Market Intersection:

A Quarterly Look at the U.S. Credit Markets

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US syndicated loan volume down 15% in 2022 amid bearish sentiment

CJ Doherty and Maria C. Dikeos

The US debt capital markets saw a sharp downturn in 2022 amid high inflation, interest rate hikes, recession fears and geopolitical uncertainty. The attempts by the Federal Reserve to bring down inflation led them to raise interest rates seven times in 2022, prompting widespread fears around slowing economic growth.

Sentiment changed markedly, with investors adopting a more cautious and risk-averse approach, a reversal from the risk-on environment of 2021. Several banks also had to increase capital buffers following the release of the Federal Reserve's stress test results in June. Against this backdrop, M&A activity moved decisively lower as both corporate and private equity buyers and sellers struggled to agree on valuations while many adopted a wait-and-see approach.

In turn, total 2022 US syndicated loan volume was down 15% year over year to log US$2.5tn.

Total M&A loan volume tumbled almost 31%, to complete just over US$430bn of issuance for the year.

INVESTMENT GRADE SOFTENING

Coming off 2021 peak conditions, investment grade lenders pushed nearly US$737bn in regular way refinancings through the market, just shy of year ago totals. Most of it cleared relatively easily – maybe a deeper credit review, a bit more in the way of fees, and, in cases, some movement around the edges among the bank groups – but no substantive disruptions.

In contrast, opportunistic, new money asks – especially term loans rooted in relative value plays vis-à-vis a more richly priced bond market – garnered more scrutiny and, in many cases, increased lender pushback over the course of the year. Less than US$60bn of investment grade term loan volume was completed in the second half of 2022, a fraction of the US$78bn raised in the first half of the year.

LEVERAGED ISSUANCE FALLS SHARPLY

In tandem with broader market volatility, the syndicated leveraged loan market also encountered an especially challenging 2022. Dealflow fell sharply as the Fed's attempts to tamp down inflation via aggressive monetary tightening fueled uncertainty and risk-off sentiment. With the market stalled at times, leveraged loan issuance fell by 35% to US$850bn in 2022, while institutional loan issuance was hit even harder, tumbling by 64% to US$285bn. Loans backing LBOs also suffered in the uncertain market conditions, falling 39% to US$114bn.

In 4Q22, leveraged issuers cleared a relatively thin US$167bn, a 2% drop from the prior quarter and a 47% year-over-year decline. 4Q22 institutional loan issuance, at US$47bn, was down 8% from 3Q22 and 73% from the corresponding quarter last year. This represented the lowest level of institutional issuance since 2Q20 during the pandemic.

For much of the year, underwriters prioritized reducing their positions in large, underwritten LBO financings undertaken in 2021 or early 2022, prior to the market's repricing of risk. Block trades in several of these underwritten deals became increasingly prevalent as banks attempted to move assets off their balance sheets and investors opportunistically took advantage of the attractive terms on offer. This remains an ongoing work in progress as the overhang of committed LBO financings is slowly reduced.

BORROWING COSTS CLIMB

Ultimately, 2022 primary market loan yields climbed sharply, driven by higher base rates, wider original issue discounts (OIDs) and richer spreads.

Unsurprisingly, not all leveraged credits are created equal.

"We are seeing good companies price tightly, flexing favorably to the borrower," said one buysider in December 2022. "We are also seeing companies that have access to the market, willingly issue at price points in low 90s to mid-90s to do add-ons in the syndicated market."

CHALLENGES ON THE HORIZON

Credit quality in the leveraged loan market remained resilient for much of the year, with default rates remaining low, though they are expected to climb in 2023.

"There are going to be pockets of stress and some companies are going to have problems with their interest coverage ratio as the year progresses so there'll be some rescue financings," said one leveraged loan underwriter.

CLO managers say they are closely monitoring CCC downgrades, which are expected to accelerate, causing some CLOs to get closer to their CCC basket limits.

