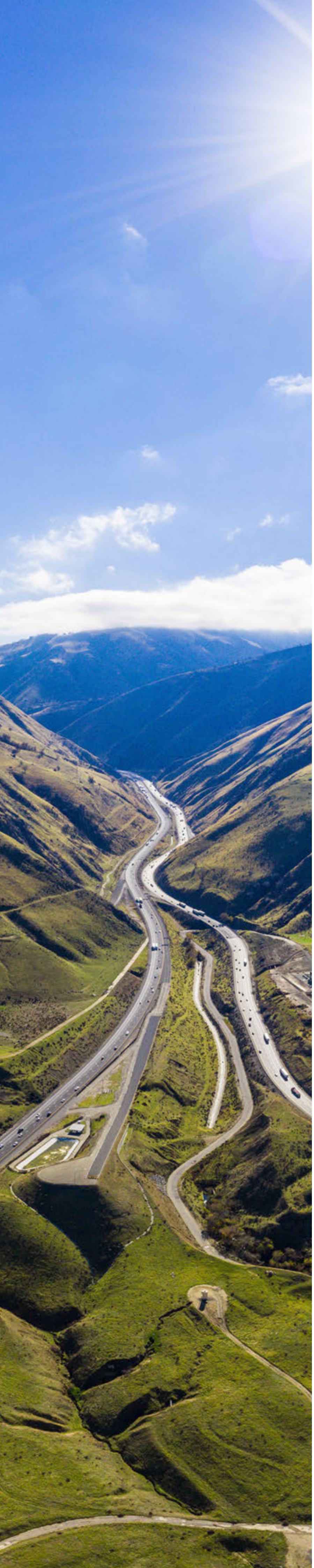
WHITE & CASE

US leveraged finance: The road ahead

What will drive issuance in a post-COVID-19 world?



Contents

Foreword

Halfway through 2021, we take stock of leveraged finance in the United States and consider the road ahead for both borrowers and lenders. After more than a year of COVID-19, are things returning to normal? Or are we just starting a whole new journey?

In many ways, COVID-19 had far less of an impact on leveraged finance markets than expected. Activity dropped in the second quarter of 2020, primarily in leveraged loan issuance, but a year later numbers returned to pre-pandemic levels. In fact, leveraged loan and high yield bond values reached record highs by the end of Q1 2021—the highest quarter since Q2 2018 and the second-highest quarter, respectively, on *Debtwire Par* record going back to 2015.

What drove this relatively high-speed recovery? First, the Coronavirus Aid, Relief and Economic Security (CARES) Act, signed into law in March 2020, protected many businesses from the full brunt of the pandemic. At the same time, many businesses shored up their finances, taking on debt to ensure liquidity as lockdown measures continued to have an impact through the second half of 2020. Issuances rose and that upward trajectory carried on into 2021.

By the end of Q1 2021, the picture had changed once again. Vaccines were being distributed quickly and efficiently, raising hopes for a post-COVID-19 future. The economy was also improving, as various states began to open up and a year of pent-up consumer demand was released. By May, core retail sales in the US had reached levels typically only seen over the Christmas period, according to the National Retail Federation. An air of optimism crept into the market, with lenders increasingly willing to take more risks on borrowers in their pursuit of yield. Financing earmarked for M&A and buyout activity also began to climb, hinting at growth plans for the months ahead. Perhaps most significantly, the low interest rate environment gave businesses an opportunity to reprice and refinance their maturing debt in droves.

What's next for 2021?

While these are all very positive signs for lenders in the leveraged finance space, there are still a few red flags on the horizon. First is inflation—in July, the Bureau of Labor Statistics reported that the US consumer price index had climbed 5.4 percent in the 12 months to June, a level not seen in 13 years. These growing inflationary pressures are part of the rush to reprice and refinance existing debt, as businesses try to avoid any unpleasant surprises if interest rates begin to climb as well.

Second, companies in robust sectors that enjoyed a degree of preferential treatment from lenders during the pandemic may find that sentiment shifting in the months ahead as other sectors begin to recover. The "flight to quality" witnessed in the early days of the pandemic will likely return to a more evenly balanced state of affairs. Documentation may also go through some changes in the coming months, as adjustments brought in during COVID-19 are phased out.

Finally, as the dust settles in debt markets, issues that were gaining ground before the pandemic will return in force, especially environmental, social and governance factors, which continue to take on increasing importance among borrowers and lenders alike.

All of which means the road ahead is not quite as clear as many would like, but there will be fewer obstacles blocking the path.

After the storm: The US leveraged finance story so far

HEADLINES

■ Leveraged loan issuance reached US$763.5 billion in the first half of 2021, up 60 percent from US$478.1 billion in the same period in 2020 ■ High yield bond market issuance also rose 22 percent year-on-year, from US$219.6 billion to US$267.1 billion ■ Refinancings and repricing deals accounted for 62 percent of overall loan issuance in H1 2021

By Joseph Brazil, Eric Leicht, Eliza McDougall, Daniel Nam and Andrew Weisberg—partners, White & Case

By all accounts, leveraged finance markets in the United States were hot in the first quarter of 2021. This activity was driven primarily by refinancing and repricing. Borrowers jumped at the chance to take advantage of the favorable terms and pricing to refinance existing loans and bonds at lower margins and extend maturities. Recent high-profile refinancings include a US$5 billion term loan B maturing in 2028 by United Airlines and a US$1 billion term loan B refinancing by WW International, also maturing in 2028.

The market's pace cooled slightly in the second quarter, but the fundamentals still point to a positive second half, with strong investor demand supporting sustained levels of activity as the economy begins to open up.

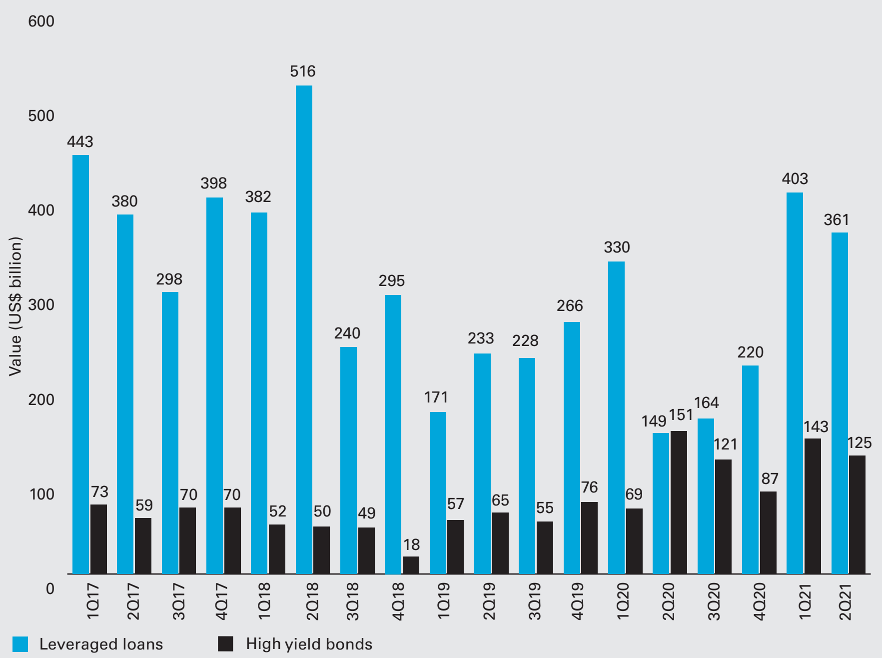
Leveraged loan issuance to the end of June 2021 climbed to US$763.5 billion, up 60 percent from US$478.1 billion over the same period in 2020.

Institutional loans, i.e., the portions (tranches) of a loan that are structured/sold to non-banks, such as funds, pensions and insurance companies, have seen an even sharper rise. Issuance climbed from US$288.7 billion in 2020 to US$520.4 billion year-on-year, supported by investor demand.

Issuance in the high yield bond market is also up for the period, climbing 22 percent from US$219.6 billion a year ago to US$267.1 billion over the first six months of 2021.

Refinancing and repricing deals in US loan markets reached US$471.7 billion by the end of June 2021 and accounted for 62 percent of overall loan issuance in that period. Refinancing and repricing expanded even faster in the institutional loan market—up 92 percent on the same period in 2020, reaching US$329.7 billion and accounting for 63 percent of total

US leveraged loan versus high yield bond quarterly issuance (2017–H1 2021)



Source: *Debtwire Par*—figures rounded up to nearest whole number

60%

The rise in leveraged loan issuance in H1 2021, year-on-year

institutional issuance.

In the high yield bond market, refinancing represented 70 percent of overall activity, with issuance for that purpose reaching US$186.8 billion, up 48 percent on the same period the previous year. For example, telecoms operator T-Mobile US refinanced a cluster of senior unsecured bonds with a combined value of US$3 billion and prices ranging from between 2.25 percent and 3.5 percent.

The market paused for breath after busy first quarter

Although year-to-date issuance figures have recovered strongly from levels observed a year ago—when COVID-19 sent the market into a temporary shutdown—borrowers, lenders and investors pumped the brakes somewhat in the second quarter of 2021.

Leveraged loan issuance for April slid 16 percent from March levels to US$147.2 billion, with month-on-month high yield bond activity down 13 percent between March and April at US$50.7 billion. The April slowdown came as the frantic pace of refinancing tailed off. Loan refinancings and repricings eased from US$122.9 billion in March to US$88.7 billion in April, while high yield bond refinancing was down from US$48.5 billion in March to US$31.6 billion in April.

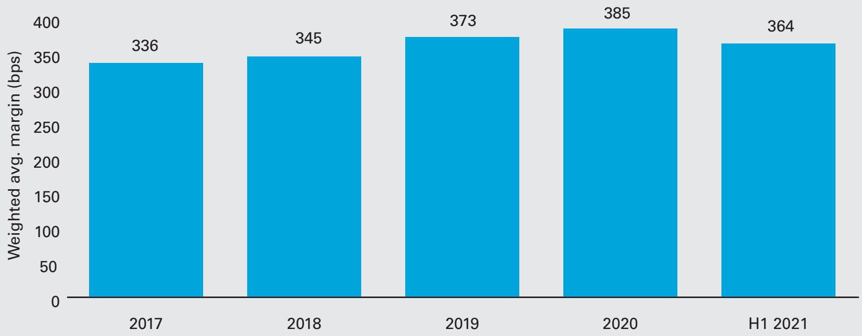
This cooling off period in refinancings and repricings, however, was countered by a welcome uptick in new money deals, with an especially notable improvement in new money issuance in the institutional loan space.

