



Q3 2022 Leveraged Finance Market Overview

November 8, 2022



Q3 2022

Global credit reached an inflection point in Q3 2022 as macroeconomic headwinds continue to build and impact the entirety of the leveraged loan market from ratings to pricing and returns. Rating agencies and many industry experts project the global economy is likely enter a recession in 2023 as the US government increases rates and tightens monetary policy to reign in rampant inflation. Supply chain shortages and delays, ongoing geopolitical tensions between Russia and Ukraine and the emerging European energy crisis add to the mounting headwinds impacting the global market environment.

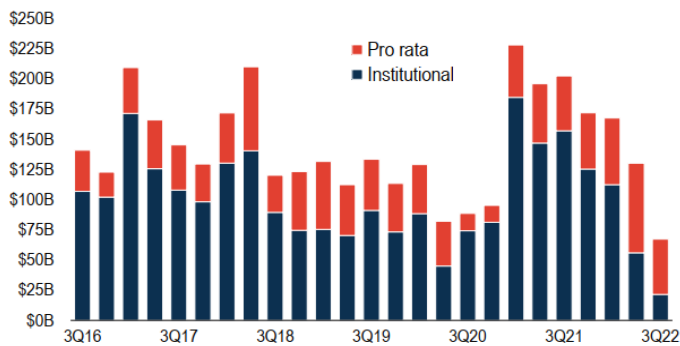
Trends observed in the leveraged loan market this quarter include (i) rising cost of debt, (ii) decreasing liquidity, (iii) increasing credit downgrades, and (iv) volatility in the loan and bond secondary markets. Nevertheless, favorable financing conditions in 2020 and 2021 created fertile ground for loan issuance which skyrocketed during that time allowing corporates to push out maturity walls and bolster cash positions. Relative to other investment options, leveraged loans historically perform well in times of economic distress.

LOAN ISSUANCE CONTINUES TO DECLINE

Increasing costs of liquidity and deteriorating credit conditions brought leveraged loan issuance to a 10-year low during Q3 2022. Global leveraged finance volume declined to \$105 billion in Q3, the lowest quarterly issuance since Q4 2011 in the wake of the Great Financial Crisis “GFC”.

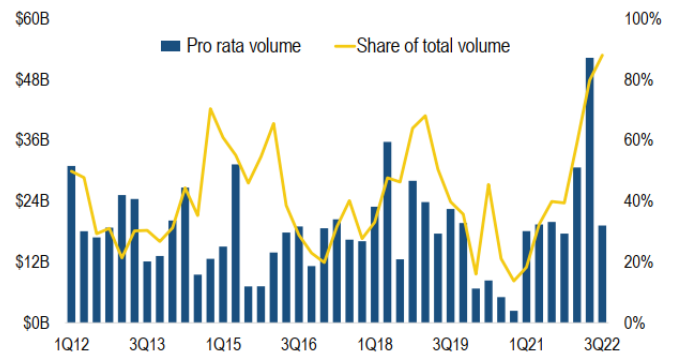
Total US leveraged loan issuance reached just \$67.2 billion this quarter, \$24.1 billion of which was institutional loan issuance, 82% lower than the same period in 2021 and 62% lower than Q2 2022. M&A activity made up the majority of institutional loan issuance as refinancings and dividend recaps dwindled with rate increases. Interestingly, year-to-date (“YTD”) refinancing activity for pro-rata loans (TLA combined with a RCF) is up 78% compared to the same period in 2021 while refinancings for institutional loans (TLB’s etc.) are down 76% for the same period.

