William Blair

Leveraged Finance

Q4 2022

Private Credit Emerges as Primary Financing Solution as the Leveraged Finance Market Remains Subdued in Q4

In This Report

Private Credit Emerges as Primary Financing Solution as the Leveraged Finance Market Remains Subdued in Q4

Despite a surge of refinancing activity, the overall leveraged loan market remained depressed in Q4 2022 as macroeconomic challenges and rising interest rates persisted, causing M&A-related volume to continue to shrink.

Overall, the U.S. institutional leveraged loan market rebounded modestly in Q4 with volume of $35.7 billion—an increase of almost 70% from the historic lows of the previous quarter. The uplift in volume was driven by refinancing activity, which accounted for approximately 60% of total leveraged loan volume at $21.5 billion. Most of this volume was generated from large refinancings ($500 million and up) of rated borrowers in the syndicated market. M&A-related volume declined for the fifth consecutive quarter to $12.8 billion as new deal activity was severely limited due to continued macroeconomic uncertainty, hawkish Fed policy, and compounding recessionary fears.

For a fourth straight quarter, the William Blair Leveraged Lending Index shifted deeper into lender-friendly territory as the index fell to 2.0 (scale of 1 to 5 with 5 being the most borrower-friendly). Respondents to William Blair's Leveraged Finance Survey further echoed this sentiment as more than 85% of respondents indicated pricing increased and leverage and terms tightened during the quarter. Consistent with the broader leverage loan market, more than half of survey participants indicated new-issue loan volume was down versus the previous six months. In addition, lender aggressiveness continued to wane, with over 90% of respondents not willing to make borrower-friendly concessions to win a new deal.

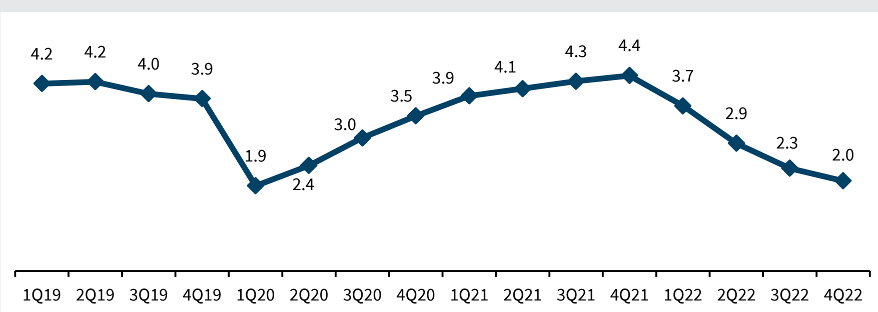
Looking ahead to 2023, lenders expect pricing to continue widening and leverage and terms to continue tightening. In conjunction, lenders are expected to continue exercising heightened scrutiny during diligence and curtailing aggressiveness given the prevailing threats to cash flow coverage and margins. In addition, the volume of leveraged buyout activity is expected to have an impact on the market in the coming year.

Seller valuation expectations remained elevated in the second half of 2022. This resulted in a widening dislocation between bid/ask spreads and - in concert with reduced leverage capacity driven by rising rates - in a precipitous decline in buy-side activity. Going into 2023, we expect this phenomenon to linger until valuations come down. However, this may result in the continuation of soft M&A activity as owners are not willing to sell at depressed valuations.

Lastly, as the numerous operating and financing impediments that occurred in 2022 roll into upcoming LTM periods, a vast majority of survey respondents expect default rates to continue to rise. Over 85% of respondents to our survey indicated rates would modestly to significantly increase in 2023.

William Blair Leveraged Lending Index Reaches COVID Lows (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. During Q4, the index continued to shift further in lenders' favor, reaching lows of 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?"

Direct Lenders financed almost 5x the number of leveraged buyouts in 2022 compared to syndicated lenders.

Direct Lenders Supplant Syndicated Counterparts and Cautiously Remain Open for Business

As discussed in the 2Q22 William Blair Leveraged Finance Report, the lines between the syndicated and private debt markets began to blur as pricing and terms converged following a kickstart of macroeconomic challenges, geopolitical unrest, and restrictive monetary policy. This trend was exacerbated over the second half of 2022 as the bearish themes in the market persisted and the syndicated market was all but shut down, paving the way for private credit to become the lending market of choice.