The US$147.4 billion in new money issuance in the leveraged loan space in Q2 2021 was up 42 percent on the previous quarter's US$104 billion total and a big part of the 36 percent year-on-year uplift in new money activity to US$251.3 billion.

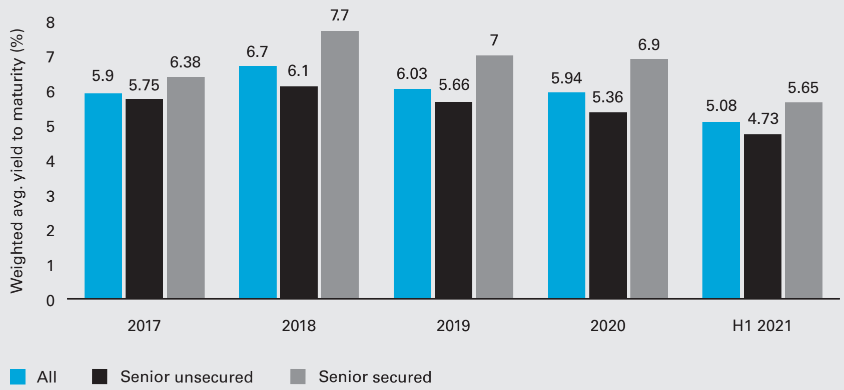
In the high yield market, new money issuance of US$50.7 billion in Q2 2021 was almost double the US$26 billion seen in Q1.

In the institutional loan space, the proportion of lending allocated to new money deals—US$161.5 billion—stood at 31 percent for H1 2021, though it was approximately 50 percent for much of Q2 according to *Debtwire Par*.

US institutional loan pricing (2017–H1 2021)



New issue high yield bond pricing (2017–H1 2021)



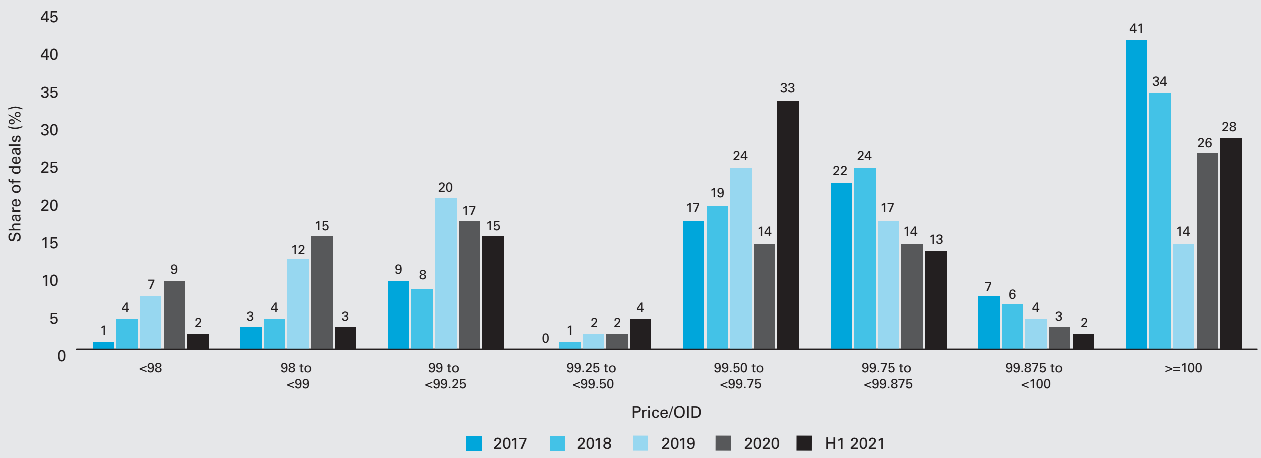
Source: *Debtwire Par*

Consistent rises in institutional loan issuance for M&A (excluding buyouts) and LBO deals—finishing the half year at US$71.2 billion and US$50.2 billion respectively—have been particularly encouraging after a period of relative scarcity for new M&A and LBO deals during the first quarter of the year.

High yield bond markets also enjoyed increased activity due to M&A and LBO deals, with issuance for these purposes reaching US$30 billion and US$8.4 billion in H1 2021, respectively. Issuance for both purposes reached record heights in Q2 2021, with US$22.9 billion allocated to M&A activity and US$6.9 billion issued for LBOs—in both cases, this was the highest quarter on record going back to 2015.

Significant LBO deals in the US this year included CoreLogic, a California-based property data analytics business, which locked in US$4.5 billion in leveraged loans and a US$750 million high yield bond to fund its take-private buyout by PE firms Insight Partners and Stone Point Capital. In the high yield market, the Michaels Companies—an arts and crafts retailer that sells through its Michaels chain of stores—issued US$2.15 billion in high yield notes to support its takeover by buyout investor Apollo Global Management.

Original issue discounts (OIDs)* (2017–H1 2021)



Source: *Debtwire Par*

*Based on universe of deals where OID data available

RealPage, another property software business, was also in the market with a US$4 billion leveraged loan to fund its acquisition by buyout house Thoma Bravo.

Pricing squeeze eases

The calmer market in Q2, coupled with the rise in new money deals, also gave lenders and investors the space to take a firmer position on pricing.

High investor demand in Q1 2021 gave borrowers the opportunity to negotiate tighter pricing and push out maturities, which saw the weighted average margins on first-lien institutional loans recorded at 3.46 percent over LIBOR in Q1 this year, down from 4.17 percent over LIBOR in Q4 2020 according to *Debtwire Par*.

By the end of the second quarter, however, the average margin on first-lien institutional term loans edged back up to 3.61percent. In addition, original issue discounts (OIDs)—the discount from par value at which a loan is sold—widened in favor of investors. Average OID discounts of 99.65 percent (35 bps discount) in Q1 widened to 99.35 percent (65 bps discount) by the end of June. This has seen average yields on loans increase from 4.21 percent at the end of Q1 to 4.55 percent at the end of Q2 2021.

High yield bond yields edged lower in the first half of the year. The weighted average yield to maturity on senior secured high yield bonds narrowed from 5.97 percent in Q1 2021 to 5.36 percent in Q2 2021. For senior unsecured high yield bonds, pricing moved from 4.77 percent for Q1 2021 to 4.66 percent for Q2 2021.

This change in pricing dynamics prompted more borrowers to reset their pricing expectations. *Debtwire Par* tracked 14 borrowers in April 2021 that agreed to pricing wider than initial indications—the highest level observed this year. One Call, for example, secured a US$700 million first-lien term loan priced at LIBOR +5.5 percent with a 98 percent OID, after initially going to market with plans to raise a loan package of US$850 million with a 99 percent OID and pricing range of LIBOR +4.75 percent-5 percent.

Looking forward

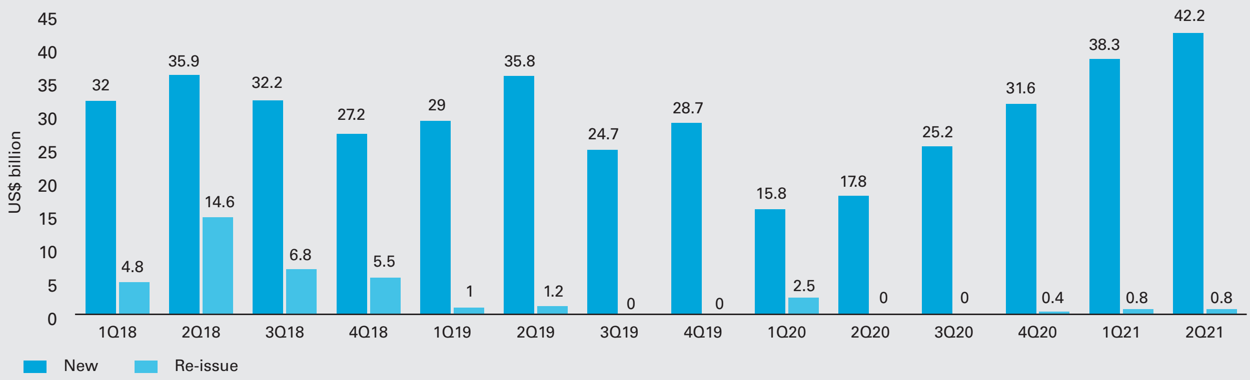
Despite the slight dip in activity, the outlook remains positive for the second half of the year. Investor demand remains strong, with CLOs active and retail investors showing appetite for loans.

CLO issuance of US$80.5 billion for the year to the end of June is up 140 percent year-on-year and Lipper reports that loan exchange traded funds and loan mutual funds are attracting incoming funds after a period of outflows.

In the secondary leveraged loan market, meanwhile, pricing has stabilized. *Debtwire Par* figures show that, at the end of June, 24 percent of loans in the secondary market were trading above par (having climbed as high as 44 percent earlier this year), with 47 percent of the market trading in the 99 percent to par pricing range.

