William Blair

Q2 2022

Leveraged Finance Market Tiptoes Through Uncertain Q2 Environment

In This Report

Leveraged Finance

Leveraged Finance Market Tiptoes Through Uncertain Q2 Environment

The leveraged finance market searches for balance amidst continued macroeconomic and geopolitical volatility

The U.S. institutional leveraged loan market continued to contract in Q2 with volume declining 62% year-over-year and 50% quarter-over-quarter to $56.0 billion. The sustained uncertainty and volatility in the macroeconomic and geopolitical landscape during Q2 challenged the broader capital markets as conservatism began to take hold across the lending universe.

In-line with recessionary and other pressures, the results of William Blair's Leveraged Finance Survey suggest a market shift toward a more lender-friendly environment. William Blair's Leveraged Lending Index experienced consecutive quarterly declines for the first time since the COVID outbreak, falling to a level of 2.9. Further, more than 60% of respondents said pricing increased and leverage and terms tightened during the quarter, as underwriting shifted its focus to mitigating uncertainty and risk during a quarter of discovery.

For the remainder of 2022, lenders expect recessionary, inflationary, and rising interest rate pressures to have the most significant impact on the leveraged loan market. In addition, most survey respondents anticipate higher default rates as portfolio company performance continues to be pressured by a volatile operating environment.

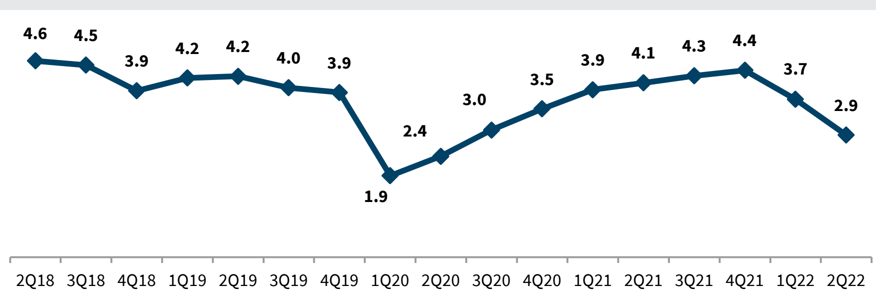
Recession Expectations Shape Lender Decision-Making

According to William Blair's Leveraged Finance Survey, over 85% of respondents anticipate a cycle to occur within the next 12 months. Those expectations, in combination with other macroeconomic and geopolitical headwinds, have forced lenders to view new opportunities through a more conservative lens and, in many cases, re-think overall portfolio exposure. This was particularly apparent in the syndicated debt market as significant sell-off activity flooded the secondary market, driving asset values down. According to LCD, a part of Pitchbook, the average bid for the Leveraged Loan 100 Index fell below 93 by the end of Q2—almost five points lower than at the end of Q1. This dynamic also permeated into the primary market as original issue discounts for broadly syndicated loans declined to sub–95 by the end of Q2 while average pricing increased approximately 200 basis points during the quarter. That risk-off sentiment in the syndicated market also resulted in the private credit market becoming more affordable on a comparative basis. As of the end of Q2, all-in yield for middle market loans was 7.5% compared to 7.6% for broadly syndicated counterparts, according to data from LCD, a part of Pitchbook.

On the private credit side, direct lenders initially remained very active and constructive, continuing their aggressive pursuit of new opportunities with borrower-friendly pricing and terms. However, as recession fears grew and the challenges imposed by the broader macroeconomic and geopolitical landscapes continued, the private credit market experienced modest contraction in the second half of Q2.

William Blair Leveraged Lending Index Trending in Lenders' Favor [1]

Each quarter we ask middle-market lenders to rate overall conditions in the leveraged finance market on a scale of 1 to 5, with 5 being the most borrower-friendly conceivable. After a steady rebound since the initial COVID outbreak, the past two quarters have seen the index trend sharply in lenders' favor.



1 = Most Lender-Friendly; 5 = Most Borrower-Friendly

(1) Average lender response to the question, "On a scale of 1 to 5, how would your firm rate today's lending environment?"