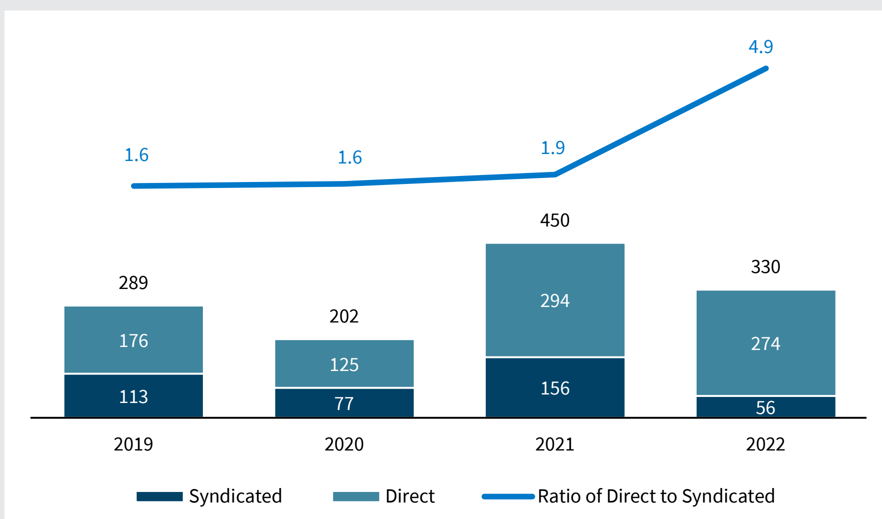
According to LCD, a part of Pitchbook, of the leveraged buyout transactions that were completed in 2022, direct lenders fulfilled the debt financing needs at a ratio of almost 5:1 compared to syndicated lenders. Of the 128 leveraged buyouts completed in the second half of 2022 alone, over 90% of the deals were supported by direct lenders.

While we expect this trend to continue and private credit to be the primary supplier of debt capital in 2023, direct lenders are becoming increasingly risk-off and patient with their capital deployment. Apart from widening pricing spreads and tightening terms, the largest obstacle in obtaining private debt capital is the reduction in hold sizes. Over the second half of 2022, hold sizes were reduced anywhere from 25% to 50% from their levels a year ago. This resulted in the need to club a lending group together to accomplish the majority of financing requirements, particularly with borrowers of scale. This can become extremely burdensome for sponsors, particularly in situations where a sponsor's traditional stable of lending partners are unable to support required financing objectives, given the lack of resources, capabilities, and bandwidth to source additional providers of debt capital.

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

Sponsors Flee to Private Credit

The below represents a summary from LCD, a part of Pitchbook, of leveraged buyouts financed by the broadly syndicated market compared to private credit. As illustrated, direct lenders took significant share in 2022, financing almost five times the number of leveraged buyouts compared to syndicated counterparts.

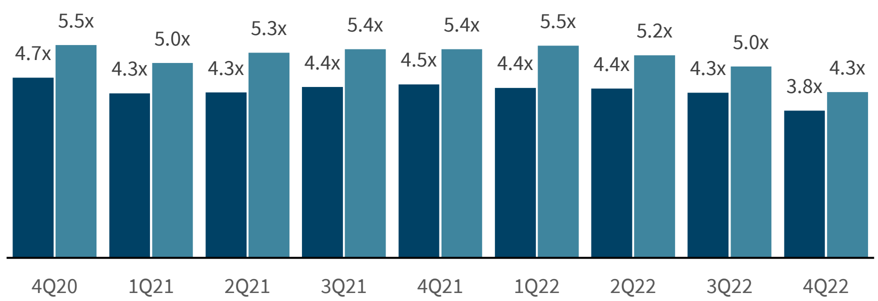


Market Analysis

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

All Loans Leverage Multiples

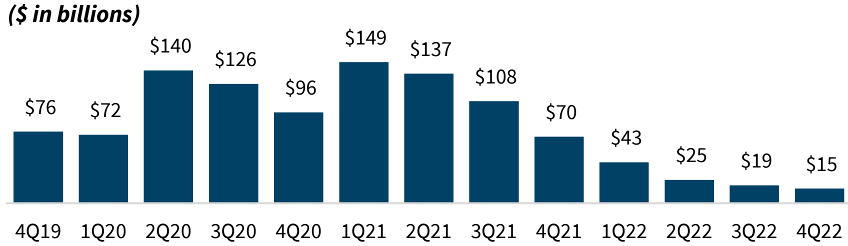
Total leverage dipped below 4.50x for the first time since COVID-impacted 2Q20.



