Market Intersection:

A Quarterly Look at the U.S. Credit Markets

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3Q22 US syndicated loan volume down 24% year over year

Maria C. Dikeos

The global debt capital markets turned bearish in the third quarter of 2022 and the loan market was not immune from the fallout. US syndicated loan volume tumbled 24% year over year to log just over US$472bn, the weakest quarterly results in almost two years. In turn, issuance for the first nine months of 2022 totaled US$1.8trn, down 15% compared to the year ago period. Most of the shortfall came amid top line market concerns around stubbornly high inflation figures, growing recessionary pressure and ongoing geopolitical uncertainty which threatens energy supplies heading into the fourth quarter.

From a demand standpoint, liquidity largely remained in place but lenders and borrowers across the leveraged and investment grade markets were more cautious. At the same time, in the loan space specifically, several lenders faced unexpected struggles following the late June release of the Fed's stress test results and the subsequent requirements for some banks to increase capital buffers.

In the leveraged space, concerns were more weighty. Less than US$165bn of leveraged loan volume was sold down in the broadly syndicated loan market in the third quarter, down 45% compared to the same time last year. At US$669bn, leveraged loan issuance through the end of September marked the weakest nine-month total since 2020.

Bad Timing

As inflation data and Fed action unnerved the market, launches for leveraged credits were postponed (Nielsen Holdings), select names already in market had to tweak terms (Covertus), while others were pulled (Brightspeed). A last grouping of underwritten issues slated to hit retail syndication in the fourth quarter served as reminders of the overhang still on the books (Tenneco, Tegna).

More frustrating, said lenders, is the fact that despite the limited supply of dealflow overall, there are few indications – at least for the moment – that new dealflow will emerge.

Ultimately, US$204bn in new loan assets cleared the market in the third quarter, down 17% year over year. M&A deal volume represented 44% of this total. M&A loan issuance totaled US$87bn, echoing the weak results last observed during the peak of the Covid pandemic. Dealflow for the first three quarters totaled US$325.9bn, down 28% compared to the year ago period.

Discounted LBO Credits

Across each of the investment grade and leveraged loan spaces, worrisome, negative expectations weighed more on market tone than actual credit fundamentals.

On the demand side, liquidity remained in place even if it was not backed by conviction to put money to work. Over US$103bn in new collateral loan obligation (CLO) formations have come together so far this year, down compared to the record totals logged at the same time last year, but respectable, nonetheless.

The rest of the demand picture was more mixed. Retail loan funds had outflows totaling over US$23bn over the last five months, culminating in net inflows hovering at roughly US$2bn so far this year. Bond flows struggled more with over US$54bn exiting the market year to date.

Better quality credits – most notably BB-names – could still get done albeit at higher pricing. Yields on BB loans averaged 7.36% during the quarter, over 300bp wider than second quarter levels. Single B LBO credits struggled more acutely, with pricing garnering a 300bp premium over BB credits to yield roughly 10.27%.

The US$8.55bn debt financing backing the buyout of Citrix Systems incurred losses for the underwriting banks as did several other buyout credits. The Citrix loan was ultimately issued at a deep discount, garnering an OID of 91. But in a testament to market appetite, the syndicate remained top heavy and the paper failed to subsequently trade up in the secondary.

This was unfortunately consistent with broader trends observed in the secondary market, which has traded off dramatically. The LPC 100, which tracks the most widely held leveraged credits, is down 7.0% this year and is currently bid at 91.6, the lowest average bid since May 2020.

Ultimately, the volume of loans backing buyout financings during the quarter was down 61% year over year at just over US$27bn. Sponsors raised just under US$65bn via the broadly syndicated loan market during the third quarter, a 63% drop over year ago totals.

Ultimately, less than US$182bn in leveraged loan and high yield bond volume was completed in 3Q22, the weakest quarterly results in over six years. While the loan market struggled, the most crushing impact from the economic headlines was borne by the high yield bond market. Just over US$17bn in new issues cleared the market in 3Q22, the lowest quarterly total since 4Q18 and an 83% year over year drop. At US$90bn, high yield bond volume for the first nine months of the year was 77% lower than year ago totals and the lowest since 1-3Q2008 during the height of the credit crisis.

