Market Intersection:

A Quarterly Look at the U.S. Credit Markets

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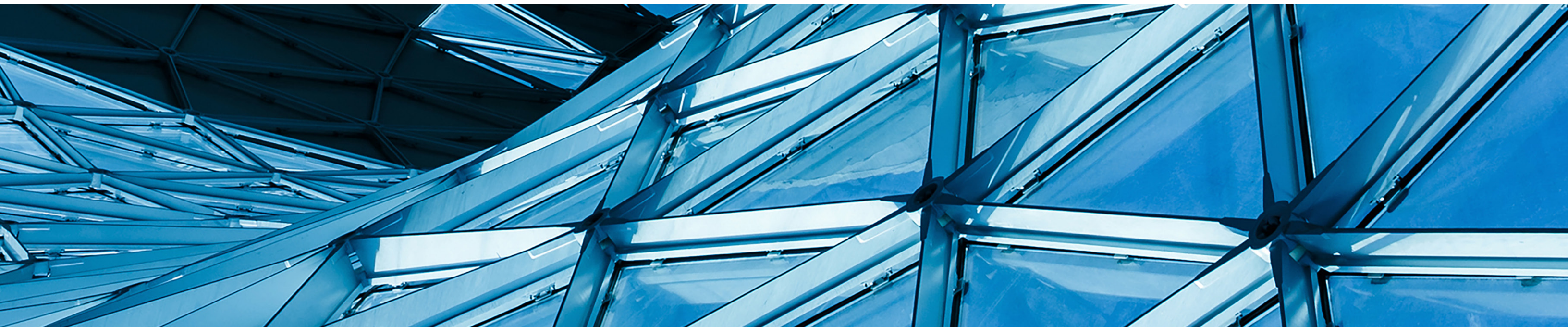


1Q23 US syndicated loan volume down 13% year over year as bank crisis rattles markets

Maria C. Dikeos

The global debt capital markets began the year feeling pretty good – perhaps a bit slower than lenders would have hoped, but absent major concerns. The tone changed dramatically in early March following the collapse of Silicon Valley Bank and Signature Bank, and wavering confidence in the viability of others. Although one can debate whether initial market reaction to the events was overblown, there is little doubt that lenders, borrowers and investors were spooked.

At US$453.5bn, 1Q23 US syndicated loan volume was down 13% year over year. In practical terms, the decline was less a reflection of any direct pullback as a result of the March bank crisis (although a flurry of deals were postponed or pulled from the market as a result of the crisis) and more a reaction to protracted inflationary pressures and growing expectations of a looming recession. Nevertheless, the last few weeks of the quarter did present challenges for loan arrangers as well as prospective borrowers.

MARKET WAIT & SEE

At US$205.5bn, 1Q23 investment grade loan volume was down 5% compared to the same time last year. The pipeline of deals held steady although sources said the funded side of the market seemed less busy with term loan debt concentrated among a smaller number of large credits.

Despite the increased market volatility in March, high-grade lenders said M&A discussions remained in play, though at less than US$6bn, 1Q23 investment grade M&A loan volume marked the weakest quarterly results since 4Q19.

1Q23 investment grade refinancing activity totaled US$164bn, up 19% year over year. Lenders noted that despite the turbulence, the bank stress in March was neither a replay of the 2008 credit crisis nor reminiscent of the 2020 Covid upheaval, in which borrowers drew down on backstop facilities in a bid to secure liquidity access. Instead, corporates rolled overnight commercial paper (CP) and tapped the bond market to term out other CP programs.

Term loan liquidity remained in place, although tenors were shortened to two and three years rather than five. Term loan spreads that were ratcheted up at the end of last year remained steady, no longer pricing through revolvers.

Investment grade arrangers said the biggest concern they are hearing from borrowers is around the management of their bank groups and, more specifically, how to keep their bank groups together.

"The investment grade market is somewhat oblivious to market conditions from the standpoint of refinancings," said one lender. "But I would say that there is some noise and, on every transaction, we are worried about someone dropping out."

RANGE BOUND LEVERAGED MARKET

At US$167.25bn, 1Q23 leveraged loan volume was down 23% compared to the year-ago period as any hopes of a developing forward calendar slowed dramatically over the last three weeks of the quarter.

