William Blair

Leveraged Finance

Q3 2022

Leveraged Finance Activity Slows in Q3 Amidst Rising Interest Rates and Sustained Macroeconomic Volatility

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Leveraged Finance Activity Slows in Q3 Amidst Rising Interest Rates and Sustained Macroeconomic Volatility

Rising interest rates and continued macroeconomic pressures challenge the leveraged finance market as institutional volume reaches near record lows

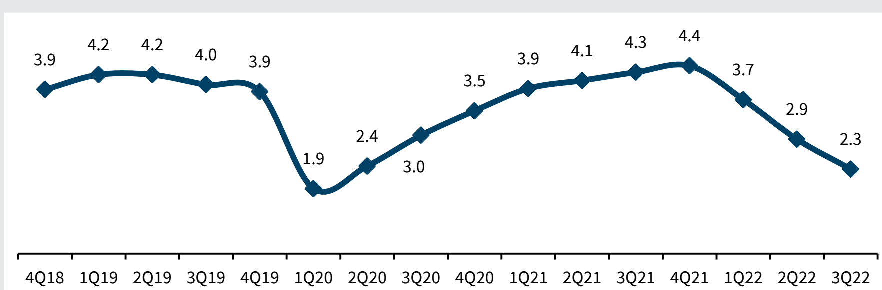
Significant headwinds continued in the U.S. institutional leveraged loan market with Q3 volume declining to $21.4 billion — the lowest quarterly volume since the Great Recession. The largest driver was a decline in M&A-related volume, which declined for a second straight quarter to a volume of about $16B, down 56% from Q2. A litany of factors caused this decline, but most notably sharply rising interest rates, inflation, and labor costs, as well as sustained recessionary pressures.

The results of William Blair's Leveraged Finance Survey followed suit as more than 50% of respondents indicated new-issue loan volume declined compared to that in the previous six months. In addition, the William Blair Leveraged Lending Index shifted further into lender-friendly territory. For a third straight quarter the index declined, falling to a level of 2.3, in-line with that during COVID-impacted 2020. Not surprisingly, lenders took even greater steps in Q3 to mitigate volatility and price risk. According to the survey, more than 85% of respondents said pricing increased and leverage and terms tightened, almost 50% of respondents indicated hold sizes had been reduced compared to 2021, and 90% of lenders were not willing to provide concessions to win a new deal.

As we approach the end of 2022, lenders expect a modest increase in pricing and further tightening on leverage and terms. In addition, lenders anticipate an uptick in default rates as portfolio company performance continues to be challenged by the rising interest rate environment and the volatile macroeconomic backdrop.

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. Over the past three quarters the index has trended sharply in lenders' favor, reaching its lowest level since the COVID-19 pandemic.



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?"

Significantly elevated cash interest burden fueled by rising interest rates and widening spreads is having a material impact on leveragability and represents a key challenge in today's lending market.

Widening SOFR and Pricing Spreads Curtail Leveragability

According to Bloomberg, the three-month Secured Overnight Financing Rate ("SOFR") has increased almost 400 basis points since the beginning of 2022, reaching a current high of 4.17% as of early November 2022. As a result, cash interest burden on variable-rate loans, which represent the majority of both the direct lending and broadly syndicated loan markets, has increased significantly.

For example, at the beginning of 2022, the annual cash interest burden for the LBO of a $30 million EBITDA business levered at 6.00x with pricing of SOFR + 6.00% would be approximately $12.6 million.[2] Today, however, given the rise in SOFR plus widening of pricing spreads, the LBO of that same company would have an annual cash interest expense of more than $19.0 million.[3] As a result, lenders are placing heightened scrutiny on a company's fixed charge coverage ratio ("FCCR"). For context, using the same company in the previous example and assuming a modest level of taxes ($5 million), capex ($5 million), and 1.00% amortization, the FCCR today falls below the 1.00x breakeven threshold (0.95x) and is nearly 0.50x lower than it would have been at the beginning of the year (1.39x), leading to a debt quantum that is not supportable by the cash flow of the business.

This dynamic is reducing maximum leverage levels on new transactions in order to reduce the burden on cash flow. In the previous example, leverage would need to come down two full turns before achieving FCCR in-line with that at the beginning of 2022.