Chart 1: US leveraged loan volume



Data through Sept. 30, 2022.
Source: Leveraged Commentary & Data (LCD)

Chart 7: Refinancing-related pro rata loan volume & share



Data through Sept. 30, 2022.
Source: Leveraged Commentary & Data (LCD)

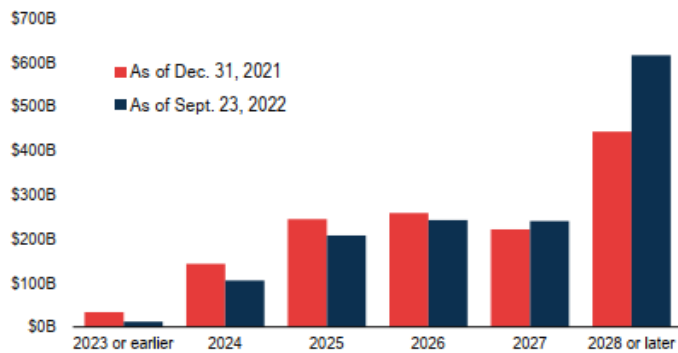
Despite slowing issuance, the total par amount outstanding tracked by the US Leveraged Loan Index increased by \$85.5 billion in 2022 to an all-time high of \$1.44 trillion. This is, however, mostly due to the slowing of repayments this year.

Even though 2022 issuance levels are compressed, favorable market conditions (cheap debt and abundance of balance sheet liquidity) in 2020 and 2021 led to record breaking issuance globally. Companies generally took advantage of an abundant supply of cheap money to push out maturity walls and create a level of insurance via refinancing flexibility. 78% of US leveraged loans mature in 2026 or later and 48% in 2028 or later, European loans follow similar suit.



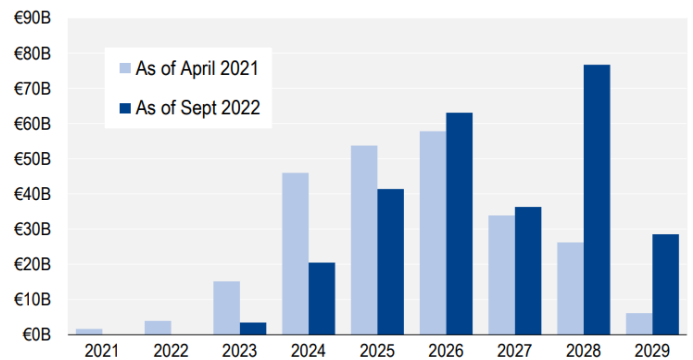
Data through Sept. 30, 2022.
Sources: Leveraged Commentary & Data (LCD); Morningstar LSTA US Leveraged Loan Index

Chart 8: US leveraged loan maturity wall



Source: Morningstar LSTA US Leveraged Loan Index; Leveraged Commentary & Data (LCD)

Chart 19: European leveraged loan maturity wall

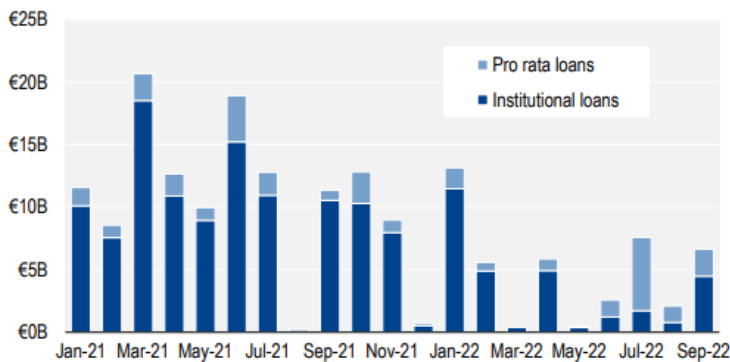


Data as of Sept. 30, 2022.

Sources: Leveraged Commentary & Data (LCD); Morningstar European Leveraged Loan Index.

Q3 2022 leveraged loan issuance in Europe increased slightly to €18.6 billion from €13.3 billion in Q2; September was its busiest month since April. Nevertheless, YTD issuance of €47.6 billion for the period is the lowest since the Eurozone debt crisis in 2012. While majority of new loan issuance supports buyouts, M&A and refinancings has declined to their lowest levels since 2013.