It is also noteworthy that no deal in market failed, although an opportunistic US$1.16bn TLB extension for Russell Investments was postponed in the third week of March pending better market conditions, as was a dual currency M&A financing backing Ineos Enterprises' acquisition of MBCC Admixture and an amend and extend financing for Agiliti.

Nevertheless, market technicals signaled turbulence.

The high yield bond market saw weekly outflows totaling over US$6.6bn in March and issuance stalled for almost two weeks.

The loan market was a bit more sanguine as nearly US$5.5bn exited retail loan funds during the last month of the quarter, although the Collateralized Loan Obligation (CLO) market continued to provide a reliable liquidity backstop to the outflows. Over US$31bn of new CLO issuance was created via 20 deals in 1Q23, on pace with year-ago results (US$31.6bn). Tempering hopes, only two new CLO issues have come to market since March 16.

Having tumbled to levels in the 91.3 range at the end of 2022, bids among the 100 most widely held leveraged loans recovered to a high of just over 93.2 by mid-February only to drop below 91in mid-March, before recovering to 91.4 by month end.

HARD OR SOFT LANDING?

What does this mean for dealflow?

"It is hard to get issuers to come to market when there has been so much volatility," said one arranger of leveraged debt. "Issuers have the luxury of timing the market. This is especially true if there are no near-term maturities for borrowers to manage. As a result, the pipeline – limited as it was – skewed toward higher-quality credits. B3 deals were largely non-starters.

Although prospects for the leveraged refinancing deal calendar are spotty, sustained M&A recovery is even more unclear. In early March, specialty chemicals company Solenis announced its buyout of Diversey Holdings in a deal valued at US$4.6bn and underwritten by Goldman Sachs and Bank of America.

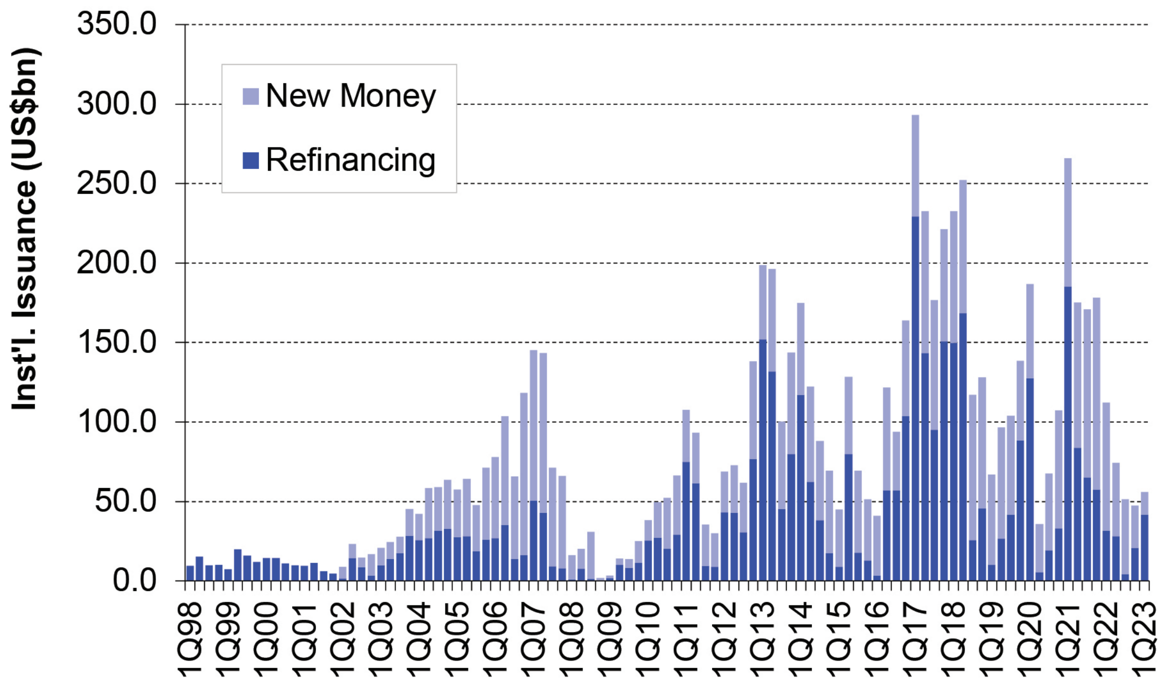
While the all-cash deal represents an opportunity for lenders to put money to work, arrangers said that in the absence of data points it is difficult to gauge where a buyout credit – loan or bond – would print today.