Of course, there are nuances from business-to-business and sector-to-sector (e.g., margins, level of capex spend, etc.) but broadly speaking, the combination of rising interest rates and widening spreads is frequently becoming the limiting factor on maximum leverage.

Although they can change with new economic data, SOFR rates are expected to remain elevated for the foreseeable future. According to Chatham Financial, the three-month SOFR forward curve is projected to peak at 5.03% at the beginning of Q2 2023 but remain above 3.50% until the middle of 2026, indicating this dynamic may stick around for quite a while.

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

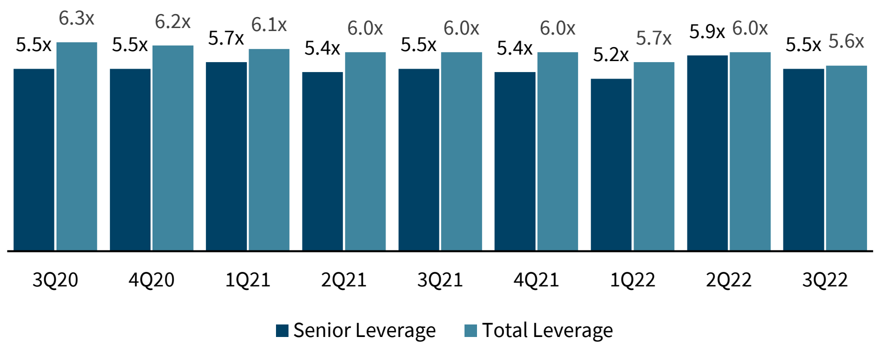
2. Assumes hypothetical debt facility includes a 1.00% SOFR floor.
3. Assumes pricing spread would be 50 basis points higher, or S + 6.50%, today.

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

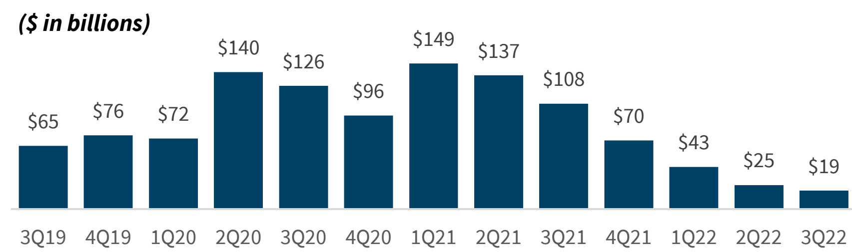
Leverage multiples for middle-market LBOs from William Blair's proprietary database decreased approximately 0.50x as rising interest rates and widening pricing spreads pressured cash flow coverage and ultimate leveragability.



Source: William Blair Proprietary Mid-Market LBO Financing Database

High-Yield Bond Volume

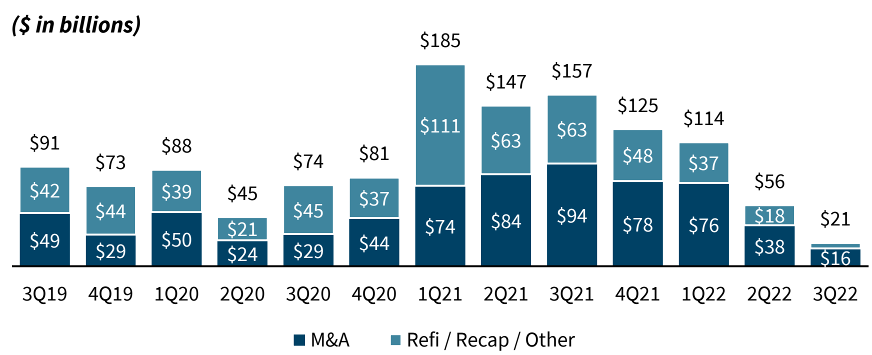
High-yield bond volume continued its downward trajectory in Q3, declining to $19 billion, representing the second lowest quarterly volume in ten years.



Source: LCD, a part of Pitchbook

Institutional Loan Volumes

Institutional loan volume declined significantly in the third quarter, reaching its lowest quarterly total in over ten years, as the broadly syndicated debt and M&A markets were challenged as a result of rising interest rates and macroeconomic challenges.