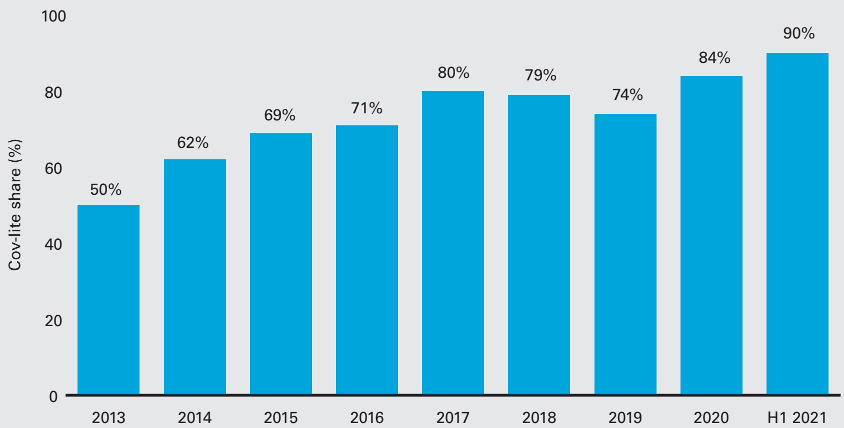
Credit quality has also improved. In June, ratings agency Fitch forecast that US leveraged loan and high yield bond defaults were on track to hit ten-year lows. Fitch reduced its leveraged loan and high yield bond default rates forecasts for 2021 from 2.5 percent and 2 percent to 1.5 percent and 1 percent, respectively. Credit rating actions have been moving in the right direction too—in the last two weeks of June, out of the 153 actions taken for 137 companies in North America, 60 percent were changed to "stable" and 12 percent were revised to

US CLO volume, quarterly new issue versus re-issue (2018–H1 2021)



Source: *Creditflux*

US covenant-lite share of institutional loans (2013–H1 2021)



Source: *Debtwire Par, Xtract Research*

"positive" while just 6 percent were changed to "negative" ratings.

President Joe Biden is also expected to influence loan and bond market regulation and trends in the months ahead. For example, he appointed Janet Yellen as Treasury Secretary. Separately, Maxine Waters regained the chair of the House Financial Services Committee. These two people could prove significant.

Yellen, who was Federal Reserve Governor in 2013 when government agencies issued guidance to limit leverage multiples at 6x EBITDA, has long been hawkish about the amount of leverage in the system, especially when carried by borrowers that are not investment-grade issuers. She has also considered increased regulatory oversight of non-bank direct lenders, which could shift the dynamics for borrowers.

Waters, meanwhile, has been a long-time supporter of a policy to cap leverage levels at 6x EBITDA and, alongside Yellen, was a vocal opponent of the decision to loosen rules and allow banks to back debt funds. Both figures will want to see leveraged finance markets regulated more closely during their terms.

The Biden administration has also made the fight against climate change a central policy objective, the impact of which should not be underestimated in leveraged loan and bond markets. The President's focus on climate change and other environmental, social and governance (ESG) objectives has contributed to a surge in the issuance of green bonds, sustainability-linked debt instruments, and leveraged loans and bonds that include ESG ratchets, which shift margins on loans up or down depending on compliance with pre-agreed ESG criteria.

The inclusion of ESG clauses in debt documentation is expected to continue to gain traction, as borrowers, banks and investors move ESG up on the list of priorities.

From closing loopholes to rising inflation: Five trends that will drive leveraged finance

HEADLINES

■ Leveraged loan and high yield bond markets shrugged off COVID-19 uncertainty to post year-on-year increases in issuance in 2021 ■ Features of documents through the COVID-19 period—such as liquidity covenants and EBITDAC metrics—are fading from the market ■ Lenders are increasingly sensitive to the risk of subordination in either right of payment or lien priority

By Joseph Brazil, Binoy Dharia, Rebecca Gottlieb, Gary Kashar and Eliza McDougall—partners, White & Case

Leveraged finance markets largely returned to the pre-pandemic status quo in the first half of 2021 following a tumultuous 2020. From January to June 2021, US leveraged loan issuance climbed 60 percent compared to the same period in 2020, and high yield bond activity improved 22 percent for the same period.

The long-term drivers of low interest rates and significant available liquidity, an ongoing trend since before the pandemic, have continued to limit major creditor-favorable shifts to loan documentation.

As vaccine roll-outs progress across the globe and the US economy fully reopens, what are the priorities for lenders and borrowers and what will dictate the direction of leveraged finance through the second half of the year?

The following five trends are expected to shape the US loan and high yield bond markets through the rest of 2021.

1. Expect COVID-19 adjustments to fade

Features intended to mitigate risks for lenders, like liquidity forecasting and increased reporting secured in return for waiving covenants in the immediate response to COVID-19, are now fading from the market.

Waiver changes have either expired or borrowers have been able to refinance or reprice loans in a favorable market and shed these obligations. For the year to the end of June 2021, high yield bond refinancing increased 48 percent year-on-year to US$186.8 billion and leveraged loan refinancing and repricing activity is up 79 percent year-on-year at US$471.7 billion.

On the lender side, so-called EBITDAC (earnings before interest, taxes, depreciation, amortization and COVID-19) measures were used to add-back sales that companies theoretically missed out on because of lockdowns. These are also now being phased out.

EBITDAC allowed borrowers to secure funding against a higher earnings figure when COVID-19 was factored in but, as economies and businesses reopen, lenders are pivoting back to providing credit based on actual EBITDA numbers.

2. Sector lending preferences are starting to disappear

When issuing new debt in 2020, lenders showed a strong preference for credits in sectors that were less impacted by lockdowns. Technology and computer-related leveraged loan issuance, for example, more than doubled between Q2 2020 and Q4 2020.

By contrast, sectors faced with enforced shutdowns saw issuance move in the opposite direction. For example, in the leisure industry, issuance more than halved between the first and last quarters of 2020.

However, as the US economy fully reopens and trading in troubled industries returns to relatively normal conditions, lender industry preferences are becoming less entrenched. Credit quality remains paramount, but a more agnostic attitude toward sectors is re-emerging.

Resilient sectors like technology remain popular—technology leveraged loan issuance spiked through Q1 2021 to US$70.4 billion, the second-highest quarterly total on *Debtwire Par* record—but sectors that struggled under COVID-19 have also seen significant improvement. Leisure issuance in Q1 2021 reached US$16.1 billion, up 80 percent from Q4 2020 levels.

3. Lenders are focusing on documentation terms

Although lenders have been comfortable issuing debt on cov-lite terms and at attractive pricing for borrowers, there has been a tightening on documentation with respect to super-senior debt capacity and unrestricted subsidiaries.

Through the course of 2020, borrowers were able to find and use flexible structural mechanics in documentation that lenders have now moved to tighten.

There is particular focus in senior loan documentation on limiting the potential for borrowers to bring in new lenders senior to incumbent creditors in the capital structure in return for additional liquidity at cheaper pricing than

would be available for unsecured borrowing.

Allowing these super-senior tranches could, in the event of a default, translate to existing lenders being at a higher risk of incurring losses, as their seniority in the capital structure will have been diluted. These scenarios, when effected, have created tensions among lenders within the credit group and have even led to litigation.

Accordingly, when underwriting new deals, investors are now reducing the risk that this will occur by including documentation provisions that allow for a lender vote on any "uptiering" transaction.

Lenders are also tightening documentation to limit the use of unrestricted subsidiaries to shift valuable assets out of the existing credit group to affiliates in order to raise additional debt.

Overall, investors are laser-focused on avoiding the risk of being subordinated in either right of payment or lien priority.

4. M&A and LBOs are likely to drive issuance in the second half of the year

Refinancing and repricing dominated activity through the first half of 2021, accounting for 62 percent of US leveraged loan issuance for the year to the end of June 2021 and 70 percent of US high yield activity.

The uptick in US M&A activity seen during H1 2021—up more than fourfold on the same period in 2020—indicates that a rising share of issuance through the second half of 2021 will be attributable either to M&A or LBOs.

In leveraged loan markets, for example, M&A issuance (excluding buyouts) started climbing steadily halfway through 2020, from US$22.2 billion in Q2 2020 to US$58.8 billion in Q2 2021.

Similarly, LBO loan issuance improved from US$12.9 billion in Q2 2020 to US$43.1 billion in Q2 2021, the highest quarterly tally since the fourth quarter of 2018.

5. Inflation could be a big driver for issuance

If inflation remains low, leveraged loan and high yield activity could be expected to sustain the issuance levels observed last year. But that's already changing.

US inflation is creeping higher after a period of declining prices following the first round of lockdowns and oil & gas market price wars, which dropped oil prices to record lows.Figures published in May showed that the US consumer price index had climbed 4.2 percent year-on-year in April, a level not seen since 2008. Capital markets, which anticipated a figure of 3.6 percent, were caught by surprise, and the S&P 500 shed 2 percent on the day the numbers were released. By July, the CPI had climbed 5.4 percent in the 12 months to June, a level also not seen in 13 years. Many asset prices, including for leveraged loans and high yield bonds, have been set against a backdrop of low rates, leaving investors unnerved.

At the end of May, US Treasury Secretary Janet Yellen said that above-normal inflation was expected to persist through the end of the year as COVID-19 supply chain bottlenecks opened up, but this was no cause for concern. Federal Reserve Chair Jerome Powell has also pledged to allow for above-target inflation before considering interest rate rises to support economic recovery post-COVID-19.

It is too early to tell whether the consumer inflation figures are a blip as the market returns to normal activity or signal a longer-term shift. But if inflation figures continue to increase over a longer period and interest rates do go up, leveraged loan and high yield bond markets can be expected to be impacted.

Fund finance: Harnessing NAV finance in new ways

HEADLINES

■ Anecdotal evidence points to a surge in uptake of net asset value finance over the past 12 to 18 months ■ NAV finance is useful for the prevailing longer PE holding periods, which climbed from 3.8 years in 2010 to 5.4 years in 2020 ■ Deloitte estimates that the average loan-to-value ratios for NAV facilities sit in the 25% to 30% range

By Sherri Snelson—partner, White & Case

Demand for net asset value (NAV) finance—where private equity (PE) firms raise borrowings against the NAV of the assets in their funds—is on the rise.

NAV finance is still a relatively esoteric, industry-specific product, and authoritative data tracking the market's size and rate of expansion is scarce, but anecdotal evidence points to a surge in uptake over the past 12 to 18 months.

COVID-19 served as the catalyst for rising NAV finance demand, as managers explored alternative sources of cash. The need for additional liquidity came as exits were put on hold in the immediate aftermath of lockdowns, and managers moved to raise additional capital to see their portfolio companies through market volatility.

