Q3 2023 Leveraged Loan Market Overview

The Credit Recovery Gains Momentum

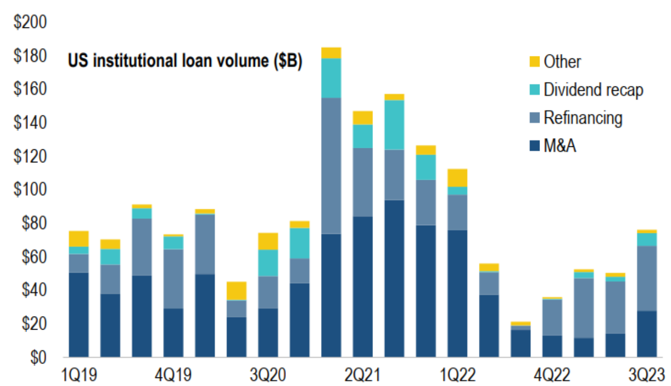
November 27, 2023

Q3 2023

RECOVERY HEATS UP

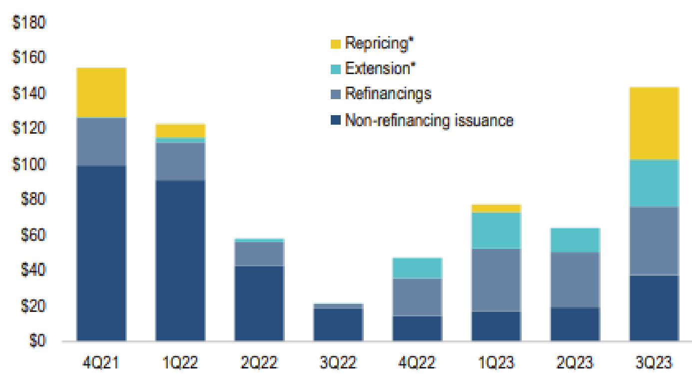
Stabilizing market conditions and retreating recession fears in 3Q23 created a renewed sense of optimism allowing for deal making. As a result, volume reach levels not witnessed since 1Q22. In a nutshell, secondary prices rallied, spreads stabilized, issuance volumes improved, defaults declined, and the leveraged loan asset class achieved its strongest returns since 2009. Opportunistic transactions re-emerged in the form of dividend recaps and repricings as borrowers reduced interest costs and extended maturities at the fastest pace of the year. It is apparent, however, not all issuers have the same market access. Activity remains largely skewed toward higher rated issuers while the volume of "weakest links" continue to grow. High funding/refinancing costs and high base rates lead the list of concerns of market participants.

New issuance in Q3 hits highest mark since rate-hike onset in 1Q22...



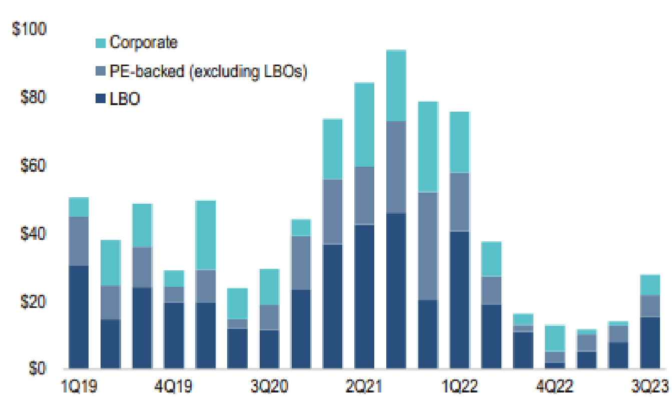
Source: PitchBook | LCD • Data through Sept. 30, 2023

Chart 4: US institutional loan volume ($B)



Source: PitchBook | LCD • Data through Sept. 30, 2023
*Reflects repricings and extensions done via an amendment process only

Chart 5: US institutional loan volume backing M&A ($B)



Source: PitchBook | LCD • Data through Sept. 30, 2023

SUPPLY: MAKING A COMEBACK

Issuance flourished in 3Q23 with U.S. institutional new deal and refinancing loan volume reaching $76.0 billion, marking its highest quarterly output since 4Q21.