Source: LCD, a part of Pitchbook. Represents the rolling 90-day average leverage multiples from all loan activity

High-Yield Bond Volume

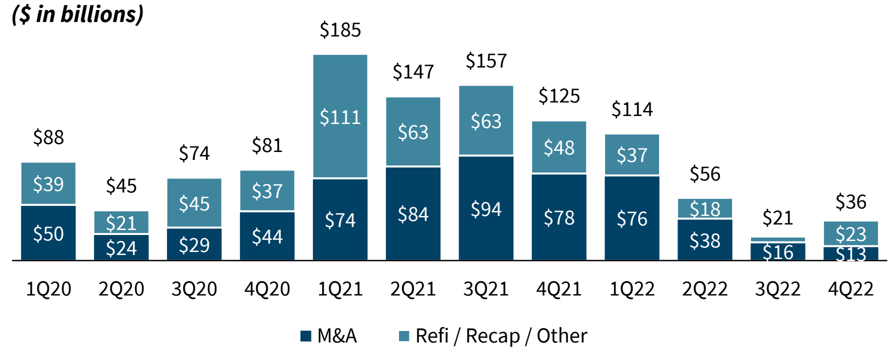
High-yield bond volume remained soft, declining to a historically low level of $15 billion.



Source: LCD, a part of Pitchbook

Institutional Loan Volumes

Institutional loan volume rebounded slightly in the fourth quarter driven by refinancing activity. The M&A and broadly syndicated debt markets, however, remained challenged as the macro environment and rising interest rates hampered activity.



Source: LCD, a part of Pitchbook

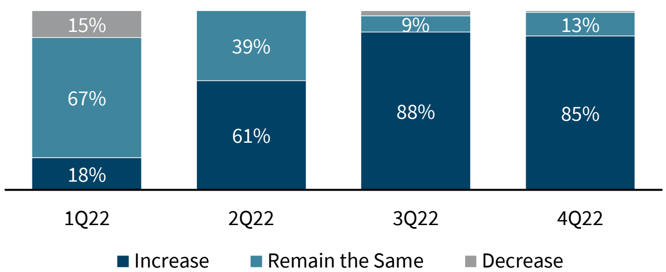
Highlights From William Blair's Q4 2022 Leveraged Finance Survey

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.

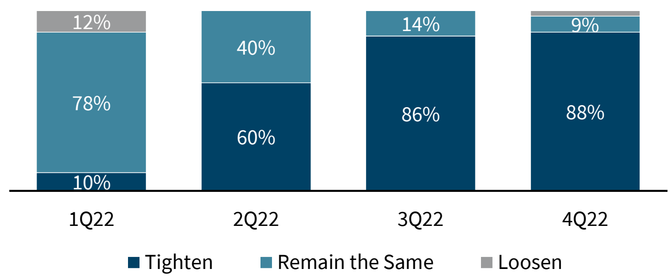
Lender-Friendly Borrowing Environment Takes Stronghold

According to survey respondents, pricing continued to widen and leverage and terms further tightened over the quarter as macroeconomic challenges, recessionary concerns, and a hawkish Fed continued to drive lender conservatism.

Pricing



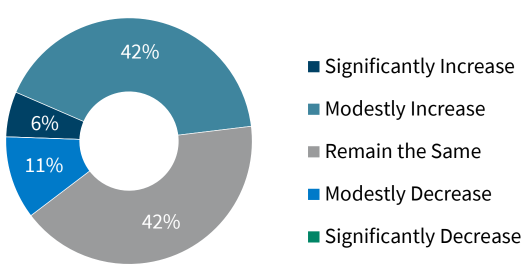
Leverage and Terms



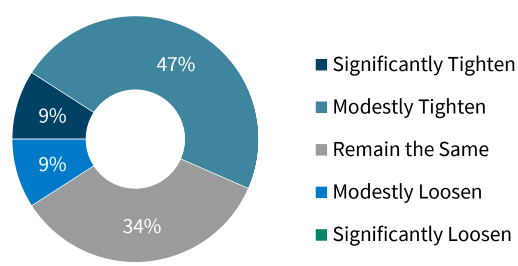
Lending Expectations for 2023

Pricing appears to have stabilized somewhat as approximately 50% of respondents expect pricing to remain the same or modestly decrease over the coming year. Leverage and terms are expected to continue modestly tightening as lenders seek ways to mitigate risk through documentation as pricing comes more into equilibrium.