Even though capital markets and exit activity have now largely stabilized, PE appetite for NAV facilities is ongoing and the market has seen an influx of new lenders with NAV offerings to meet the new baseline of demand.

5.4

The average holding period in PE in 2020, up from 3.8 years in 2010

Evolving NAV finance usage

As this uptake of NAV finance has increased, PE managers have begun exploring ways to use the product beyond servicing the immediate liquidity needs of portfolio companies.

NAV finance has proven especially helpful for managers that want to hold on to prized assets for longer. According to recent research from eFront, the alternative assets software group owned by BlackRock, average holding periods in PE climbed from 3.8 years in 2010 to 5.4 years in 2020.

The study also found that longer hold periods predict higher returns. According to the software group, on average, multiples on invested capital (gross of fees) came in at less than 2x for portfolio companies held for less than two years, but improved to around 2.5x after a five-year hold, and around 2.6x for deals held for between nine and 10 years.

NAV finance also allows managers to make distributions to their investors without having to sell crown jewel portfolio companies.

Investors stand to benefit too. Deloitte estimates that the average loan-to-value ratios for NAV facilities sit in the 25% to 30% range, so when used for limited partner (LP) distributions pre-exit, investors can receive a significant slice of value earlier in a hold period, which in turn enhances their internal rates of return.

Back-levering deals with NAV facilities

Managers are also starting to use NAV facilities to add in an additional layer of leverage to deals immediately following acquisitions.

Managers are effectively back-levering transactions at the fund level by putting NAV facilities in place as, or just after, the acquisition of a portfolio company closes. This means that, in addition to the borrowing done at the portfolio company level, the manager is also borrowing with NAV finance at the fund level.

The back-levered NAV facility has no direct credit support from the portfolio company but increases the leverage on the overall underlying transaction, as the sponsor is essentially financing part of their equity contribution.

For example, if a deal structure for a portfolio company requires a 40% equity contribution, the sponsor can pay for that equity contribution by only putting in 10% equity from the fund, with 30% coming from a loan facility up the chain on a back-levering basis.

General partner (GP)-led fund restructurings—where managers transfer assets held in an existing fund that is approaching the end of its term into a new vehicle—have also seen NAV facilities increasingly used in this way. Historically, fund restructurings would have been initiated by limited partner investors but, in recent years, GPs have proactively initiated restructuring deals to offer investors an opportunity to either roll their stakes over into a new vehicle set up by the GP, or take liquidity.

GP-led deals are typically funded by secondaries (investors who buy and sell fund stakes in PE funds). In a GP-led scenario, secondaries will buy out incumbent investors to facilitate the transfer of assets to a new vehicle, and then provide additional follow-on funding for the new fund structure. To ensure that they hit

their return metrics, secondaries will often put an NAV facility in place to back-lever their equity commitments to the follow-on fund.

As the volume of GP-led deals increases (according to fund adviser Triago, GP-led deals accounted for the majority of secondaries deals for the first time in 2020) more deal flow is anticipated for NAV finance providers.

On the margin

Back-levered NAV loan structures have come to resemble those used for margin loans—interest-bearing loans that allow borrowers to lend against the value of securities they already own. What NAV lenders and borrowers are grappling with, however, is how to price the underlying assets in an NAV facility.

Margin loans are secured against liquid securities like equities or bonds, for which daily prices are quoted on public markets. In the event of default, the collateral securities can be sold easily on listed exchanges to reimburse lenders.

Privately owned assets that serve as security for NAV facilities, however, are usually illiquid and do not have easily identifiable reference securities that can be looked to for daily pricing. This poses interesting questions around how to track compliance with NAV facility loan-to-value ratios.

This is a developing area in the NAV finance space, as stakeholders determine how to use margin loan frameworks in a private market context. In some cases, borrowers and lenders will try to create a synthetic reference security linked to the listed bonds (if there are any) of the underlying portfolio companies. In other scenarios, lenders will require lower loan-to-value advance rates and higher pricing to account for the added risk.

There are no cookie-cutter solutions, with lenders and borrowers taking a bespoke, innovative approach in what is still a developing and rapidly changing market.

Downgrades, defaults, distressed debt and refinancing

HEADLINES

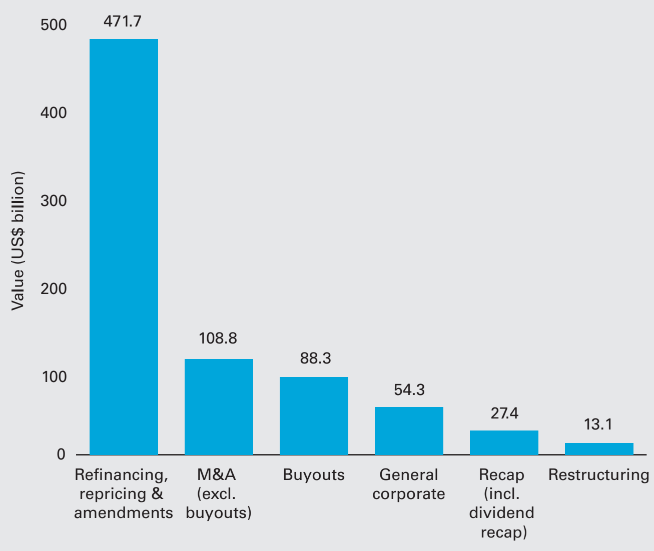
■ Refinancing and repricing in US leveraged loan markets surged to US$471.7 billion over the first six months of 2021 ■ US high yield bond refinancing accounted for 70 percent of total high yield issuance ■ Amend-and-extend deals give borrowers further breathing room ■ The extension of maturities has reduced near-term risk of default and limited the number of borrowers running out of cash and facing bankruptcy

By Philip Abelson, Will Guerrieri and Stephen Moeller-Sally—partners, White & Case

79%

Refinancing and repricing in US leveraged loan markets totaled US$471.7 billion over the first six months of 2021, up 79% year-on-year

US leveraged loan use of proceeds (H1 2021)



Source: *Debtwire Par*

Abundant liquidity, a red-hot refinancing market and improving credit ratings combined through the first half of 2021 to limit defaults and ease any near-term pressure on the balance sheets of US borrowers.

Borrowers have found lenders open and amenable to refinancing existing loans and bonds. Refinancing and repricing in US leveraged loan markets totaled US$471.7 billion over the first six months of 2021, a 79 percent year-on-year rise that represents almost two-thirds of total issuance for the year. US high yield bond refinancing accounted for 70 percent of total high yield issuance, climbing 48 percent year-on-year to US$186.8 billion by the end of June 2021.

The high levels of refinancing activity have strengthened the underlying credit fundamentals of borrowers, who have been able to extend maturities and either lock in lower pricing or increase the size of borrowing facilities.

Atlanta-based payments company Fleetcor Technologies, for example, refinanced its securitization term loan B facilities to lock in close to US$2 billion of liquidity at lower rates and with longer maturities.

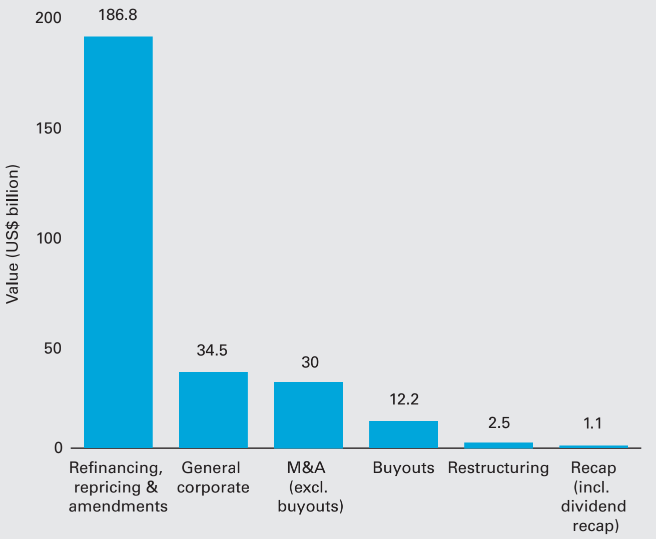
Borrowers have also had the option to amend-and-extend the terms on their loans to push out any imminent maturity cliff edges. According to ratings agency Standard & Poor's, US$41 billion in amend-and-extend deals were secured for the year to the end of April 2021—up year-on-year and already more than half of the annual amend-and-extend activity posted in all of 2018 and 2020.

Default risk diminishes

The capacity in the market to either amend-and-extend terms or refinance deals in such high volumes has all but removed the risk of defaults for borrowers that were running low on liquidity due to COVID-19 lockdowns and approaching maturity walls.

According to Standard & Poor's, the volume of loans falling due between 2021 and 2023 was reduced by US$198.3 billion between the end of 2019 and the end of April 2021. The volume of loans falling due in 2024 and 2025 dropped by US$135.1 billion over the same period. Longer-dated maturities due in 2026 or later, meanwhile, have swelled to US$348.4 billion as maturities have been pushed out and borrowers kick the can down the road.

US high yield bond use of proceeds (H1 2021)



Source: *Debtwire Par*

With the threat of a maturity cliff edge effectively averted, default rates have decreased and credit ratings have improved. In June, ratings agency Fitch lowered its leveraged loan and high yield bond default rates forecasts for 2021 to 1.5 percent and 1 percent respectively. And as corporate balance sheets stabilized and company earnings improved, the credit ratings environment is looking far healthier—according to *Debtwire Par*'s Ratings Tracker, in the last two weeks of June, out of the 153 actions taken for 137 companies, just six percent were changed to "negative" ratings.

The benign default rates and improving credit ratings observed so far in 2021 stand in stark contrast to the distress and volatility seen a year ago. In the first half of 2020, ratings downgrades became a feature of the market: 101 companies downgraded in June following 121 downgrades in May, 230 downgrades in April and 169 downgrades in the second half of March, according to the *Debtwire Par* Ratings Tracker.

The wave of downgrades was accompanied by a spike in default rates, which climbed to 4.5 percent among institutional loans in 2020, up from 1.7 percent in 2019, representing the highest levels observed since 2009 in the aftermath of the global financial crisis. High yield bond default rates, meanwhile, spiked from approximately 3 percent in January 2020 to close to 6 percent by the middle of the year.

