William Blair

Leveraged Finance

Q2 2023

Positive Signs Emerge in the Leveraged Finance Market but a Resurgence Remains Elusive

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Analysis of Q2 U.S. Institutional Loan Volume

Highlights, Analysis, and Results From William Blair's Quarterly Leveraged Finance Lender Survey

Positive Signs Emerge in the Leveraged Finance Market but a Resurgence Remains Elusive

The U.S. leveraged loan market appears to have stabilized in Q2 but it's too early to tell if a resurgence is imminent.

U.S. institutional leveraged loan volume remained flat in the second quarter, reaching a total of $50.5 billion. Despite this positive sign, year-to-date volume of 102.9 billion represented the lowest level of activity since 2010. While M&A activity generally remained anemic during the quarter, loan volume tied to M&A did increase quarter-over-quarter to $13.9 billion, representing the first such quarterly improvement in almost two years. Refinancing loan volume remained relatively stable during Q2, reaching $36.5 billion, and accounted for more than 60% of total institutional loan volume.

Pricing Begins to Tighten as Lender Aggressiveness (Cautiously) Returns

William Blair's Leveraged Lending Index remained steady in the second quarter at 2.4 (scale of 1 to 5, with 5 being the most borrower-friendly). Although the index remained unchanged and points to a more neutral lending environment, respondents to William Blair's Q2 2023 Leveraged Finance Survey indicated an increased willingness to make borrower-friendly concessions to win deals as M&A volume remained subdued and the lack of quality credits in the market spurred heightened competition. Survey results revealed LTM highs for lenders providing concessions overall, for tightening of fees and spreads, and for giving credit for certain EBITDA adjustments. Further, pricing relief is expected to continue as 36% of survey respondents expect their pricing to modestly decline over the remainder of 2023.

This is in line with what the William Blair Leveraged Finance Group has experienced across live debt advisory engagements as well as anecdotally from conversations with direct lenders. Regular way pricing has declined approximately 50 basis points, as lenders have become more comfortable investing in the current financing environment and look to deploy excess dry powder. Survey results supported this sentiment as the level of lender aggressiveness toward new opportunities increased to an LTM high and was on par with pre-COVID lending appetite.

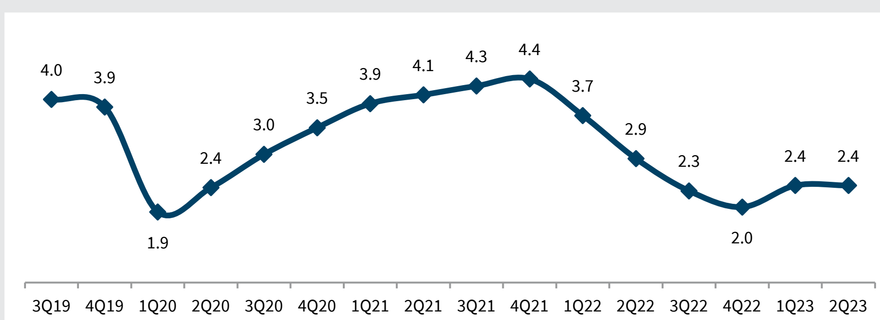
Sustained Elevated Interest Rates Begin to Weigh on Borrowers

Over the past year, the Fed raised interest rates at a pace not seen in more than three decades. This resulted in a sustained and significantly elevated Secured Overnight Financing Rate (SOFR) — the variable base rate for most middle-market loans. Survey results indicated that borrowers are beginning to feel the impact on their ability to service debt obligations as the higher interest burden begins to roll into LTM performance. For Q2, 45% of respondents indicated that they are seeing higher rates of default than what was seen during the previous six months.

As discussed in our June 2023 Front Line Insights Article "The Delayed Impact of Higher Rates and the Re-Emergence of PIK," and further attested to in this quarter's lender survey, lenders expect default rates

William Blair Leveraged Lending Index Holds Steady

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. The index remained unchanged in Q2 indicating possible stabilization within the financing markets.



Despite challenging financing markets, private credit remains open for business and lenders have even become slightly more aggressive.

to further increase over the latter part of the year, with more than 80% of respondents expecting an uptick in defaults over the next six months. Lenders expect continued pressure from materially higher interest rates and the related impacts on liquidity to be the biggest market factor in the near term. Many borrowers, particularly those that put credit facilities in place prior to rates rising in mid-2022, still have not experienced the full-year impact of cumulative rate increases on earnings. Toward the end of Q3 the market will have better insight into the overall impact of 5.0%+ SOFR rates on borrowers' cash flow.