M&A IN EARLY 2023?

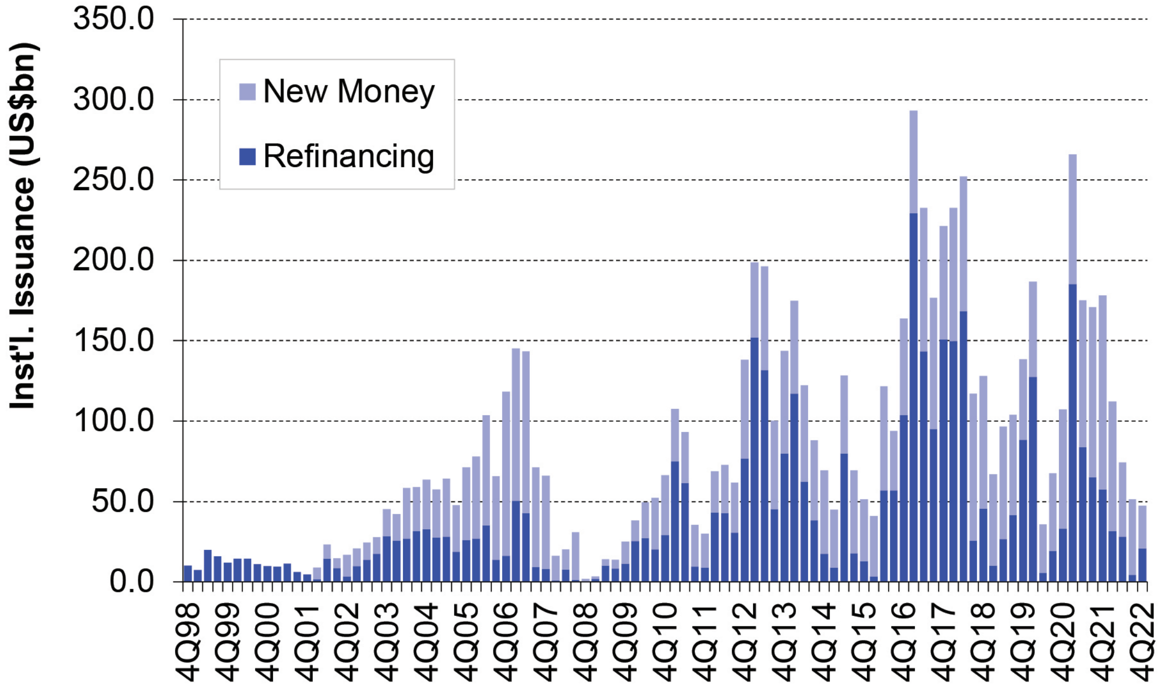
Looking ahead to 2023, the expectation is that there will be a further whittling down of the underwritten deal overhang via secondary trades at the start of the year.

In terms of other dealflow, lenders said the loan calendar looks very light now, with little M&A or large LBO activity in the pipeline. The leveraged M&A market will come back and banks will be willing to underwrite the deals when buyers and sellers come to agreement on the readjustment of valuations that have occurred over the last year, according to several lenders.