"It slows things down," said one transactor. "There is more discussion than there would normally be."

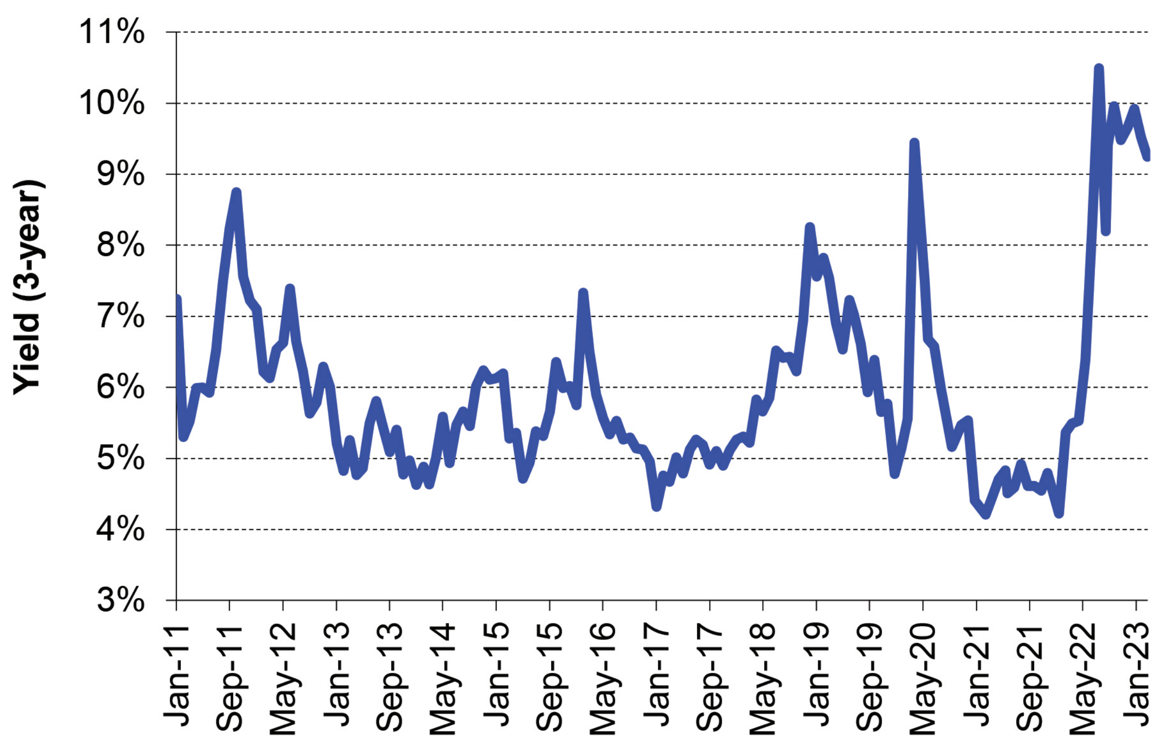
Against this backdrop, 1Q23 sponsored loan volume was down 30% year over year at US$75.3bn. At US$3.35bn, broadly syndicated LBO loan volume dropped 92% year over year to log the lowest quarterly total since 3Q09.

There is desire to do deals, said bank lenders, but there are also good reasons to be cautious for now.

Institutional loan issuance



Primary market yields continue to increase as activity stalled in 1Q22



Source: Refinitiv LPC

1Q23 middle market lending dropped back to pandemic levels

Diana Diquez

2023 began at a slower pace than usual for the middle market, as both issuers and lenders began the year on cautious footing. By late February, however, activity started picking up. But the momentum waned in early March, as turmoil in the banking sector led to a dramatic change in broader market sentiment and the effects trickled into the middle market. US middle market lending, including syndicated and direct lending executions, totaled US$39bn in 1Q23, down roughly 34% both quarter-over-quarter and year-over-year, and logging its lowest level since 3Q20.