For the market to be functional again, lenders said transactors need to be able to look beyond today's pipeline and begin to underwrite deals at current market pricing levels. For the moment, the market lacks the conviction to do so.

Fig. 1 Institutional loan issuance

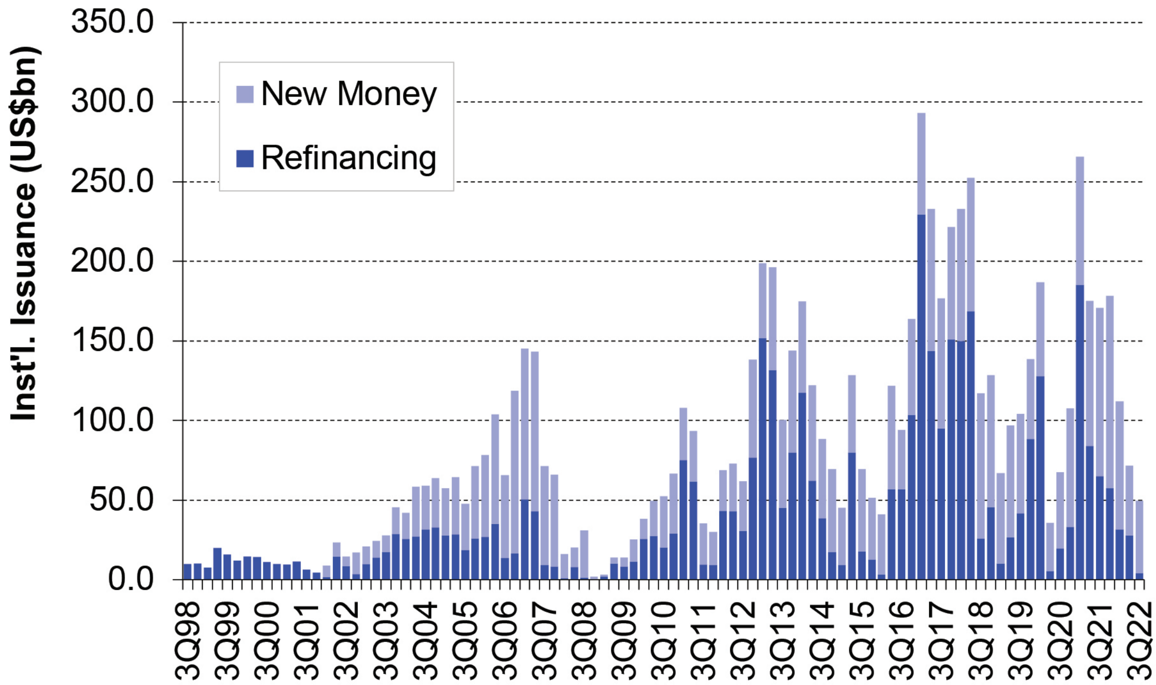


Fig. 2 Primary market yields continue to increase as activity stalled in 3Q22

Source: Refinitiv LPC

Volatility spills into the middle market

Diana Diquez

A few weeks into the last quarter of the year, middle market lenders are surprised by the shifting dynamics and fast pace of change and are trying to figure out and prepare for what is coming next. After being somewhat isolated to broader market trends earlier in the year, the middle market is dealing with the effects of persistent inflation, rising interest rates, recessionary fears, and geopolitical uncertainties. In the syndicated middle market, loan issuance, including sponsored and non-sponsored lending, tumbled to US$35bn in the third quarter from US$55bn in 2Q22.

In contrast, the direct lending market had a strong showing in 3Q22 with sponsored middle market direct lending volume climbing 17% quarter-over quarter to US$35bn, its highest level since 4Q21's record US$55bn. However, many changes took place during the quarter, and there are signs that suggest a slowdown might be coming to this end of the lending space.