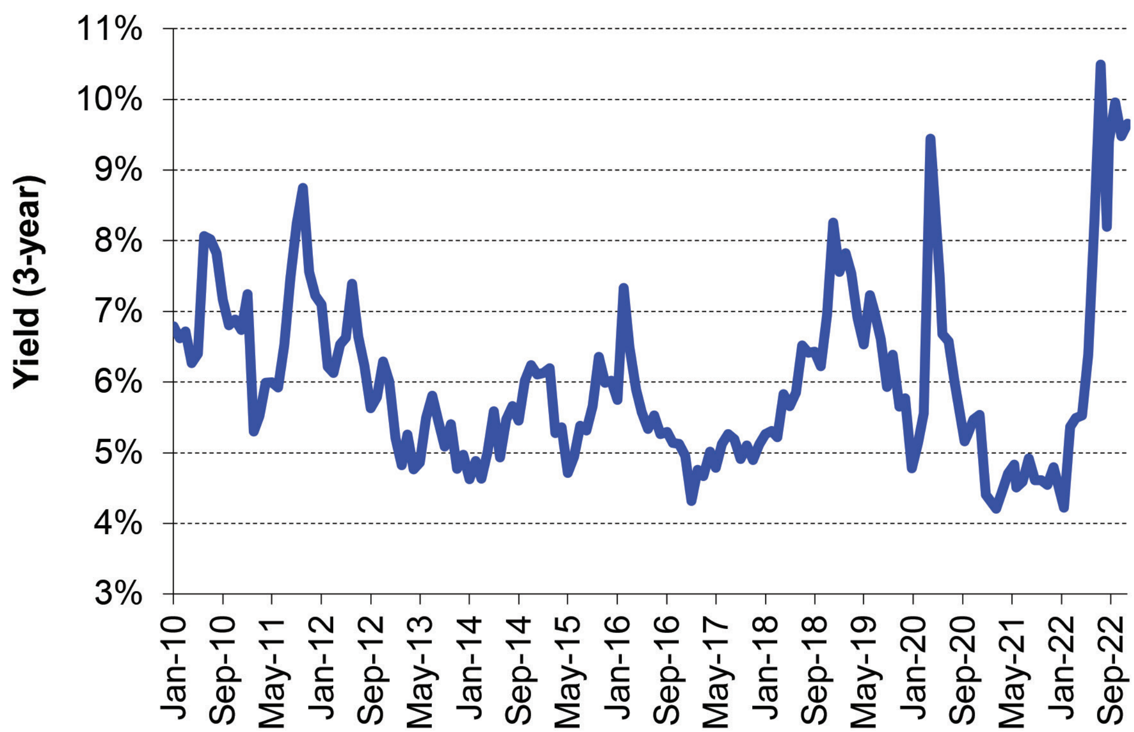
"So even if we get back to the business of making M&A commitments, which I think we will, those deals are not going to come out for five or six months hence," said one banker.

Until then, the expectation is that leveraged loan activity in the early part of 2023 will be comprised mainly of add-ons and refinancings.

Institutional loan issuance tumbles in 2022



Primary market yields climb sharply in 2022



Source: Refinitiv LPC

Middle market loan volume declined 12% in 2022

Diana Diquez

In a year plagued by global volatility, high inflation, interest rates hikes and heightened risk aversion, overall middle market lending, including syndicated non-sponsored and sponsored, and direct lending, declined 12% to US$280bn in 2022.

On the heels of a hectic 4Q21, 2022 got off to a slow start. Activity picked up steam in the second quarter across all segments but in the third quarter, the syndicated end of the market took a hit as the middle market grappled with the effects of persistent inflation, rising interest rates, recessionary fears, and geopolitical uncertainties. In contrast, direct lending increased that quarter, as more deals gravitated to this market. However, in 4Q22 direct lending also declined as some lenders faced capital constraints and others were cautious with their capital.

Still, two-thirds of respondents to Refinitiv LPC's Quarterly Survey said they were able to lend as much as they wanted to in 4Q22. But a significant shift occurred in 4Q22, as a higher share of banks (82%) than direct lenders (57%) said they were able to lend as much as they wanted in 4Q22. In 3Q22 86% of direct lenders and 44% of banks met their lending goals.

NON-SPONSORED STEADY

Most opportunities for banks came from the non-sponsored syndicated market. At US$29bn, non-sponsored syndicated loan issuance in 4Q22 was only down slightly from 3Q22's US$31bn. Moreover, for the year, non-sponsored volume of US$129bn in 2022 was up marginally from 2021 and logged its highest level since 2014.