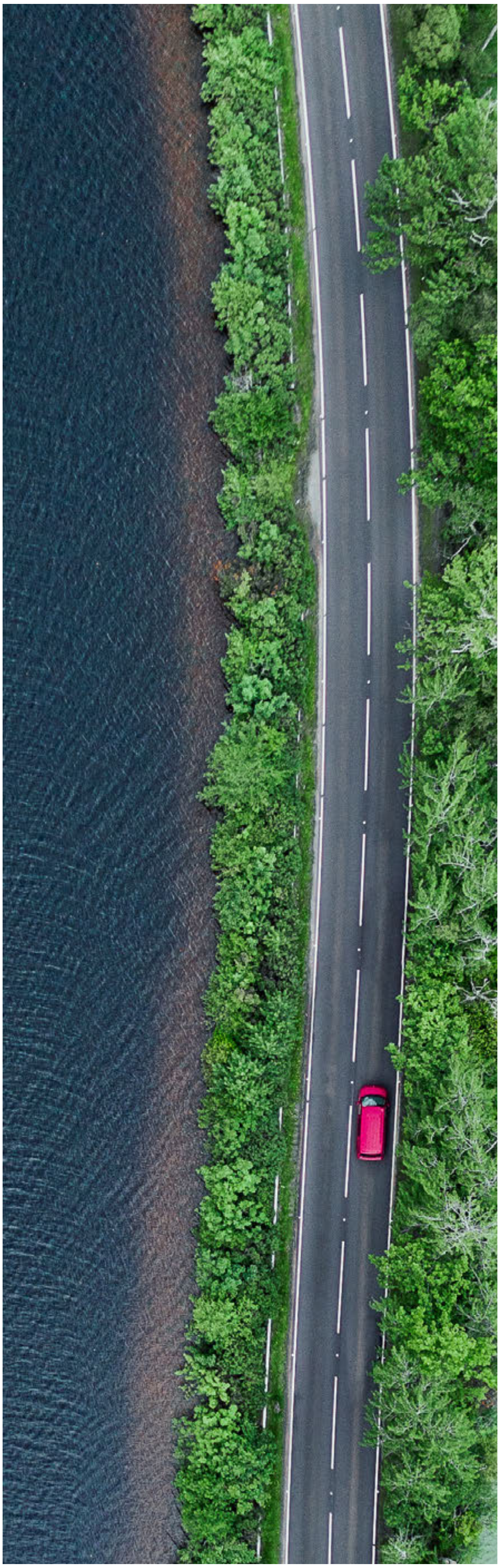
Restructurings on hold

The surge in default rates and ratings downgrades never led to the anticipated levels of deep financial distress and restructurings, as borrowers refinanced or amended-and-extended their loans and bonds. Cases where companies ran out of cash and faced chapter 11 bankruptcy were kept to a minimum as a result.

The rising number of credit ratings upgrades is expected to keep this supportive backdrop in place through the rest of 2021, especially as it will encourage sustained demand from collateralized loan obligation (CLO) managers, whose targets are linked to ratings.

With ratings improving, CLOs will have a significant influence on the levels of liquidity available in the market—new CLO issuance over the first six months of 2021 was up 140 percent year-on-year at US$80.56 billion, supported by this trend of improved ratings.

The wave of US debt restructurings anticipated during the depths of the COVID-19 debt crisis appear to have been put on hold—at least for now.



A more sustainable approach to debt financing

HEADLINES

■ Global green bond issuance reached US$305.3 billion in 2020, according to Bloomberg data ■ Ratings agency Standard & Poor's forecasts that global issuance of sustainability-linked debt instruments will exceed US$200 billion in 2021 ■ President Biden has pledged to cut US carbon emissions to at least 50 percent below 2005 levels by 2030, advancing the ESG agenda

By Brenda Dieck, Elizabeth Kirk and Sherri Snelson—partners, White & Case

From growing concerns around climate change and sustainable consumption to the social and political impact of the Black Lives Matter and gun control movements, environmental, social and governance (ESG) issues are being pushed increasingly into the spotlight for commercial debt investors in the United States.

No longer simply "nice to have," ESG features are increasingly prominent in deals and investments across all asset classes.

In a recent study of 50 of the world's largest asset managers, with a combined US$60 trillion of assets under management, shareholder advisory firm SquareWell Partners found that all but one had signed on to the United Nations Principles for Responsible Investment (UNPRI). Of those, 60 percent are using their own ESG ratings systems and 68 percent are publishing reports and materials on ESG topics such as climate change, human capital and biodiversity.

ESG comes to debt markets

The growing investor focus on ESG has filtered into debt markets, with lenders and borrowers looking at how to structure financings in a way that is more sustainable and supports and measures environmental and social objectives and outcomes.

A range of ESG-linked debt products have gained traction. Green bonds (which raise capital specifically for climate-linked and environmental projects) and sustainability-linked bonds and loans (which are not linked to specific green projects but are issued to incentivize sustainability performance objectives) have all seen growing investor interest through the past year.

50%

President Joe Biden has pledged to cut US carbon emissions to at least 50% below 2005 levels by 2030—pushing ESG up the agenda for US borrowers and issuers

According to Bloomberg data, total green bond issuances reached US$305.3 billion in 2020, a 13 percent increase on 2019 levels, despite a steep decline in activity during the COVID-19 lockdowns in the first half of 2020. Since 2007, cumulative green bond issuances have climbed to beyond US$1 trillion.

In April 2021, ratings agency Standard & Poor's, meanwhile, forecast that global issuance of sustainability-linked debt instruments will exceed US$200 billion in 2021. According to Bloomberg, sustainability-linked debt issuances reached US$131 billion in 2020, an almost 300 percent increase compared to levels observed just two years prior.

Ratcheting up ESG-linked lending

ESG criteria are also filtering into more "vanilla" debt products. An increasing number of mainstream borrowers are issuing leveraged loans and revolving credit facilities (RCFs) that include ESG-linked margin ratchets in their loan documents. These ratchets are triggered by pre-agreed corporate, social and responsibility metrics and adjusted based on performance against such metrics during the life of the loan. If a company achieves a certain number of these key performance indicators (KPIs), the margin on the loan decreases accordingly, but if criteria are not met, margins tick up and loans become pricier.

According to Bloomberg, Europe leads the way with these types of facilities, driven by European Union regulation and accounting for around 70 percent of the market, but the US is catching up fast. The election of President Biden—who has made climate change a policy priority for his administration and pledged to cut US carbon emissions to at least 50 percent below 2005 levels by 2030—has helped to push ESG up the agenda for US borrowers and issuers.

In April 2021, for example, General Mills renewed its five-year, US$2.7 billion RCF and included a pricing structure tied to environmental impacts through the term of the revolver. The ESG KPI metrics are linked to reductions in greenhouse gas emissions across its operations and use of renewable electricity for global operations. General Mills believes it is the first US consumer packaged goods company to put a sustainability-linked RCF in place.

The world's largest asset manager, BlackRock, meanwhile, recently agreed to a deal with a group of banks linking the costs of a US$4.4 billion credit facility to targets for women in senior leadership positions and increasing the number of Black and Latino employees in its workforce. In addition, BlackRock wants to grow the US$200 billion it

has invested in sustainable strategies to US$1 trillion by 2030.

Other esoteric forms of finance, meanwhile, such as subscription line finance, which is used exclusively by private equity (PE) managers to fund deals before making capital calls to investors, have also developed an ESG flavor.

Global PE franchises such as KKR and EQT have agreed to sizable ESG-linked subscription lines in the past year. KKR's Global Impact Fund arranged a US$1.3 billion ESG line in June 2020 and, in November, EQT locked in a similar facility worth €2.7 billion. Much like the loans and credit revolvers with ESG ratchets, these subscription lines have fee or margin incentives and penalties based on achieving ESG KPIs.

Setting standards

As the uptake of sustainability-linked financing products increases, the next challenge for borrowers and issuers will be standardization, to make it possible to compare the value of deals that cover different environmental and social impacts.

Borrowers, lenders and investors are eager to build the credibility of the market, but without standardization, the transparency and verifiability of ESG across products and sectors will remain challenging.

Moves are afoot to use international regulations and environmental conventions as the basis for ESG KPIs, rather than relying on an iterative set of internally generated practices.

The US Loan Syndications and Trading Association, Europe's Loan Market Association and the Asia Pacific Loan Market Association have all published a set of sustainability-linked loan principles, while the International Capital Market Association has issued a similar set of guidelines for sustainability-linked bonds. Ratings agencies Fitch and Standard & Poor's are also now including ESG assessments in their methodologies.

These guidelines are providing a foundation for best practice and control around the issuance of ESG-linked lending and will support a more uniform approach regarding the scrutiny and monitoring expected from borrowers. Standardization will also be driven by disclosure requirements as part of legal and regulatory obligations to reduce emissions and climate change risk or to ensure a responsible and ethical supply chain, for example.

Building a coherent and uniform set of standards will bring further credibility to the market and give borrowers that can demonstrate compliance access to additional pools of liquidity while also reducing financing costs.

Sustained SPAC surge reshaping capital structures

HEADLINES

■ 248 SPACs listed in 2020, raising US$82.6 billion—a more than six-fold rise on 2019 issuance ■ 362 SPAC vehicles raised US$110.2 billion in H1 2021 ■ 176 M&A deals worth more than US$386.1 billion have been completed via SPACs in H1 2021

By Rob Morrison, David Ridley and Sherri Snelson—partners, White & Case

Special purpose acquisition companies (SPACs) continued to top fundraising records through the first half of 2021 despite the market's pause for breath after Q1 2021.

After cresting at an all-time high of US$82.6 billion in 2020, global investor appetite for SPACs—blank check companies that raise equity on stock markets to invest in M&A transactions—showed no sign of slowing in 2021. By May of this year, the market had already surpassed last year's record, with 330 SPAC vehicles raising US$103.8 billion, according to *Dealogic*.