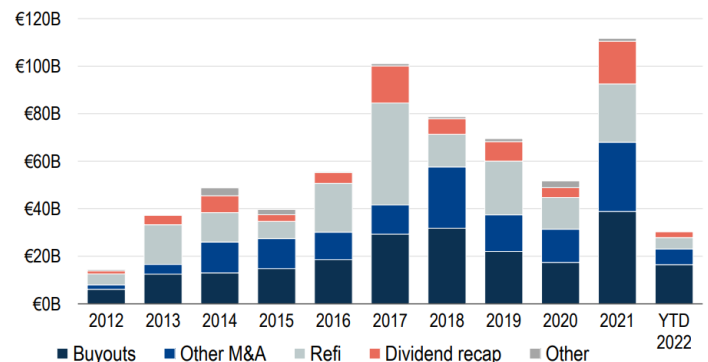
Chart 6: European new-issue leveraged loan volume — monthly



Data through Sept. 30, 2022.

Source: Leveraged Commentary & Data (LCD)

Chart 18: Annual European institutional loan volume by deal type



Data through Sept. 30, 2022.

Source: Leveraged Commentary & Data (LCD)

RETURNS CONTRACT ACROSS ALL ASSET CLASSES

The leveraged loan asset class lost 2.27% of value in September after a positive return in August, bringing the YTD total to negative 3.91%. Despite this loss, leveraged loans outperformed all other asset classes by at least 11.32%. Loans in the European Leverage Loan Index “ELLI” saw similar nonnegative returns earlier in the quarter before dropping into the red by quarter end. The ELLI was down -3.49% in September and is down -6.34% YTD.

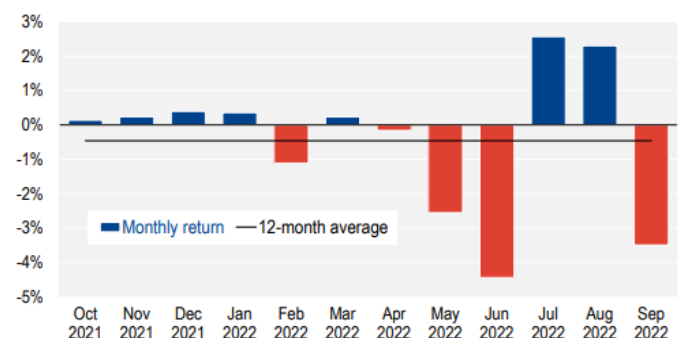
Returns by asset class

	Sep 2022	Aug 2022	YTD
Morningstar LSTA US LL Index	-2.27%	1.54%	-3.25%
Morningstar US High-Yield Bond	-3.99%	-2.37%	-14.57%
Morningstar US Corporate Bond	-5.45%	-2.82%	-18.73%
BAML 10-year Treasury (GA10)	-5.28%	-3.89%	-16.83%
S&P 500	-9.21%	-4.08%	-23.87%

Data through Sept. 30, 2022.

Sources: Leveraged Commentary & Data (LCD); Morningstar; Bank of America Merrill Lynch

Chart 5: Morningstar European LL Index monthly returns



Data through Sept. 30, 2022.

Sources: Leveraged Commentary & Data (LCD); Morningstar European Leveraged Loan Index TR LCL.