Activity was better-than-expected in 4Q22, with many of the opportunities coming from other banks that pulled back either because they were preserving capital or because they were going through acquisitions.

While many banks remain active and want to put money to work, they are cautious. Not only are credit committees being more selective as concerns with the economy are front and center, but there is a bigger focus on returns as regulatory capital requirements are rising.

Almost one month into the new year, bankers said the market seems relatively quiet. However, some say a few new deals are coming in and that the flip of the calendar year and new budgets have had positive impacts, despite the uncertain economic outlook.

DIRECT LENDING CEMENTS ITS LEAD

Total sponsored middle market lending, including syndicated and direct executions amounted to US$151bn in 2022, down 23% from 2021, a smaller decline than the 35% seen in the overall leveraged market. However, it was direct lenders that supported middle market lending activity.

With challenging conditions in the syndicated loan market, more sponsors turned to the direct lending market for funds. In 2022, middle market sponsored volume done via direct lending executions exceeded syndicated lending by 2.6 times. For LBOs, the ratio was even higher at 4.1 times for the year.

At US$55bn, 2022 overall middle market LBO issuance was down 28% from 2021. However, the decline was more tempered in the direct lending space, which held up well through most of the year. However, in 4Q22, issuance in this segment declined 21% quarter-over-quarter to US$11bn, far below 4Q21's record US$25bn.

Conditions were radically different when compared to the year before. At that time, sponsors were dictating terms, financing was significantly cheaper, and there was an unprecedented number of LBOs and add-on acquisitions that quarter. Fast forward a year, and sentiment, pricing, terms and base rates looked different and the power to dictate terms had shifted significantly towards lenders. Moreover, some direct lenders were dealing with capital constraints. Others were being cautious and selectively putting money to work as fundraising became more challenging and repayments slowed down.

For those looking to deploy capital, even selectively, it was and still is a good time to do so as terms have shifted significantly to lenders' favor.

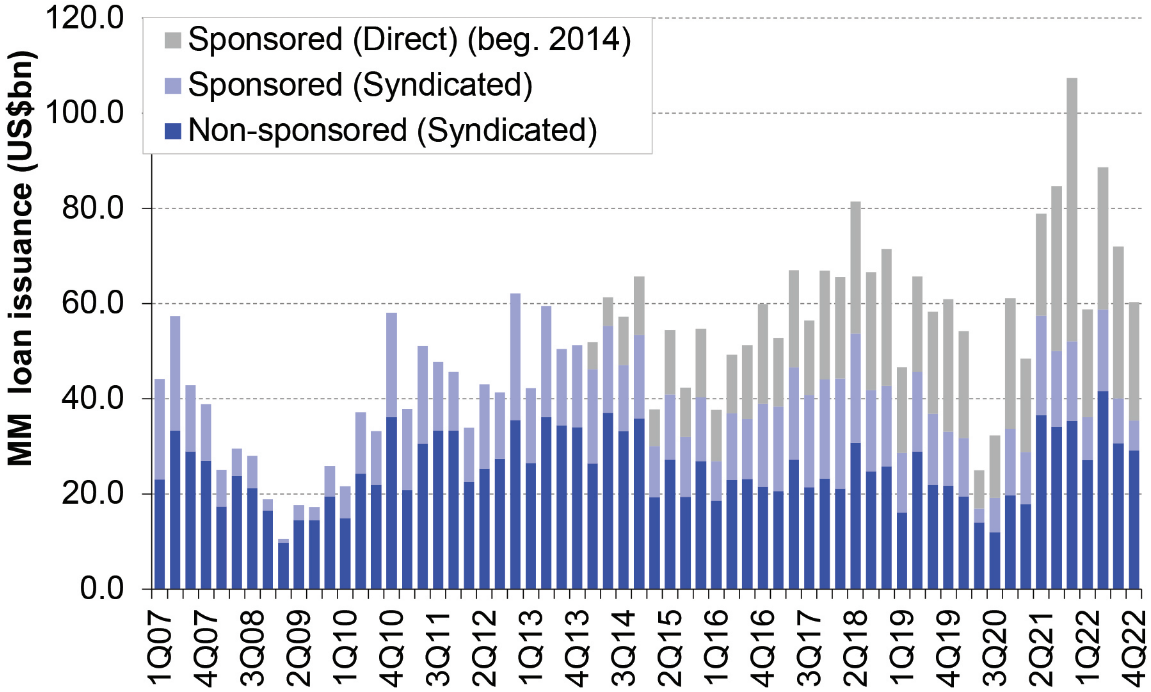
The average yield, assuming a three-year term to repayment, on first-lien middle market sponsored term loans, excluding unitranches, jumped to a record 11% in 4Q22. While the increase was mostly due to rising base rates, spreads and OIDs also widened. The average spread was 574bp in 4Q22, the highest level tracked to date. For unitranches, the average blended spread was 649bp in 4Q22, 65bp above 4Q22 levels.