Broadly, direct lenders started to be more selective with new investment opportunities, reduce hold sizes, modestly widen new-issue spreads and tighten terms, particularly for highly cyclical businesses. Throughout Q2, private credit pricing spreads have increased anywhere from 50–100 basis points with total leverage coming down by approximately 0.5x. However, interest in and aggressiveness towards attractive credit opportunities with strong supply/demand diversification, high recurring revenue streams, and/or recession-resistant attributes, for example, remain very strong. As was illustrated during COVID, direct lenders' long-term focus and certainty of capital make them an attractive option for borrowers during volatile market environments.

Rise of the Jumbo Unitranche and the Continued Shift to Private Credit

Over the past 18 months, the leveraged loan market has experienced an explosion of jumbo unitranche credit facilities (categorized as large, $1 billion-plus in facility size) provided by direct lenders to help support various financing objectives of large borrowers. Typically, these types of financings would have been cleared through public markets where access to this magnitude of capital was easier to source. From 2016–2020, there were only seven jumbo unitranche transactions that closed compared to a whopping 20 transactions completed since the start of 2021, with an average facility size of almost $1.9 billion. So, what is driving this phenomenon? In examining the rise in the jumbo unitranche product, we will also gain insight into why and how private credit has been successful at taking share from the syndicated market and the primary catalysts that intertwine these two movements.

Over the last decade, as the private credit market matured and illustrated its attractive risk/return profile to institutional investors, particularly during a tumultuous, COVID-impacted 2020, alternative credit providers furiously sought to raise capital. According to LCD, a part of Pitchbook, since 2016 private debt providers have raised over $1 trillion of capital globally, resulting in tremendous growth in assets under management, dry powder availability, and overall fund size. With that influx of capital, direct lenders were forced to increase check sizes, and—in an effort to put money to work—move up-market, targeting significantly larger borrowers.

This encroachment of private credit into traditionally syndicated territory has resulted in the convergence of terms between the two products. As the lines between syndicated and private debt market pricing and terms began to blur, private credit solutions continued to gain popularity. That trend was accelerated during the second quarter as syndicated solutions were no longer an option for many borrowers and became a more expensive option for others.

Under the backdrop of recessionary pressures, a hawkish Fed, and significant macroeconomic and geopolitical challenges, the shift toward private debt is expected to continue with private credit further supplanting syndicated providers. Until there is further clarity in the market, we expect any new large, formerly syndicated deals/jumbo unitranche opportunities to be financed by larger clubs as direct lenders have begun reducing hold sizes in an effort to mitigate exposure to any single credit.

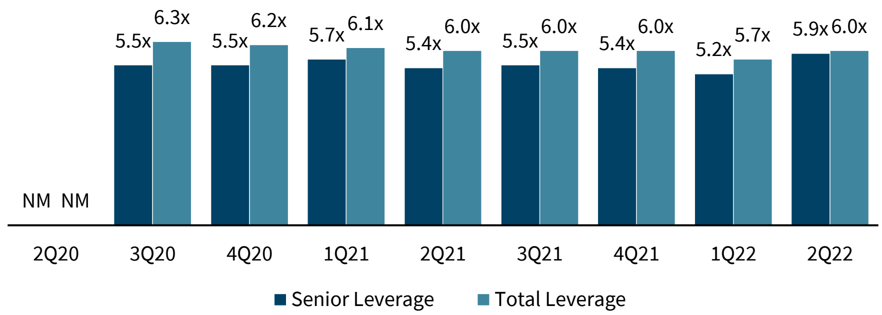
To learn more about these and other trends shaping the leveraged finance market, please don't hesitate to contact us.

Market Analysis

Each quarter we look behind the numbers to examine the market dynamics that are driving trends in pricing and volume in leveraged finance transactions.

