Market Intersection:

A Quarterly Look at the U.S. Credit Markets

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3Q21 US syndicated lending slows but LBO-related financings approach 2007 peaks

Ioana Barza

The record pace of US syndicated lending in the first half of this year fell to US$531bn in the third quarter as opportunistic deals slowed. While this figure is double the lending levels at this time last year and is the strongest third quarter in four years, the pace could not keep up with second quarter's US$829bn, the second busiest on record after 2Q18's US$870bn. It also fell behind first quarter's US$706bn in overall US lending, which ranked as the third busiest quarter on record. While many issuers had already refinanced to lower their Covid and pre-Covid rates, underwriters and investors focused on new LBO-related loan financings in the third quarter, which reached US$55bn and were just shy of 2007's yet unsurpassed quarterly US$58bn-$59bn peaks. "We have seen an explosion of supply in loan and bond market over the last several months and I would have thought that accounts would be overwhelmed, liquidity would be depleted, and secondary would be up," said one underwriter. "The good news is the market is digesting it very, very well."

This was helped by the fact that the calendar was visible months in advance which allowed asset managers time to reserve capital for upcoming trades. In addition, despite the heavy flow of deals, not all were net new money. In fact, US new money lending shrank to US$206bn in the third quarter which is down significantly from second quarter's US$306bn. "Even as the Fed looks at easing and inflation concerns, given that loans are floating rate, it will affect high yield a lot more," said a second underwriter, adding that tapering will cause underlying rates to move wider, putting pressure on the higher quality end of the market. In addition, the spreads compression that resulted as both ends of the market rallied now could be unwound. "The other risk that exists in the bond market is that you could see a decompression dynamic develop if growth becomes less clear and people wonder how companies will perform.

As for loans, "the markets get good, people get complacent, put extra leverage on, cut covenants, cut pricing. Does it sustain? Can it be sustained in a weaker economy?" asked one asset manager. "The high yield bond market and loan market are correlated to what happens in equities but showed resilience in the face of incredibly robust primary market activity. We were all surprised by how well the market is absorbing the supply," said a third underwriter. This activity was supported by robust investor demand as flows into retail loan funds were at levels not seen since 2013 while new issue CLOs through September inched past 2018's full year record, reaching US$128bn. In addition, the global CLO market surpassed US$1trn in outstandings, including more than US$830bn in assets under management in US CLOs. "If I were to point to any surprises I would point to how resilient the market has been on the demand side," said a source. "It is a bull market for everything – real estate, crypto, leveraged finance."

This is echoed by the boom in private credit fundraising from diversified sources which allowed direct lenders to compete with mega-unis in the broadly syndicated market, both for deals "where they put on more leverage than we would, we couldn't do syndicated deals in some of these instances, but also for very high quality credits which we would love to do," said one leveraged bank lender. Another underwriter said, "We are having a record year for P&L in leveraged finance and while direct lenders are taking some share there is still plenty to be done. The world has become more complicated and it is no longer a linear relationship between borrower, bank and investor. The leveraged finance market has grown up."

Three fourths of buyside and sellside market participants said that in one year they expect the direct lender role to increase among large leveraged financings across the board as sponsors prioritize non-rated structures with speed to completion, while 12% said it depends on how market conditions and overall credit quality hold up in this time. Only 6% said the role will increase among large leveraged financings, but only for deals outside of banks' parameters.

Fig. 1 Institutional loan issuance

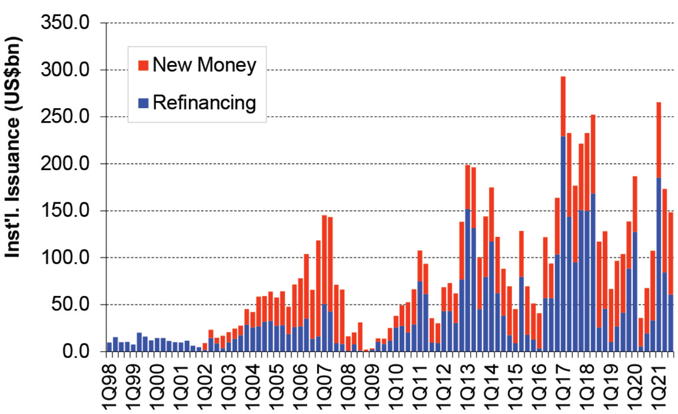
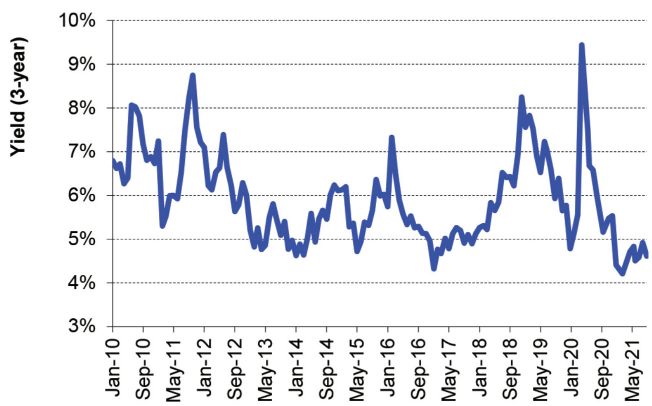


Fig. 2 Primary market yields continue to decline based on strong investor demand



Source: Refinitiv LPC

Middle market lending remains competitive despite robust activity

Diana Diquez

Overall middle market issuance, including syndicated and direct lending was up from 2Q21 at US$78.4bn in 3Q21, only US$3bn shy of the quarterly record set in 2Q18.

