William Blair

Q1 2023

Mixed Results in Q1 – Reason for Optimism or More of the Same for the Leveraged Finance Market?

In This Report

Overview of Leveraged Finance Market Activity and Trends

Impact of Silicon Valley Bank Collapse on the Leveraged Finance Market

Highlights From William Blair's Quarterly Leveraged Finance Lender Survey

Leveraged Finance

Mixed Results in Q1 – Reason for Optimism or More of the Same for the Leveraged Finance Market?

The U.S. leveraged loan market showed signs of improvement in Q1 as overall volume rebounded modestly but M&A-related volume declined to historic lows.

For a second consecutive quarter, U.S. institutional leveraged loan volume increased, reaching a volume of $49.5 billion in Q1—an increase of almost 40% from Q4 and more than double that compared to the historic lows of Q3. As was the case the previous quarter, refinancing activity was the primary driver of volume and accounted for 70% of total leveraged loan volume at $34.5 billion. M&A-related volume declined for the sixth consecutive quarter to a total of $9.8 billion, a level not seen since the Great Recession, as continued macroeconomic uncertainty, hawkish Fed policy, compounding recessionary fears, and the banking crisis curtailed activity.

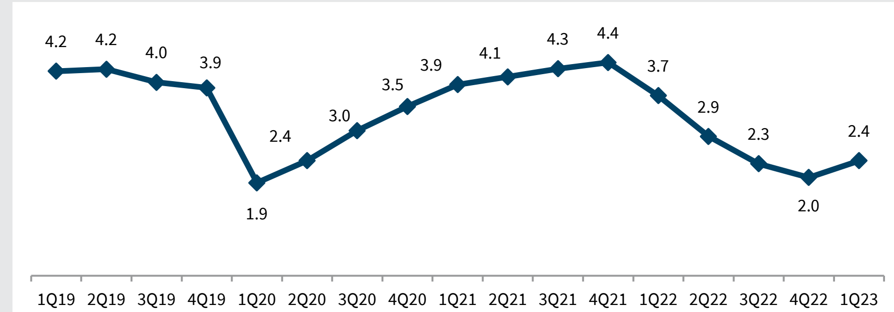
In Q1, the William Blair Leveraged Lending Index inched towards neutral territory, increasing to 2.4 (scale of 1 to 5, with 5 being the most borrower-friendly) after four consecutive quarters of decline. Competitive pressure played a large role in the reversal, as the lack of M&A activity combined with a relatively consistent base rate, pushed lenders to become more aggressive, particularly for high quality credits. While 61% of respondents to William Blair's quarterly Leveraged Finance Survey indicated pricing continued to widen and 67% stated leverage and terms further tightened during Q1, a shift towards stability in pricing, leverage and terms did emerge. 30%+ of respondents indicated pricing, leverage, and terms remained unchanged during the period—an increase of almost 2x from Q4. This is further evidenced by approximately 50% of respondents expecting pricing, leverage, and terms to remain the same for the remainder of 2023. In-line with institutional M&A loan volume, survey respondents indicated new-issue loan volume was materially down versus the previous six months with almost 75% stating volume declined during the quarter.

The prediction made in the previous quarter's report of an increase in default rate activity was realized in Q1 as over 40% of respondents indicated default activity increased compared to that in the previous six months. Lenders expect this trend to continue with over 80% of respondents expecting the number of defaults to increase over the remainder of 2023.

Other key themes that lenders expect to play a major role in 2023 include interest rate volatility and impact on cash flow, overall M&A volume, assessing the timing, duration, and impact of a potential recession, and the continuation of negative macroeconomic impactors, with broadline inflation being the most notable. Given rising interest rates, macroeconomic headwinds, and recessionary fears have persisted over the last six to nine months, the primary driver of a rebound in lending activity in the near term will be M&A activity. As more time passes and excess dry powder at both credit and equity funds remains underutilized, reductions in valuations and less disparate bid-ask spreads between buyers and sellers will be key for the market to return to "normal."

William Blair Leveraged Lending Index Shifts Towards Neutrality

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 Q1, the index reversed course and increased towards a neutral lending environment after four consecutive quarters of movement in lenders' favor.



Despite the timing of the SVB collapse amidst an already volatile macroeconomic and financial market backdrop, the impact to the direct lending market was relatively mild.