In the non-sponsored market, activity slowed significantly in 3Q22 following a strong second quarter. At US$26bn, non-sponsored syndicated lending fell 32% quarter-over-quarter and 23% year-over-year.

Dragging down non-sponsored volumes was a 42% drop in new money lending to US$11bn in 3Q22 from a high of US$18bn in 2Q22. In the current uncertain economic environment, corporate issuers have become even more cautious about their expansion plans and about taking on new debt. After increasing in 2Q22, non-sponsored syndicated M&A issuance plunged to US$2.4bn in 3Q22.

Banks are also more selective and are scaling back their hold levels. On the flip side, as banks reduce or exit their exposures to clients, opportunities have arisen for other banks that are looking to step up their commitments on existing deals or to grab pieces of new ones. But even banks looking to put more money to work are being cautious given the current environment and some said it is a "market of the haves and have nots."

Bankers that focus on the non-sponsored space said they expect the rest of the year to be somewhat slow, with most opportunities coming from other banks reducing hold levels. With few exceptions, they don't expect to see much activity coming from acquisitions or building of new capacity as many companies are dealing with increased inventories and lower sales. Bankers are keeping an eye on their portfolios because there has been a general softness in performance, however, most of the companies are low levered and can withstand inflation pressures and rising rates.

In the sponsored market, total volume, including syndicated and direct, was also down in 3Q22. At US$44bn, 3Q22 sponsored volume declined from US$46bn in 2Q22. However, the decline was due to muted activity in the syndicated market, which saw issuance drop almost 50% both quarter-over-quarter and year-over-year to US$8.6bn in 3Q22. Direct lenders stepped up to fill in the gap. At US$35bn in 3Q22, direct lending sponsored volume logged its second-highest quarterly volume on record, behind 4Q21. In turn, the ratio of direct to syndicated lending volume soared to 4.0 times in 3Q22, way ahead of the prior high of 3.3 times in 4Q21.

LBO loan volume increased for the third quarter in a row to US$18bn. Direct lending led the charge with a 21% quarter-over-quarter increase to US$14bn in 3Q22. For the first nine months, there was 3.7 times more LBO volume done in the direct market, the highest ever. However, a few weeks into 4Q22, some lenders said it feels that things are slowing down in the deal front.

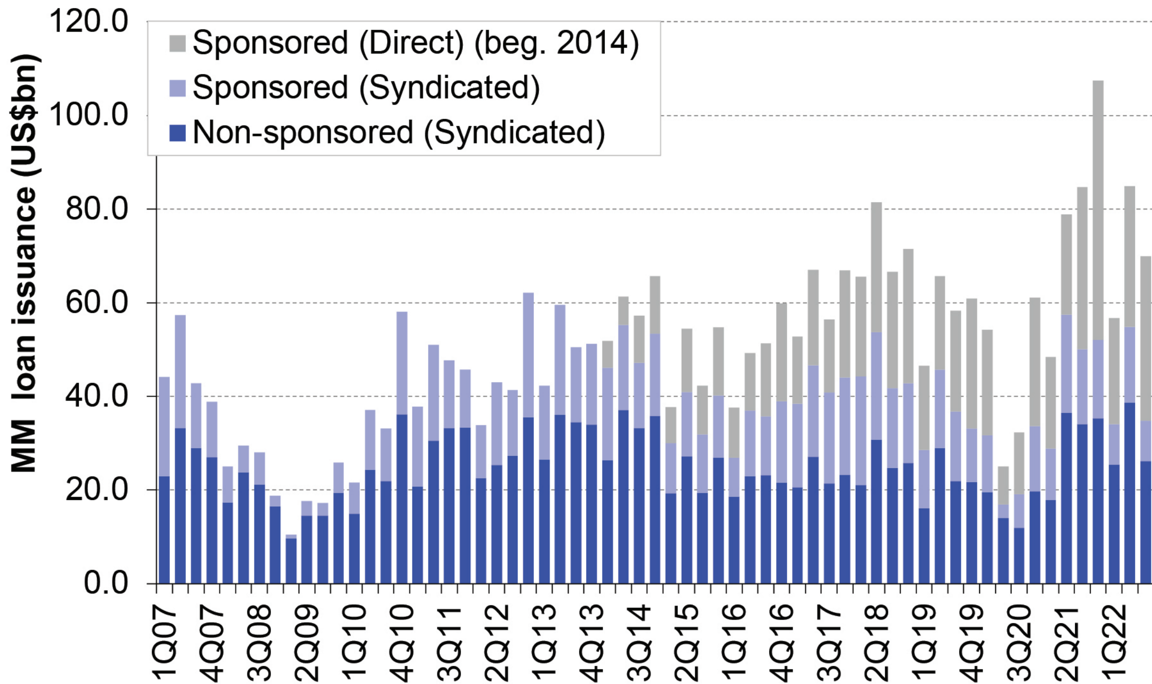
A challenging syndicated market and an uncertain economic horizon have given direct lenders more negotiating power, a shift from an extended period of sponsors dictating terms. Heading into 4Q22, 35% of direct lenders that took Refinitiv LPC's Quarterly Survey are looking at a maximum total leverage of 6.0 times and above. This was a lot lower than 57% of respondents three months earlier.

