Leveraged Finance

Q4 2023

Lender Competition Burns Through Winter Chill

In This Report

Analysis of Q4 U.S. Leveraged Loan Market Performance

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

Lender Competition Burns Through Winter Chill

The finale to the 2023 leveraged finance market wasn't the New Year's Eve celebration people had wished for, but 2024 brings hope for a resurgence.

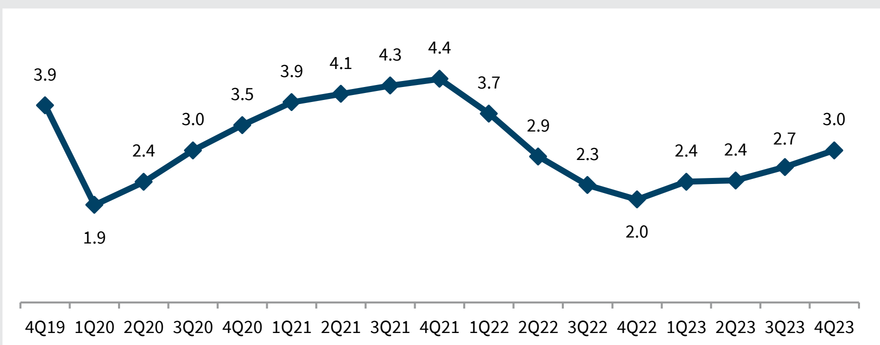
The fourth quarter concluded the year with consistent themes prevailing in the leveraged loan market. Fiscal 2023 was characterized by lackluster deal flow, a persistent shift toward private capital and away from the syndicated markets, and elevated interest rates taking a significant toll on borrowers. These themes fueled competition among lenders for high-quality credits, and with the Fed expected to cease interest rate hikes, prospects for 2024 appear to be looking up.

After a post-Labor Day rally, the leveraged loan market cooled off significantly to close out the year. U.S. institutional loan volume of $55.6 billion in the fourth quater exceeded the first and second quarters, but finished 27% below the third-quarter rebound. This brought total 2023 loan volume to $233.9 billion, which was slightly above total loan volume of $225.2 billion in 2022. Refinancing-driven volume accounted for 56% of total loan volume, marking the fifth consecutive quarter exceeding half of total volume. M&A-related loan volume of $16.7 billion decreased nearly 40% from the prior quarter. However, this was still higher than first and second quarter averages and M&A-related volume surged in the third quarter to $27.5 billion. While M&A related volume was down quarter-over-quarter, causing the year to end below expectations, fourth-quarter volume was the second highest recorded since Q2 2022. Dividend-related volume remained strong, with fourth-quarter volume totaling $6.1 billion, the second-highest amount since Q4 2021. Total 2023 loan volume improved compared to 2022, but anticipations for a more robust year-end were tempered with limited deal opportunities.

As we closed out 2023, overall lender sentiment continued to track upward. William Blair's Leveraged Lending Index increased to 3.0 (scale of 1 to 5, with 5 being the most borrower-friendly) and has increased or remained flat every quarter since its trough in the fourth quarter of 2022. Competition has been the primary driver over the last 12 months, with dismal new deal activity. Due to a shortage of high-quality assets in the market, investment committees remain cautious and are hesitant to deploy capital in potentially cyclical categories. Consequently, competition for top-notch credits remains fierce as lenders continue to make borrower-friendly concessions to win new deals. Nearly 45% of respondents to William Blair's Quarterly Leveraged Finance Survey admitted they made borrower-friendly concessions that they historically would not have made to win a deal, which is the highest percentage in the last 12 months and over 10% higher than the prior quarter. Among these, 33% and 23%, respectively, indicated tighter pricing and higher leverage as the primary concessions made—both representing LTM highs. This trend is expected to persist as survey respondents anticipate pricing to decrease and leverage and terms to loosen in 2024.

William Blair Leveraged Lending Index Continues to Climb

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 for the fourth straight quarter as lender sentiment continues to improve.



The market for dividend recapitalizations continues to thaw as increasingly more lenders warm up to the idea.

Mezzanine Debt Is Winning the Popularity Contest

As interest rates rose to the highest level in decades, borrowers' abilities to service floating rate loans became much harder. As a result, mezzanine debt has taken a seat at the popular table because of its fixed rate and ability to PIK some or all of its interest, which allows borrowers to defer cash interest payments and conserve cash flow. Not surprisingly, mezzanine fundraising has surged over the last two years, with $31.0 billion raised in 2022 and $27.1 billion raised through September 2023. Mezzanine debt is also attractive to sponsors as it can help bridge the gap in financing needs and allow for higher leverage in an LBO in lieu of additional cash equity. With record levels of fundraising in the last two years and elevated interest rates lingering, the allure of mezzanine debt is likely to persist.