Heightened refinancing and extension activity allowed borrowers to reduce the 2024 maturity wall to $17.6 billion, a 76% decline from 2Q23. $40.7 billion, or 53.6% of issuance, was driven by refinancings. Extensions reached $26.6 billion, a post-GFC high. Repricing activity surged in Q3 to $40.7 billion, its highest quarterly output since January 2022. Note, extension and repricing totals do not count toward quarterly issuance.

While refinancings reached the highest volume since 1Q21, their overall share of total issuance decreased. This decline occurred as M&A activity continued to rise for the third consecutive quarter, reaching $27.8 billion and constituting 37% of issuance—its most substantial quarterly output since 2Q22. 55% of M&A issuance was driven by leveraged buyout ("LBO") activity.

BSL: GREEN SHOOTS EMERGE

The return of M&A and LBO dealmaking signifies a soft reopening of the broadly syndicated loan ("BSL") market. As anticipated, banks returned to the BSL market in 3Q23, and eased into the space with issues to higher rated credits.

As deal flow rises, opposing viewpoints emerge over the future of BSL and private credit. LCD concludes that private credit and BSL can co-exist in the long term, with private credit being the "go-to market for deals that are unrated or have riskier structures". The president of First Eagle Alternative Credit observed that financial sponsors will likely keep both to have the best possible structures available at all times.

Contrarily, Moody's believes large banks will likely compete aggressively as new LBOs emerge to recoup lost market share, leading to the erosion of credit quality and introducing systemic risk to the market.

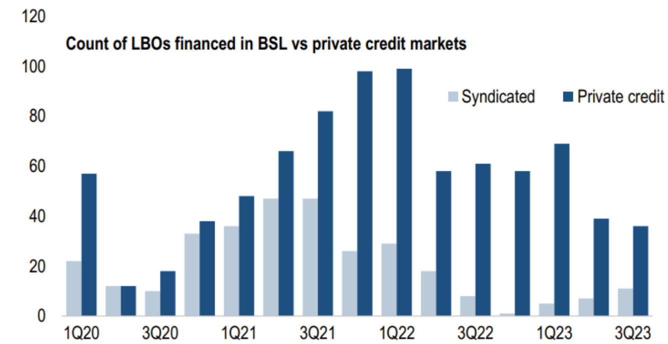
PRIVATE CREDIT TO MAINTAIN EDGE

Private credit has dominated the market across all transactions since 1Q22. In the near term, private credit is expected to remain the #1 source of buyout financing through the end of 2024, according to LCD.

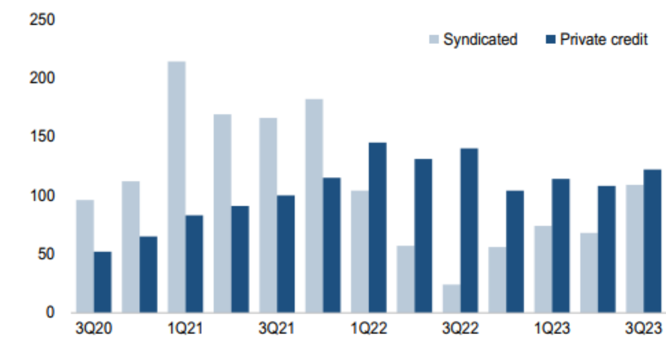
In 3Q23, private credit was focused on refinancing large, syndicated loans into private debt. The most notable example was Finastra's $4.8 billion unitranche credit facility, representing the largest takeout of an institutional loan by private credit on record.

At the 2023 ABS East conference Scott Rosen, Partner at Ares Management, remarked that it is a golden age for private credit: "We're doing stuff that used to be done by banks. We're just doing it at private credit returns. But I think that's great for our investors.". Other panelists at the conference described this change to the corporate loan landscape as "transformative and permanent".

The BSL market even regains some ground, versus private credit...