Impact of Silicon Valley Bank Collapse on the Leveraged Finance Market

In March 2023, the 16th largest bank in the U.S., Silicon Valley Bank ("SVB"), was shut down by the California Department of Financial Protection and Innovation after a combination of the significant loss in value of its long-term investments and a large withdrawal run from depositors. Shortly thereafter, more dominoes of the banking crisis fell as Signature Bank was also shut down, First Republic Bank was propped up by the private sector, and Credit Suisse was rescued in a merger with UBS.

Much like we have seen the reactions of the public and private debt markets differ under the challenging macroeconomic and financing market conditions over the last six to nine months, both too have had divergent responses to the banking crisis.

At the end of 2022, the broadly syndicated loan market was showing signs of positive momentum, with Q4 volume increasing quarter-over-quarter for the first time in four quarters. This momentum continued into 2023 as volume in January and February each increased month-over-month, with February volume achieving year-over-year growth for the first time in 12 months. However, upon the collapse of SVB—and compounded by the Fed's rate hike—institutional loan volume contracted once again in March, declining more than 60% from February, as investors sought to de-risk. That said, April volume appears to be rebounding favorably. Through the first two weeks of trading, institutional loan volume is almost on par with total volume in March, pointing to signs of recovery and a glimmer of hope for resumed activity after a prolonged pause in 2022.

Alternatively, the private credit market experienced less interruption from the collapse of SVB and the banking crisis. Despite the timing of this occurrence amidst an already volatile macroeconomic and financial market backdrop, the impact to the direct lending market was relatively mild. Given SVB's banking and investing focus primarily centered around the venture space, the negative impact on private credit overall was not much more than a conversation topic. Direct lenders remained active and open for business, looking to put dry powder to work. In fact, and as discussed in last quarter's issue of William Blair's Leveraged Finance Report, the banking crisis has only further cemented private credit as the financing provider of choice, as direct lenders further displaced their syndicated counterparts. According to LCD, a part of Pitchbook, direct lenders financed 95% (72 out of 76) of leveraged buyouts in Q1.

That is not to say that lending requirements have laxed, however. Direct lenders have remained conservative, most notably through meaningfully reduced hold sizes and an increase in binary decision factors with less appetite to work through or diligence perceived red flags.

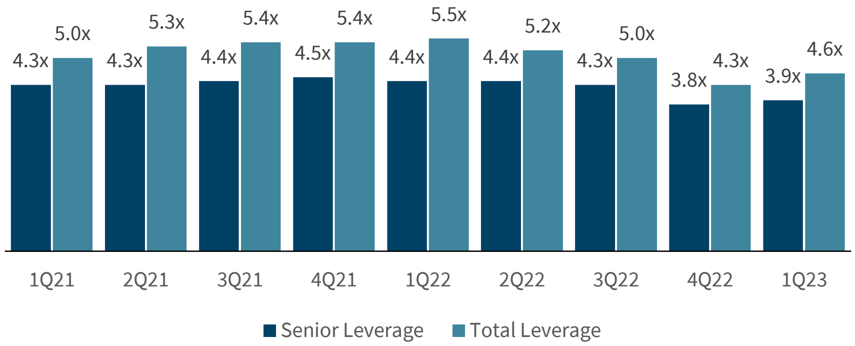
To learn more about these and other trends shaping the leveraged finance market, please don't hesitate to contact us.

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.

All Loans Leverage Multiples

Total Leverage modestly ticked up in Q1 but remained depressed compared to historical levels.

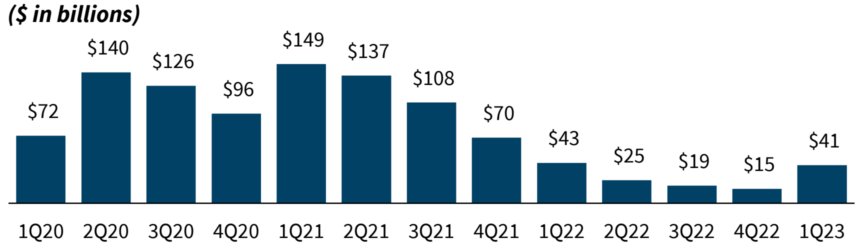


Source: LCD, a part of Pitchbook. Represents the rolling 90-day average leverage multiples from all loan activity

High-Yield Bond Volume

High-yield bond volume rebounded in Q1, increasing 2x+ over 4Q22 and was flat year-over-year.