Middle-Market LBO Leverage Multiples

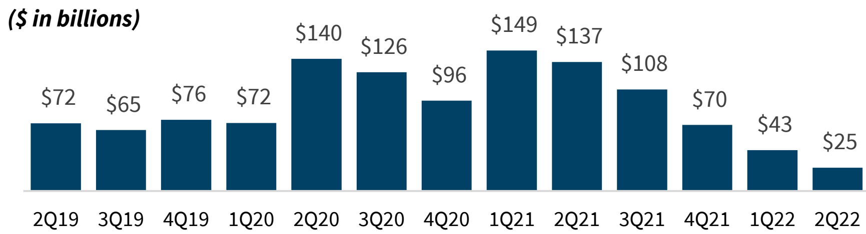
Leverage multiples for middle-market LBOs from William Blair's proprietary database remained stable during the second quarter driven by a skew towards high quality credit opportunities.



Source: William Blair Proprietary Mid-Market LBO Financing Database

High-Yield Bond Volume

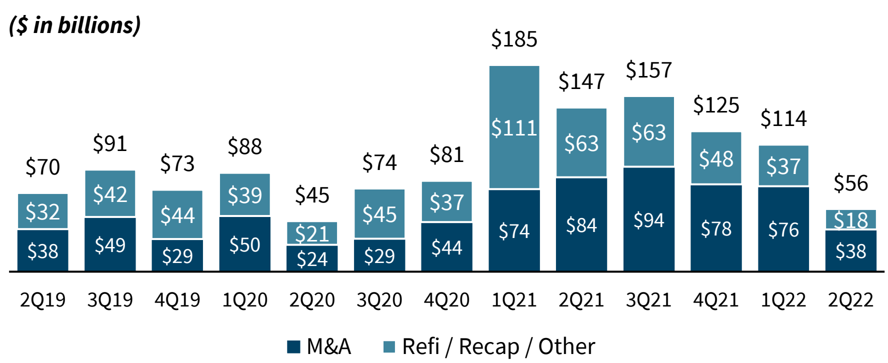
High-yield bond volume continued its downward trajectory in Q2, declining to $25 billion, representing the lowest quarterly volume in almost four years.



Source: LCD, a part of Pitchbook

Institutional Loan Volumes

Institutional loan volume dropped sharply in the second quarter, declining by 50% quarter-over-quarter, amidst a growing list of macroeconomic and geopolitical concerns.



Source: LCD, a part of Pitchbook

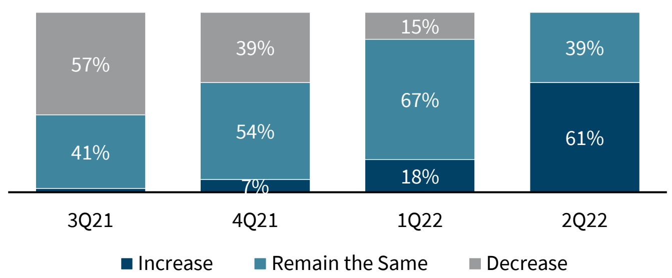
Highlights From William Blair's Q2 2022 Leveraged Finance Survey

Each quarter William Blair surveys middle-market leveraged finance professionals representing leading credit funds, BDCs, commercial finance companies, commercial banks, and other credit providers to measure sentiment in the leveraged finance market. The data reflect responses from approximately 60 leveraged finance professionals who participated in the survey this quarter.

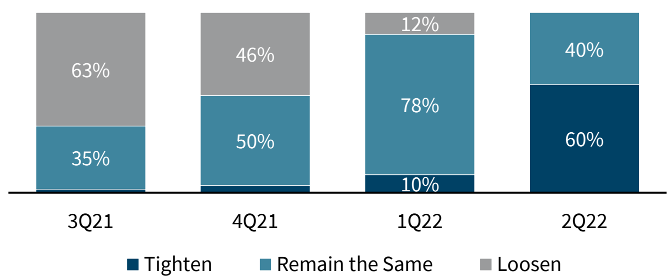
Leveraged Lending Market Conditions Tighten Considerably

For the first time since the onset of COVID, a majority of lenders indicated that pricing increased while leverage and terms tightened over the quarter as macroeconomic and geopolitical volatility continued to pressure a long-standing borrower-friendly environment.

