Market Intersection:

A Quarterly Look at the U.S. Credit Markets

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US: US syndicated lending increased by 53% to US$788bn in the second quarter

Ioana Barza and CJ Doherty

US syndicated lending was up 53% to US$788bn in the second quarter even as inflation and rate hikes hurt some segments of the market. The investment grade market was the biggest driver of this increased activity, with lending jumping to US$343bn in 2Q22 from US$213bn in the first quarter. On a year-to-date basis, investment grade issuance was down 16%.

"The investment grade market is still functioning normally, copacetic. There is pressure but deals are getting done and we have issuers who execute (on a bond deal) as they said they will execute. We are not worried about a major execution; they are pragmatic in terms of viewing the world for what it is, not what it was," said one investment grade lender, adding, "the big risks are recession, higher credit losses, and continued challenges in the leveraged finance book for more of the deals that have to clear. These are the headwinds we are facing.

Investment grade refinancings in the second quarter ranked as the third-busiest quarter at US$247bn, on the heels of 2Q18's US$250bn and the record US$273bn registered at this time last year. Seasonally, issuers returned to refinance 364-day facilities which made up one-fifth of revolving facilities, on par with this time last year while the share of revolvers with 5-year tenors dropped to 55% given a shift toward 4-year facilities which comprised 15% of revolver issuance. In the investment grade M&A space, Broadcom's takeover of VMware, financed via a US$32bn bridge loan, ranked as the eighth-biggest bridge in the US investment grade loan market and helped drive M&A financings to US$45.4bn over five deals.

Conversely, institutional loan issuance was hit hard by the surge in market volatility during the quarter, posting its lowest quarterly level since the second quarter of 2020. Leveraged loan issuance increased 26% to US$268bn in the second quarter, with leveraged pro rata volume nearly doubling to US$203bn while institutional loan volume tumbled 39% to US$65bn, according to Refinitiv LPC. On a semi-annual basis, leveraged loan volume in 1H22 fell by one-third from the same period last year, while institutional lending was down 60%.

Market volatility spiked in 2Q22, prompted by more aggressive monetary tightening by the Federal Reserve as it tries to bring inflation down. While rising rates are normally good for loans, given their floating-rate nature, this was outweighed more recently by concerns that the Fed might increase rates to an extent that hurts economic growth, causes a recession and leads to a deterioration in credit quality.

Even with higher yields, leveraged lending stalled in June. Banks are now focused on devising a strategy to clear the backlog of loans they underwrote before market conditions shifted so dramatically. The challenge facing underwriters is that lenders are now looking to get paid much more than they were several months ago. In order to clear the market, recent deals have had to offer steep original issue discounts (OIDs) in the low to mid 90s. "It's all about the discounts these days. Lenders really want that OID," stated a second underwriter.

Amidst this backdrop, direct lenders provided around 10 unitranche deals in 2Q22 that topped US$1bn in size. That said, it remains to be seen whether liquidity will become more scarce in the private debt market if volatility persists in the third quarter.

Loan prices have been buffeted by volatility in the secondary market recently, with the average loan bid falling to the 92 area, the lowest level since 2020, and down from 98.5 at the start of the year. Even with the drop in prices, leveraged loans have outperformed most other asset classes. US leveraged loan returns are down 4.5% through June 30, outperforming high yield bonds (-14%), investment grade corporate bonds (-14%) and the S&P 500 (-20%).

In the uncertain market environment, loan investors are closely monitoring their portfolio companies as the operating environment has changed significantly this year. Companies' ability to pass on cost increases has come under additional scrutiny in the inflationary environment. "The credit crisis came with defaults and an observable deterioration. This is a little different as it is companies being impacted by inflation and lower margins," noted another banker.

These market conditions combined with the drop in secondary market prices have left investors evaluating the potential risk and reward of picking up paper at the lower prices on offer. CLO managers have the opportunity to build par by buying loans at sizeable discounts in the secondary market.

New CLO deal flow has in recent weeks been impacted by the reset in market conditions and issuance is expected to slow. CLO Triple A spreads have widened sharply to the 200bp area, up over 40bp in the last month. Feeding into this is a material widening in CLO secondary market spreads across the capital stack.