($ in billions)

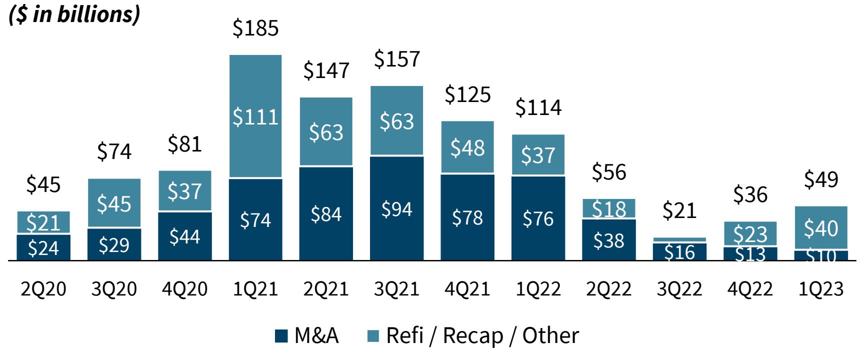


Source: LCD, a part of Pitchbook

Institutional Loan Volumes

Institutional loan volume increased modestly in the first quarter, driven by significant refinancing volume in January and February. However, M&A volume continued to struggle, falling to its lowest total since the Great Recession, as the financing markets faced sustained pressure from macroeconomic volatility and rising interest rates.

($ in billions)



Source: LCD, a part of Pitchbook

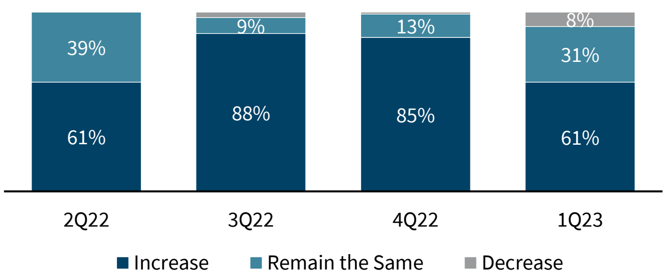
Highlights From William Blair's Q1 2023 Leveraged Finance Survey

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.

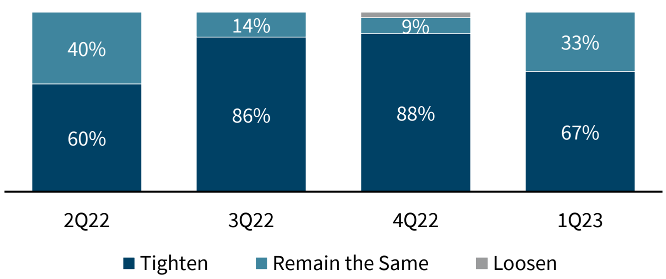
Debt Markets Settle into Lender-Friendly Environment

While the majority of survey respondents indicated pricing continued to widen and leverage and terms further tightened during 1Q23, a shift towards stability in pricing, leverage and terms emerged as lenders acclimated to investing in a highly volatile environment.

Pricing



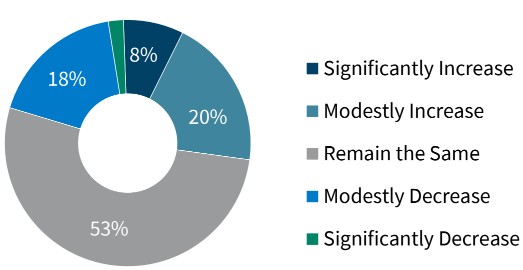
Leverage and Terms



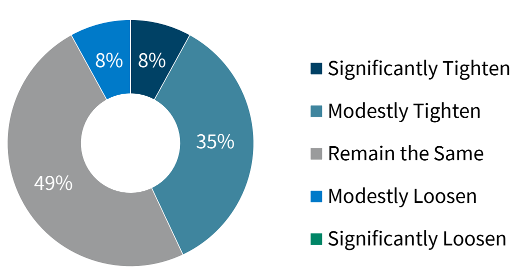
Lending Expectations for 2023

Similarly, survey respondents expect less volatility in pricing, leverage, and terms for the remainder of 2023. Over 50% of respondents expect pricing to remain the same with those anticipating pricing to modestly increase or decrease essentially offsetting one another. Leverage and terms are expected to continue modestly tightening as lenders seek ways to mitigate risk through documentation as pricing stabilizes at a faster pace.

