.

[xvii] Benton Lewis, Christopher Machera and Samantha Patel, “M&A, Professional Perspective – The Rise of Private Credit & Its Impact on Acquisition Dynamics”, September 2023.

[xviii] John Sage and Carmen Arroyo, “Private Debt Firms Roil Asset-Based Loans as Liquidity Heroes”, July 20, 2023.

[xix] Benton Lewis, Christopher Machera and Samantha Patel, “M&A, Professional Perspective – The Rise of Private Credit & Its Impact on Acquisition Dynamics”, September 2023.

[xx] Refinitiv LPC’s Gold Sheets, October 9, 2023.

[xxi] Claire Ruckin, “Price Transparency on Junk Debt Deals Smoothes the Way for More”, September 22, 2023.

[xxii] Claire Ruckin, “Price Transparency on Junk Debt Deals Smoothes the Way for More”, September 22, 2023.

[xxiii] Lina Khan, “It’s time to halt roll-up schemes that violate antitrust laws”, September 21, 2023.

[xxiv] David Ratch, Campbell Soup-Sovos Brands Delay Merger Close, October 24, 2023.

[xxv] LSTA, “Policy Matters How to Survive (& Thrive) in Tomorrow’s Regulatory Environment”, October 12, 2023.

[xxvi] Jon Hill, “SEC Silence In Loan Case Speaks Volumes, 2nd Circ. Told”, August 2, 2023.

[xxvii] Refinitiv LPC’s Gold Sheets, October 16, 2023.

[xxviii] Sarah Foster and Tori Rubloff, “Survey: Odds of a recession by September 2024 fall to 46%”, October 10, 2023.

[xxix] George Smith, “Assessing Potential Market Impact of Israel-Hamas War”, October 10, 2023.

Banking & Finance Alert is published by the Banking & Finance practice group of Weil, Gotshal & Manges LLP, 767 Fifth Avenue, New York, NY 10153, +1 212 310 8000, www.weil.com.

If you have questions concerning the contents of this alert, or would like more information about Weil's Banking & Finance practice group, please speak to your regular contact at Weil or to authors:

Authors

Andrew Colao (NY)	View Bio	andrew.colao@weil.com	+1 212 310 8830
Jacqueline Oveissi (NY)	View Bio	jacqueline.oveissi@weil.com	+1 212 310 8717
Angel Torres (DA)	View Bio	angel.torres@weil.com	+1 214 746 8114
Angela Estrada (DA)	View Bio	angela.estrada@weil.com	+1 214 746 7801