US CLO new-issue volume trended down as the quarter progressed but still posted a robust US$40bn in 2Q22, up 25% over the first quarter. On a year-to-date basis, CLO activity fell 12% from last year, but still posted its second fastest start to the year, topping US$70bn, despite the recent drop off in deal flow.

With the broader market volatility and falling prices in the secondary loan market, retail loan funds have experienced over US$8bn of outflows since the start of May. This represents a reversal from the first four months of this year when inflows amounted to US$25bn, according to Refinitiv Lipper.

"Across the board, the leveraged loan and CLO markets are going to continue to slow down," said another banker, before adding "you would think with more rate hikes on the way, the volatility is by no means going away. You would like to see a couple of months where the inflation number was even moderating, that would do a lot for sentiment but we just haven't seen it yet."

Fig. 1 Institutional loan issuance

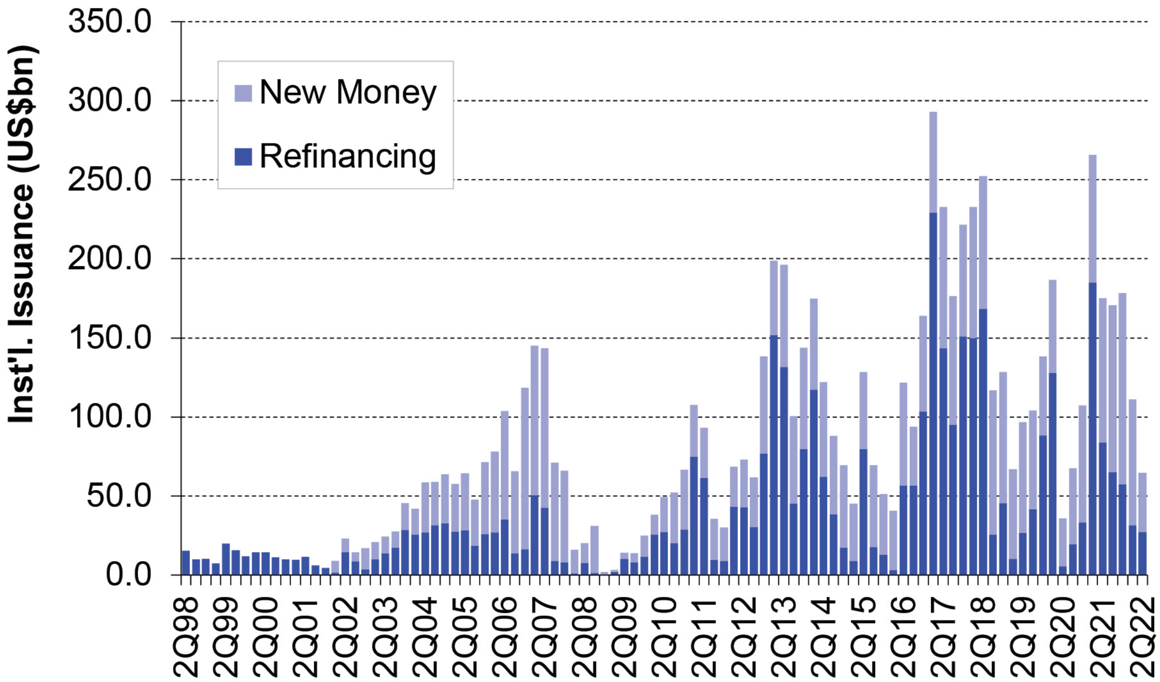
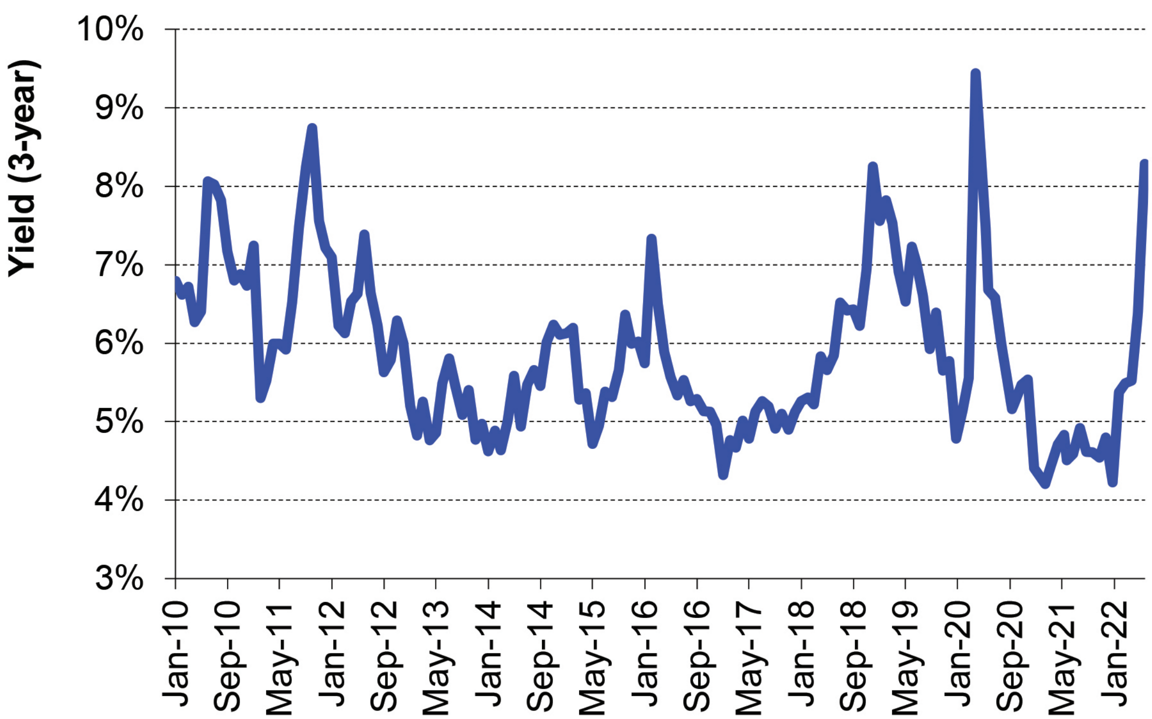