Pricing Expectations



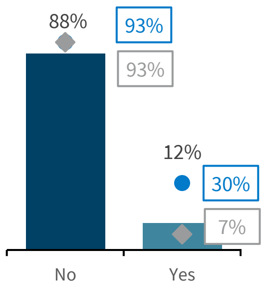
Leverage and Terms Expectations



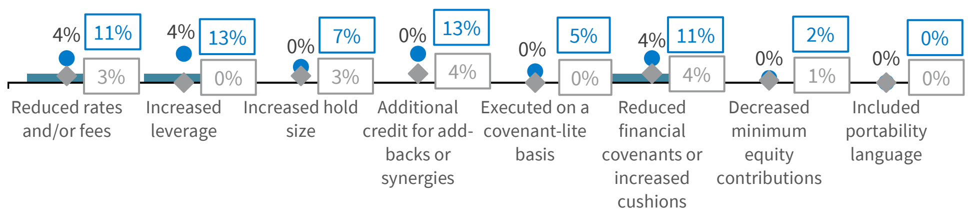
Lenders Remain Conservative

Lender aggressiveness to stretch in order to win new opportunities remained low during Q1 as high interest rates sustained, recessionary pressures heightened, and the banking crisis unfolded.

During 1Q23, did you make borrower-friendly concessions you historically would not have to win a deal?