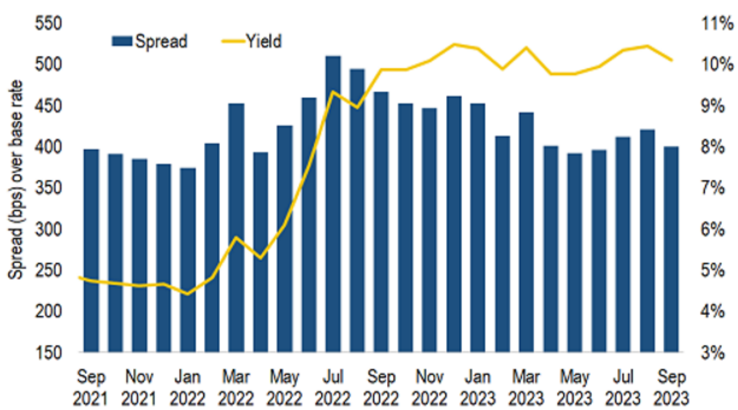


Count of non-LBOs financed in BSL vs private credit markets



Source: PitchBook | LCD • Data through Sept. 30, 2023
Private credit count is based on transactions covered by LCD News

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



Source: PitchBook | LCD • Data through Sept. 30, 2023

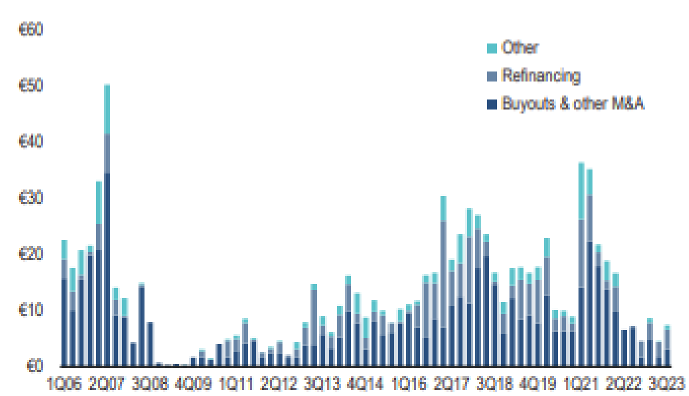
YIELDS TIGHTEN

While heightened base rates continue to keep yields near peaks, rate increases cooled in 3Q23. Both spreads and yields retreated by quarter end after slight upticks in July and August. The average new issue yield for B/B+ rated issuers declined slightly to 9.80% from 9.96% in June. This figure peaked in July at 10.27%. Similarly, the average new issue spread compressed to 400bps from 443 bps at the end of 2Q23.

ISSUANCE: EUROPE

YTD European leveraged loan issuance increased to €29.8 billion from €19.9 billion in 2Q. Although the supply of loans accelerated as risk appetite returned, YTD issuance remains behind that of previous years (€45.6 billion YTD in 2022). Refinancings accounted for 48% of institutional issuance, followed by M&A contributing 47% to supply. Last year these percentages were 5.4% and 76%, respectively. Extensions totaled €32.4 billion YTD as borrowers address refinancing needs through 2025. According to LCD, much of expected M&A activity has been pushed to January, and sponsors are working with banks to generate alternative deal flow.

Chart 5: Quarterly European institutional loan volume by deal type (€B)

