William Blair

Leveraged Finance

Q3 2023

Trick or Treat? The Leveraged Loan Market Gained Momentum in Q3 but Will 2023 End on a Sweet Note or Leave Investors Haunted?

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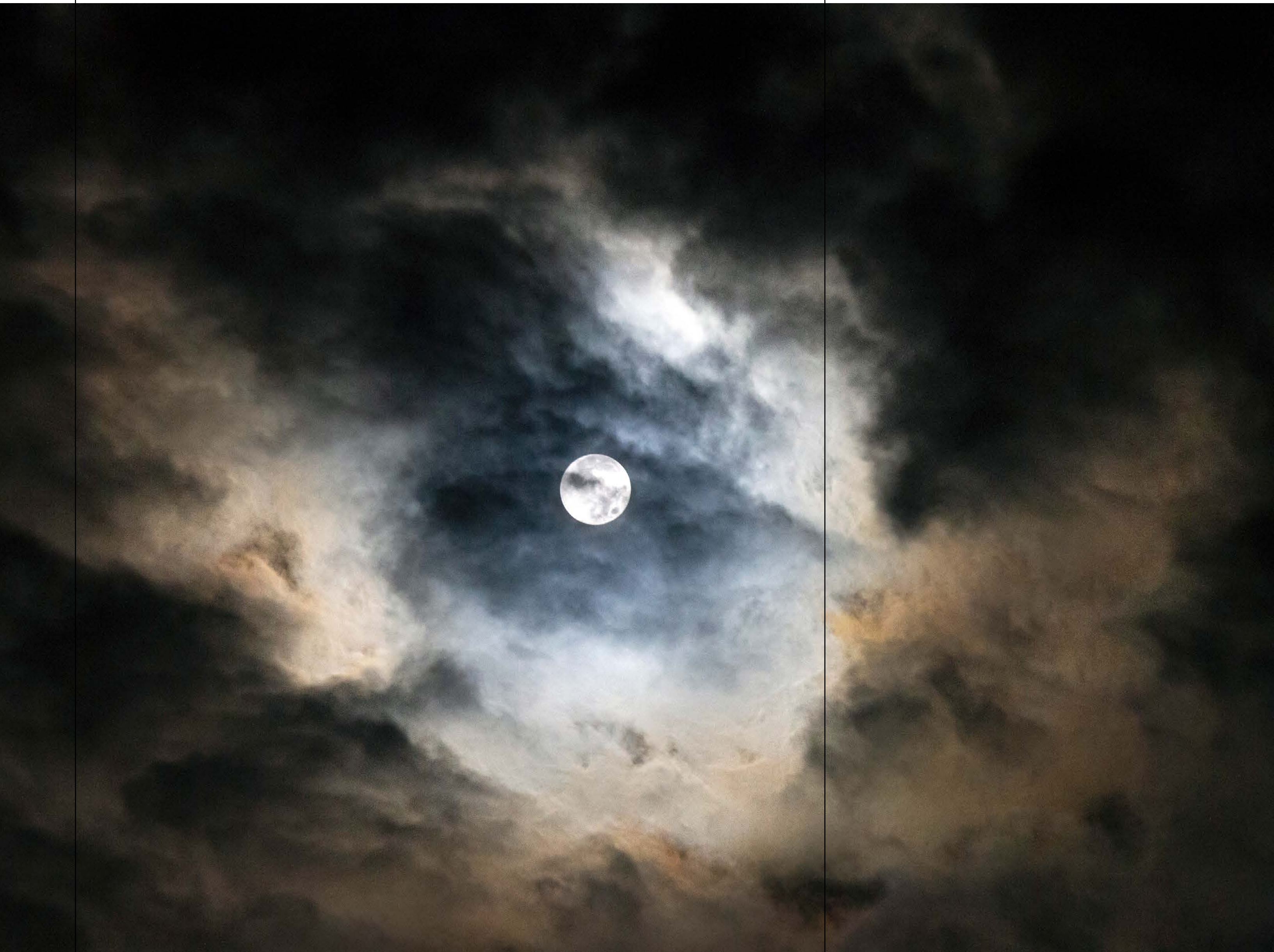


Trick or Treat? The Leveraged Loan Market Gained Momentum in Q3 but Will 2023 End on a Sweet Note or Leave Investors Haunted?

After a lackluster start to the year and muted summer, lender aggressiveness ignites U.S. leveraged loan activity in September.