Can Dividends Make a Comeback? Investors Are Still Lukewarm

Dividend recap activity in the syndicated market rose from the dead in the third quarter, with some of that momentum carrying into Q4. Although total dividend-related volume declined to $6.1 billion from $7.6 billion in the prior quarter, the two-quarter total was more than the previous six quarters combined. While direct lenders generally expressed more enthusiasm for dividends than they have in the recent past, many direct lenders are still lukewarm on the idea. 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), 47% of survey respondents fell in the 1-2 range, commenting that dividend transactions would be reserved for the highest-quality credits. Lenders noted remaining cash equity, pro forma leverage, and company quality as the primary factors in determining their willingness to support a divided recap.

What to Expect in 2024

Many investors are leaving 2023 behind and have high hopes for 2024. While the upcoming election and whether the Fed can deliver a soft landing will continue to create uncertainty, there is market optimism with anticipated rate cuts and lender eagerness to deploy capital. As deal activity and risk appetite improve, lenders continue to pursue new opportunities aggressively, with spreads tightening to the lowest levels in the past year. Additionally, with private capital and private equity dry powder either at or near all-time highs, investors are poised for more deal activity this year. For 2024, lenders expect M&A volume and deal flow, anticipated rate cuts, ongoing geopolitical issues, opening of the broadly syndicated market, default rates, and macroeconomic performance to have the most significant impacts on the leveraged loan market.

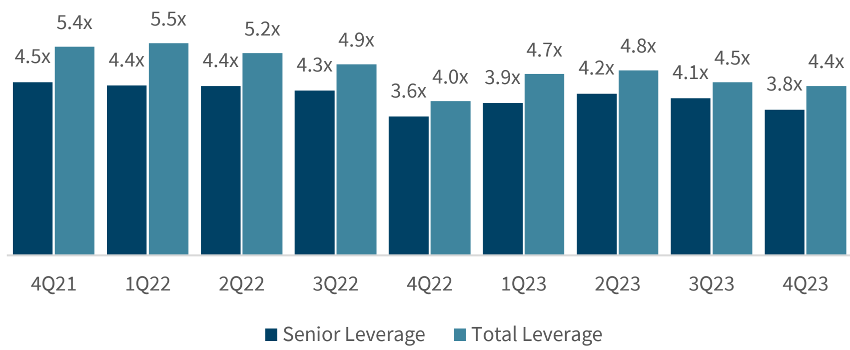
To learn more about these and other trends shaping the leveraged finance market, please don't hesitate to contact us.

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 continued to retract in Q4 after increasing in both Q1 and Q2.

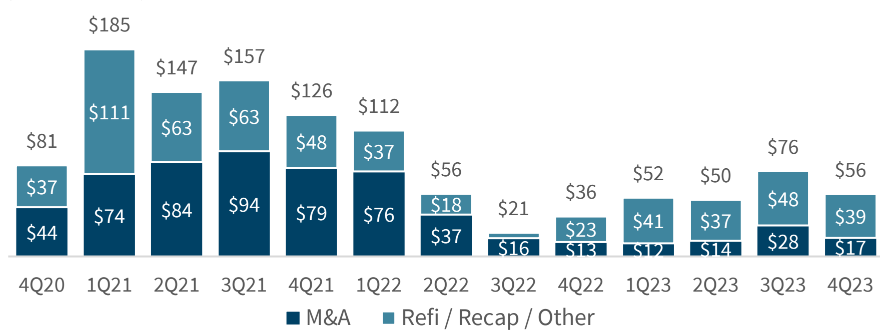


Source: LCD, a part of Pitchbook. Represents the rolling 90-day average leverage multiples from all loan activity

Institutional Loan Volume

Institutional loan volume contracted in Q4 after reaching the highest level since Q1 2022. However, total volume surpassed the quarterly average for the first two quarters of the year and reached the second-highest amount since Q2 2022.