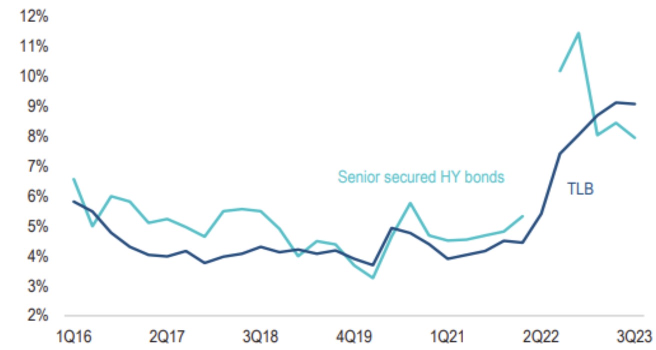


Source: PitchBook | LCD • Data through Sept. 30, 2023

LOAN-FOR-BOND REFIS TO INCREASE

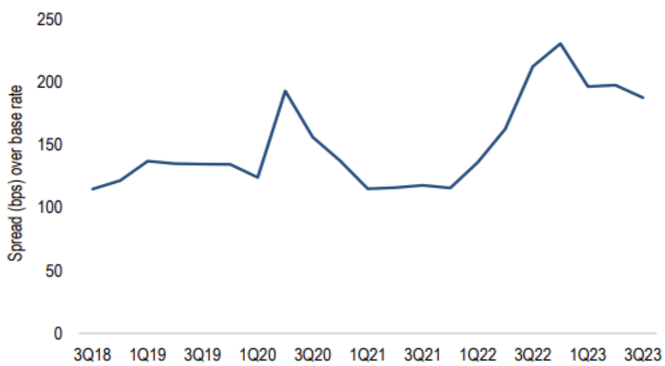
Historically in Europe, the yield on senior secured bonds exceeded that of institutional term loans. In Q3, however the trend inversed, making bond financing more attractive for BB rated issuers. LCD notes there is increasing evidence of loan-for-bond refinancings to achieve more favorable funding costs. As such, the percentage of BB rated bonds by high-yield deal count reached 38% in 3Q23, the highest since 2020. Alternatively, single-B issuance has fallen to its lowest share since 2020.

Chart 14: New-issue YTM: Senior secured bonds vs inst. term loans



Source: PitchBook | LCD • Data through Sept. 30, 2023 • Senior secured high-yield bonds left blank for 2Q22 due to insufficient observations for a meaningful average.

Chart 20: Average US CLO AAA spread



Source: PitchBook | LCD • Data through Sept. 30, 2023 • Excludes middle-market CLOs

AAA SPREADS TIGHTEN

Average CLO AAA spreads continued to tighten in 3Q23 to 188 bps from 199 bps in 2Q23. As a result, CLO activity returned after a slow Q2. This includes refinancings and resets which have been largely absent from the market amongst heightening spreads between 4Q21 and 4Q22.

Looking toward the end of the year, views are mixed over where the AAA spread will land. According to a survey conducted by JPM, 30% expect stability, while 26% expect marginal tightening and 24% expect spreads to widen.

IMPROVING ARBITRAGE CONDITIONS ALLOW FOR CLO DEAL FLOW

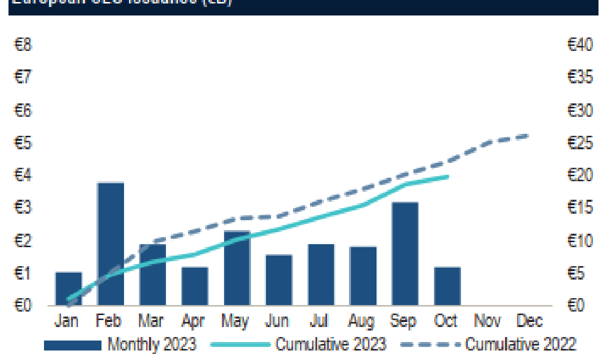
Tightening AAA spreads and diminishing recession fears improved CLO market sentiment and allowed for increased deal flow. 3Q23 issuance increased marginally however, to $28.0 billion from $22.4 billion in 2Q23 due to muted BSL supply. For the remainder of 2023, U.S. bank demand is expected to remain subdued as banks prepare for amended Basel I capital requirements; activity is expected to pick up in 2024. That said, middle market (MM) CLOs continue to gain market share, with volume double that of last year, $13.2 billion. JPM reports this activity is likely to serve as a tailwind going into 2024; similarly, Barclays projects record MM issuance in 2024.

CLO issuance in Europe produced €6.4 billion across 17 deals, in line with 3Q22 issuance and up from the €5.0 billion printed in 2Q23. Spreads reduced to the tightest levels since early 2022 across the capital stack in Europe, making deals more attractive to managers.

US CLO issuance ($B)

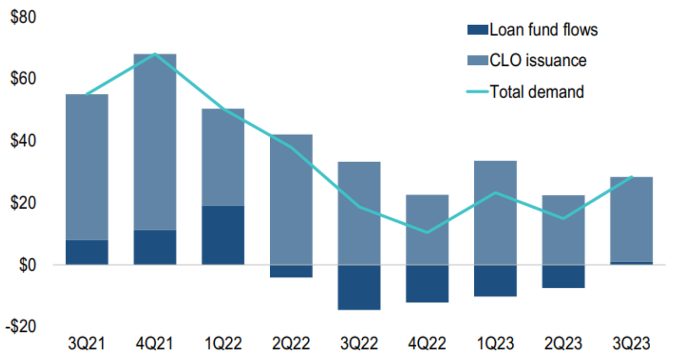
Data through Oct. 9, 2023
Source: PitchBook | LCD

European CLO issuance (€B)



Data through Oct. 9, 2023
Source: PitchBook | LCD

Chart 3: US leveraged loan market – measurable investor demand ($B)



Sources: PitchBook | LCD; Morningstar Direct • Data through Sept. 25, 2023
Fund flows data includes monthly reporters.