Source: LCD, a part of Pitchbook

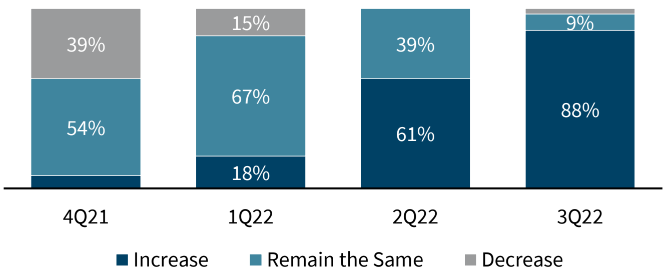
Highlights From William Blair's Q3 2022 Leveraged Finance Survey

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 70 leveraged finance professionals who participated in the survey this quarter.

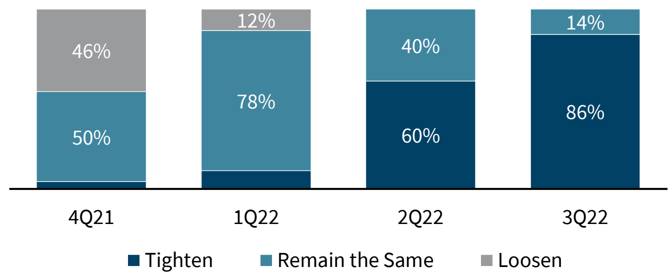
Leveraged Lending Market Conditions Continue to Tighten

An overwhelming majority of lenders indicated that pricing, leverage, and terms increased and tightened over the quarter as rising interest rates, macroeconomic challenges, and recessionary concerns limited risk appetite and flexibility.

Pricing



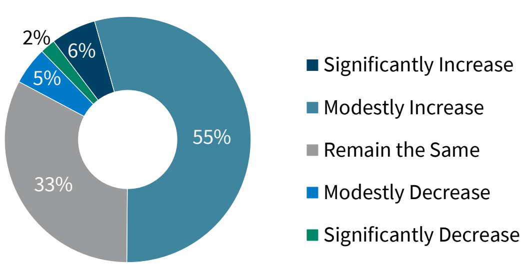
Leverage and Terms



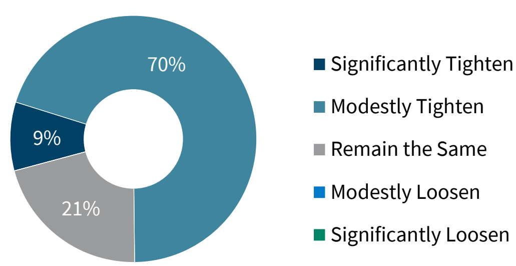
Lending Expectations for the Remainder of 2022

Respondents expect pricing, leverage, and terms to continue modestly increasing and tightening over the remainder of 2022.