At the same time, terms and documents are tightening. Leverage levels moved lower across all structures in 4Q22 and were also down year-over-year.

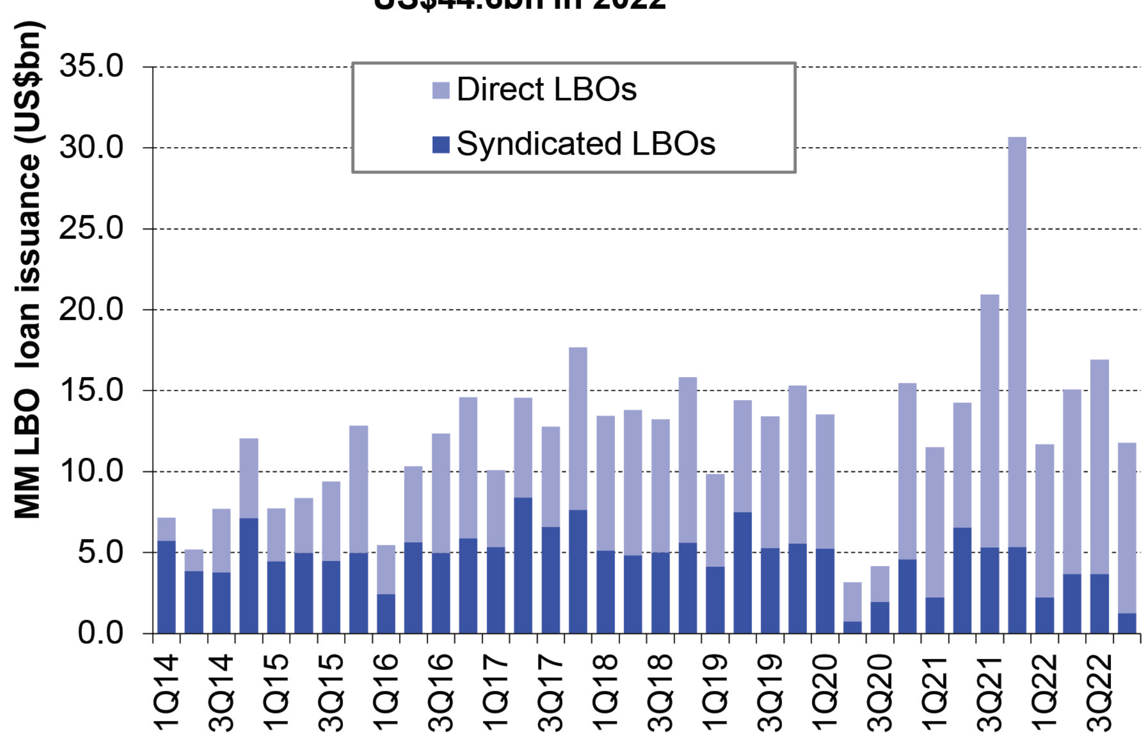
Lenders said leverage will continue to tighten and interest and fixed charge coverages have become more relevant in new deals given the significant increase in interest rates. The average Ebitda to interest ratio on new sponsored loans fell to 2.41 times in 4Q22 from 2.81 times in 3Q22. Meanwhile, middle market LBO loan-to-value levels declined to 40% in 4Q22, the lowest level since 2Q20.