The third quarter presented a wide array of headlines that ranged from a narrowly avoided government shutdown and ongoing labor strikes to economic soft-landing discussions and Taylor Swift's takeover of the National Football League. Despite these, the U.S. leveraged loan market surged to its strongest quarter in 18 months as lender sentiment improved and borrower friendly concessions resurfaced. Even dividend recapitalizations rose from the dead, just in time for Halloween.

U.S. institutional loan activity was revived in the third quarter with volume reaching $76.0 billion, representing a staggering 51% increase quarter-over-quarter and nearly 300% growth year-over-year. This brought total year-to-date volume to $178.7 billion. Refinancings continued to lead the way for loan activity, accounting for 51% of loan volume. While that has been a consistent trend since Q3 2022, volume related to non-refinancings has continued to chip away at its share of total activity over the last three quarters. M&A-related loan volume nearly doubled quarter-over-quarter to $27.8 billion and was fueled by 11 broadly syndicated LBOs transacting in the quarter compared to just 13 in the previous three quarters combined. While positive, this level of volume is still significantly below historical levels.

Lenders' Increased Aggressiveness Leading to More Borrower-Friendly Concessions

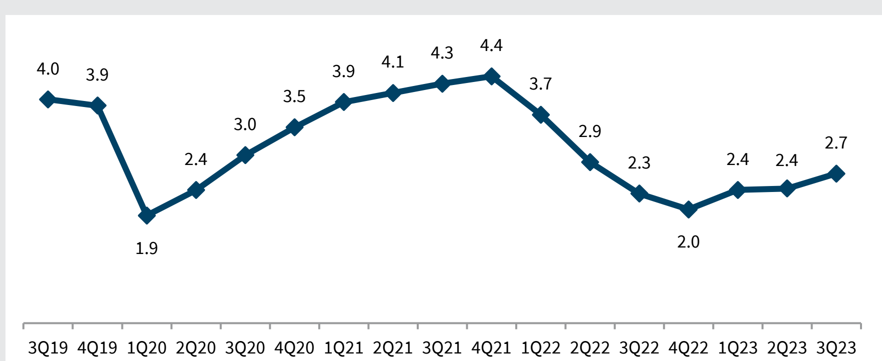
Overall market sentiment has trended upward this year after bottoming out in the fourth quarter of 2022. William Blair's Leveraged Lending Index increased to 2.7 (scale of 1 to 5, with 5 being the most borrower-friendly) and has increased or remained flat every quarter over the year-to-date period. Although the index is well below the recent highs of 2021, lenders have indicated an increased willingness to make borrower-friendly concessions to win new deals. As competition continues to ramp up for high quality credits, lenders signaled they were willing to stretch on terms to stand out over their peers. More than 30% of respondents to William Blair's Quarterly Leveraged Finance Survey indicated they made borrower-friendly concessions they historically would not have to win a deal, the highest percentage in the last 12 months. Among those concessions, 31% of respondents noted they reduced pricing and 17% noted they increased leverage. Respondents also indicated that loan volume modestly increased in Q3 compared to the previous six months. If volume remains tight, we expect lenders will continue to be aggressive and terms will further loosen in borrowers' favor for the remainder of 2023.

Dividend Recapitalizations Join the Conversation

Dividend recap activity, which has largely been absent over the last 18 months, climbed out of the dungeon in Q3. Dividends tend to be more prevalent when interest rates are low and the macro environment is

William Blair Leveraged Lending Index Trends Upward

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 increased in Q3 as lender sentiment improved.



Dividend recapitalizations sprout and private credit continues to prove its popularity despite challenging financing markets.

significantly positive, but with M&A volume remaining suppressed, sponsors opportunistically sought ways to return capital to investors. Pairing this with growing appetite from lenders has allowed dividends to re-enter the conversation. Loan volume related to dividends soared to $7.6 billion, the highest quarterly amount since Q4 2021 and more than the previous five quarters combined. However, when asked about appetite level for supporting a dividend recapitalization transaction over the next six months (scale of 1 to 5, with 5 being very high), lenders indicated sustained cautiousness, as ~70% of survey respondents marked either a 1 or a 2. This is in line with what William Blair's Leveraged Finance Team has observed in conversations with investors, and despite the uptick in activity during Q3, dividend recapitalizations will presumably be reserved for first-class credits in the near term.

Private Credit is Still the Favored Option – When Will the Broadly Syndicated Loan Markets Truly Bounce Back?