The non-sponsored market's "revival" continued as a very busy summer led to syndicated volume of US$30.3bn in 3Q21. This was the highest level for a third quarter since 2014. New money lending continued its upward trend, increasing for the fifth quarter in a row to hit its highest quarterly level in almost 15 years at US$15.4bn.

Non-sponsored middle market M&A lending increased for the fifth quarter in a row, reaching a new post-financial crisis high of US$4.44bn, just above 4Q17's US$4.39bn. However, competition from sponsors and cautious business owners are still factors hindering M&A activity in the space.

"The acquisitions that are taking place in the non-sponsored space are those in which the business owner will take a lower price because they don't want to sell to a sponsor, but these are very rare cases," said the commercial banker. "Others that are materializing are those when there is a case of a vertical integration play that will generate synergies allowing the buyer to pay a hefty multiple."

While a third of bank respondents to Refinitiv LPCs Quarterly Survey said they were not able to lend as much as they wanted to in 3Q21, the majority said they did, and a few bankers stated that they are "knocking it out of the park."

The sponsored middle market did not take its usual summer break this year. Instead, the number of 3Q21 deals crashed the prior quarterly record. A total of 401 sponsored middle market deals (syndicated plus direct lending) were done in 3Q21, up from 2Q21's prior high of 360 deals. Middle market sponsored direct lending broke new territory as volume surged to US$35.7bn in 3Q21. This was up 61% quarter-overquarter and topped 2Q18's prior high of US$27.8bn.

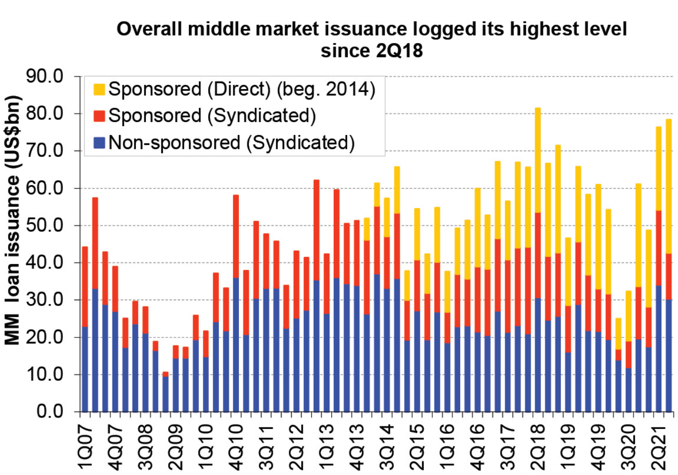
Middle market LBO issuance also set a record, popping to US$20.6bn in 3Q21, 79% of which was financed in the direct lending market. At US$16.3bn in 3Q21, direct lending LBO volume almost doubled the prior quarter level and eclipsed the high of US$10.9bn set in 4Q20. While LBO activity has flourished, there is still a lot of dry powder in private equity shop coffers that needs to be deployed. Sponsor competition for deals has been intense and LBO purchase price multiples have skyrocketed to a record-setting 12.5 times on average in 3Q21. Meanwhile, the unitranche loan structure has become increasingly popular on buyout deals as 44% of middle market LBOs were financed via unitranches in 3Q21, up from 35% in 2Q21. At US$20.3bn, unitranche volume set a new quarterly record.

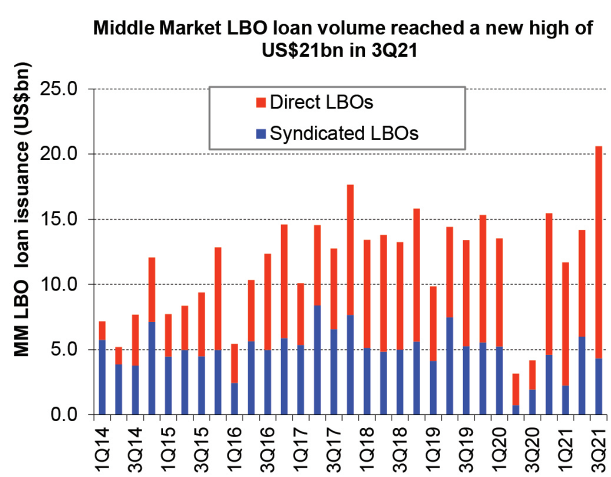
While direct lenders have had a lot of opportunities to put money to work this year, which have expanded beyond the middle market, the fundraising spigot remains at full force and the market remains competitive. "We've seen a lot of dealflow, but we have had to move into places we don't want to be because of so much competition." said the third direct lender. "We repeatedly get these grids from sponsors with asks that are shocking and if you just meet the asks you lose the deal."