Lender Hold Sizes Constrained

Another dynamic currently impacting the leveraged loan market, particularly on the private side, is decreased lender hold sizes for any given transaction. As interest rates have risen and borrower operations have been hampered by a multitude of negative macroeconomic factors, lenders have reduced their hold sizes as another method of risk mitigation. This sentiment was reflected in this quarter's lender survey in which half of the respondents indicated hold sizes have declined from the "Golden Year" for financiers in 2021. As a result, many transactions that would have cleared with a single lender historically, now require a club of lenders to execute. That dynamic can add significant complexity to the capital-raising process and increase overall execution risk for the transaction. Particularly for LBOs, sponsors are now having to invest more time on the financing side of transactions, pulling attention away from their core acquisition-related work streams. Unable to rely on a stable of lenders with a strong relationship history, sponsors find themselves having to execute broader lender outreach processes.

Private Credit Continues to Win Out

Despite some of the challenges facing the broader loan market, the private credit market remains open for business and has even become slightly more aggressive in pursuit of financing opportunities over the past quarter. As a result, the trend of the private credit market taking share from the syndicated loan market continued in Q2. Direct lenders' broad investment mandates, flexible structures and documentation, and funding certainty have enabled them to become the preferred financing option for sponsors. During the first half of 2023, private credit providers financed 9x more LBOs than what was completed through the syndicated market, with a total of 108 direct deals compared to just 12 on the syndicated side.

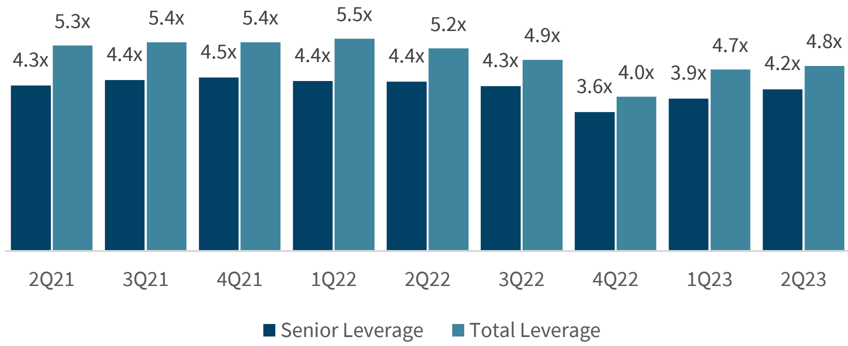
To learn more about these and other trends shaping the leveraged finance market, please don't hesitate to contact us.

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.

Average Senior and Total Leverage Multiples

For the second consecutive quarter, total leverage modestly improved but remained depressed compared to historical levels.

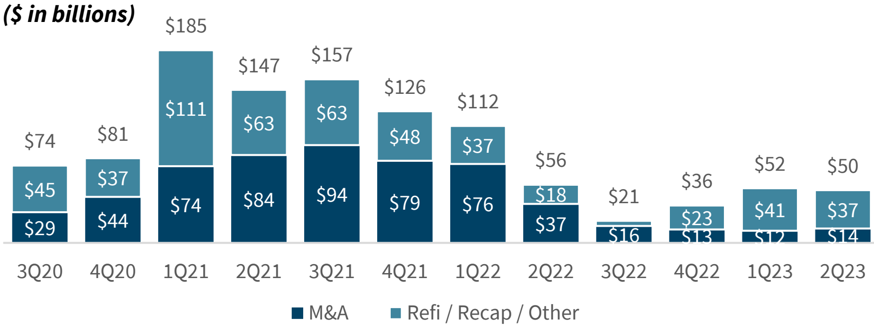


Source: LCD, a part of Pitchbook. Represents the rolling 90-day average leverage multiples from all loan activity

Institutional Loan Volume

Institutional loan volume remained stable in Q2 2023 due to a small uptick in M&A financing activity offsetting a modest decline in refinancing activity. Overall, the financing markets continued to be challenged by macroeconomic volatility and uncertainty, a disconnect between buyer and seller valuations, and the persistence of elevated interest rates.