($ in billions)

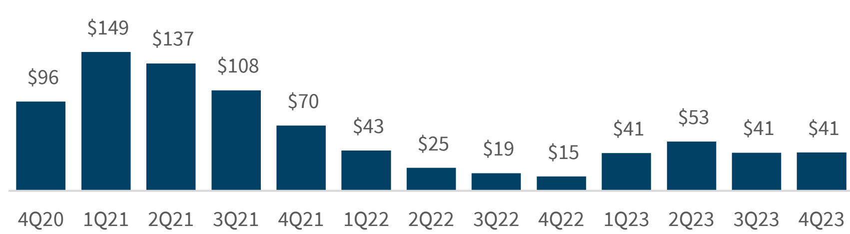


Source: LCD, a part of Pitchbook

High-Yield Bond Volume

High-yield bond volume remained flat at $41 billion in Q4. However, 2023 total volume of $176 billion is over 70% more than total volume of $102 billion for 2022.

($ in billions)



Source: LCD, a part of Pitchbook

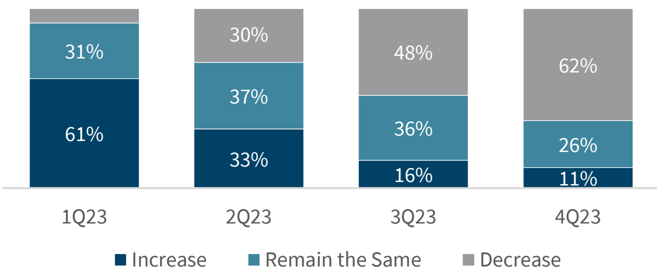
Highlights From William Blair's Q4 2023 Leveraged Finance Survey

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.

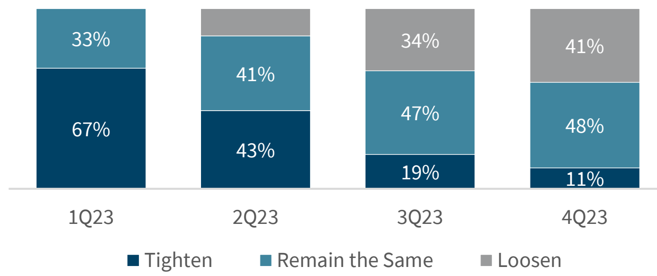
Market Conditions in 2023 Move in Borrower's Favor

Momentum toward more borrower-friendly pricing, leverage, and terms continued in the fourth quarter as over 60% of respondents indicated pricing tightened and over 40% of respondents indicated leverage and terms loosened.

Pricing



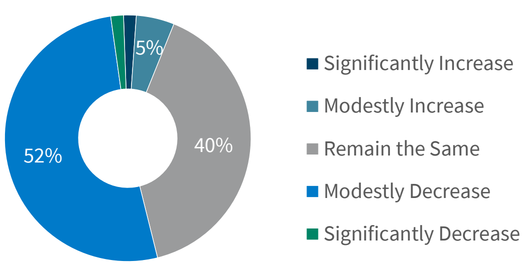
Leverage and Terms



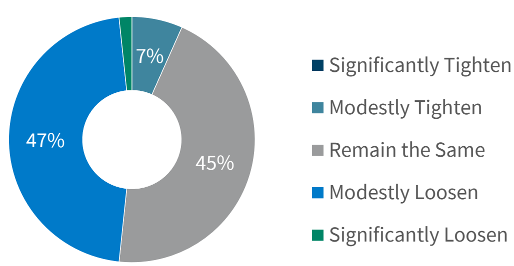
Lending Expectations for 2024

Similarly, survey respondents expect pricing, leverage, and terms to remain in favor of borrowers in the year ahead. Over 50% of respondents expect pricing to decrease, and nearly 50% of respondents expect leverage and terms to loosen for 2024 as competition remains elevated, paired with anticipated monetary easing.