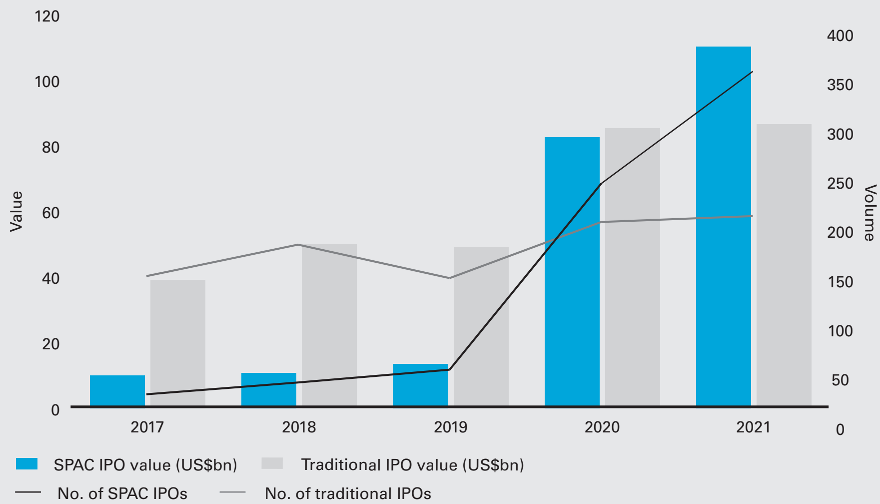
And while some of the heat has left the SPAC market recently—shares in some SPACs have fallen post-acquisition in recent weeks, as retail investors and institutions have traded out—the vast overhang of capital that has already been raised and is ready for deployment over the next two years will continue to generate deal flow for lenders and other M&A market participants through the rest of 2021.

The unprecedented levels of SPAC fundraising have already sparked a corresponding uplift in M&A activity involving SPACs. These vehicles typically have 24 months to either consummate an M&A transaction (known as a "de-SPAC," where the acquisition target merges into the SPAC to become the listed company) or return capital to investors. The market has already seen a wave of de-SPACs this year, with *Dealogic* recording 176 such deals worth in excess of US$386.1 billion.

Even with this rate of dealmaking, these de-SPAC deals trail the pace of new SPAC IPOs announced in Q1 2021, meaning there are many SPACs still seeking targets. This sets the stage for sustained high levels of dealmaking from SPACs through the rest of the year, with these vehicles being used more aggressively and pursuing deals quickly. According to PitchBook, the median time gap between a SPAC IPO and a de-SPAC reverse merger in 2020 was only seven-and-a-half months.

For debt markets, this wave of activity has opened up windows for companies to pay down debt. SPACs are also targeting ever-bigger deals which, in time, could see SPACs start to tap debt markets more actively to secure the financing needed to reach higher valuations.

US SPAC activity in H1 2021



Source: Dealogic

176

M&A deals worth more than US$386.1 billion were completed via SPACs in H1 2021

Sponsors and lenders ride the wave

In most SPAC deals in the market so far, however, companies have moved to either refinance or pay down debt, especially when the vendor is a PE firm that has used leverage in previous deal structures.

In many cases, Standard & Poor's has issued improved ratings or ratings outlooks for companies that have done deals with SPACs and reduced their leverage multiples post-transaction.

For example, the ratings agency lifted the credit outlook on hardware and home improvement company Hillman Cos from B-/CreditWatch stable to B-/Positive after the business reduced its leverage multiple from 8x to 4.5x following a SPAC deal.

Whole Earth Brands, meanwhile, saw its credit rating improve from CCC/Negative to B/Positive after post-SPAC deal debt reduction. Advantage Sales & Marketing, a marketing agency backed by buyout firms Bain Capital, CVC and Leonard Green & Partners, shifted from a CCC/Negative rating and outlook to B/Stable following a US$5.2 billion deal that reduced its leverage multiple from 7.3x to 4.9x.

SPAC deals have also allowed certain acquisition targets to take the opportunity to enter into new credit facilities, sometimes on improved terms.

After the announced acquisition by the Conyers Park II Acquisition Corp SPAC, for example, Advantage Sales & Marketing lined up new senior secured credit facilities comprising a US$2.1 billion term loan facility and a US$400 million asset-based credit revolver.

In another example, the acquisition of Platinum PE-backed data center cooling equipment manufacturer Vertiv by the GS Acquisition Holdings Corp SPAC—sponsored by Goldman Sachs and run by former Honeywell chief executive David Cote—saw Vertiv raise a US$2.2 billion term loan to refinance its existing term loan and high yield bonds. The new term loan was priced at LIBOR +3 percent—a margin 1 percent lower than that of its previous term loan.

Larger SPAC targets keep lenders in the mix

Although de-SPAC transactions see target companies take on public company listings, which usually infer lower debt multiples than in private market deals, the sheer volume of activity by SPAC sponsors, coupled with the fact that SPACs are aiming at ever larger target companies, could see lending markets play an increasingly important role in supplying financing to help SPACs reach target company valuations.

According to PitchBook, the size of target companies is expanding relative to the size of the SPAC after its IPO, reaching an average of 5.3x early in 2021. At the extreme end of the scale, there are cases like Grab, the Singapore-based Southeast Asian ride hailing app, which achieved a US$39.6 billion valuation after agreeing to a merger with Altimeter Growth Corp, a Nasdaq-listed SPAC. Altimeter Growth Corp only raised US$450 million when it listed as a SPAC.

To date, SPAC sponsors have primarily opted to bridge the gap to company valuations through private investment in public equity (PIPE) deals, where private investors club together to fund deals in companies about to go public. In the case of the Grab investment, for example, asset managers BlackRock, Fidelity and T. Rowe Price, along with Morgan Stanley's Counterpoint Global fund and Singaporean sovereign wealth fund Temasek, put together a US$4 billion PIPE to support the SPAC deal for Grab.

But as SPAC deal sizes increase, PIPEs could prove insufficient to bridge the gap to valuations alone—rollover equity as well as debt may be required.

Debt could also be increasingly used in SPAC deals to refinance a target's existing borrowings, top up balance sheets, cover fee costs or make distributions to shareholders.

Software company E2Open, for example, agreed to a US$2.5 billion SPAC merger and then went to market to raise a US$525 million term loan B and a US$75 million revolver for these purposes, according to S&P.

Distressed companies open the liability toolbox to avoid full-blown bankruptcies

HEADLINES

■ Announced US corporate bankruptcies climbed to 630 cases in 2020, according to Standard & Poor's—up from 2019 levels, but still lower than expected ■ Bankruptcies ticked higher early in 2021—from 14 cases in January to 23 cases in March, before dropping to 11 in June—but are still well below 2020 levels according to *Debtwire Par* ■ Covenant relief and uptiering, as well as drop down deals and other liability management structures have offered companies a variety of levers to pull to avoid entering bankruptcy situations

By Rob Bennett, Harrison Denman, Jonathan Michels, Rafael Roberti and Justin Wagstaff—partners, White & Case

Management teams and private equity (PE) sponsors have successfully deployed a range of liability management tools to steer companies through the COVID-19 downturn and avoid both bankruptcies and full-blown restructurings.

According to Standard & Poor's, US corporate bankruptcies climbed from 580 in 2019 to 630 in 2020. Although volumes did rise, the number of bankruptcies came in significantly lower than anticipated, and well down from the 819 recorded in 2010 in the aftermath of the global financial crisis.

Although *Debtwire Par* figures show an uptick in bankruptcy filings from 14 cases in January to 23 in March 2021, volumes are still low year-on-year. Monthly bankruptcy totals consistently exceeded 25 in the first half of 2020, pushing to as high as 40 cases in July 2020 and 37 cases in May 2020.

Holding firm

The relatively benign levels of bankruptcies reflect a combination of factors that have favored distressed companies, giving them time to manage their liabilities without resorting to bankruptcy.

One major factor that has helped borrowers navigate COVID-19 volatility is that the lion's share of outstanding debt has been issued with covenant-lite terms. A covenant-lite loan has fewer covenants to protect the lender and fewer restrictions on the borrower regarding payment terms, income restrictions and collateral (e.g., no maintenance covenants that default due to deterioration of financial performance alone). According to Standard & Poor's, more than 80 percent of the S&P/LSTA Leveraged Loan Index (which tracks the performance of the largest US institutional leveraged loans) is composed of covenant-lite loans—compared to a share of just 15.5 percent at the end of 2008. This offered much-needed breathing room to companies that saw earnings flatline and leverage multiples mushroom during the pandemic, developments that would have tripped financial maintenance covenants if not for covenant-lite terms.

23

Bankruptcies in the US climbed from 14 cases in January 2021 to 23 in March, but are still below the levels seen in 2020

Even debt instruments that continue to have financial maintenance covenants—primarily pro rata revolving credit facilities and amortizing loans that are held by banks post-syndication—have been able to obtain covenant relief from lenders to help them through this volatile period. But this relief has often come at a cost.

According to Standard & Poor's, by the end of April 2021, there were 15 covenant relief deals, which is consistent with pre-pandemic levels. Although less than half the number of covenant relief deals observed over the same period last year, the option has remained open for borrowers even as capital markets have rebounded and, in fact, thrived post-pandemic.

When borrowers have pushed up against potential breaches of financial maintenance covenants, lenders that agreed to offer covenant relief typically did so in return for newly inserted liquidity-based covenants that required borrowers to share cash-flow projections of up to 13 weeks with lenders, as well as hold lender calls to outline financial performance expectations, and maintain certain minimum liquidity levels.

Dropping down and uptiering

Even borrowers that have been running out of cash and have not been positioned to raise additional capital have used innovative tools to avoid bankruptcies, de-lever their balance sheets, reduce their overall interest expense and extend their debt maturity profiles.

Companies facing various pandemic, industry and other headwinds have taken advantage of flexibility in documentation through so-called "asset drop down" and "uptiering" deals.