($ in billions)

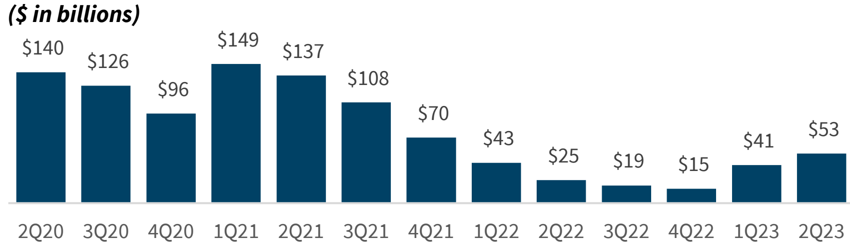


Source: LCD, a part of Pitchbook

High-Yield Bond Volume

High-yield bond volume in Q2 increased for the second consecutive quarter, and was up more than 100% year-over-year, although volume remained relatively light compared to historical averages.

($ in billions)



Source: LCD, a part of Pitchbook

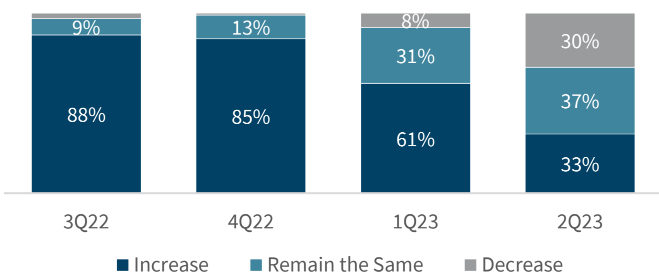
Highlights From William Blair's Q2 2023 Leveraged Finance Survey

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.

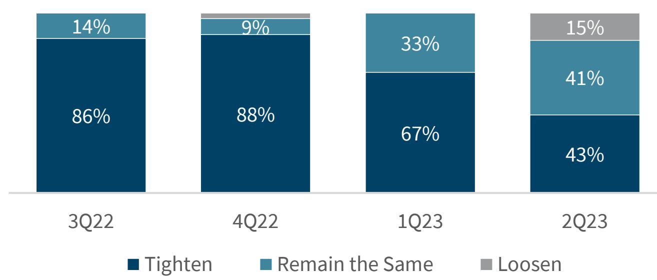
Debt Markets Becoming More Neutral

While leveraged loan activity remained suppressed, momentum toward more borrower-friendly pricing, leverage, and terms continued in the second quarter, as almost a third of respondents indicated pricing declined and, for the majority of respondents, leverage and terms either remained the same or loosened.

Pricing



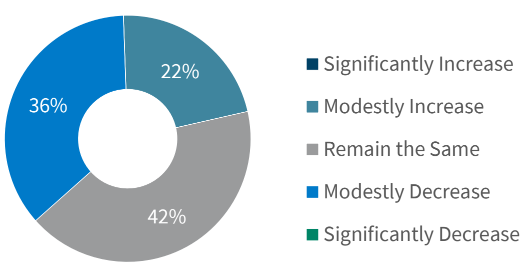
Leverage and Terms



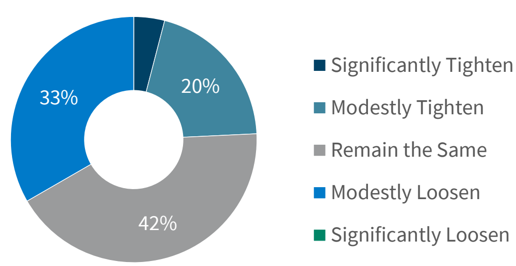
Lending Expectations for 2023

Similarly, survey respondents expect pricing, leverage, and terms to continue stabilizing and further shift in favor of borrowers over the second half of 2023. Over 75% of respondents expect pricing to remain the same or modestly decrease and for leverage and terms to remain the same or modestly loosen during the remainder of 2023.