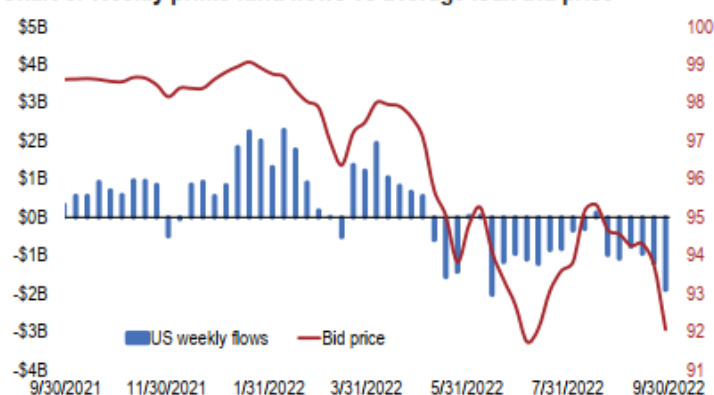
SECONDARY MARKET REMAINS VOLATILE

Greater market volatility continued to trickle into the secondary in Q3 2022. Secondary market bids rallied in the first half of Q3 to 95.50 after opening the quarter at a low of 91.75. The quarter ended with secondary market bids just above open at 91.92, erasing virtually all gains. For context, Q1 and Q2 peak bid prices reached 99.08 and 97.48, respectively.

Similarly, the secondary market in Europe rallied earlier in the quarter, posting a 2.6% and 2.3% return in July and August, respectively. Come September the weighted average bid price dropped from ~93 to 89.55 amid a mix of political shifts within Europe.

The average new issue spread in September decreased slightly from July's SOFR+510 high to SOFR+467 as new issue yield-to-maturity climbed to 9.88% due to declining secondary pricing. Yield-to-maturity is now higher than at any point since the GFC. Spreads for Euro denominated single-B TLB's in Q3 averaged Euribor+515 with yield-to-maturity reaching 7.55%, up from Euribor+453 and 4.45% in Q2 2022.

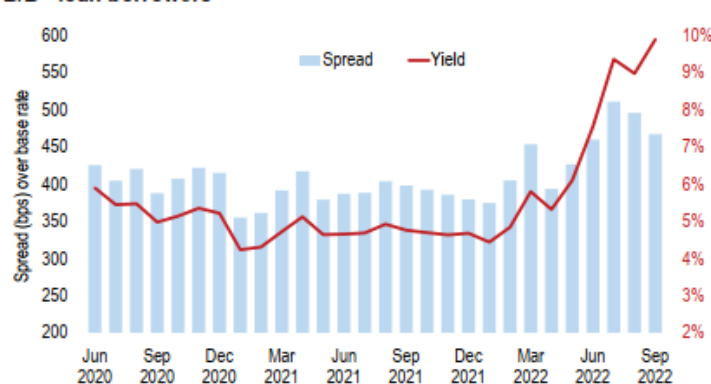
Chart 3: Weekly prime fund flows vs average loan bid price



Data through Sept. 29, 2022.

Sources: Leveraged Commentary & Data (LCD); Lipper FMI

Chart 12: New-issue spread and yield-to-maturity of B/B+ loan borrowers



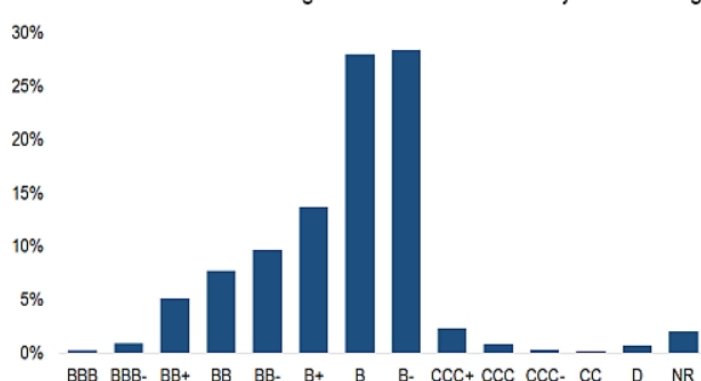
Data through Sept. 30, 2022.