NON-SPONSORED FEELS THE HEAT

The non-sponsored end of the market logged US$19.9bn of syndicated loan issuance in 1Q23. This was down 32% from 4Q22 and 26% year-over-year. After a sluggish January, loan volume jumped to US$9.5bn in February, but then retrenched to US$6.3bn in March following the collapse of Silicon Valley Bank and Signature Bank. The shift was more evident in non-sponsored M&A, as the volume of loans backing M&A activity sank to just US$90m in March, from US$1.5bn in February. The final tally for the quarter was US$1.8bn, the lowest level since 4Q20.

Lenders are uncertain as to when activity will pick back up as most issuers are not in growth mode and banks are being careful about their capital deployments and are more focused on deposits and on the overall relationship. The promise of ancillary business does not cut it anymore. Instead, more bankers are looking for certainty that they will indeed get the business coupled with higher pricing. In the middle market this is challenging as smaller companies have less business to spread around, so some lenders wonder how this will affect the composition of bank groups over time.

SPONSORED BACK TO PANDEMIC LOWS

The first quarter was also challenging for the sponsored market. Lenders were prudent with their capital and while sponsors were eager to put money to work, there was a big disconnect between buyers' and sellers' expectations, leverage was harder and more expensive to come by, and processes were also taking longer, as deals faced more scrutiny. 1Q23 total sponsored middle market volume, including syndicated and direct executions, retrenched to US$19bn, a level not seen since the worst of the pandemic. Direct lending volume was hit hardest, with volume plunging 50% quarter-over-quarter and 45% year-over-year to just US$12.5bn. Sponsored syndicated loan volume was flat from 4Q22 at low levels of US$6.6bn.

With an overall slowdown in deal volume, less actionable opportunities and slower processes, LBO lending took a hit in 1Q23. At US$7.8bn, total LBO loan volume logged its lowest first quarter level since 1Q16. The volume of LBOs financed in the direct lending market was 4.7 times higher than the volume of syndicated LBOs in 1Q23, a huge drop from 4Q22's whopping 8.2 times, but still the third highest quarterly level tracked so far.

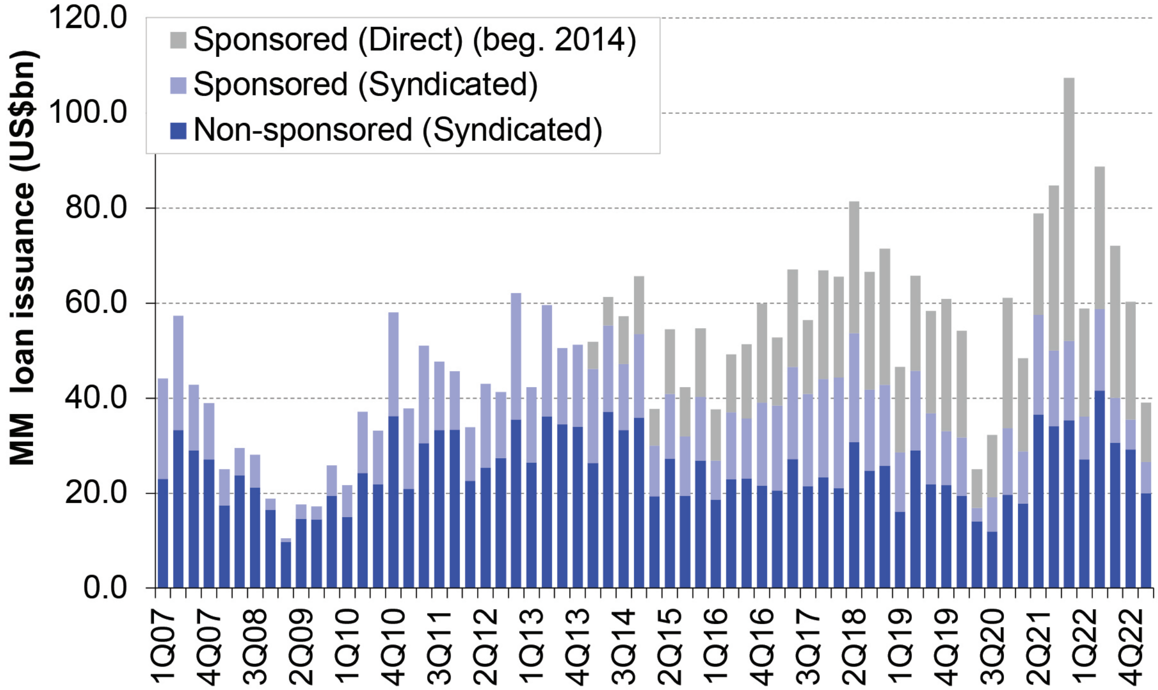
While there are many factors hindering LBO activity, lenders said the disconnect between buyers' and sellers' expectations is at the top of the list. They said that sellers are "still drunk" from valuations of the last decade and with the uncertain economic environment, and with leverage harder to get by and more expensive, buyers are a lot more selective, and valuations have come down. Indeed, LBO purchase price multiples declined from 12.3 times in 2022 to 11.4 times in 1Q23, the lowest level since 3Q20. While purchase price multiples declined, the equity multiple was only down minimally, to 7.3 times, from 7.4 times in 2022. In contrast, the leverage component dropped to 4.1 times in 1Q23 from 4.9 times in 2022.