Asset drop down transactions (which often use flexibility found through using unrestricted subsidiaries) have seen borrowers use flexibility present in their existing debt documentation to transfer valuable assets and collateral out of the restricted group that benefits the senior secured creditors. In these deals, assets (often intellectual property) have been transferred into new "unrestricted" subsidiaries that can raise additional debt using those assets as collateral, or can be sold without the restrictions imposed by existing debt documentation.

Lenders have been moving, as and when opportunities arise, to shut down this flexibility through unrestricted subsidiary blocker terms, which provide that certain "core" assets are prohibited from being transferred to unrestricted subsidiaries. But, over the past 12 months, borrowers have nonetheless been able to bring in additional liquidity by using drop down flexibility.

In uptiering deals, meanwhile, borrowers have structured transactions pursuant to which they offer certain existing senior creditors the opportunity to exchange some debt instruments (often at a discount to par) for new instruments that layer into new structurally senior positions in the capital structure. This has proven an effective way for borrowers to reduce leverage and improve their liquidity profiles by reducing debt service, while also extending their debt maturity profiles to provide additional runway to navigate challenging industry landscapes. However, in some instances, this has triggered litigation in US courts by lenders that were excluded from this uptiering.

As has been the case with asset drop down deals, lenders are zeroing in on terms in new deals, and in the context of amendment and waiver discussions, to block uptiering.

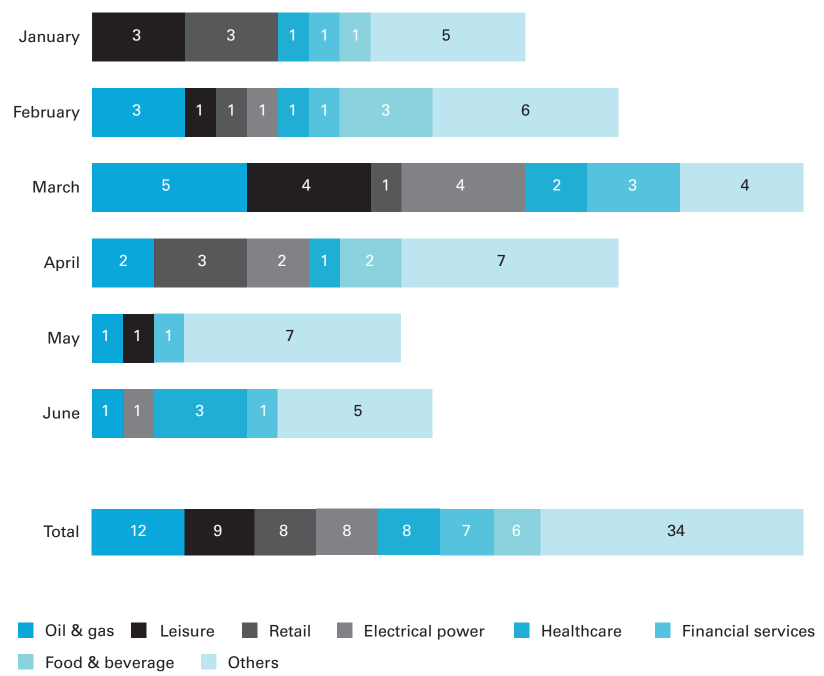
Uptiering and drop down deals have proven valuable tools for borrowers but, as capital markets have recovered, borrowers have not had to turn to these options as frequently. Borrowers that have not benefited from this recovery, but whose tools have been locked away through blocker provisions, continue to seek ever-more creative options to raise liquidity—which may account for the recent rise in interest for preferred equity structures.

A big rebound in secondary prices for debt has reduced the opportunity to capture discount through uptier transactions.

In June 2020, the average price for debt in the secondary loan market was trading at 85.51 percent of par. In June 2021, prices averaged 97.95 percent of par. High volumes of refinancing activity have also given borrowers greater flexibility to extend maturities and lower financing costs.

Innovative structures that use the flexibility found in debt documentation have provided, and will continue to provide, valuable tools that distressed companies can deploy to manage their balance sheets through challenging market backdrops.

Bankruptcy cases filed in the US by sector (H1 2021)



Source: *Debtwire Par*

> **Even borrowers that have been running out of cash and have not been positioned to raise additional capital have used innovative tools to avoid bankruptcies, de-lever their balance sheets, reduce their overall interest expense and extend their debt maturity profiles**

Energy transition: How to finance the race to net-zero

HEADLINES

■ Green bond issuance climbed 13% in 2020, to US$305.3 billion ■ Global energy investment will have to increase more than three-fold to US$5 trillion by 2030 if net-zero carbon emissions are to be achieved by 2050 ■ At the start of 2021, renewables accounted for more than 20 percent of total energy generation capacity in the US, surpassing the use of coal

By Mark D. Holmes and Elena Maria Millerman—partners, White & Case

Global momentum behind the fight against climate change has never being stronger, as governments and energy companies around the world make ambitious pledges to reduce carbon emissions to net-zero by 2050.

The US, under the administration of President Joe Biden, has taken a leading role in the race to net-zero by putting an ambitious program in place to facilitate the country's energy transition away from hydrocarbons to renewables.

On his first day in office, President Biden signed the US back on to the Paris Agreement, the international climate change treaty signed in 2016. The Biden administration subsequently outlined targets to deliver a 50 percent to 52 percent reduction in net greenhouse gas emissions from 2005 levels by 2030 and to have a carbon-free power sector by 2035, on the way to achieving net-zero carbon emissions by 2050.

20%

Renewable energy sources now account for more than 20% of the total energy generation capacity in the US

Finding finance

The technology required to facilitate energy transition is developing at an accelerating pace, with huge strides in renewables, battery storage, electric vehicles, carbon capture, green hydrogen and energy efficiency technologies. But these technologies require a significant financial outlay to scale at the pace required to meet the net-zero 2050 timetable and retrofit existing hydrocarbon infrastructure to cover demand from renewable sources.

The government balance sheet will be an essential source of funding but given the size of investment required, private investors will have to step in to cover the funding needs.

According to the International Energy Agency (IEA), which outlined a roadmap to achieving net-zero, annual global energy investment will have to reach US$5 trillion by 2030, a more than three-fold increase on the US$1.52 trillion of global energy investment recorded by the IEA in 2020.

For private investors and energy companies, many of which have significant sums of capital locked up in hydrocarbon infrastructure, maintaining market returns while simultaneously reorienting to green energy provision poses a major challenge.

Private markets, driven by investor demand, have already begun to pivot in this direction. The issuance of green bonds raised specifically for climate-related and sustainability projects increased by 13 percent to US$305.3 billion in 2020, according to Bloomberg. In April 2021, ratings agency Standard & Poor's forecasts that issuance of sustainability-linked debt instruments (credit facilities not linked to specific projects, but which incentivize compliance with key performance indicators relating to sustainability) will climb by more than a third in 2021, reaching more than US$200 billion in total.

These already burgeoning markets, however, will have to grow at far faster rates to cover the net-zero fund requirements. What makes this particularly challenging is that much of the investment will have to be in still nascent renewable and carbon-free energy technologies. According to the IEA, by 2050, almost half of the reductions in hydrocarbon usage will have to come from technologies that are still in the early stages of prototype development.

Risk and reward

Investors see significant potential for strong returns from investments in renewables and green energy, and commitments to net-zero targets offer opportunities to benefit from these rapidly growing industries.

The expansion of now established renewable energy sources such as solar and wind—both of which are now as competitively priced and commercially viable as hydrocarbon energy—serves as a blueprint for these growth opportunities.

According to a *Forbes* analysis of the most recent BP Statistical Review of World Energy, the renewable energy sector has quadrupled in size over the past decade and is the only energy vertical to have shown double-digit growth during this period.

Investing in solar or wind is now no riskier than investing in any other energy source, which gives investors comfort and the confidence to deploy.

Investing huge sums of capital upfront in newer technologies

and infrastructure, such as hydrogen, however, represents a very different risk-reward dynamic. There are no established customer bases for these energy sources, and they feature long lead times before an investment may start to return capital.

This is where governments have a role to play by investing in upfront R&D to develop proofs-of-concept for new technologies, sharing risk for investment in green energy infrastructure and supporting the formation of new renewables markets through clear policy and regulation.

If their private capital is to be released into the market, developers and investors need a clear long-term policy vision for how the energy transition will progress, as well as the assurance that governments will not change direction.

The US government and regulators have put a variety of measures in place to support renewable energy development and mitigate the risks posed by these projects. These include a federal government renewable portfolio standard, which mandates that a percentage of electric power sales in states come from renewable energy sources; feed-in tariffs, where the government covers any price differentials between new renewable sources of energy and established energy supplies; and renewables R&D grants.

Renewable energy consumption in the US surpassed coal for the first time in 2019, according to the US Energy Information Administration. Early in 2021, the Federal Energy Regulatory Commission reported that renewables now represent more than 20 percent of total energy generation capacity in the US. This demonstrates that governments can play a role in creating new commercially sustainable industries, and corral private sector investment.

Governmental measures will be essential to encourage private sector investment into new renewable energy technologies and projects, and to achieve the ambitious targets for a net-zero future.

Direct lending in the US is in good shape post-COVID-19

HEADLINES

■ North American private debt fundraising increased by 15.8 percent in 2020 despite falling fundraising in other jurisdictions ■ The private debt default rate never rose above 2 percent in 2020 and was lower than high yield bond and leveraged loan default rates ■ Current private debt yields of 7 percent are outpacing high yield bonds and leveraged loans

By David Bilkis, Eric Klar, David Ridley and Jacob Schtevie—partners, White & Case

After a volatile and challenging year, US direct lenders moved into 2021 with reputations enhanced and teams strongly positioned to fund new deals. But we cannot discuss current direct lending in the US without casting a slightly wider net for comparison.

According to data collected by Preqin and analyzed by McKinsey, global private debt fundraising (where direct lending represents the largest amount of capital) fell by 6.7 percent to US$124.4 billion in 2020, as COVID-19 saw investors put commitments to new funds on hold. The North American market, however, bucked the global trend, with private debt fundraising up 15.8 percent year-on-year at US$79.8 billion.