Source: Leveraged Commentary & Data (LCD)

B- RATINGS TAKE OVER

For the first time ever, B- rated companies comprise 28.4% of the US Leveraged Loan Index, making this rating category the largest in the index. A trend toward lower-rated debt emerged in 2021 as investors searched for yields among historically low rates. More recently, credit downgrades are consistently outnumbering upgrades, which has also contributed to this trend. This creates a potential risk for CLO vehicle portfolios which are subject to concentration tests regarding the ratings distribution of its underlying loans.

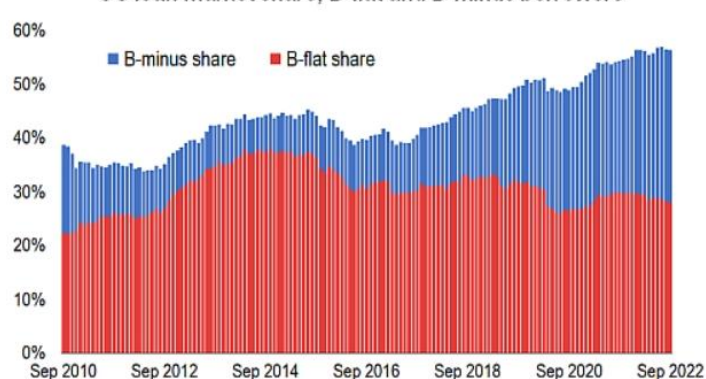
Breakdown of the Morningstar LSTA US LL Index by issuer rating



Data as of Sept. 9, 2022.

Sources: Leveraged Commentary & Data (LCD); Morningstar LSTA US Leveraged Loan Index

US loan market share, B-flat and B-minus borrowers



Data through Sept. 9, 2022.

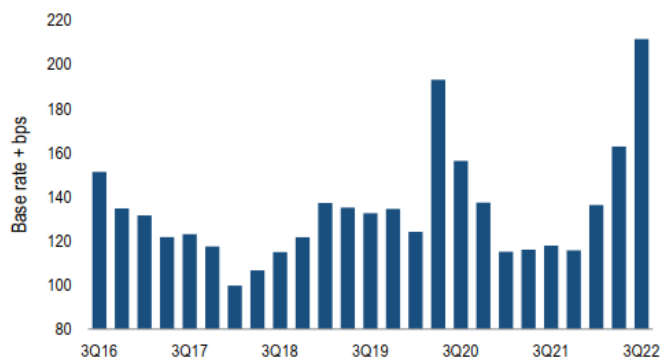
Sources: Leveraged Commentary & Data (LCD); Morningstar LSTA US Leveraged Loan Index

CLOs REMAIN RESILIENT

Historically, institutional investors have been attracted to the floating rate aspect of CLOs and their resilience in economic downturns. The warehousing period in CLOs allow managers a degree of flexibility in controlling the credit quality of the underlying collateral. Naturally, CLO managers are working to boost the credit quality of their portfolios in anticipation of a recessionary environment.

\$92 billion (~11%) of CLO collateral has been downgraded this year and the share of B- rated loans within CLO's has grown to 29%; CCC rated loans within CLOs have coincidentally dropped from 10% in 2020 to 5% to date. The Fitch Weighted Average Rating Factor ("Fitch WARF"), which measures the weighted average credit quality of a portfolio, decreased this quarter to 24.34 for newly priced CLOs compared to 24.97 for those closed in Q1. The share of defaulted loans in CLOs nevertheless remains miniscule, representing just 0.33% of total portfolio amount. Fitch ran several default scenarios pushing default rates as high as 5% and 11% and reported the structures remain resilient to potential collateral underperformance.