Pricing Expectations



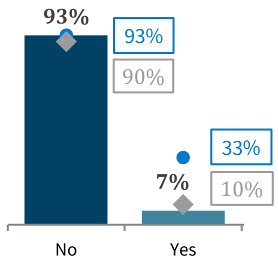
Leverage and Terms Expectations



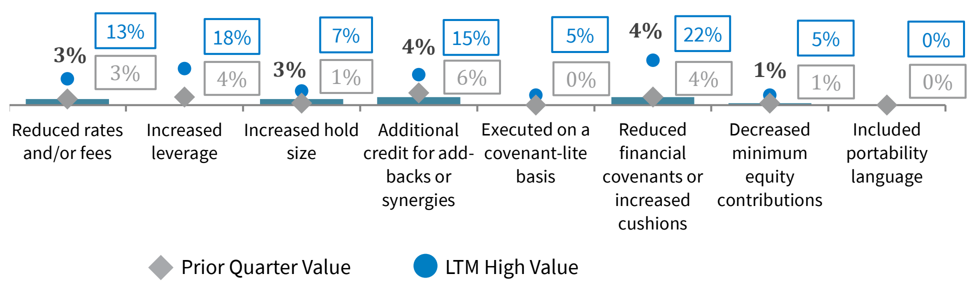
Lenders Becoming More Selective

The lender-friendly borrowing environment continued in Q4 as the appetite for flexing terms aggressively to win new opportunities subsided amidst continued challenges from a rising rate environment and recessionary outlook.

During 4Q22, did you make borrower-friendly concessions you historically would not have to win a deal?