Fig. 2 Primary market yields continue to increase as activity stalled in 1Q22



Source: Refinitiv LPC

Middle market loan volume was up 40% to US$78bn in the second quarter

Diana Diquez

In a quarter filled with volatility, middle market loan volume, including syndicated and direct lending executions, jumped 40% to US$77.8bn in 2Q22 and was almost on par with year-ago levels. In contrast to 1Q22, when 77% of respondents to Refinitiv LPCs Quarterly Survey, said they were not able to lend as much as they wanted to, over half of respondents said they did in 2Q22.

The middle market was mostly unfazed by the levels of volatility in 2Q22, and the disconnect between the broadly syndicated market and the middle market was in evidence for most of the quarter.

In the primary market, middle market issuance was 5% ahead of year-ago levels at US$133.3bn in 1H22, in contrast, overall market leveraged loan volume was down 31% in the same period.

Bankers that focus on the non-sponsored space describe 2Q22 as a calm quarter, in which corporate issuers were still looking at opportunities but were also more cautious given increased economic uncertainty and many headwinds.

Non-sponsored syndicated loan issuance was up 37% quarter-over-quarter to US$34bn in 2Q22 and was on par with 2Q21 levels. New money lending bounced back to US$15.8bn, after retreating in 1Q22. M&A loan volume edged higher to US$3.4bn in 2Q22, however, at these levels, it was much lower than the totals seen in the last two quarters of 2021.

Volatility has put a damper on M&A activity in the corporate space and there has been a slowdown on this front, lenders said. Volatility has also led to more caution and scrutiny by credit committees as more thought is going into approval processes, given that there is so much uncertainty surrounding the economy. Lenders said that there are too many questions, the main one being if there is a recession, how deep is it going to be?