Pricing Expectations



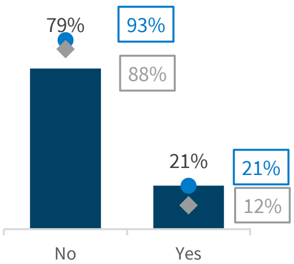
Leverage and Terms Expectations



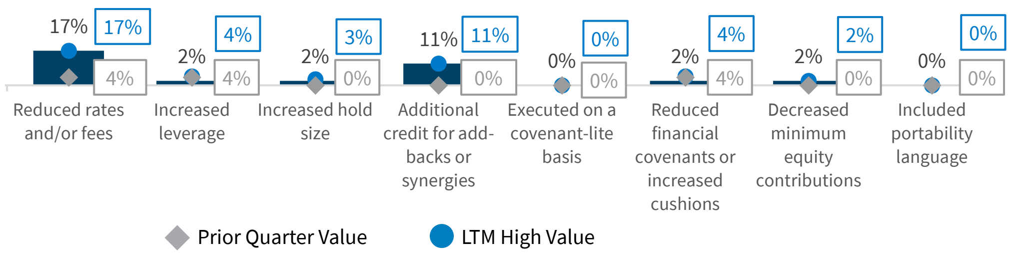
Lender Aggressiveness Perks Up

Lenders indicated an increased willingness to stretch in order to win new opportunities during the second quarter, as the continuation of muted deal volume and heightened competition resulted in modest tightening of fees and spreads, as well as improved acceptance of certain EBITDA adjustments.

During Q2 2023, did you make borrower-friendly concessions you historically would not have to win a deal?

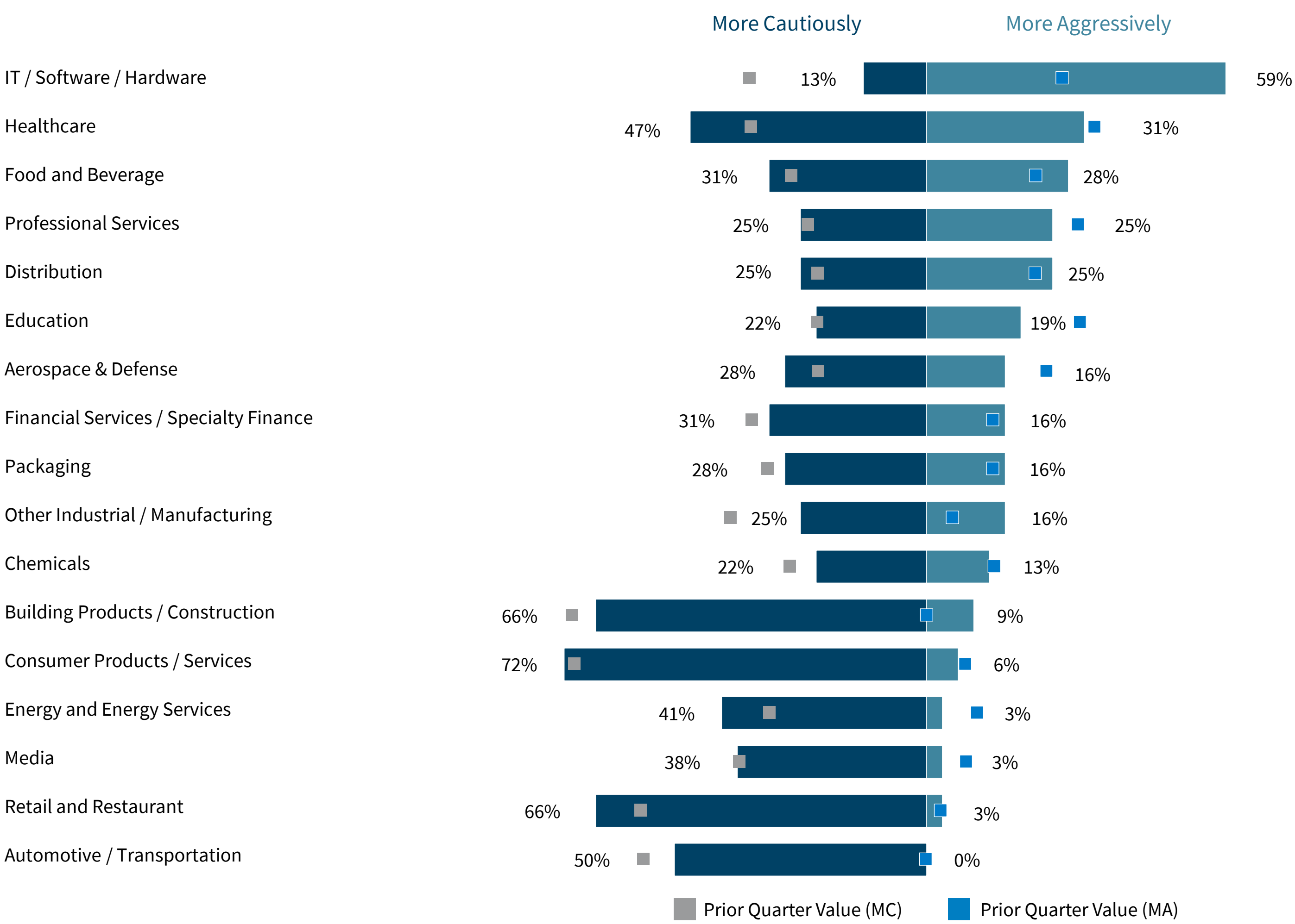


If yes, what were the concessions?