Pricing



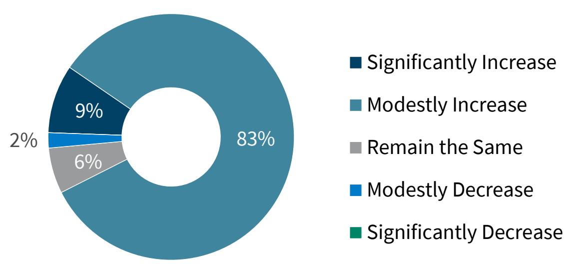
Leverage and Terms



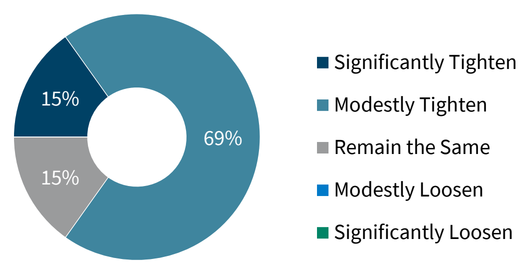
Lending Expectations for the Remainder of 2022

Respondents overwhelmingly expect pricing to modestly increase and leverage and terms to modestly tighten over the remainder of 2022.

Pricing Expectations



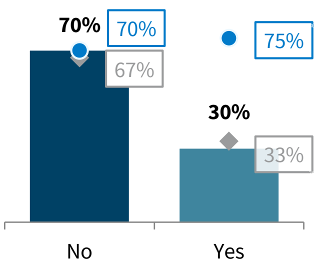
Leverage and Terms Expectations



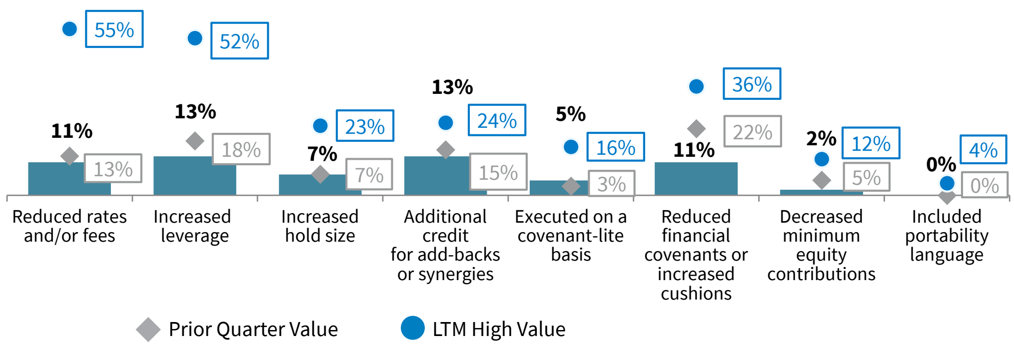
Lender Aggressiveness Wanes

As recession fears arose and the challenges imposed by the broader macroeconomic and geopolitical landscapes sustained, respondents indicated a lack of willingness to make borrower-friendly concessions in order to win new opportunities.

During 2Q22, did you make borrower-friendly concessions you historically would not have to win a deal?