Private credit continued its dominance as the favored financing option for LBOs in Q3, with 36 LBOs financed by private credit compared to 11 in the broadly syndicated loan market. Over the last year, the broadly syndicated market has been mostly watching from the sidelines, though it did experience a pickup this quarter, financing the most LBOs since Q2 2022. This was partially expected coming out of Labor Day, which usually marks the end of the summer slowdown, yet many investors were hoping for a larger come back. Consequently, we will likely have to wait until 2024 for the broadly syndicated market to fully return.

Lender Sentiment for the Remainder of 2023

For the remainder of 2023, lenders expect elevated interest rates, inflation, limited deal opportunities, lender aggressiveness, and macroeconomic performance to have the most significant impacts on the leveraged loan market. Furthermore, lenders continue to expect the level of default rates to rise as many portfolio companies struggle with free cash flow as the full year impact of higher rates and softer than expected performance continues.

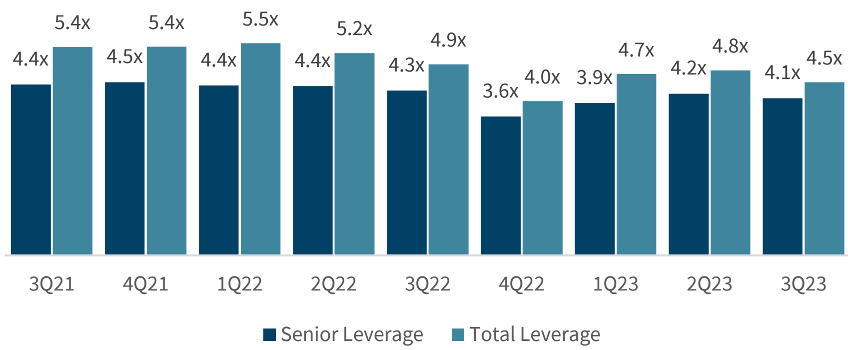
To learn more about these and other trends shaping the leveraged finance market, please don't hesitate to contact us.

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.

Leveraged Loan Multiples

Total Leverage modestly retracted in Q3 after increasing in both Q1 and Q2.

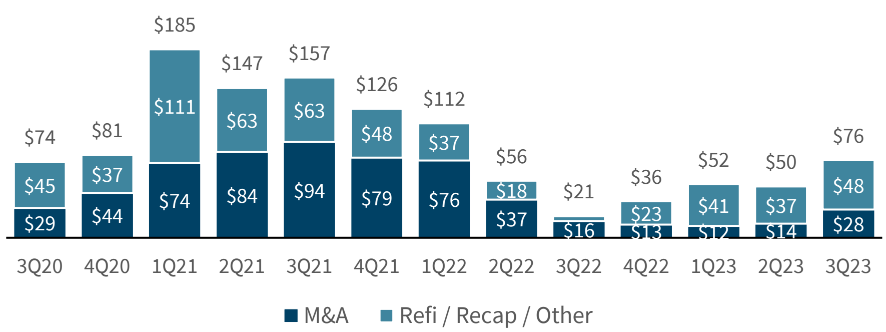


Source: LCD, a part of Pitchbook. Represents the rolling 90-day average leverage multiples from all loan activity

Institutional Loan Volume

Institutional loan volume jumped to the highest level since Q1 2022, driven primarily by refinancings and an uptick in M&A activity. This is the third consecutive quarter where M&A volume has increased as market sentiment improves.

($ in billions)

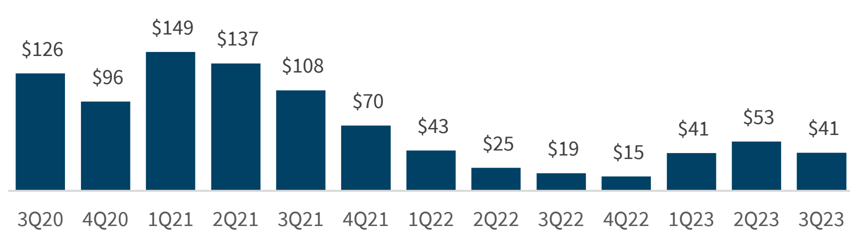


Source: LCD, a part of Pitchbook

High-Yield Bond Volume

High-yield bond volume softened in Q3, declining to $41 billion. However, year-to-date volume of $135 billion has already surpassed total volume for 2022.