Pricing Expectations



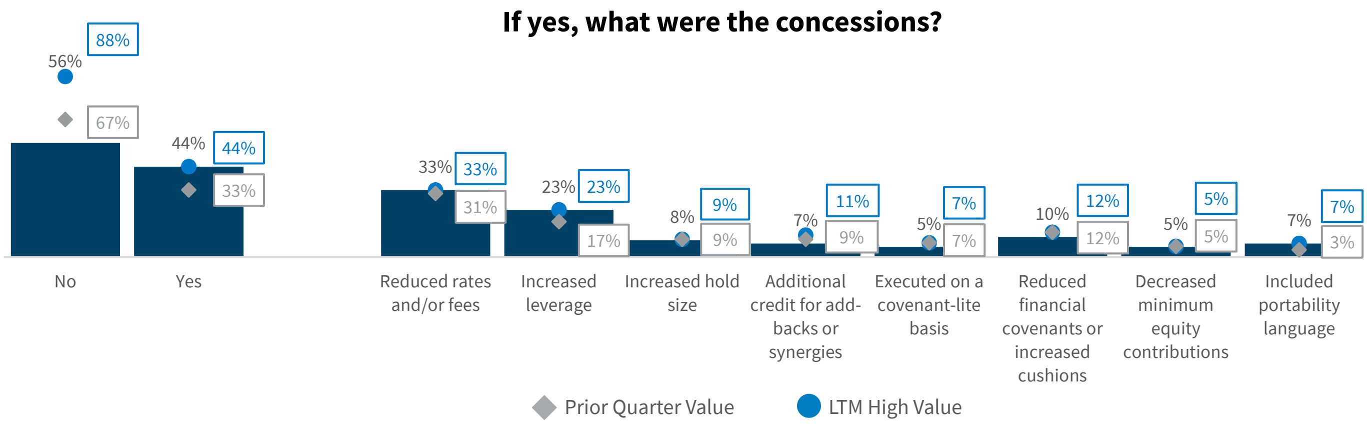
Leverage and Terms Expectations



Lender Competition Intensifies

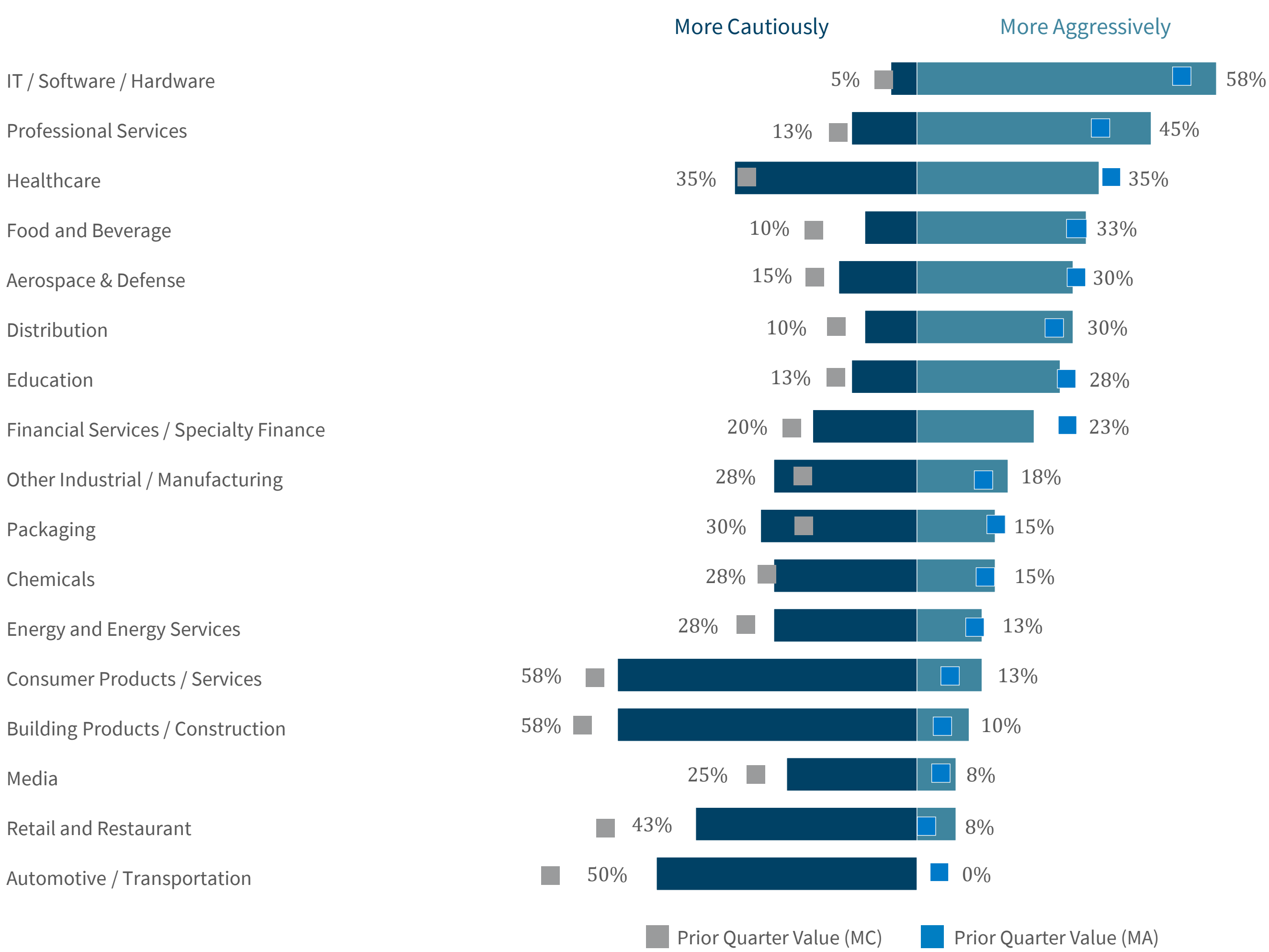
With limited deal activity and competition intensifying, lenders continue to make borrower-friendly concessions to win new deals. Concessions related to lower interest rates and higher leverage reached LTM highs this past quarter.