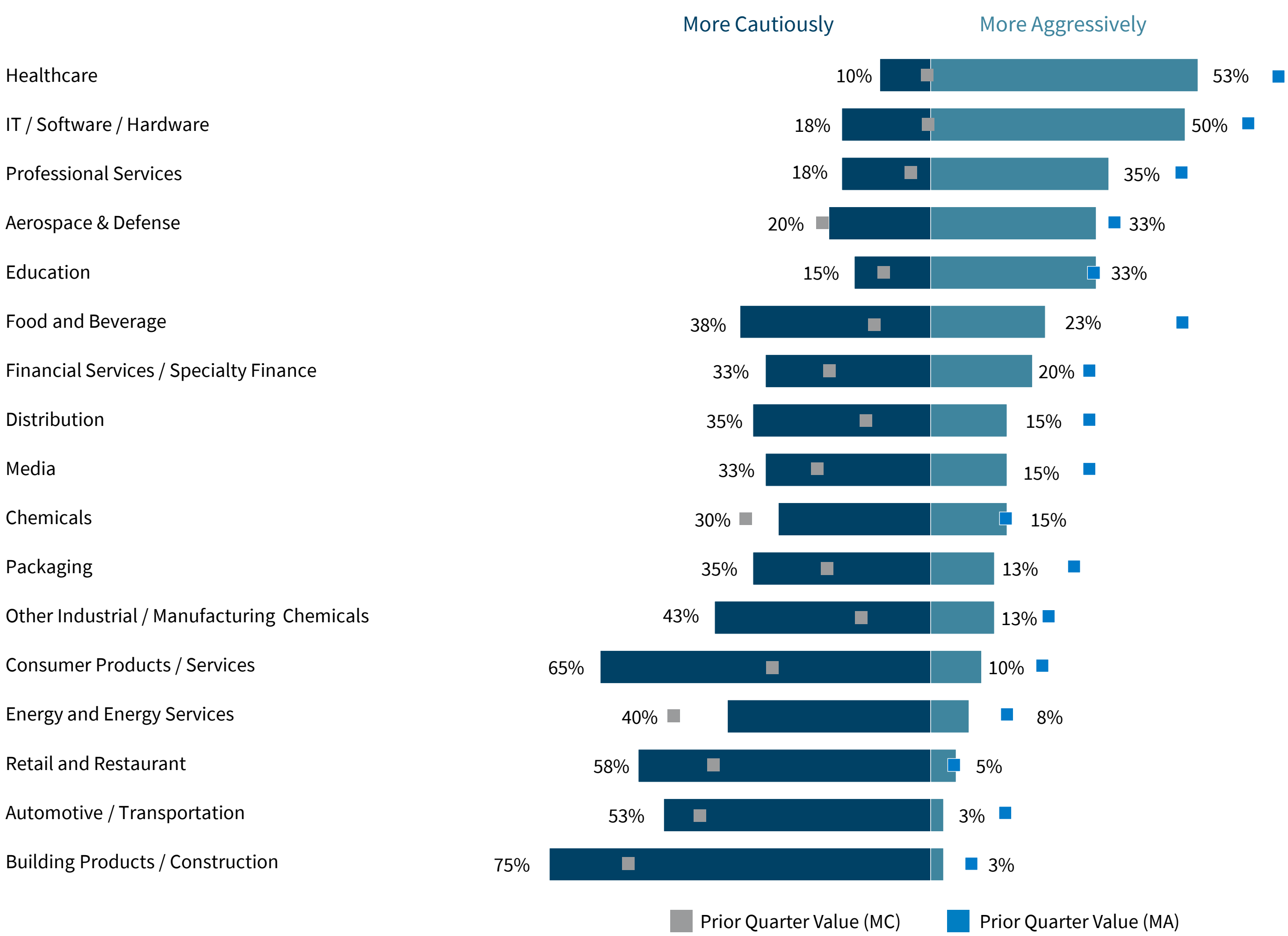


If yes, what were the concessions?

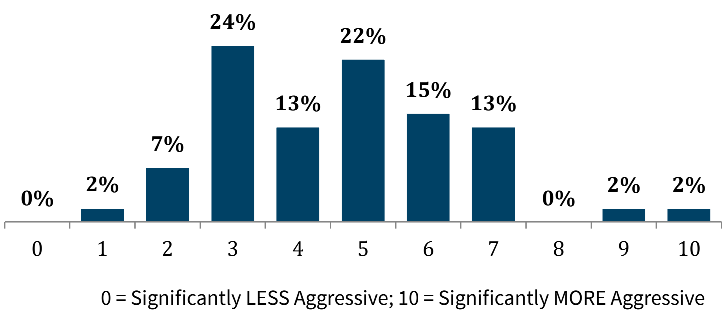


Additional Highlights

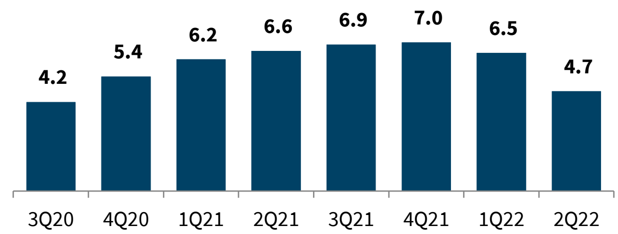
Are there any specific sectors or industries for which your firm is proceeding more aggressively or cautiously today compared with 6 months ago?