Chart 21: BSL CLO AAA spread



Data through Sept. 30, 2022.
Source: Leveraged Commentary & Data (LCD)

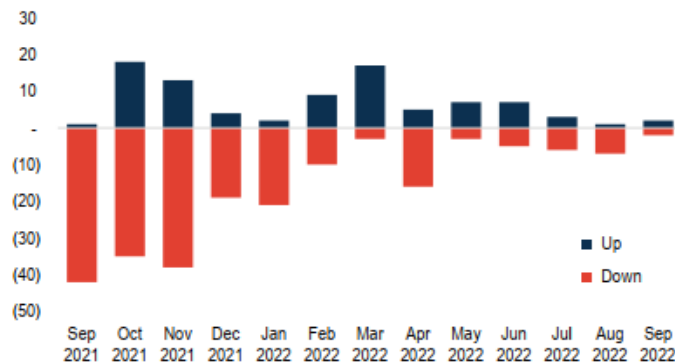
PRICING FLEXES UP AS SPREADS WIDEN

With worsening credit conditions and therefore lower issuance, deals completed in Q3 2022 incorporated large discounts. Many of these deals were completed out of necessity and featured investor friendly flexes with downward flexes outnumbering upwards for the quarter at a ratio of 2.5:1. In September the ratio evened 1:1 but only included four deals, representing a limited sample size.

AAA SPREADS CONTINUE TO RISE

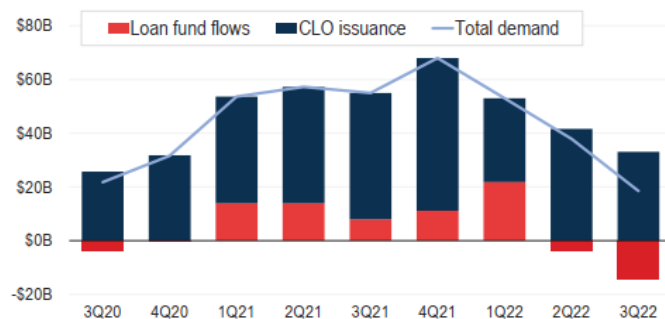
Average AAA spreads increased from 136 bps in Q1 to 155 bps in Q2 and increased further to 211.5 in Q3. Questions arise around whether the consistent spread increases are sustainable or make sense when AAA defaults are nearly impossible. Speculation points mostly to market technicals as a few large banks and institutions seem to be pulling away from the investment vehicle despite sound credit quality and historically low default rates; which have pushed up spreads to maintain demand.

Chart 4: Count of upward to downward flexes



Data through Sept. 30, 2022.
Source: Leveraged Commentary & Data (LCD)

Chart 2: US leveraged loan market – measurable investor demand



Data through Sept. 30, 2022.
Fund flows data includes monthly reporters.
Sources: Leveraged Commentary & Data (LCD); Lipper

CLO ISSUANCE CONTINUES TO DECLINE

CLO issuance and retail flows continued to decline in the quarter amid recession concerns, dwindling loan issuance and a tough pricing environment. CLO issuance in the quarter totaled \$33.1 billion, 20% and 30% lower than Q2 2022 and Q2 2021, respectively. While CLO issuance has declined and mutual fund outflows have accelerated, measurable demand (defined as CLO issuance less mutual fund outflows) remains positive at \$6.4 billion for the quarter. While this level is well below the average measurable demand over the last 12 months of \$14.8, loan supply is declining at a faster pace.

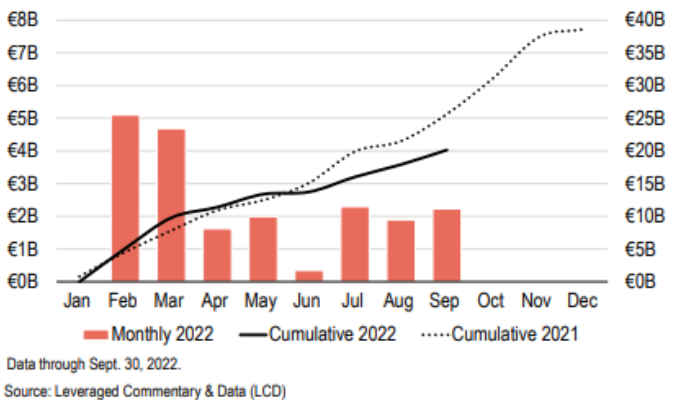
Nonetheless, the \$100.6 billion of CLO issuance through Q3 2022 represents the third highest three-quarter total on record.