Pricing Expectations



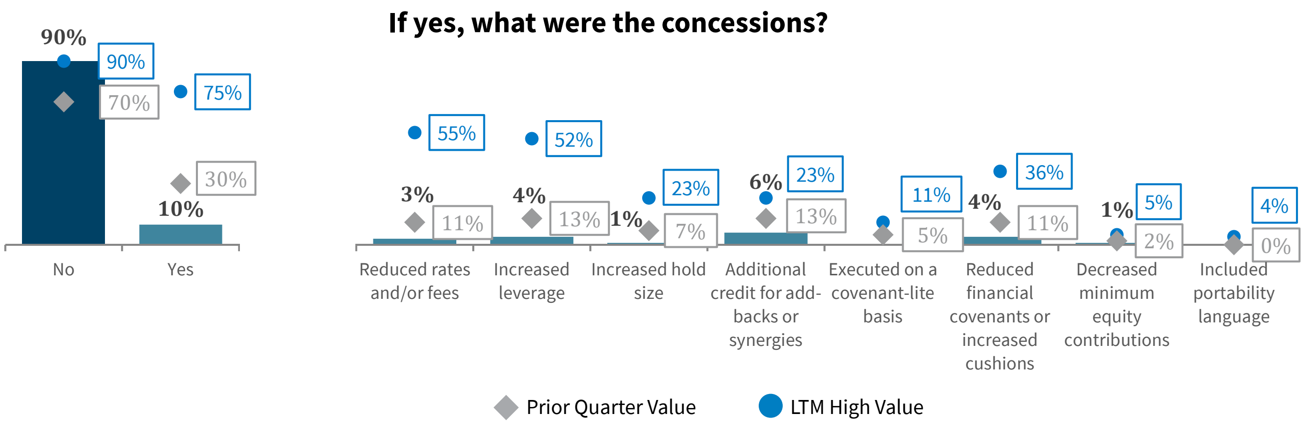
Leverage and Terms Expectations



Lender Aggressiveness Wanes

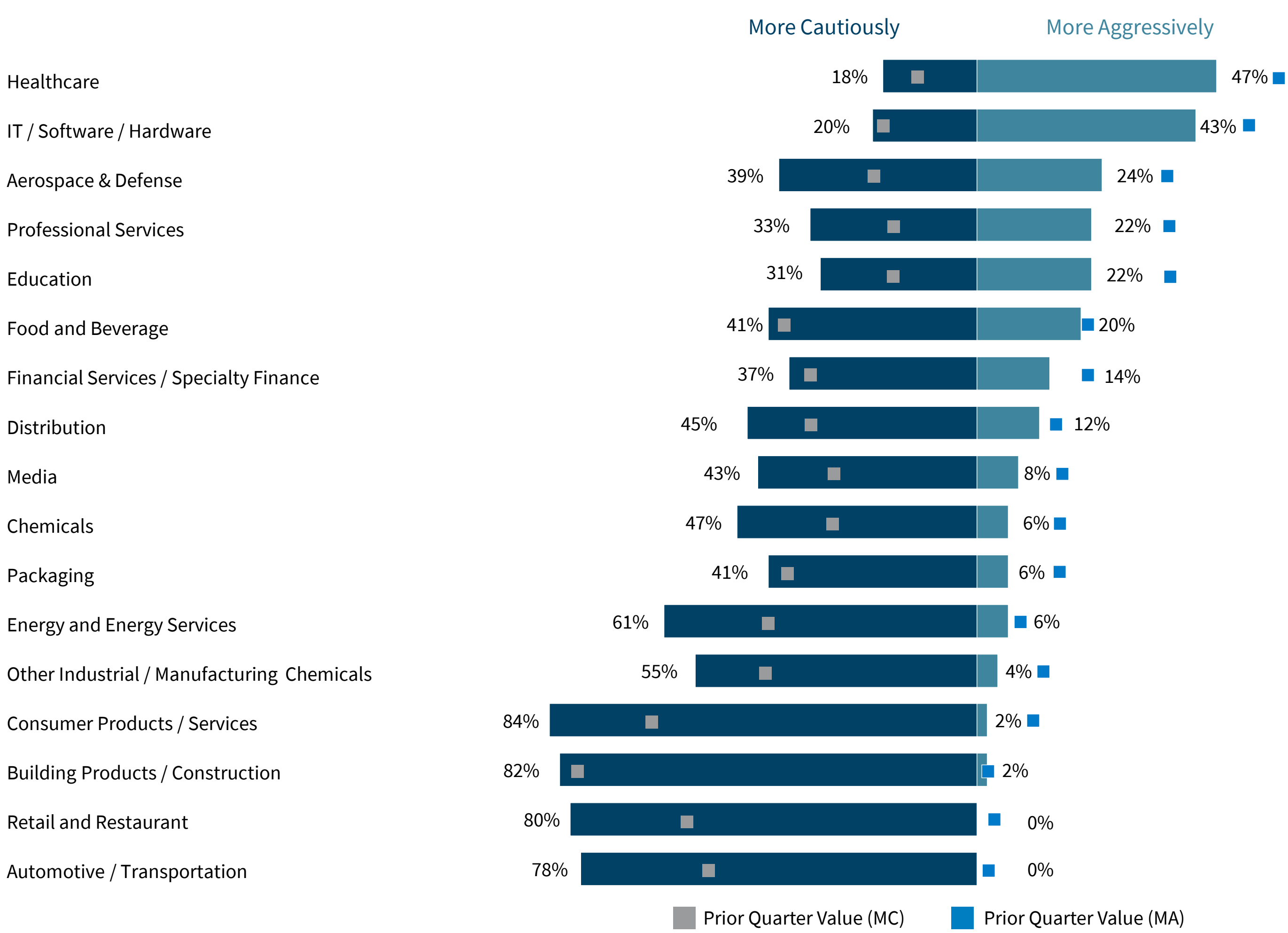
Lenders are increasingly unwilling to stretch in order to win new opportunities as operating and financing environments remain challenged from rising interest rates, recessionary pressures, and other macroeconomic factors.