“Given so many unknowns, we are being asked to not only run a base case and a downside case, but we are also being asked to run a soft-landing scenario,” said one banker.

Bankers are also being pressured on the return side, but most said that there has not really been much change in pricing.

“There has been a lot of chatter about increasing pricing given broader market dynamics, but that has not materialized. There has been a buildup in deposits and banks still have a lot of cash to put to work, so there is a lot of competition, and I have not seen much movement in pricing,” said another banker.

Lenders said that they are awaiting 2Q22 results to see how companies are tracking given all the headwinds. Others said that they don’t expect many negative surprises for the second quarter but are uncertain about what is coming in the second half of the year.

The sponsored middle market also had a very strong performance in 2Q22. At US$44bn total sponsored middle market volume including syndicated and direct executions was up from US$31bn in 1Q22. Though both direct and syndicated sponsored loan volumes were up from 1Q22, syndicated lending dropped 34% year-over-year while direct lending was up 41%.

Direct lenders continue to take market share, and this was most evident in LBO activity. The volume of middle market LBOs financed in the direct lending market was almost 5 times higher than the volume of syndicated LBOs in 2Q22, an all-time high.

Middle market issuers are not the only ones seeking direct lending solutions. With investors in risk off mode, broadly syndicated institutional issuance, was down 61% year over year in 1H22. The direct lending market offered an effective alternative source of financing for these larger deals. Overall unitranche loan volume of US$38.3bn was up 56% from 1Q22. Leading the increase were large corporate issuers with US$25.6bn in issuance in 2Q22.

The resilience of the direct lending market to broader market volatility, while welcomed by lenders that had to put a lot of money to work, also raised some concerns.

“We are very busy doing deals, but when you look around and you see the state of the equity and high yield markets and the fact that we might be on the verge of this recession, it feels like we have blinders,” said a direct lender.

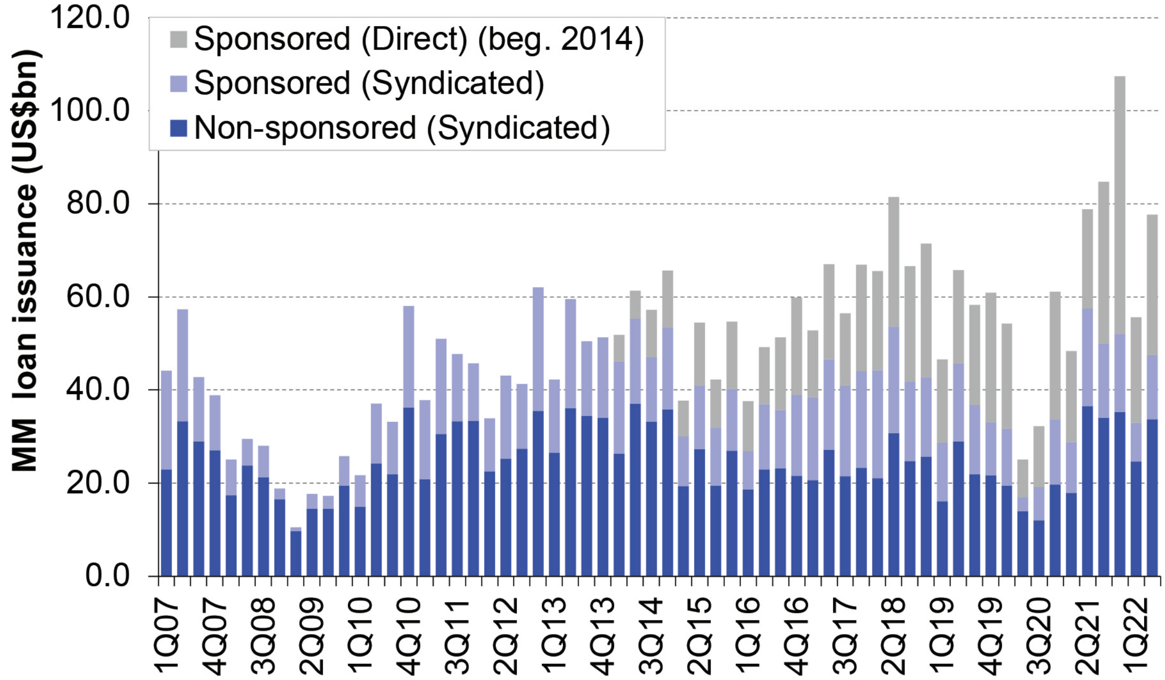
Pricing was a clear indicator of the disconnect between direct lending and the broadly syndicated markets in 2Q22. After many quarters of stability, yields jumped in the direct lending space in 2Q22. The average all-in-yield on first-lien middle market term loans (including unitranches) widened by 106bp for direct-lender deals to 8.21%. However, the premium between these deals and broadly syndicated term loans to Single-B issuers fell to 142bp in 2Q22 as yields increased at a much higher rate in the syndicated market in reaction to market volatility.