This growth in private debt fundraising is conclusive evidence that the North American direct lending space has matured into a credible, established industry, able to operate through credit cycles.

Despite pandemic disruption, private debt markets have continued to benefit from the long-term regulatory trend following the 2008 global financial crisis, according to McKinsey. Regulatory developments established post-crisis constrained traditional bank lending channels and gave non-bank direct lenders an opportunity to win market share and expand their franchises. A prolonged period of low interest rates and dovish monetary policy have also supported the direct lending industry's growth.

Private debt portfolios also appear to have been less impacted by pandemic volatility. As private credit assets are not traded publicly and held in closed-ended fund structures, they are less exposed to market volatility.

This idea is reinforced by a Q1 2021 research note from private markets investment platform Adams Street, finding that private debt default rates never rose above 2 percent in 2020, while leveraged loan and high yield bond default rates came in at around 4 percent and 10 percent respectively.

US investment manager Nuveen notes further that, as the market for private credit investments is illiquid, managers in the space have also taken a more conservative approach to credit risk. Unlike high yield bond and leveraged loan investors, who have the flexibility to trade out of underperforming assets as required, private credit managers follow "buy-and-hold" strategies, which has seen them show a proclivity for funding deals in defensive, asset-light sectors.

In addition, private credit managers often align with borrowers backed by private equity (PE) firms with specific industry/operational expertise, which adds a layer of downside protection.

Private debt funds, however, have not only proven effective at mitigating downside risk. Managers have also continued to deliver returns for investors. According to Adams Street, private debt funds have produced current average yields of approximately 7 percent, versus average yields of 4.73 percent for high yield bonds and 4.61 percent for leveraged loans.

7%

According to Adams Street, private debt funds have produced current average yields of around 7%, versus average yields of 4.73% for high yield bonds and 4.61% for leveraged loans

Perfect positioning

As the US economy has reopened, direct lenders have shifted attention and resources back to new deals and are well-placed to continue securing new deal flow and deliver superior returns to other fixed income classes.

According to Nuveen, the potential pipeline of transaction opportunities for private debt managers looks promising. The ratio of dry powder held by PE firms (the primary users of private debt capital) versus private debt funds sits at 5:1. As private market M&A deals are typically structured with debt of between 50 percent and 75 percent of total pro forma capitalization, the ratio of debt dry powder versus PE dry powder would have to shift to between 1:1 and 1:4 before there was any risk of private debt market saturation. All of which means post-pandemic supply-demand dynamics still favor private debt managers.

Furthermore, Nuveen's analysis notes that, while the COVID-19 downswing is very different from other economic downturns, private debt vintages launched in downturns have historically outperformed other years, with 2001 and 2009 being the two best-performing private debt years on their record to date.

The growth in private debt assets under management has also meant

that direct lenders have been able to compete for credits that would otherwise have defaulted to either the syndicated loan or high yield bond markets.

Some direct lenders have the capacity to digest credits of up to US$1 billion or form lending clubs with each other that can cover check sizes of up to US$3 billion.

Direct lending has served as an attractive option for borrowers, especially PE sponsors, due, in part, to the speed of execution of direct lending transactions and the fact that pricing and other terms applicable to these transactions are not subject to modification due to market flex provisions.

In addition, PE sponsors appreciate the simplicity of working with a single or small group of lending counterparties rather than a large mix of lenders in a leveraged loan syndicate.

Competing with the syndicated loan and high yield bond markets means direct lenders have had to tighten the pricing of their loans and, in some cases, lend on covenant-lite terms, which until now has not been a feature of direct lending documentation in the core mid-market.

The active selection of credits and PE-backed borrowers by direct lenders, the large sums of liquidity at their disposal and the resilience of their portfolios following the pandemic period, however, suggest that direct lenders are well positioned to continue expanding their platforms and take on increasingly large tickets in the year ahead.

Conclusion

Refinancing, repricing, M&A and buyout activity all surged in the early months of 2021, but then lenders shifted gears in pursuit of yield and borrowers realized they could tap the market for more than just liquidity. Where will this fork in the road lead for the rest of 2021?

On the face of it, there's every reason to be optimistic about 2021. Leveraged loans and high yield bonds posted strong numbers in the first six months of the year, with both up year-on-year. There was an uptick in new money deals as companies pursued growth opportunities. CLO new issuance more than doubled year-on-year. And an anticipated wave of defaults, bankruptcies and full-blown restructurings failed to emerge, as companies were able to find the financing they needed to see them through the worst of the pandemic.

At the same time, it's clear that the market isn't quite back to business as usual. For example, while there was a flurry of leveraged loan issuance in February (US$159.3 billion), March (US$174.8 billion) and April (US$147.2 billion), activity was down by more than a third in May to US$86.5 billion.

This slight pause is likely to be temporary, as companies strive to find their footing in a post-COVID-19 recovery, but it also means that lenders and borrowers alike are keeping a close eye on where markets are heading.

Big deals

One clear indicator of the state of the market has been the resurgence in financing earmarked for M&A and buyouts, with both leveraged loans and high yield bonds. For example, in Q2 2020, leveraged loan issuance was applied to just 47 M&A deals (excluding buyouts). By Q2 2021, that figure had more than doubled, reaching 97 deals.

It was a similar story for high yield bonds, with issuance for M&A (excluding buyouts) jumping from US$7.1 billion in Q1 2021 to US$22.9 billion in Q2 2021.

Even more notable are the jumbo LBO deals that have gone through in the first half of the year, including one of the largest on *Debtwire Par* record. Overall, LBOs have reached historical highs in the US—deal count for the first quarter of the year (709) set a record and deal value in the second quarter (US$236.7 billion) was the highest since the second quarter of 2007, according to *Mergermarket* data.

It seems private equity (PE) dry powder is finally being spent, as firms chase higher yield deals, spurred on by the threat of rising inflation as well as the availability of inexpensive financing. The fact that several PE houses closed sizable funds in Q2 2021 suggests that we can expect even more LBO activity in the months ahead, which will have a clear impact on issuance.

A more sustainable approach

Another high-profile factor that is likely to influence debt markets is the rise in environmental, social and governance (ESG) criteria being applied to leveraged finance.

The Biden administration has brought climate change back into the spotlight and, while implementing policy changes may be an uphill battle for the president, more and more lenders and borrowers have already been adapting to this new world in their deals.

Green bonds and sustainability-linked bonds and loans have all attracted interest. ESG ratchets—which cause margins on loans to rise or fall depending on whether agreed ESG targets are met—are being added to leveraged loans and revolving credit facilities.

50%+

At the halfway point in 2021, leveraged loan issuance was up more than 50% on the year before

Major PE firms are launching ESG-linked subscription lines, which are used by PE to fund their deals. Standardization and regulation still must be addressed when it comes to ESG and leveraged finance, but all of this points to a more sustainable future in debt markets.

The road ahead

While it is impossible to say exactly where the current path will take leveraged finance markets for the rest of the year, there is no denying that companies are trying to thrive, not merely survive, and lenders are happy to finance those efforts, for the right price.

There is also a light at the end of the COVID-19 tunnel, as the vaccination roll-out continues and lockdown measures are reduced, which is also encouraging borrowers to look beyond liquidity concerns.

But there are still unknowns on the horizon. Inflation and the threat of rising interest rates are already driving issuance to a degree, and the potential impact of the end of the COVID-19 federal relief package in the next few months may be cause for concern. At the same time, President Biden's "Build Back Better" plans, with sweeping investment in everything from infrastructure to job creation, will no doubt influence the direction of travel for debt markets, as they encourage growth and support businesses hoping to move beyond the pandemic.

Time will tell how these various influences play out, but for now, it looks like the bends in the road ahead may be straightening out at last.

WHITE & CASE

Phil Abelson
T +1 212 819 8903
E philip.abelson@whitecase.com

Rob Bennett
T +1 212 819 8249
E rbennett@whitecase.com

David Bilkis
T +1 212 819 8413
E dbilkis@whitecase.com

Joseph Brazil
T +1 212 819 8401
E jbrazil@whitecase.com

Harrison Denman
T +1 212 819 2567
E hdenman@whitecase.com

Binoy Dharia
T +1 212 819 8260
E bdharia@whitecase.com

Brenda Dieck
T +1 213 620 7717
E bdieck@whitecase.com

Rebecca Gottlieb
T +1 212 819 8802
E rgottlieb@whitecase.com

Will Guerrieri
T +1 312 881 5429
E william.guerrieri@whitecase.com

Mark D. Holmes
T +1 713 496 9715
E mark.holmes@whitecase.com

Gary Kashar
T +1 212 819 8223
E gkashar@whitecase.com

Elizabeth Kirk
T +1 212 819 7822
E ekirk@whitecase.com

Eric Klar
T +1 305 995 5296
E eklar@whitecase.com

Eric Leicht
T +1 212 819 8796
E eleicht@whitecase.com

Eliza McDougall
T +1 212 819 2590
E emcdougall@whitecase.com

Jonathan Michels
T +1 212 819 8661
E jmichels@whitecase.com

Elena Millerman
T +1 212 819 8977
E elenamaria.millerman@whitecase.com

Stephen Moeller-Sally
T +1 617 979 9324
E ssally@whitecase.com

Rob Morrison
T +1 213 620 7707
E rmorrison@whitecase.com

Daniel Nam
T +1 212 819 8542
E dnam@whitecase.com

Gregory Owens
T +1 212 819 7832
E gregory.owens@whitecase.com

David Ridley
T +1 212 819 8771
E dridley@whitecase.com

Rafael Roberti
T +1 212 819 7589
E rafael.roberti@whitecase.com

Jake Schtevie
T +1 312 881 5465
E jacob.schtevie@whitecase.com

Sabrena Silver
T +1 212 819 7056
E sabrena.silver@whitecase.com

Sherri Snelson
T +1 212 819 8430
E sherri.snelson@whitecase.com

Justin Wagstaff
T +1 212 819 2694
E jwagstaff@whitecase.com

Andrew Weisberg
T +1 212 819 8980
E aweisberg@whitecase.com

Francis Zou
T +1 212 819 8733
E fzou@whitecase.com