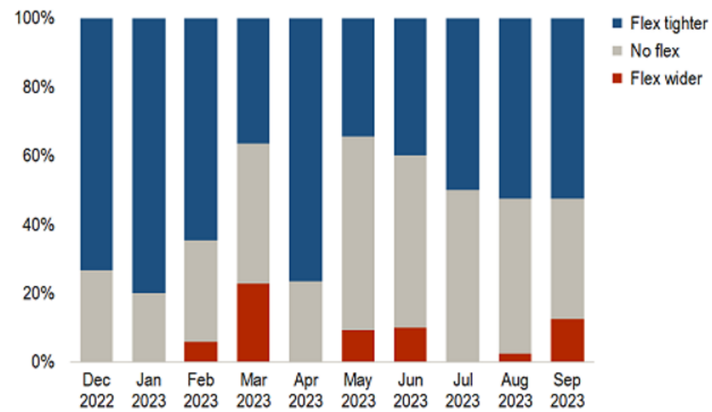
LOAN SHORTAGE CONTINUES

Net demand increased in 3Q23, adding to the continued streak of demand outstripping supply (new issue volume). Investor demand, measured as CLO issuance and net loan flows totaled $29.0 billion from $14.9 billion. Although loan supply did increase quarter-over-quarter, so did CLO issuance. More notably, retail fund flows turned positive after being negative for the past five quarters.

PRICING CONTINUES TO FLEX IN FAVOR OF ISSUERS

Deals continued to flex in favor of issuers in 3Q23 as market conditions improved. Spreads compressed for both BB/BB- and B/B- issues in 3Q23. Even though the supply demand balance persists, the secondary market performed well in Q3 before dropping slightly at quarter end. As a result, the deals flexing wider in 3Q23 occurred toward the end of the quarter.

Share of US leveraged loan price flexes

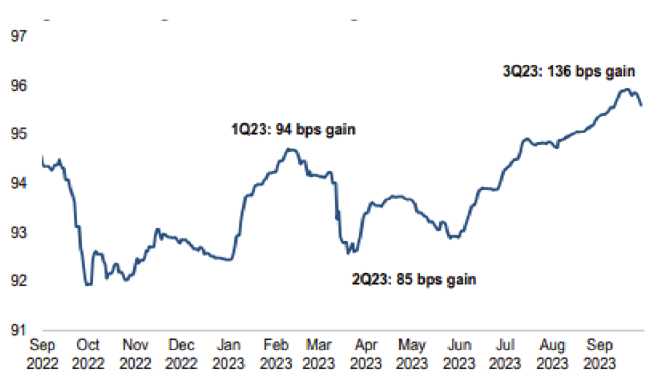


Source: PitchBook | LCD • Data through Sept. 30, 2023

SECONDARY PRICES RALLY

Easing recession concerns and rising loan prices contributed to a robust secondary market in 3Q23. The weighted average bid of U.S. leveraged loans increased for a fourth consecutive month, closing September at 95.56, just after peaking at 95.91. For reference, 1Q23 and 2Q23 closed with 93.38 and 94.24, respectively. The European Leveraged Loan Index (ELLI) had its longest positive streak since 2013. The index gained ~250 bps to a peak before dipping slightly come quarter end to ~96 bps.