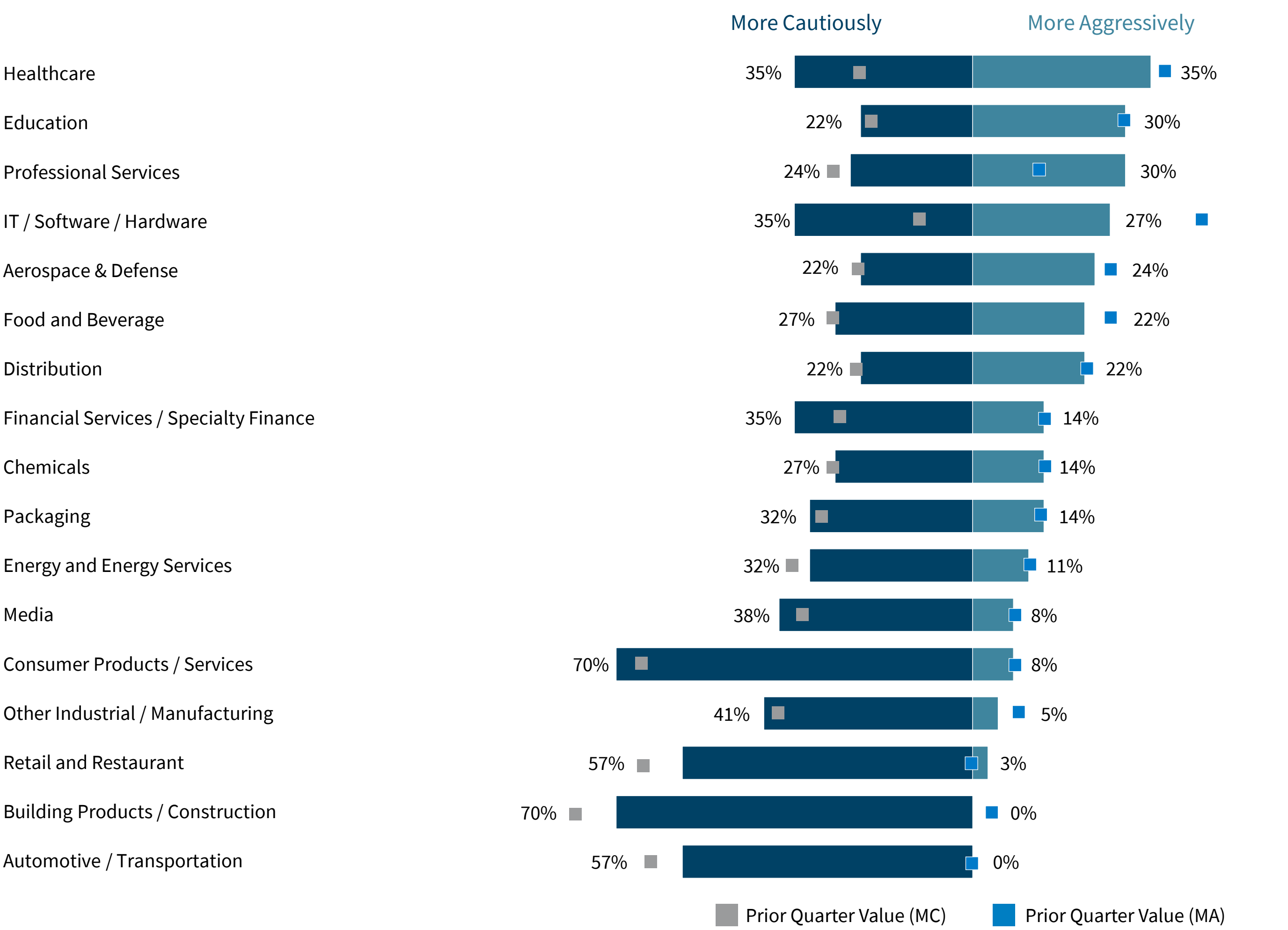


If yes, what were the concessions?

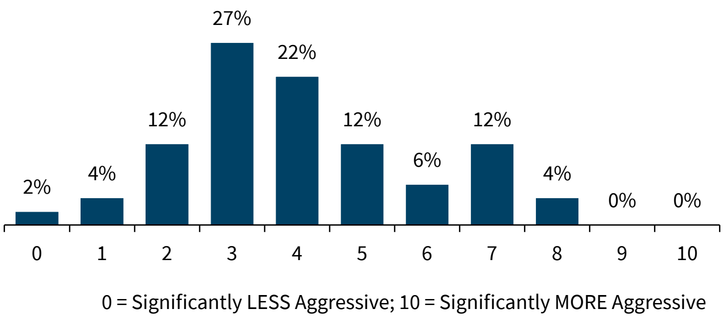


Additional Highlights

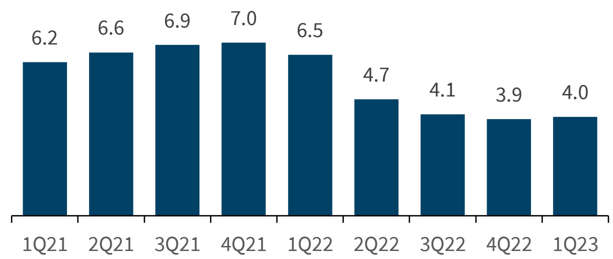
Are there any specific sectors or industries for which your firm is proceeding more aggressively or cautiously today compared with 6 months ago?



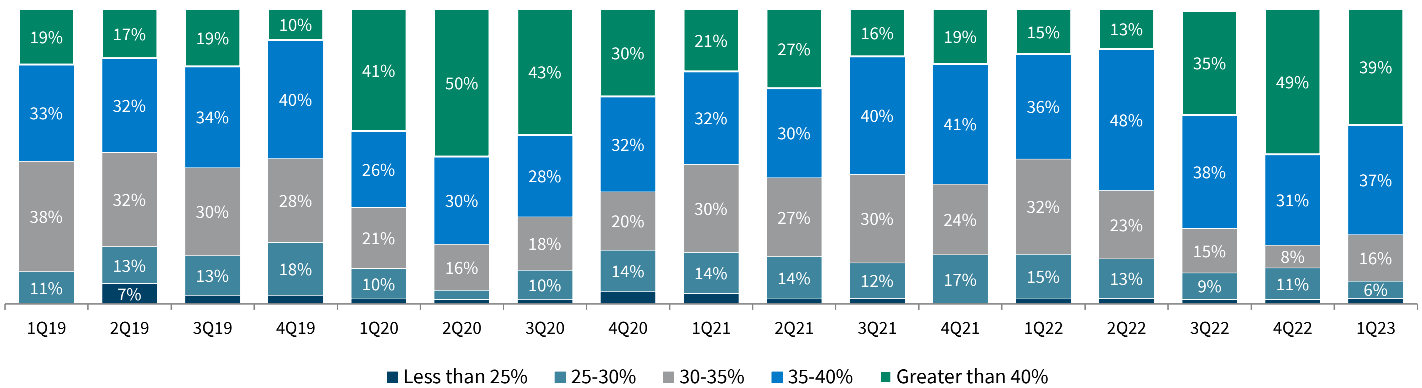
Assuming your firm's pre-COVID rating was a 5, how would you rate the aggressiveness of your firm's approach to new debt opportunities today?