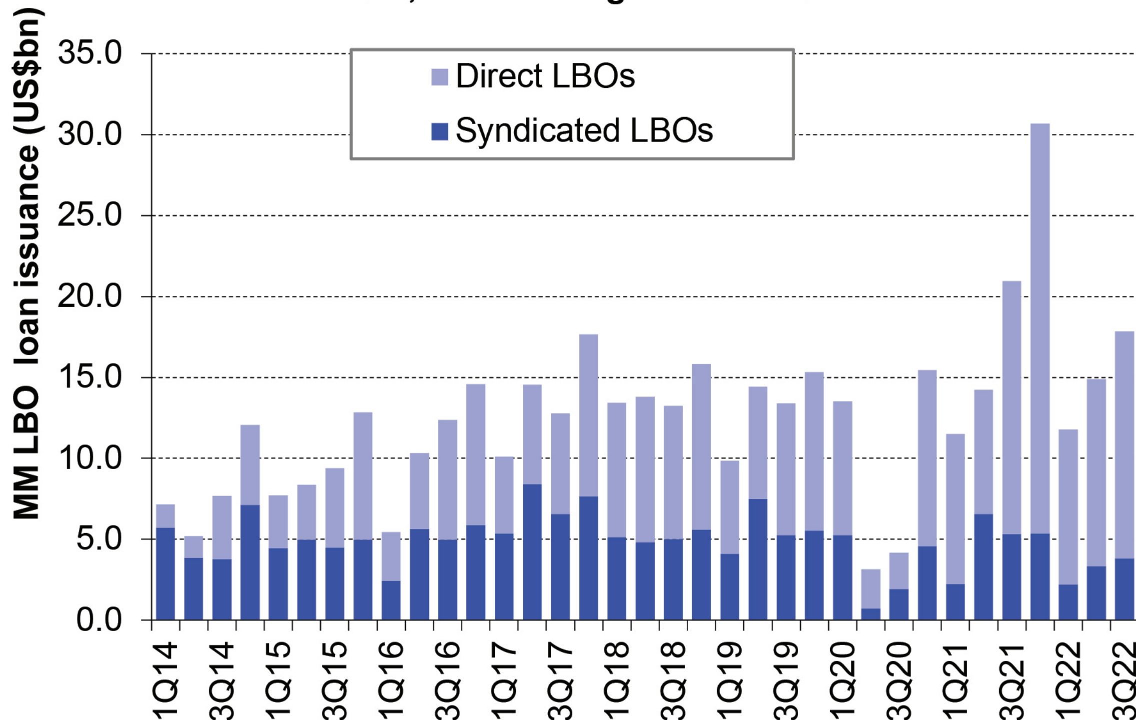
After years of low interest rates, interest expenses have soared and with higher rates in the horizon, lenders are paying close attention. The average Ebitda to interest ratio declined to 2.8 times in 3Q22 from 3.1 times in 2Q22, its lowest level since 3Q19.