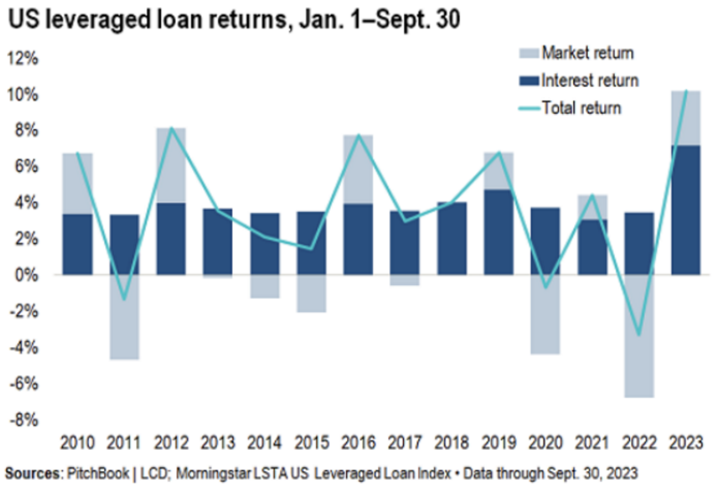
Chart 2: Weighted average bid of US leveraged loans



Sources: PitchBook | LCD; Morningstar LSTA US Leveraged Loan Index • Data through Sept. 28, 2023

European secondary loans went on record-breaking summer tear...

Sources: PitchBook | LCD; Morningstar European Leveraged Loan Index • Data through Sept. 30, 2023



LOAN RETURNS REACH RECORD HIGHS

Low volatility in the broader market and increasing sentiment in the state of the economy allowed returns for all asset classes to flourish in 3Q23. Also driven by the sustained rally in the secondary market, leveraged loan returns reached an all-time high of 10.4%. Leveraged loans continue to outpace high yield bonds which returned 6.5% but had been surpassed by equities, which generated a 11.7% return.

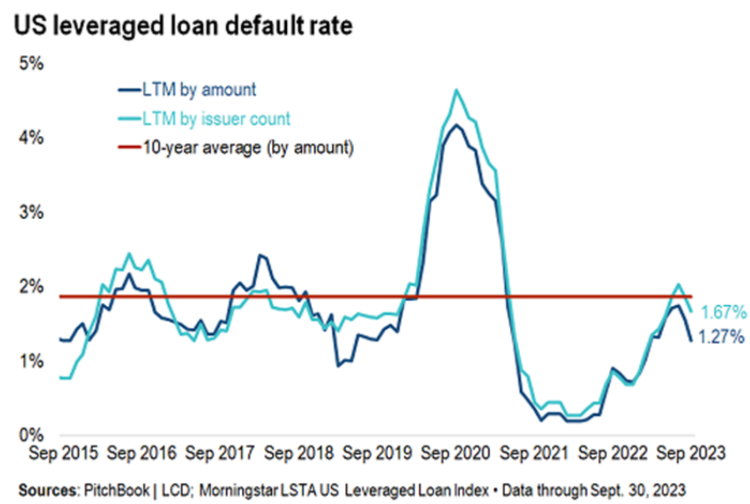
In terms of total return, this year represents the strongest year for leveraged loans since 2009. ARC notes, however, much of the return is due to the base rate increase. Removing this component, market return is the highest since 2019.

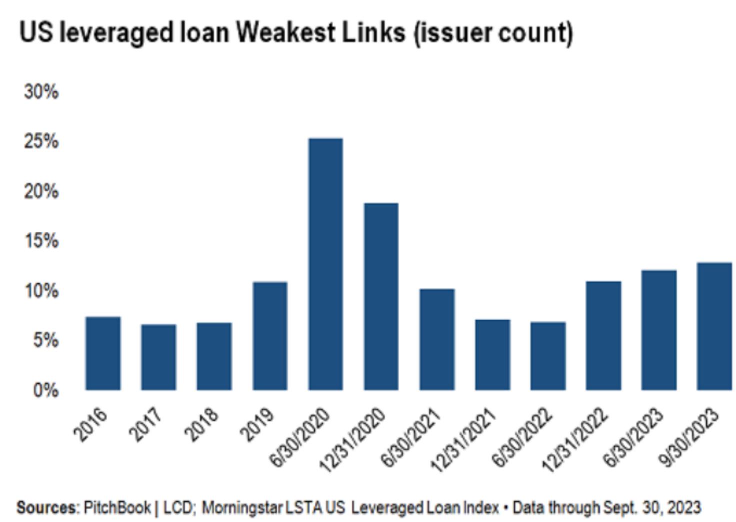
DEFAULT RATE RETREATS, TEMPORARILY

The U.S. leveraged loan default rate (by dollar amount) dropped to 1.27% from its 1.75% peak in July. This comes as downgrade activity slowed in 3Q23 and credit conditions stabilized. Despite its retreat from recent peaks, the default rate is expected to reach 2.75% one year from now, according to LCD. October data shows default rates increasing to 1.36%, which is still well below the 10-year average of 1.86%. The default rate in Europe declined from 1.51% in July to 1.27% in September and 1.26% in October.