Lenders said the market has been slow so far in January and pipelines are thin. While sponsors have money to put to work, there is a mismatch between buyers' and sellers' expectations and lenders are also being cautious with their capital deployment but are ready to jump into good quality deals from non-cyclical sectors. They also said they are spending a lot of time on portfolio management but while there might be a few deals that are starting to feel the stress, they are expecting that June and September will be when they are going to really see the full impact of rising rates on borrowers.

Overall middle market volume declined to US$280bn in 2022



MM direct lending LBO volume declined 23% to US$44.6bn in 2022



Source: Refinitiv LPC

The Legal Corner by Paul Hastings

4Q22 Trends Recap & What to Watch Out for in 2023

Direct Lending Continued to Outpace Syndicated Deals

In 4Q22, volatile market conditions persisted, including high inflation, rising interest rates, recession anxiety and geopolitical uncertainties. The impact of these conditions was reflected in decreased loan market activity, with total sponsored middle market loan volume (both syndicated lending and direct lending) depressed, down both from 3Q22 and year-over-year as compared to 4Q21. The decline in syndicated lending (as compared to direct lending) from prior periods was more pronounced, but direct lending was not fully insulated from the effects of market instability. Nonetheless, through year-end, private credit funds continued to increase their market share and injected more new capital into the market as compared to their syndicated lending counterparts.

Will Direct Lending Continue to Capture a Greater Market Share in 2023?

Direct lending's flexibility to provide customized structures and deal terms to borrowers across industries with varying capital needs and credit profiles enhanced its appeal amidst an unpredictable and choppy market. Private credit funds' capital solutions have expanded substantially beyond unitranche loans, including preferred equity, holdco loans, and other bespoke capital solutions. Direct lenders have also partnered with banks where issuers had needs for products that are not typically supported by private credit funds, such as cash management, hedges and even pro rata financings to accompany unitranche or other private credit provided loans. These expanded offerings, combined with some enhanced flexibility in terms and structure, enabled direct lending funds to generate greater returns than were available to traditional syndicated bank credit providers. With rate hikes expected to slow in 2023, and at least some degree of market recovery anticipated, syndicated lending volumes appear poised to rebound, particularly if the syndicated loan market is able to offer lower rates. Even if syndicated loan volume picks up, direct lenders will likely retain a comparatively larger segment of U.S. loan market going forward.

Pricing Pressures Dampened Incremental Issuances

In the fourth quarter of 2022, the average all-in-yield on both first-lien middle market term loans and unitranches exceeded 11% (at 11.20% and 11.42%, respectively). Faced with rising borrowing costs, interest coverage fell in 4Q22 to 2.41x from 2.81x in 3Q22. Future ability of borrowers' continued ability to repay what in some cases were dramatically increased interest obligations was also front and center. Such rising rates, including reported increases in margin to fill allocations in some deals given challenging market conditions, impacted incremental issuances into 4Q22. In some cases, borrowers were hesitant to incur fungible incremental term loans and trigger MFN protections that would increase pricing for their outstanding term loans. These pricing pressures highlighted potential malleability of all-in-yield calculations and similar metrics in loan documentation. Looking forward into 2023, the market may coalesce slightly to scale back more amorphous yield calculations given the potential for such terms to be interpreted or leveraged to avoid MFN pricing protections. Should the market achieve a greater degree of stability, it seem likely incremental issuances will slowly begin to return to more "normal" levels.

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About Refinitiv LPC

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