Rising rates have been the main driver behind skyrocketing yields. For middle market unitranches, the average 3Q22 yield soared to a record 9.91%. While the increase was mostly driven by rising base rates, there was also a widening in spreads and OIDs. The average blended spread on unitranches, including large corporate deals, was 616bp in 3Q22, the highest quarterly level since 1Q21.

Lenders said that there are many challenges ahead and the market is changing day to day, which blurs the visibility into what will happen in the longer term. While most lenders said, with a few exceptions, portfolios have been performing well, the pressure of rising rates is a major concern as many existing deals were not structured to withstand rates at currently forecasted levels. Another top concern is what will happen to liquidity in the direct lending market as the fundraising environment is facing challenges. Lenders said there are many headwinds that could make many capital sources that everyone relied on for so long disappear.

Not surprisingly, lenders are having a hard time predicting what comes next. For the time being, many said they are still putting money to work this quarter but are being selective and careful with their capital.





Source: Refinitiv LPC

The Legal Corner by Paul Hastings

The U.S. loan market continued to cool in the third quarter, amid an uncertain economic outlook. Geopolitical risks, rising interest rates, and a continued threat of recession have caused lenders to focus on credit quality as the volume of new issuances decreased. Despite such continuing volatility, some market segments, including private credit, remained relatively active and are anticipated to keep apace into early 2023.

Deal Volume Across Market Segments

New money lending decreased significantly in 3Q22, as the syndicated market struggled and borrowers faced marked increases in interest rates. One-month Term SOFR was over 300 bps at the end of the quarter and has continued to rise, likely cresting 400 bps before year end. M&A activity continued to trend downwards, and syndicated lending declined. The private credit market was less heavily impacted, in some cases stepping in for the syndicated market in financings, particularly for many middle market LBOs. Through year end and into 2023, M&A activity and overall deal volume is expected to be down year-over-year (as compared to 2020 and 2021). Some market participants are looking to 2Q23 for aggregate deal volume to return to previous levels.

Evolving Fee Structures

Given current market conditions, including syndication challenges and rising interest rates, fee structures in the U.S. loan market continue to evolve. Fee structures and information are being treated as increasingly proprietary, with everything from prepayment premiums to credit spread adjustments for SOFR loans being set forth in confidential fee letters / side letters (ostensibly to avoid bespoke fee arrangements from being used against parties in future transactions). For certain credits that include extended commitment timeframes or that may already be facing financial challenges, some credit facilities have included additional fees to compensate (perceived) increased risk. Over the past year and a half, ticking fees for extended commitment periods returned, after unsurprisingly falling out of favor in the early days of COVID. Such fees now appear more regularly in deals across the capital structure, often beginning to accrue earlier than prior to 2020 (e.g., at 121 days vs. 181 days). In select “riskier” or pre-distressed credits/deals, some lenders are reportedly pushing for certain fees to be payable at signing; however, such fee structures remain relatively rare in the U.S. loan market.

Recent Covenant Trends

The market has shifted as 2022 winds down, with fewer large syndicated deals, an increasing market share for private credit, and financing sources strategically selecting where and when to deploy their (at least in some cases) ample dry powder. Given the current economic climate, some lenders have been increasingly discerning in evaluating deal terms and structures, with tighter terms (e.g., baskets, caps, incurrence tests, etc.) and increased lender protections (around leakage and uptiering) beginning to appear in at least some deals. Some financing sources have been focused on capping EBITDA adjustments and synergies, including the Regulation S-X adjustment, as well as tightening leakage protections. Beyond traditional “J. Crew” and “Chewy” protections, there is also a renewed focus on baskets and designation conditions with respect to unrestricted subsidiaries. Some lenders are also looking for stronger protections against uptiering transactions, revisiting lender “sacred rights” and “Serta” protections, particularly following uptiering and drop-down transactions effected by Envision Healthcare Corporation and Incora (f.k.a., Wesco Aircraft Holdings, Inc.) earlier this year.

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