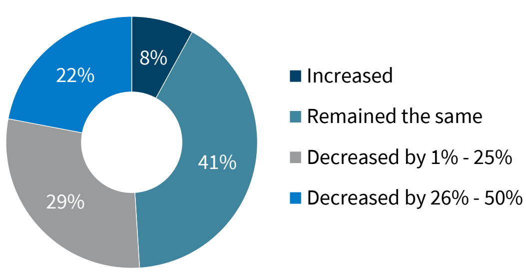
Average Rating by Quarter



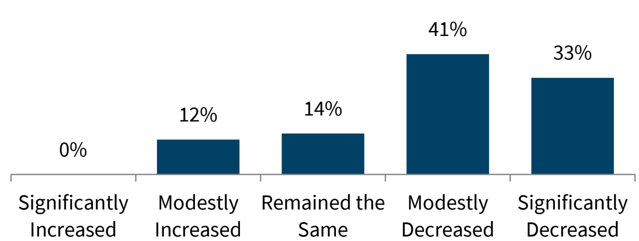
For transactions involving a private equity sponsor, what is the minimum equity contribution you require?



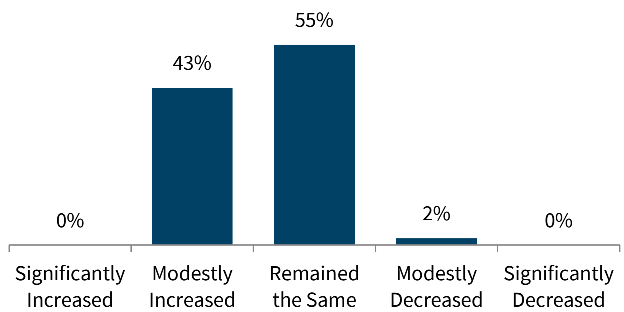
Compared to your firm's hold sizes in 2021, what have you observed regarding your firm's current maximum hold size?



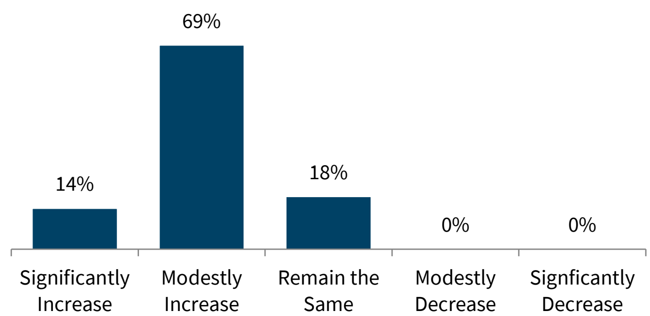
During Q1 2023, how did new-issue loan volume compare to that in the previous six months?



During Q1 2023, 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 inflation, rising rates, and risk of recession
- Fund level dynamics including increased cost of underlying fund capital, dry powder, and fundraising
- Deal volume will be biggest factor – If volume increases, terms will stay the same. If deal flow remains thin, terms and pricing may become more borrower friendly due to competition
- Economic repercussion from banking crisis and tightening rates
- Rising rates, increased interest expense and margin compression
- Deal flow volume and the quality of deals in the market, particularly in less cyclical industries
- Bank capital requirements and funding cost increases, as well as tightening lending standards
- Fed decision making, particularly future rate increases
- Increased default rates
- Ability of portfolio companies to handle higher interest costs, leading to stressed cash flows and liquidity
- Inflation, the economy, government debt default discussion, banking liquidity
- Decreased M&A volumes causing an overall lack of deal volume
- Borrowers coming to private debt market from the broadly syndicated loan (“BSL“) market. BSL market capacity should remain tight
- Top line revenue demand drivers will be muted. Recession uncertainty creates delays with growth plans
- Increased cost of debt; interest rates continue to increase becoming a major issue with levered companies

Drawing on our deep product expertise and the strength of our relationships, William Blair has built a leading leveraged finance franchise. Sponsors / owners and management teams turn to us for outstanding execution in support of their capital-raising objectives.

Recent Transactions

Potbelly Senior Term Loan 2023	EFC Senior & Subordinated Debt 2023	Cellipont Bioservices Senior Secured Term Loan 2023
Taoglas Unitranche Credit Facility 2023	Sixaxis Senior Secured Credit Facility 2022	Driven Brands Securitization 2022

William Blair Leveraged Finance by the Numbers

140+
completed leveraged finance transactions since 2015

$21B+
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 1,440 advisory and financing transactions totaling over $730 billion in value for our clients.*

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