The expectation of higher default rates comes as the number of "weakest links" ballooned by 52% to 175 over the last 12-months (for reference, the COVID peak was 329 in June 2020). Weakest links are issuers rated B- or lower with a negative outlook and serve as a leading indicator of default activity. Healthcare and high tech contributed the issuers recently added to the weakest links list.

BB and above rated issues fared relatively well in 3Q23; while B and B- issues/highly levered issuers continue to struggle with heightened interest costs, slimmer cash flows/liquidity, and lower coverage ratios. Most defaults are attributed to inability to refinance and tight liquidity. These obstacles are not expected to ease as interest rates are anticipated to remain elevated until at least 2Q24. LCD notes, however, the rate of weakest links becoming defaults has slowed due more accommodating sponsors and lenders waiving and amending before a default is registered. ARC expects default rates to increase but is skeptical that they will reach 2.5% based on continued sponsor support and the current economic outlook.



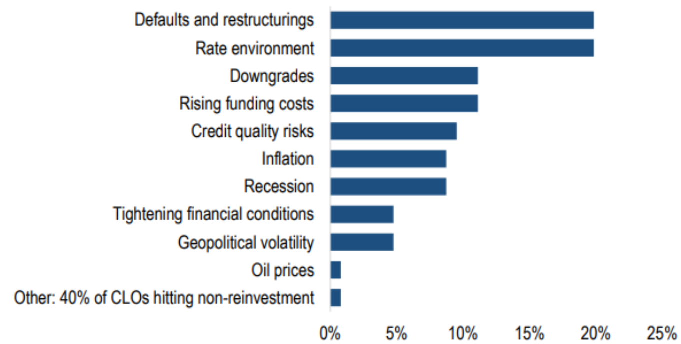


LOOKING FORWARD

LCD's most recent survey indicates improving sentiment among market participants. The percentage of market participants who believe market conditions will tighten is now 25%, down from 48% in 2Q23. Defaults, restructurings and the rate environment lead the market's list of concerns (20% each), followed by downgrades and credit quality risks. Inflation and recession tie for 6th on the list.

Regardless of these concerns, private lenders benefit from significant dry powder, and banks are looking to gain back market share. Issuance in 4Q23 is expected to increase; 82% of respondents believe issuance will favor private credit over BSL. 60% of market participants expect LBO multiples to decline.

Chart 50: Which of the following will most likely impact leveraged credit portfolio performance over the next six months?



Source: PitchBook | LCD • Data through Sept. 25, 2023

Borrowers continue adjusting to higher interest and funding costs. After this year's downgrade wave and the climbing weakest links list, higher defaults are expected to increase but remain low in comparison to the Covid-19 pandemic and the 08-09 recession. On the up-side, sponsors and lenders typically work proactively with borrowers nearing their interest coverage or leverage covenants. ARC has seen a handful of deals successfully complete amendments to adjust covenant levels or provide and equity injection, sometimes both.

Overall, the leveraged loan asset class demonstrated robust performance in 3Q23, and its positive momentum is anticipated to continue through the remainder of the year. ARC continues to see significant requests for non-payment insurance, which further supports its recovering market outlook. ARC expects issuance volume, more particularly, for M&A transactions to increase in 2024 as banks re-enter the market. Taken together with compressing spreads, continued growth in loan issuance provides fuel for CLO activity. As worries about inflation and recession diminish, and with the ongoing maintenance of market stability, conditions are conducive for strong leveraged loan market recovery.

ARC

800 Brickell Avenue, Suite 1270
Miami, FL, 33131

C: 1 (917) 648-0239
O: 1 (551) 222-6504
E: andrew@arc-credit.com