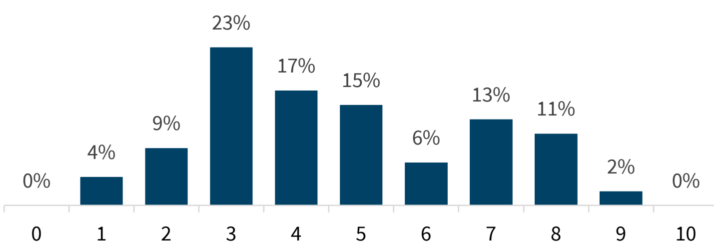


Additional Highlights

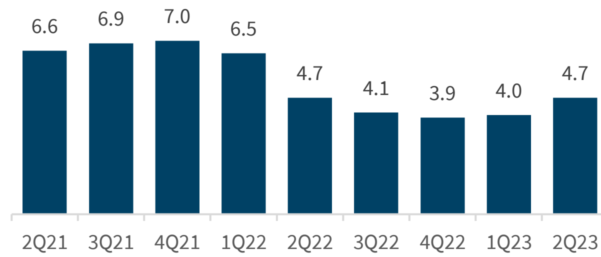
Are there any specific sectors or industries for which your firm is proceeding more aggressively or more cautiously today compared with 6 months ago?



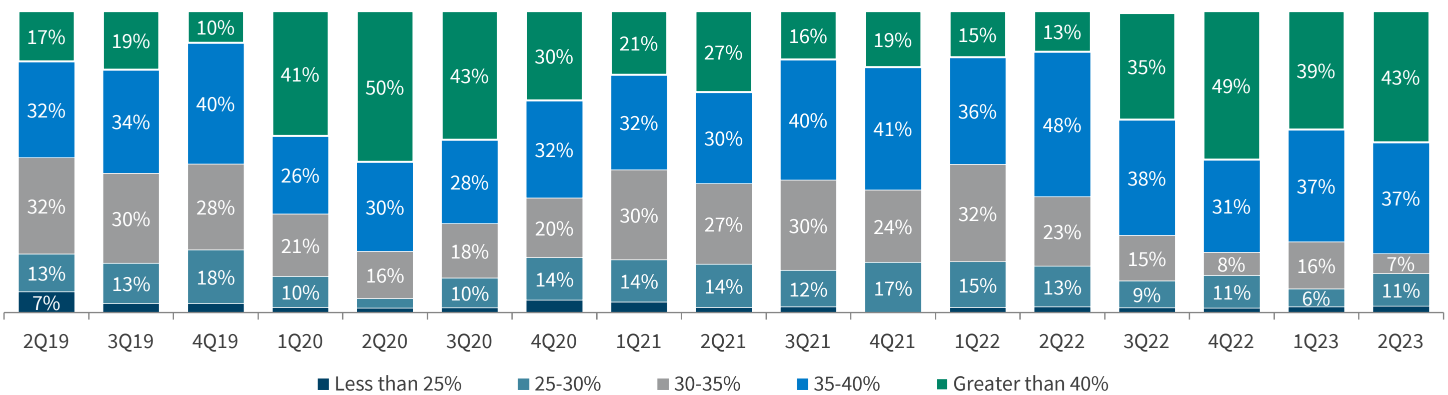
Assuming your firm's pre-COVID rating was a 5, how would you rate the aggressiveness of your firm's approach to new debt opportunities today?