Leverage widened on unitranche and all senior/stretch structures in 3Q21, to 5.9 times and 3.9 times, respectively. For the first nine months of the year, leverage of 5.84 times on unitranche structures was at a record-high. While risk on these structures has increased, blended spreads compressed in 3Q21 to a quarterly low average of 575bp. For 1Q-3Q21, they were at an average of 597bp, on par with 2019's low.

Not only have sponsors been able to get more leverage and pay less for unitranches this year, but covenant-lite has gained a lot of ground in the direct lending space. Covenant-lite unitranche volume spiked in both the large corporate and middle market segments in 3Q21, totaling US$9.8bn, far exceeding the previous high of US$1.9bn posted in 2Q21.

Lenders across the board said the fourth quarter is looking good. They are busy doing deals, but competition continues to be aggressive. When looking beyond this year, there is not as much clarity as supply chain challenges, inflation, and labor issues could have a significant impact.





Source: Refinitiv LPC

The Legal Corner by Paul Hastings

The U.S. loan market has seen rapid growth in 2021, with private credit in particular experiencing meteoric growth, including several record-breaking unitranche facilities. As we look ahead to 2022, there are several trends and developments to keep in mind.

Evolving Deal Terms, Definitions and Pricing Structures

Throughout the COVID-19 pandemic, financial definitions and calculations, as well as pricing structures, have evolved based on regulatory, legal, accounting, and market changes, impacting key metrics under financial covenants and incurrence tests. Such developments have appeared in the growing private credit markets as well, with the mega-size unitranches containing features previously limited to large cap / sponsored syndicated or institutional bank-led credit facilities.

As we appear to be moving into a new phase of the pandemic, some U.S. loan market terms have evolved to address COVID-related heightened risks and legal and regulatory changes, while others have rewarded thriving areas. Trends have emerged in these terms, which have not been limited to the syndicated loan market, but have also permeated the private credit markets.

Record-Breaking Unitranches

Direct lending in the COVID era has reached record levels, in part due to its more straightforward capital structures, covenants, and documents, low syndication risk, and often faster timelines. When direct lenders first became a fixture in the U.S. loan market, they largely operated in unitranches in the middle market and, in some cases, participated as lenders in large cap / syndicated deals. However, the past year has shattered unitranche records, with several multi-billion-dollar unitranche facilities led / agented by direct lenders closing in the U.S. and European loan markets.

During COVID, the streamlined negotiations and documentation of unitranche facilities and lack of syndication cost and risk proved particularly valuable. Some market participants sought unitranche structures to consummate some of the largest acquisitions in the market.

What Is Debt Anyway?

Nearly every credit agreement specifies what items constitute debt for leverage ratios. This is important because it will impact leverage calculations for financial covenant and incurrence tests.

The U.S. loan market has seen market participants agreeing to more and more carve outs to what constitutes debt, though they have historically looked to revolving borrowings and incurrence of additional debt as a potential marker of distress—hence, covenant lite structures where revolving borrowings beyond a specified threshold trigger financial covenant testing. Leverage ratios that include a debt component with extensive carve-outs may not paint a complete picture of the borrower's financial health and performance and may increase transactional capacity subject to incurrence tests.

The Return of Ticking Fees

When COVID began and the U.S. loan market temporarily paused, certain facets of the loan market, such as extended commitment periods that included ticking fees, nearly disappeared given the inherent risks of delaying closings by six months of more. However, in late spring of this year, market participants appeared to feel more confident that extended commitment periods were once again becoming less risky (as long as they were accompanied by appropriate fee structures).

Post-COVID ticking fee structures have shifted, at least in several deals, often kicking in for commitment periods exceeding 30 days, and, in some cases, in amounts equal to 100% of the margin for the entire ticking period. These changes are likely related to the perceived increased risk of providing extended commitment periods after emerging from the darkest COVID-related periods where supply chain disruptions, evolving governmental health and safety regulations, and other uncertainties still persist.

*For further insights, read our "**Trends to Watch in the Loan Market - 4Q21**."*

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From offices in New York, London, Hong Kong, Sydney and Tokyo we are the one source for comprehensive coverage of the syndicated loan markets worldwide.

Our publications, online news, analysis, valuation services and interactive databases are used every day by banks, asset managers, law firms, regulators, corporations and others to drive valuation, syndication, trading, and research and portfolio management activities.

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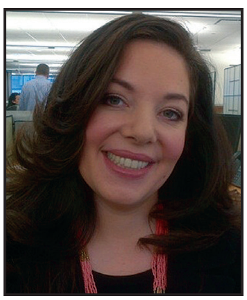

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