($ in billions)



Source: LCD, a part of Pitchbook

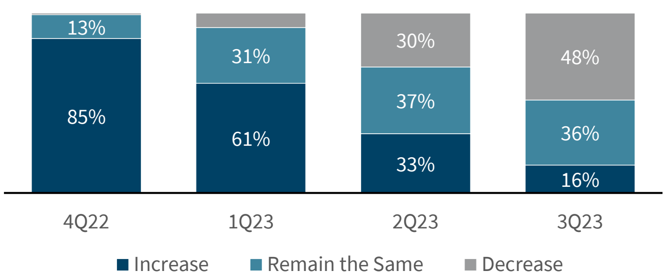
Highlights From William Blair's Q3 2023 Leveraged Finance Survey

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 reflects responses from approximately 60 leveraged finance professionals who participated in the survey this quarter.

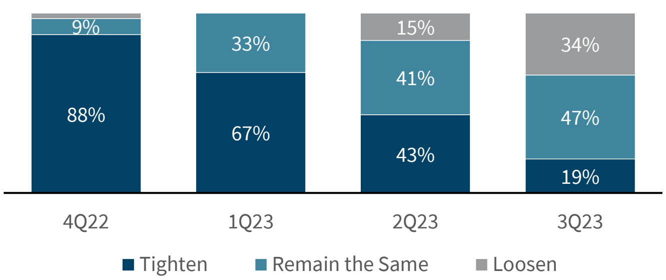
Debt Market Dips Toe into Borrower Friendly Territory

Momentum towards more borrower-friendly pricing, leverage, and terms continued in the third quarter as nearly 50% of respondents indicated pricing tightened and over 30% of respondents indicated leverage and terms loosened.

Pricing



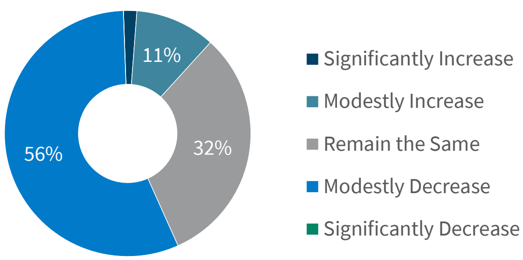
Leverage and Terms



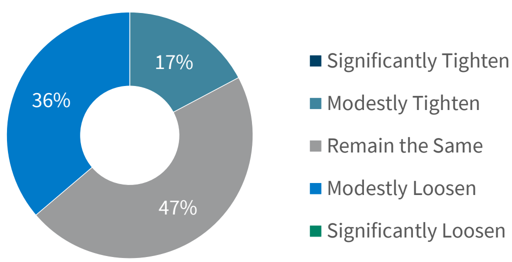
Lending Expectations for 2023

Similarly, survey respondents expect pricing, leverage, and terms to continue stabilizing and further shift in favor of borrowers for the remainder of 2023. Over 55% of respondents expect pricing to decrease and over 35% of respondents expect leverage and terms to loosen for the remainder of 2023.