During 4Q23, did you make borrower-friendly concessions you historically would not have to win a deal?

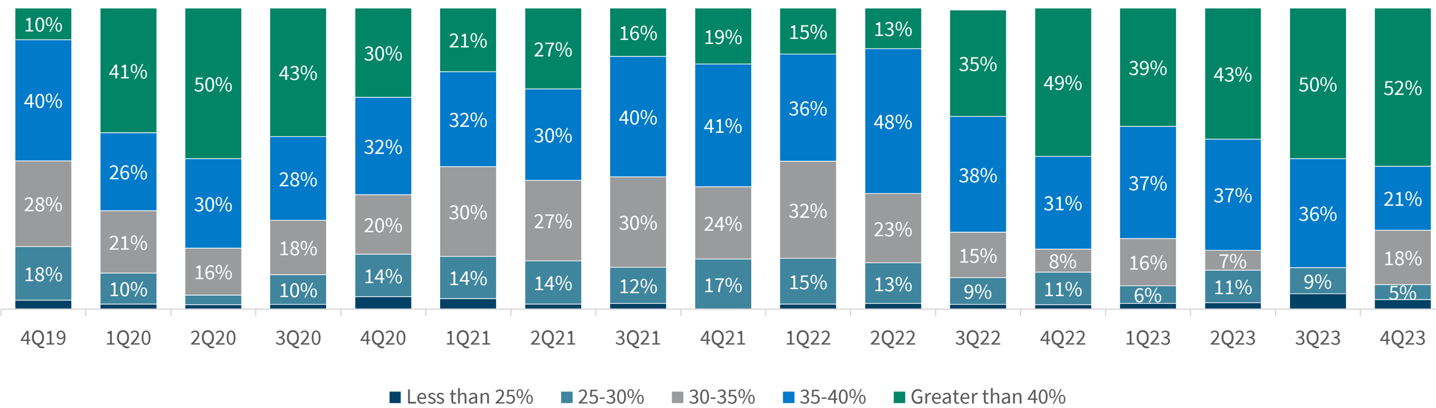


Additional Highlights

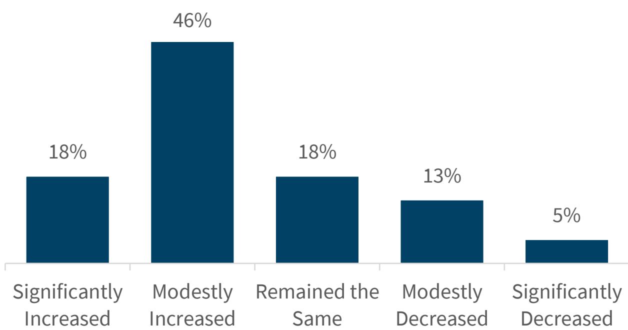
Are there any specific sectors or industries for which your firm is proceeding more aggressively or cautiously today compared with six months ago?



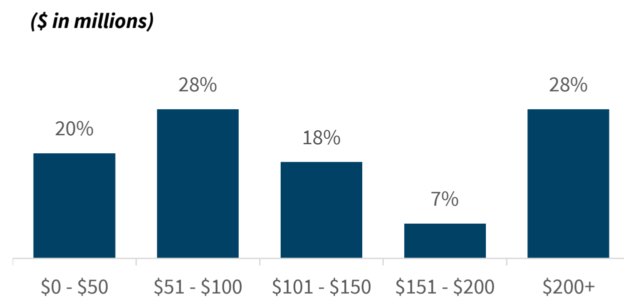
For transactions involving a private equity sponsor, what is the minimum equity contribution you require?