Not only has leverage come down, but it has also become a lot more expensive. The average yield on direct lender-led first-lien term loans, including unitranches, widened almost 100bp to 12.32% in 1Q23. While a big part of the increase was from rising base rates, spreads also widened in 1Q23. The average unitranche blended spread, including large corporate unitranches, jumped to 690bp in 1Q23, a level not seen since 2017.

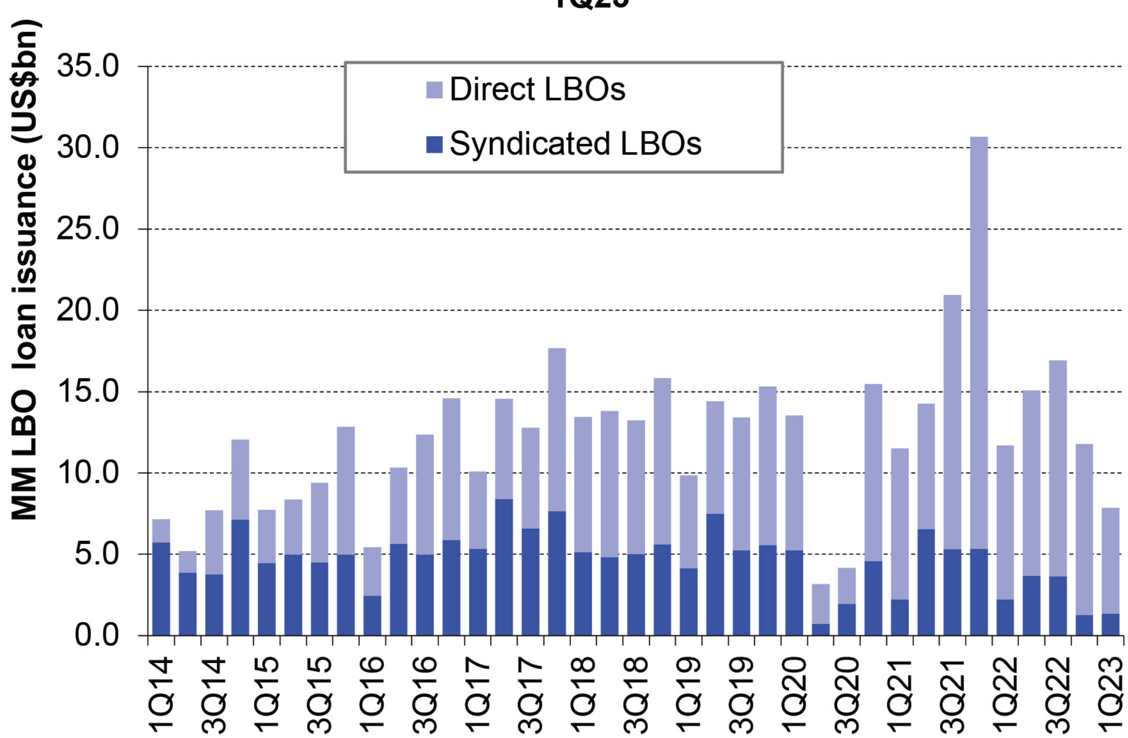
Lenders are hopeful there will be a bit of a pickup in activity in the second half of the year. Lower dealflow and the lack of quality opportunities continue to be a challenge, but if a high-quality deal hits the market, sponsors are willing to write big checks, and lenders are jumping in with somewhat aggressive terms.