Pricing Expectations



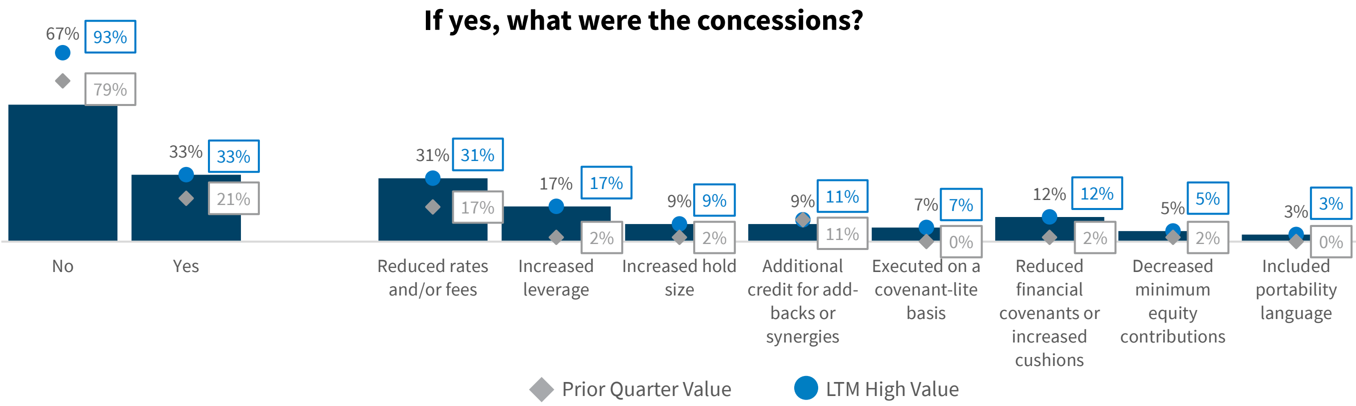
Leverage and Terms Expectations



Lender Competition Intensifies

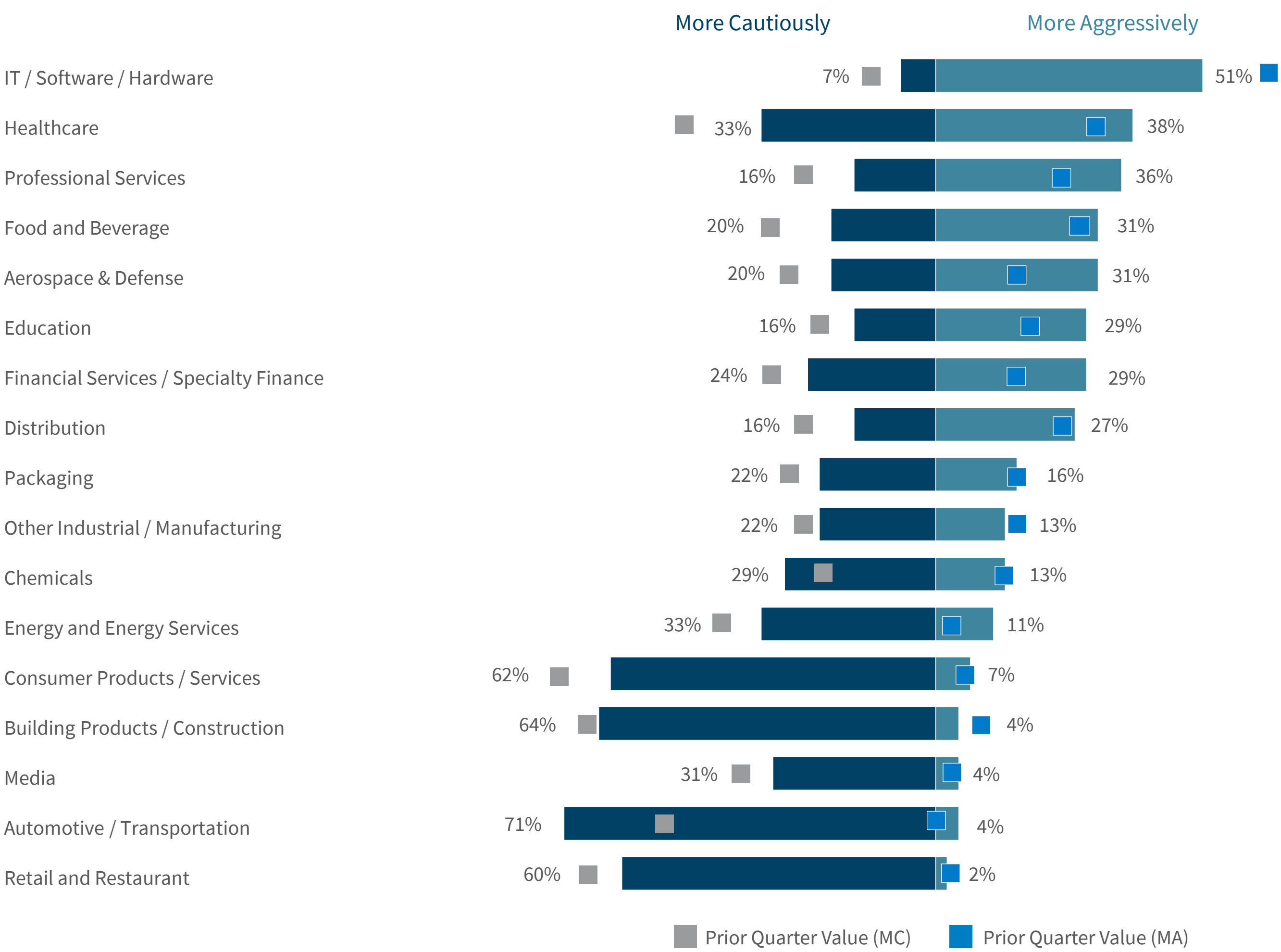
Competition picks up in the third quarter with borrower-friendly concessions reaching LTM highs across multiple categories as lenders needed to stretch on terms in order to win new deals.