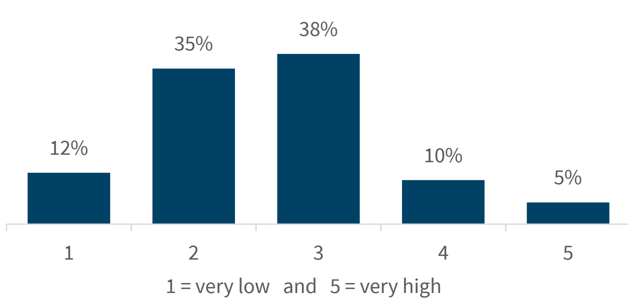
During Q4 2023, how did new-issue loan volume compare to that in the previous six months?



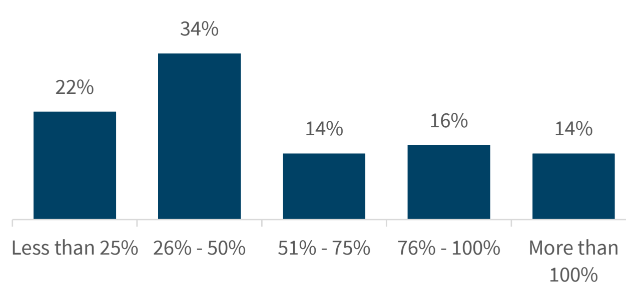
What is your firm's current maximum hold size for a single credit?



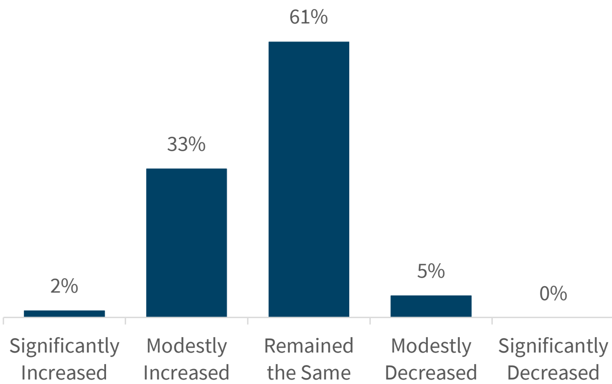
What is your appetite level for supporting a dividend recapitalization transaction over the next six months?



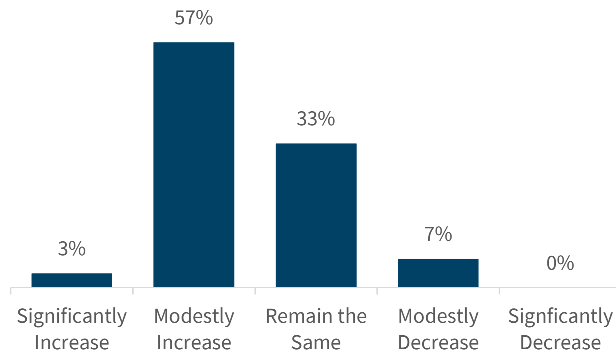
For a dividend recapitalization transaction, what is the maximum percentage of cash equity returned to investors you would be comfortable with?



During Q4 2023, how did default rate activity compare to that in the previous six months?



Looking ahead to 2024, do you expect the level of default rates to …



For 2024, 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
- Fed rate policy and the pace of future rate cuts
- Increase in M&A volume
- Performance of existing loan portfolios and the potential risk of higher default rates
- Increase in deal quality limiting how much tighter pricing moves
- Geopolitical tensions and the ongoing wars in Ukraine and Israel
- Need to deploy dry powder after a relatively slow 2023
- Reopening of broadly syndicated loan market
- Sponsor and LP appetite for investment realizations and move toward more realistic valuation expectations
- U.S. election year
- Tepid top-line performance across a number of industries
- Continued high competition for limited number of high-quality deals, leading to spread tightening and higher leverage
- Cost of lender capital causing an increase in loan spreads
- New private credit entrants entering the market
- Macroeconomic factors including GDP growth, inflation, labor rates

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 250 senior bankers around the world, William Blair has completed more than 1,420 advisory and financing transactions totaling over $745 billion in value for our clients.*

Leveraged Finance Group Leadership

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* In the past five years as of December 31, 2023