In the middle market, the increase in yields was mostly due to rising base rates, as spreads widened only slightly and unlike the broadly syndicated market that saw OIDs in the low 90’s, the OID component of yields for middle market deals was only slightly up this quarter.

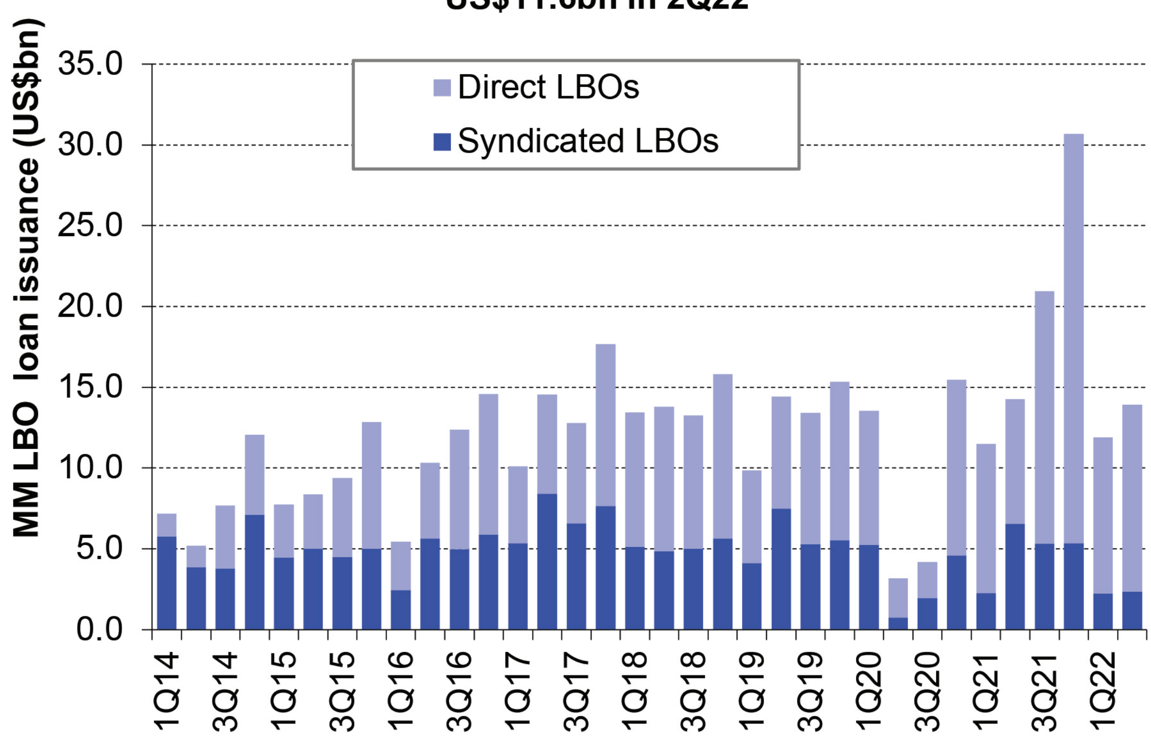
For most of the second quarter, it was business as usual in the direct lending space, but lenders said that they noticed a shift towards the end, and while they have continued to be busy with deals, it seems like the pipeline has slowed somewhat and this could lead to a slower late 3Q22 and 4Q22. Many agree that direct lenders will take a breather this quarter and exhibit more caution, but they also said that good deals will still get a lot of demand and will get done at loose terms.