During 3Q22, did you make borrower-friendly concessions you historically would not have to win a deal?

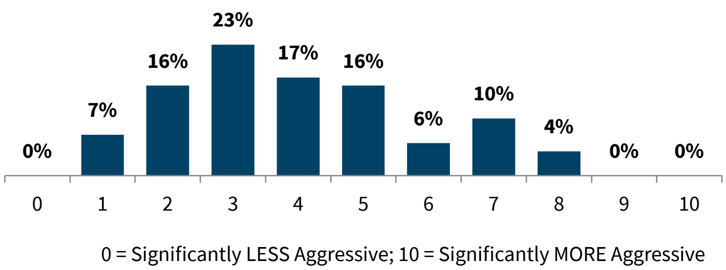


Additional Highlights

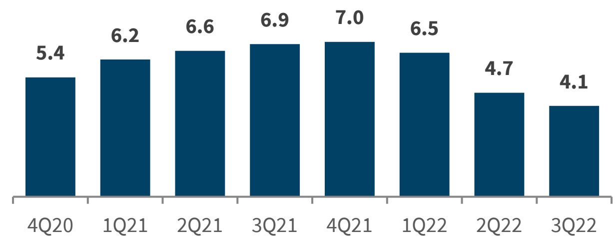
Are there any specific sectors or industries for which your firm is proceeding more aggressively or cautiously today compared with 6 months ago?



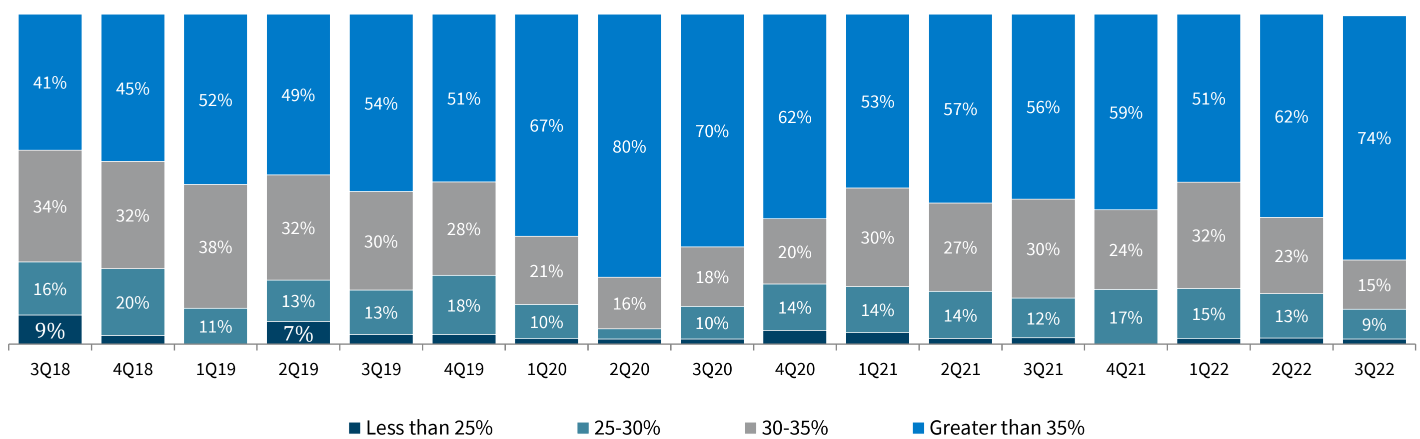
Assuming your firm's pre-COVID rating was a 5, how would you rate the aggressiveness of your firm's approach to new debt opportunities today?