European CLO issuance increased slightly to €6.4 billion in Q3 2022. Structural modifications including shorter structures, higher levels of credit enhancement, triple-A loan tranches and unfunded single-B tranches have helped get deals across the finish line. Just about all deals structured since March have been done so in the expectation of a refinancing within 18-months.

Despite challenges, 2022 has been an active year for CLOs.



Chart 25: European new-issue CLO volume, monthly and cumulative



DEFAULT RATE ON THE RISE

The US leveraged loan default rate by issuer increased to 0.85% from its record low of 0.26% in April of this year. Rating downgrades outpacing upgrades typically serves as a leading indicator for heightened default activity. Based on an LCD survey, the default rate is anticipated to increase to the 1.0%-1.5% within the next year. Macro concerns, including inflation, rising rates and supply chain disruptions, have prompted ratings agencies to scale up their default rate forecasts. Fitch is now forecasting a 2.0%-3.0% default rate in 2023, up from a 1.5%-2.0% forecast last quarter. By historical standards, this is still a modest rate of default, however.

Leveraged Loan Default Rates (%)

Year	Sept. 2022	July 2022
2020 (actual)	4.5	4.5
2021 (actual)	0.6	0.6
2022F	1.5	1.5
2023F	2.0-3.0	1.5-2.0
2024F	3.0-4.0	2.0+

F – Forecast.
Source: Fitch Ratings.

What do you think the US loan default rate will be 12 months (9/30/2023) from now?

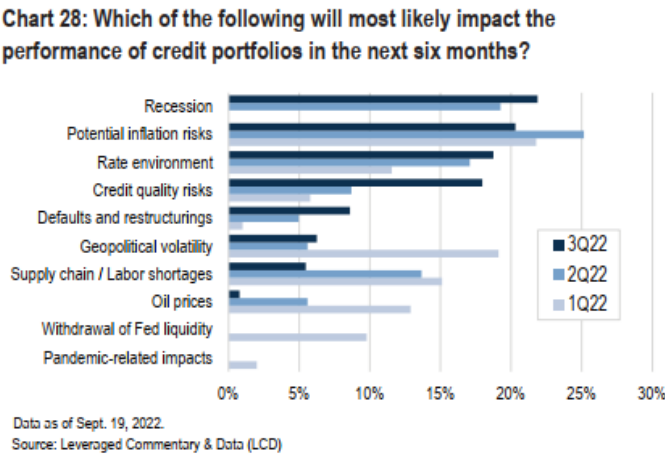


LOOKING FORWARD

LCD’s most recent survey concludes market observers are still waiting for the market to hit its low point, with 60% anticipating the worst is yet to come. Inflation, recession and the interest rate environment lead the list of concerns for market observers, while credit quality takes the fourth spot.

ARC expects new deal M&A activity to remain muted through Q4 and into Q1 as depressed secondary pricing makes underwriting activity difficult. However, it expects significant accordion loan activity as sponsors and corporates seek additional liquidity to capitalize on M&A opportunities and build cash. ARC also expects direct lenders to continue taking share from large banks as the originate-to-hold business model of direct lenders remains viable in a market where banks’ originate-to-distribute approach currently entails excessive placement risk.

Consistent with participants’ expectations and rating agency’s revised forecasts, ARC believes default rates will rise but remain historically low by recessionary standards. ARC considers the lack of near-term maturities and extensive use of covenant-light loans as significant mitigants to default going into 2023. ARC also expects supply chain issues to be largely resolved during the first half of 2023, which will ease pressure on some sectors. While ARC believes interest rates will remain elevated though 2023, it anticipates a loan market rebound in H1 as Fed rate increases decelerate.





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