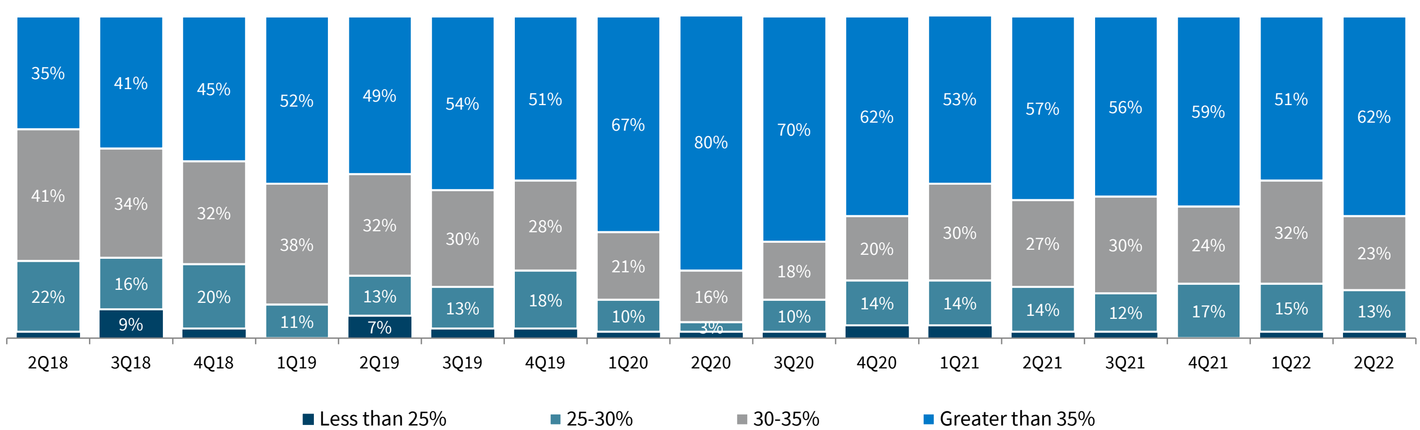
Assuming your firm's pre-COVID rating was a 5, how would you rate the aggressiveness of your firm's approach to new debt opportunities today?



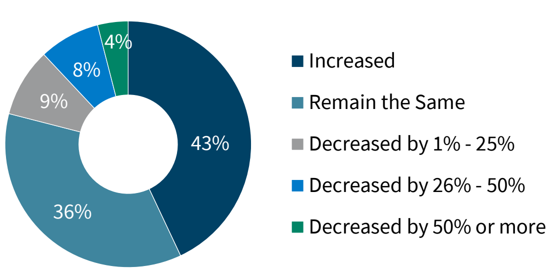
Average Rating by Quarter?



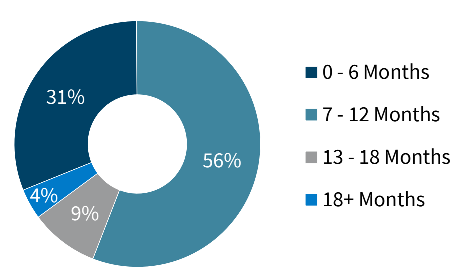
For transactions involving a private equity sponsor, what is the minimum equity contribution you require?



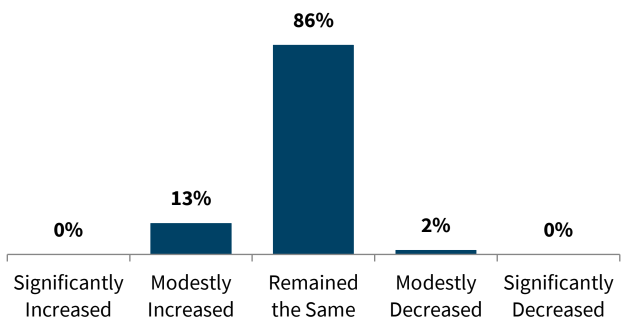
Compared to your firm's pre-COVID hold sizes, what have you observed regarding your firm's current maximum hold size?