Meanwhile, direct lenders have been even more focused on managing their portfolios. So far, companies continue to perform well and only a few, which they said were "already limping along" are starting to struggle a little. For the most part, lenders said their portfolios can withstand the effects of high interest rates, but the depth and length of the recession will be a factor, and that remains uncertain. Another uncertainty is the availability of leverage lines of credits from banks in the aftermath of the latest banking crisis. While some larger players said they have not seen much change, smaller direct lenders said they had a few banks pull out when extending their current financings, and others were looking to widen the price

Total middle market loan issuance dropped to US$39bn in 1Q23



MM direct lending LBO volume declined 34% to US$8bn in 1Q23



Source: Refinitiv LPC

The Legal Corner by Paul Hastings

General market unease in the first fiscal quarter of 2023 was evident. The back-to-back collapse of two regional banks spooked investors and the effects of two federal rate increases rippled through the market. Uncertainty in investor confidence resulted in lower new money deal flow and the tightening of terms across both new and existing credits. However, in the few trophy credits to hit the market, the competitive auction saw widespread participation across the direct lending market.

As we enter Q2 and wrap up the first half of 2023, new deal flow is expected to remain stagnant. This stagnation is driven in part by continued mismatch in valuation. However, we expect an increase in the number of amendments of existing credits in lender portfolios as a result of financial audits due in May, the LIBOR sunset in June, and the general cooling of the refinancing market.

In the first instance, early indications already show potential performance issues by Borrowers in several industries, and direct lenders are already in early discussions management to bridge the short-term liquidity crunch resulting from rising rates and other macro-economic factors. Expect to see an uptick in amendments with covenant relief packages that provide for enhanced reporting packages, interest rate increases (likely in the form of PIK given cash flow considerations), and more restrictive negative covenant usage conditions.

With the LIBOR sunset in June, there will be continued amendment activity throughout each lenders' portfolio to align floating rate credits with SOFR. Although deals closed since 2020 generally have a fallback benchmark replacement language, many will seek to amend the credit documentation to update for the latest LSTA SOFR provisions and, where applicable, hardwire credit spread adjustments for certain credits.

The cooling of the private debt market generally has impacted the ability of borrowers to refinance. Credits that closed in 2016-2018 are now nearing the window for refinancing ahead of maturity, but with rising rates and investor pullback, not only is refinancing unattractive to borrowers given the current rate environment, but also the market is less competitive for all but the most attractive credits. Instead, it seems that parties are keen to extend the maturity of existing facilities – perhaps with some increased economics and otherwise preserving the status quo for a bit longer. This generally points to optimism that perhaps the current market environment is temporary or at least recognizing that the market will need a bit longer to accept that the current environment may be the new normal.

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www.paulhastings.com

Key Contacts

Frank Lopez
Chair of the Firm
T: +1.212.318.6499
franklopez@paulhastings.com

William Brady
Head of Alternative Lender and Private Credit Practice
T: +1.212.318.6066
williambrady@paulhastings.com

Jennifer Yount
Co-Chair
Global Finance
T: +1.212.318.6008
jenniferyount@paulhastings.com

John Cobb
Co-Chair
Global Finance
T: +1.212.318.6959
johncobb@paulhastings.com

Tammy C. Davies
Of Counsel
Corporate Department
T: +1.212.318.6673
tammydavies@paulhastings.com

Serena Granger
Of Counsel
Global Finance
T: +1.212.318.6755
serenagranger@paulhastings.com

Jordan Hook
Of Counsel
Global Finance
T: +1.212.318.6604
jordanhook@paulhastings.com

Christopher G. Ross
Partner
Global Finance
T: +1.212.318.6788
christopherross@paulhastings.com

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Key Contacts

CJ Doherty
Head of Market Analysis
T: +1.914.310.2684
cj.doherty@lseg.com

Maria C. Dikeos
Head of Global Loans Contributions
T: +1.646.648.3811
maria.dikeos@lseg.com

Diana Diquez
Director of Market Analysis
T: +1.917.364.0764
diana.diquez@lseg.com

David Puchowski
Director of Market Analysis
T: +1.646.223.6843
david.puchowski@lseg.com