During 3Q23, did you make borrower-friendly concessions you historically would not have to win a deal?

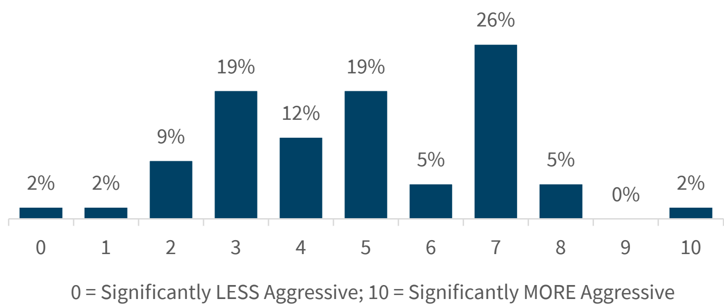


Additional Highlights

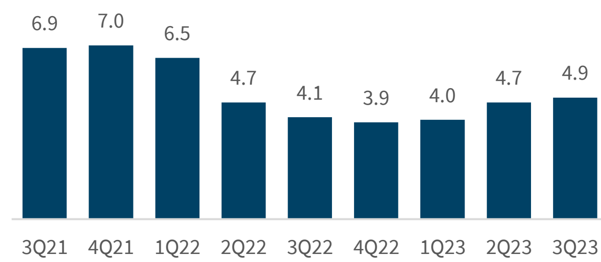
Are there any specific sectors or industries for which your firm is proceeding more aggressively or cautiously today compared with 6 months ago?



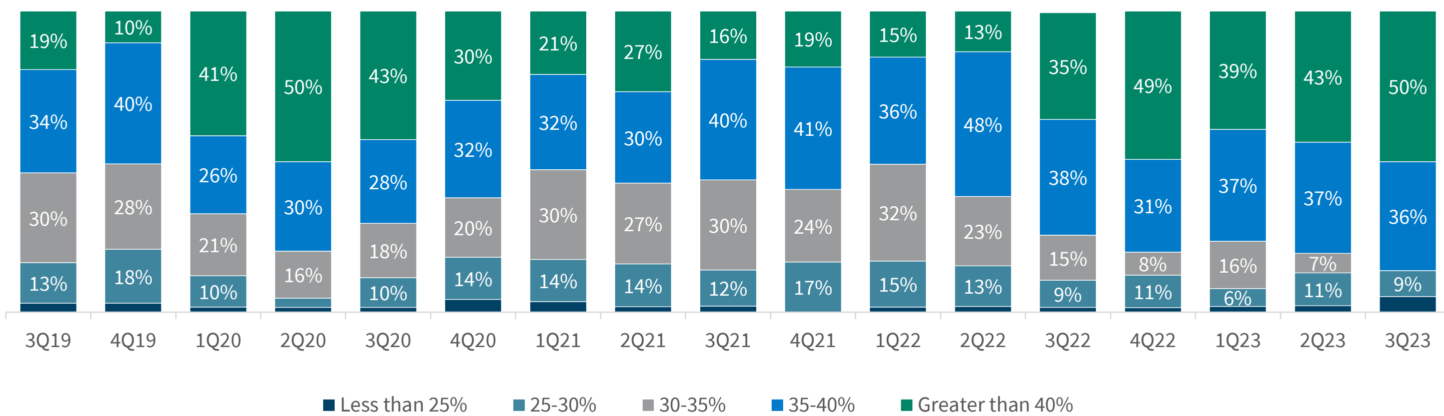
Assuming your firm's pre-COVID rating was a 5, how would you rate the aggressiveness of your firm's approach to new debt opportunities today?