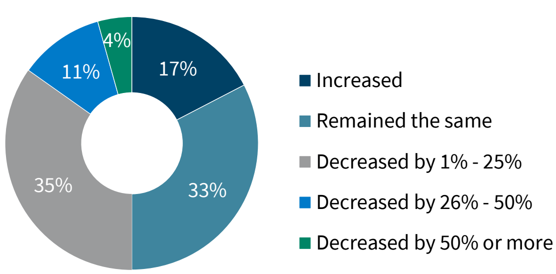
Average Rating by Quarter



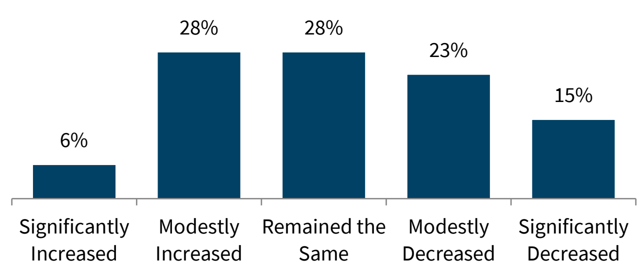
For transactions involving a private equity sponsor, what is the minimum equity contribution you require?



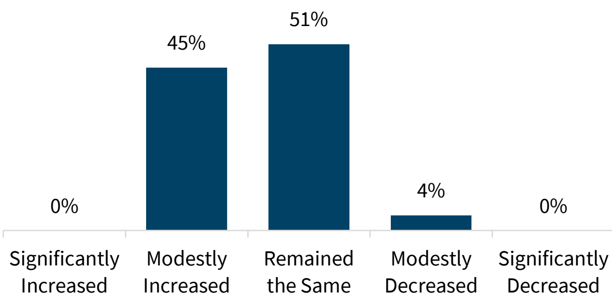
Compared to your firm's hold sizes in 2021, what have you observed regarding your firm's current maximum hold size?



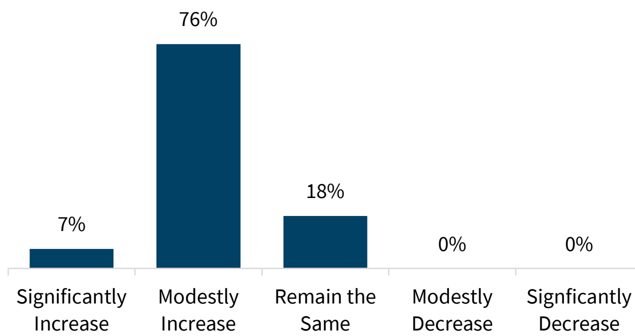
During Q2 2023, how did new-issue loan volume compare to that in the previous six months?



During Q2 2023, how did default activity compare to that in the previous six months?



For the remainder of 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
- Deal volume and quality – High-quality credits are seeing terms tighten, while lower quality names may see difficulty securing financing
- New capital requirement imposed on banks by regulators affecting their ability to remain as active in the market
- Fed policy and future rate increases. Fed decision-making will set the pace for risk appetite across all other asset classes
- Increased default rates and covenant trips
- Macroeconomic headwinds as a result of increased rates and the potential for a recession
- Whether the supply of new opportunities is sufficient for growing demand and dry powder among lenders
- Full-year impact of higher interest rates and cost of debt
- Emergence of highly structured recapitalizations for troubled borrowers that will require an equity component as part of the solution
- Continuation of depressed M&A volume due to disconnect between valuations and seller expectations
- Stress on lender balance sheets and among portfolio companies as costs and interest burden increase
- Increased cost of debt leading to tighter liquidity, higher leverage, and constrained cash flows
- Reopening of the broadly syndicated loan market
- Increased cost of debt as interest rates continue to increase and become an issue with leveraged companies

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

PRIMUTEC SOLUTIONS GROUP Senior Secured Credit Facility 2023	Certified Power Inc. Unitranche Credit Facility 2023	amino Senior Secured Credit Facility Preferred Equity 2023
POTBELLY SANDWICH WORKS Senior Term Loan 2023	EFC INTERNATIONAL Senior & Subordinated Debt 2023	Cellipont BIOSERVICES Senior Secured Term Loan 2023
TAOGLAS Unitranche Credit Facility 2023	SIXAXIS Senior Secured Credit Facility 2022	DrivenBrands Securitization 2022

William Blair Leveraged Finance by the Numbers

190+
completed leveraged finance transactions since 2015

$26B+
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
- Turnkey financing teams able to deliver unparalleled speed, execution, and certainty to close

With more than 270 senior bankers around the world, William Blair has completed more than 1,425 advisory and financing transactions totaling over $730 billion in value for our clients.*

Leveraged Finance Group Leadership

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* In the past five years as of June 30, 2023

Disclosure