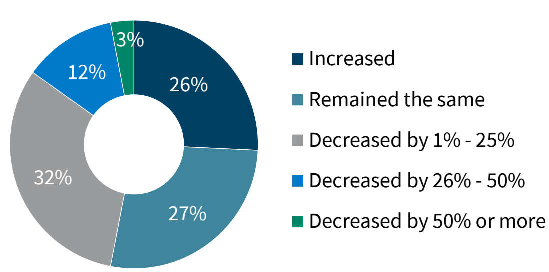
Average Rating by Quarter?



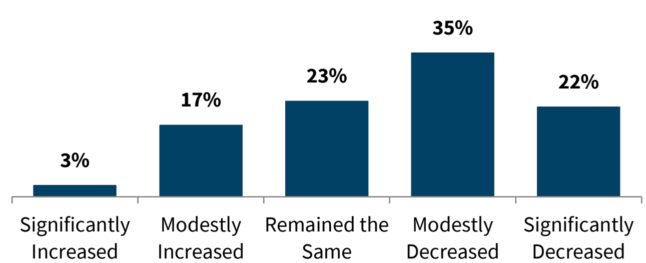
For transactions involving a private equity sponsor, what is the minimum equity contribution you require?



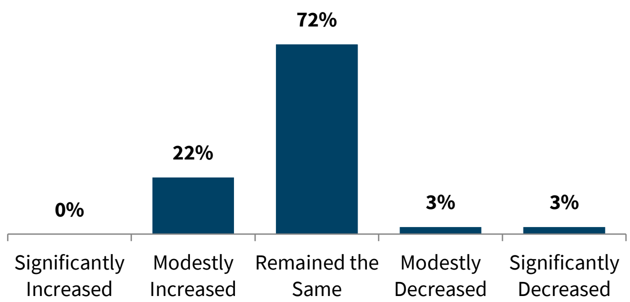
Compared to your firm's hold sizes in 2021, what have you observed regarding your firm's current maximum hold size?



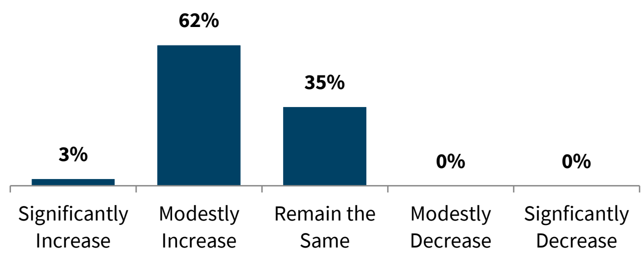
During Q3 2022, how did new-issue loan volume compare to that in the previous six months?



During Q3 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?

- Interest rates and impact on free cash flow; increased risk of a major recession
- Rising rates and cycle concerns will put pressure on average credits; strong credits or credits where sponsors have significant experience will get done, but average or lower quality deals will get less attention
- Margin compression coupled with higher rates
- More focus on upcoming maturities given companies refinancing will be doing so into a significantly different market environment vs. the last few years
- Higher debt costs (interest rate increase was not modeled) and continued increases in labor costs
- Club deals appear to be the new norm given less capital available, however will be interesting to see if fundraising efforts by credit firms has legs into year-end
- Rising interest rate and continued cost pressures that will reduce margins = more cash flow constraints
- Availability of capital to deploy - CLO formation, payoffs, etc.
- Restructuring activity picking up and how that will impact lender/IC activity
- Base rate (SOFR/LIBOR) increasing by more than 100 bps; continued pressure on margins (labor, supply chain, etc)
- Continued headlines (inflation, war, rates, energy prices) and market hesitance with few players interested, especially at the end of the year, to step in and take a view on "the bottom"
- Top tier credits continue to find financing interest, but the depth of the market has materially declined

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

$365,000,000 Driven Brands Securitization 2022	Not Disclosed MCE Motion & Control Enterprises 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

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 525 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 200 senior bankers around the world, William Blair has completed more than 1,450 advisory and financing transactions totaling over $725 billion in value for our clients.*

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

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