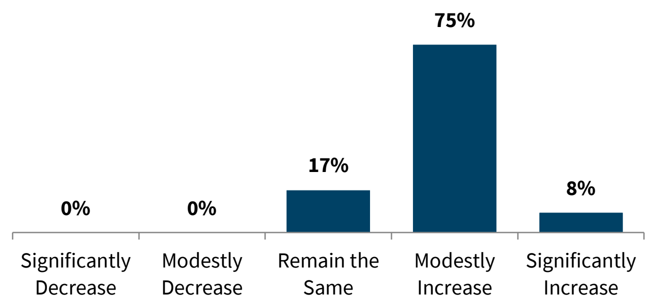
What is your firm's view of when the next cycle will occur?



During Q2 2022, how did default rate activity compare to that in the previous six months?



For the remainder of 2022, do you expect the level of default rates to?



For the remainder of 2022, what factors or trends do you expect will have the most significant impact on the leveraged loan market?

- The level of M&A and general economic conditions
- Pricing - competing factors of risk of recession and broader market relative value will compete with ample direct lending capacity and attractiveness of rising all-in rates
- EBITDA adjustments not being realized
- LBO targets / borrowers suffering from rising input prices, distorted supply chains, working capital financing
- Inflation and increased recession risk
- Volatility in the public markets challenging aggressive lending practices
- Performance declines driven by inflation and reduced consumer spending
- Rising interest rates, equity market valuations and broader economic conditions
- Private equity dry powder, public market valuations, and LTV levels. Expect good credits to prevail in this environment.
- Duration and stickiness of inflation and impact on debt terms, valuations, and general investor appetite
- Continued pressure from rate movement and other operational issues for businesses across many industries will test lenders and their portfolios
- Larger market turmoil filtering down market
- Rates will increase and terms will be more lender friendly

Drawing on our deep product expertise and the strength of our relationships, William Blair has built a leading leveraged finance franchise. Sponsors and business owners turn to us for outstanding execution in support of their capital-raising objectives.

Recent transactions include

Not Disclosed MCE Senior Secured Credit Facility 2022	Not Disclosed CCS Fundraising Senior Secured Credit Facilities Preferred Equity 2022	Not Disclosed Country Pure Foods Senior Secured Credit Facility 2021
Not Disclosed OneCare Media First Lien Credit Facility 2021	$180,000,000 HungerRush Unitranche Credit Facility 2021	Not Disclosed Kaleris Unitranche Credit Facility 2021
Not Disclosed ConnectAmerica a portfolio company of Rockbridge Growth Equity Senior & Subordinated Debt Preferred Equity 2021	Not Disclosed Andelyn Biosciences Senior Secured Term Loan Preferred Equity 2021	$170,000,000 Colson Group Unitranche Credit Facility 2021

William Blair Leveraged Finance by the Numbers

130+

completed leveraged finance transactions since 2015

$20B+

arranged financing since 2015

525+

lender and alternative credit provider relationships

William Blair's Leveraged Finance team structures and arranges debt capital in support of acquisitions, recapitalizations, and growth through its well-established relationships with debt capital providers globally.

- Conflict-free advisory focused on delivering the best solution available in the market
- Proprietary 360-degree view of leveraged finance market from William Blair's global M&A and debt advisory practices
- Relationships with more than 500 lenders and significant transaction experience with alternative credit providers
- Experts at orchestrating competitive auctions to achieve optimal financing outcomes in complex engagements, including those requiring insightful credit positioning and the arrangement of multiple layers of capital
- Seamless integration with William Blair's sector coverage teams
- Turn-key financing teams able to deliver unparalleled speed, execution, and certainty to close

With more than 250 senior bankers around the world, William Blair has completed more than 1,450 advisory and financing transactions totaling over $720 billion in value for our clients.*

Leveraged Finance Group Leadership

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* In the past five years as of June 30, 2022