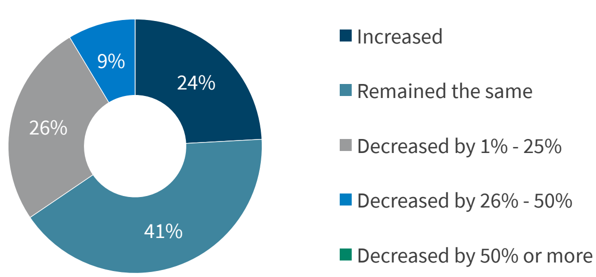
Average Rating by Quarter



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

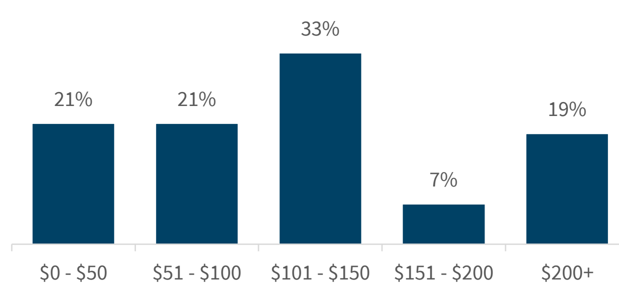


Compared to your firm's hold sizes in 2021, what have you observed regarding your firm's current maximum hold size?

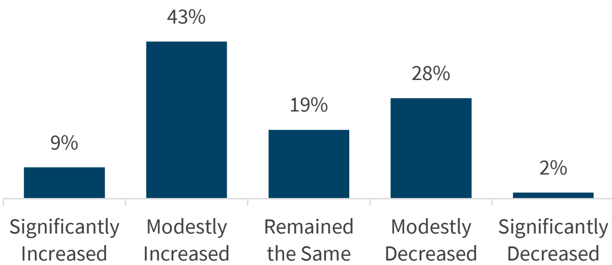


What is your firm's current maximum hold size for a single credit?

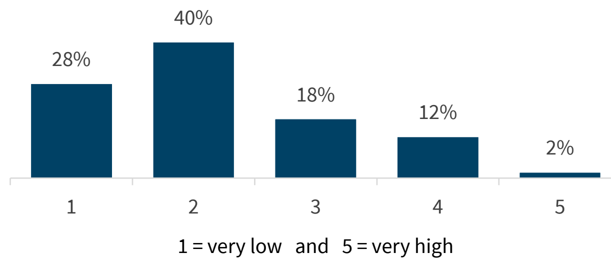
($ in millions)



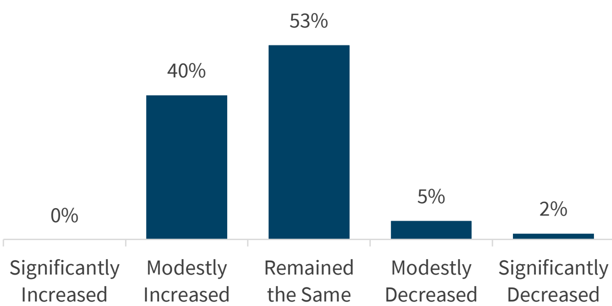
During Q3 2023, how did new-issue loan volume compare to that in the previous six months?



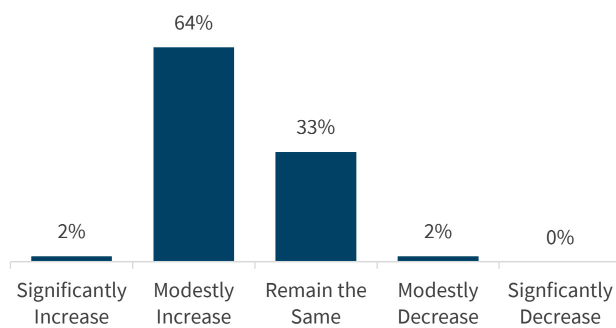
What is your appetite level for supporting a dividend recapitalization transaction over the next six months?



During Q3 2023, how did default rate 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 – if volume remains tight, terms will continue to loosen
- Increased capital ratios for banks reducing access to capital
- Fed policy and future rate changes. Fed decision making will signal long-term SOFR baseline and affect structuring
- Increased default rates and unexpected degradation across portfolios
- Continued bank dislocation
- Limited deal flow resulting in significant competition for deals up and down the capital structure
- Macroeconomic factors including GDP growth, inflation, continued labor strikes
- Increased M&A activity
- Level of deployment – lower volume in the first half of the year causing looser credit standards as funds rush to deploy capital before year end
- Valuation disconnect between buyers and sellers affecting M&A volume
- Capital allocated to private debt
- Investor fundraising
- Supply and demand imbalance in which new deal volume will dictate terms
- Full year impact of higher interest rates leading to debt service problems

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

William Blair Leveraged Finance by the Numbers

160+

completed leveraged finance transactions since 2016

$20B+

arranged financing since 2016

500+

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 260 senior bankers around the world, William Blair has completed more than 1,420 advisory and financing transactions totaling over $735 billion in value for our clients.*

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