In the longer term, lenders are very concerned about a potential recession and the effect it will have on their portfolios.

Overall middle market issuance increased 40% to US$78bn in 2Q22 from US$56bn in 1Q22



Middle market direct lending LBO volume was up 50% to US$11.6bn in 2Q22



Source: Refinitiv LPC

The Legal Corner by Paul Hastings

Conditions in the U.S. loan market remained choppy through Q2 2022. Faced with ongoing economic risks and political uncertainty, deals clearing the market varied with respect to structures, issuers and terms. The mix of transaction types and borrowers, from strong credits to those urgently requiring additional capital, maturity extensions or other amendments, resulted in dramatic variations in pricing, covenant levels, permitted debt capacity and lender protections, while simultaneously providing new investment opportunities for direct lenders.

Rise of Pro Rata Financings

Faced with inflation and record-breaking interest rates (one-month Term SOFR was under 10 bps at the start of 2022 and crested 200 bps by mid-July), there has been a marked uptick in pro rata (a.k.a Term Loan A) refinancings and (non-fungible) incrementals. Despite their typically lower margins, Term Loan As (TLAs) have enjoyed limited popularity due to their markedly higher pro rata amortization (as compared with the customarily minimal annual amortization of Term Loan Bs). With interest rates at reported near twenty-year highs, for borrowers looking to refinance or increase their existing credit facilities TLAs offer all-in margins that may help borrowers manage staggering interest expenses amid expected ongoing rate hikes in the near term.

Expanding Opportunities across the Capital Structure

Despite uneven market conditions, direct lenders have been eager to deploy their ample dry powder. In some cases, such lenders have pursued less traditional investment opportunities, resulting in what were previously “fringe” financing structures becoming more prevalent. For example, recurring revenue financings for nascent software companies are now a popular product in the loan market and offered by dozens of institutions, with more looking for opportunities to gain entry into this rapidly expanding market segment. Additionally, an increasing amount of issuers and financing sources have pursued recapitalization strategies lower down the capital structure in the form of holdco loans and preferred equity. These instruments, which usually have fixed rates, are often faster to execute and provide greater certainty of funds than traditional syndicated or even club credit facilities, increasing their appeal in the current market.

Volatility as Opportunity

In today’s loan market, one party’s risk is another’s opportunity. What may appear to be riskier credits in highly impacted industries may facilitate lenders obtaining more protective and tighter terms. For large cap credit facilities or high yield offerings that may be stalled in syndication with traditional bank lenders, some direct lenders have also been stepping in to bridge the financing gap. Such direct lenders may provide second lien term loans (in lieu of bonds) or unitranche loans, potentially with not only more lender protective terms, but also with increased margins and fees. Some recent transactions in the market have creatively leveraged loan documentation flexibility to find unique opportunities to recapitalize and / or to refinance in order to reduce immediate costs, including delaying repayment of obligations close to maturity.

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A leading global law firm, Paul Hastings provides innovative legal solutions to many of the world's top financial institutions and Fortune 500 companies in markets across the United States, Europe, Asia, and Latin America. Our leading Finance practice supports clients with a deep global bench of legal experts to address various financing challenges with strategic thinking and flawless execution. We work with clients in every key financial center on an exceptional array of both domestic and international finance matters. Our lawyers represent financial institutions and servicers as lenders, and public and private companies as borrowers, in working capital and acquisition financings across a broad range of business sectors and industries. We also have particular experience in guiding clients through complex restructurings and turnarounds and are recognized market authorities on intercreditor arrangements across all lending structures.

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About Refinitiv LPC

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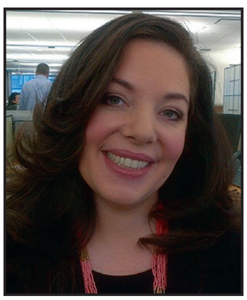

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