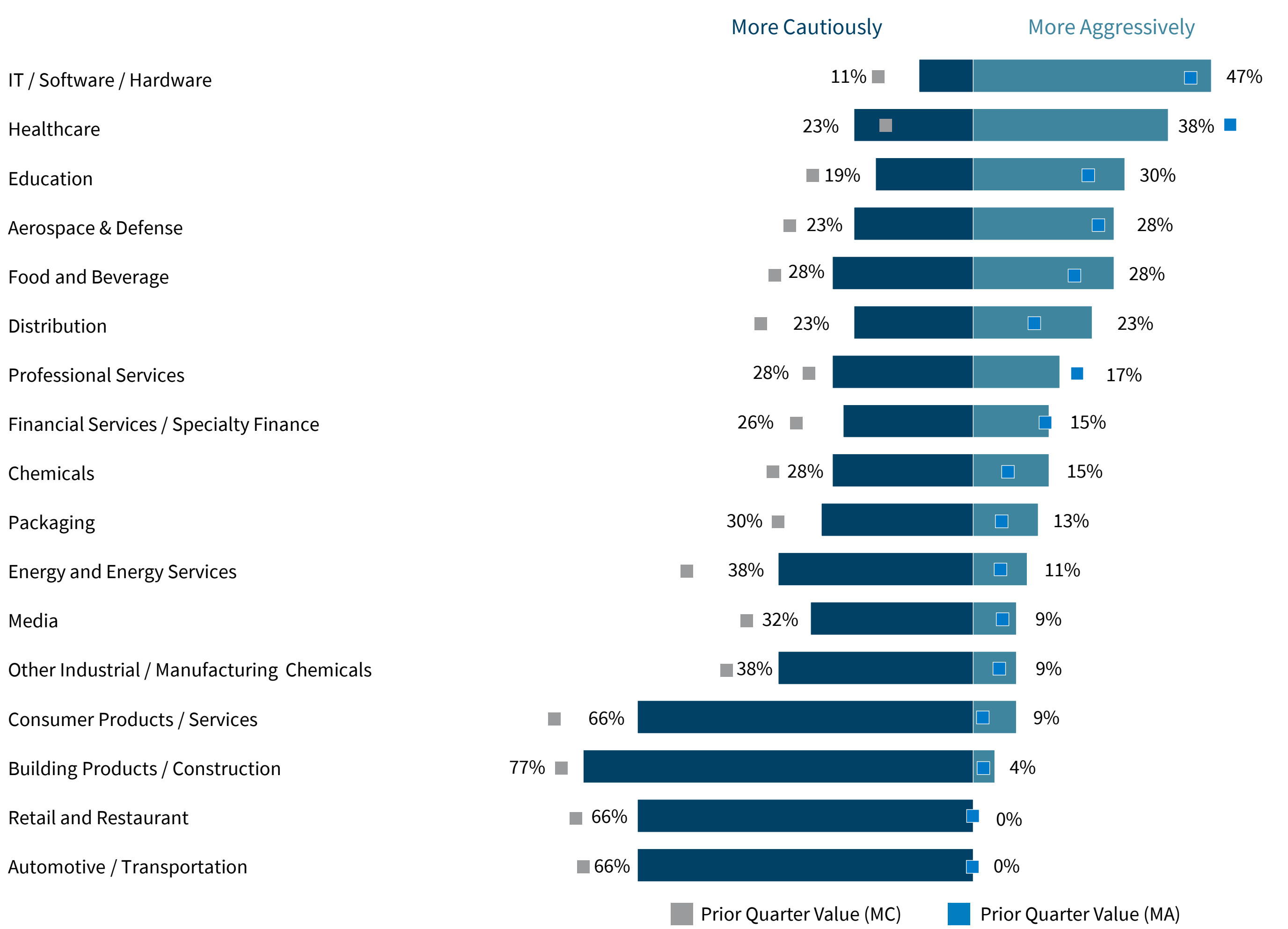


If yes, what were the concessions?

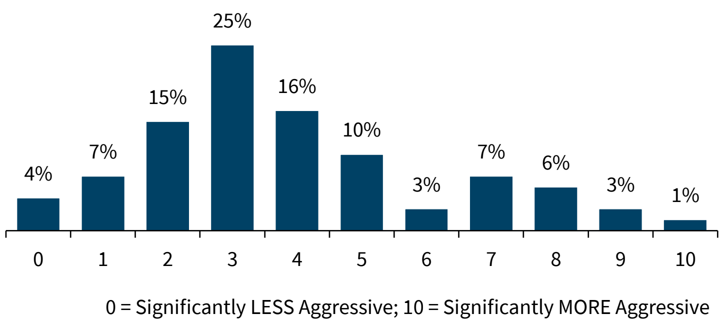


Additional Highlights

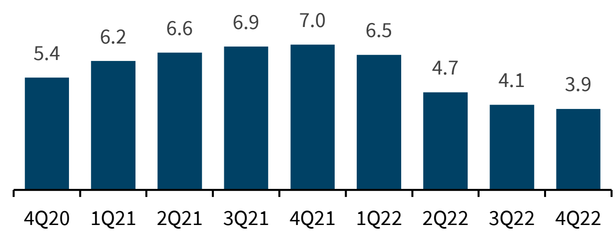
Are there any specific sectors or industries for which your firm is proceeding more aggressively or cautiously today compared with 6 months ago?



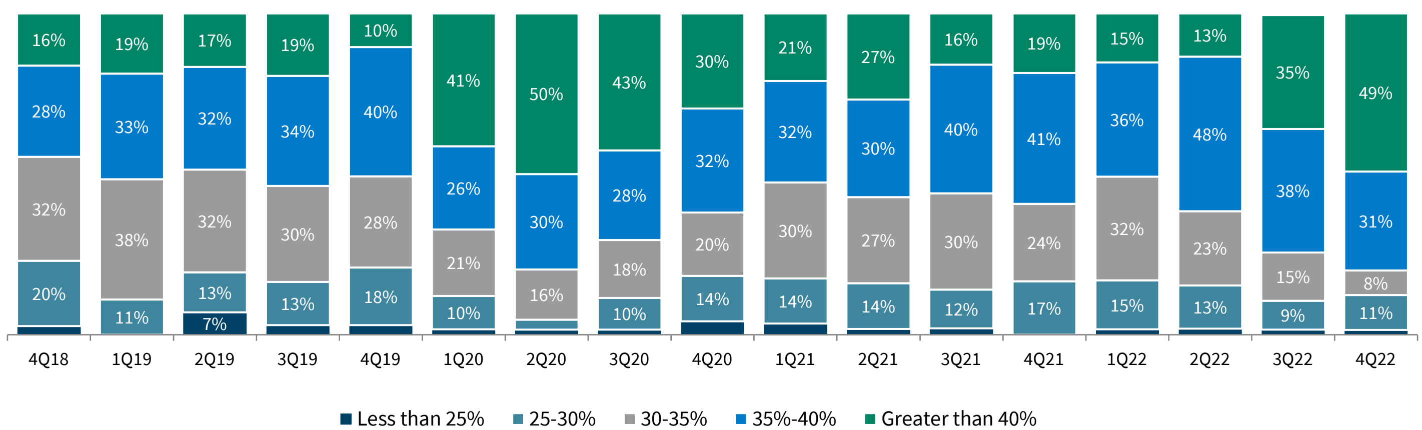
Assuming your firm's pre-COVID rating was a 5, how would you rate the aggressiveness of your firm's approach to new debt opportunities today?



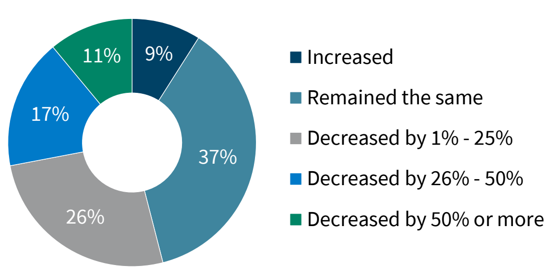
Average Rating by Quarter?



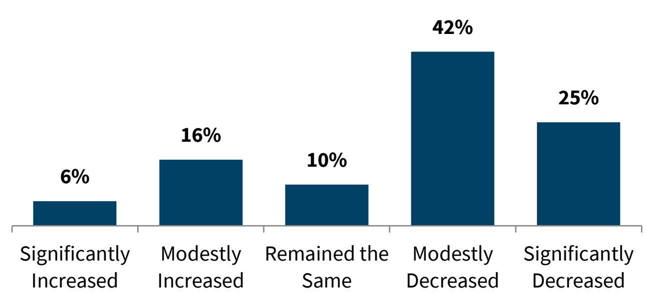
For transactions involving a private equity sponsor, what is the minimum equity contribution you require?



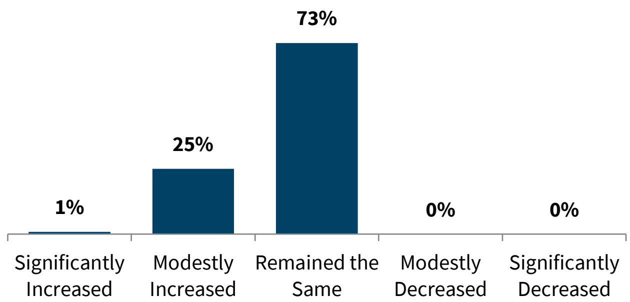
Compared to your firm's hold sizes in 2021, what have you observed regarding your firm's current maximum hold size?



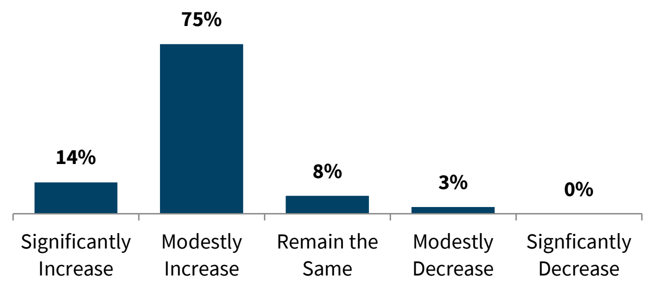
During Q4 2022, how did new-issue loan volume compare to that in the previous six months?



During Q4 2022, how did default rate activity compare to that in the previous six months?



For 2023, do you expect the level of default rates to?



For 2023, what factors or trends do you expect will have the most significant impact on the leveraged loan market?

- Increasing interest rates and impact on free cash flow; fixed charge coverage pressure
- Macroeconomic outlook including rising rates, inflation, consumer spending, and recession
- Impact of inflation on top line and margins for portfolio companies across industries
- Volume of leveraged buyouts; Sponsors choosing to hold businesses until presumed market recovery rather than sell at lower valuations
- Fed tightening, recession, and capital requirements
- Heightened lender scrutiny and diligence focus on cash flow, credit quality, and documentation; private equity commitment to and ability to address over-levered portfolio companies
- Level of fundraising and ultimately liquidity for both equity and credit/debt funds
- Decreased leverage on new deals to be able to hit target cash flow coverage metrics given rising interest rate environment
- Increased default rates and over-leveraged capital structures
- Availability of capital to deploy—dry powder, CLO formation, payoffs, etc.
- Rising benchmark interest rate; Cash flow/interest coverage will be very tight
- Sustained Fed tightening and pace of inflation
- Margin compression coupled with higher rates
- Elevated leverage levels on adjusted EBITDA and increased likelihood of adjustments not materializing

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
SIXAXIS
Senior Secured
Credit Facility
2022

$365,000,000
DrivenBrands
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

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 250 senior bankers around the world, William Blair has completed more than 1,430 advisory and financing transactions totaling over $730 billion in value for our clients.*

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* In the past five years as of December 31, 2022

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