US leveraged finance: Navigating choppy waters

Borrowers and lenders are seeking new opportunities in the face of growing market volatility

Contents

Foreword

After cresting record levels of activity last year, US leveraged finance markets slowed in the first half of 2022 as lenders and borrowers adapted to a rapidly shifting geopolitical and macro-economic backdrop—deals continued to be done, but stakeholders reset expectations as debt costs rose and investors became increasingly risk-averse.

US leveraged loan markets are in a very different place than they were just six months ago. Since the beginning of the year, lenders and borrowers have been forced to contend with soaring inflation, rising interest rates, supply chain constraints and an increasingly volatile geopolitical backdrop following events in Ukraine. The contrast with the frenetic levels of activity observed in 2021—characterized by abundant capital, low pricing and buoyant refinancing—is stark.

Macro-economic headwinds took their toll on activity levels. Leveraged loan issuance dropped by a fifth year-on-year in the first half of 2022. The impact was even more pronounced in the institutional loan issuance space, which was down by almost two-thirds on the same period in 2021, as increasingly risk-averse investors tapped the brakes. Some issuers that would have otherwise dipped their toes into leveraged loan markets opted to hold fire instead and await calmer waters.

In the face of these challenges, however, there have been positives. Cash-rich private equity firms continue to close deals and secure financing, cushioning the dip in year-on-year new money issuance. Loan issuance intended for buyouts, while suffering some decline, has also proven resilient. Collateralized loan obligations (CLOs)—the largest investors in leveraged loan assets—have also remained active, even as supply in the primary loan market dried up.

Even as markets take a moment to pause and recalibrate, the door remains open for issuers to secure financing on good terms from debt investors who are eager to put funds to work.

High yield, high costs

For high yield bonds, various headwinds, including rising inflation and interest rates, created a challenging market landscape for fixed rate instruments in the first half of the year. High yield bond issuance dropped to levels not seen since the start of the pandemic, falling by more than three-quarters year-on-year as cautious investors stepped back. According to Lipper funds data, in the first half of 2022, almost US$30 billion left the asset class.

Even in the face of volatile market conditions, stronger high yield issuers have kept a close eye on pockets of opportunities. More than a dozen others have joined the fray since, capitalizing on an improved landscape in June to bring new deals to market. These include Tenet Healthcare, which raised US$2 billion in senior secured notes, and Kinetik Holdings, which priced US$1 billion in senior unsecured notes. Both issuers raised the capital for refinancing.

As we enter the second half of the year, volatility is likely to continue weighing on the market, but investors and borrowers are already adjusting. Activity levels may not hit the buoyant highs of a year ago, but stronger credits should continue to secure investor support. There is no escaping the fact that costs have gone up for issuers accessing the more challenging markets, but patience, adaptability and nimble execution continue to be a successful formula when doing so.

Resilient US leveraged finance markets navigate volatile backdrop

HEADLINES

■ Leveraged loan issuance reached US$612.5 billion in H1 2022, down on the US$755.5 billion recorded in the same period in 2021 ■ High yield bond issuance also dropped, year-on-year, from US$267.6 billion to US$63.6 billion—though markets began to open again in June ■ Since January, the US Federal Reserve has raised interest rates four times, taking the benchmark federal-funds rate to a range between 2.25 and 2.5 percent

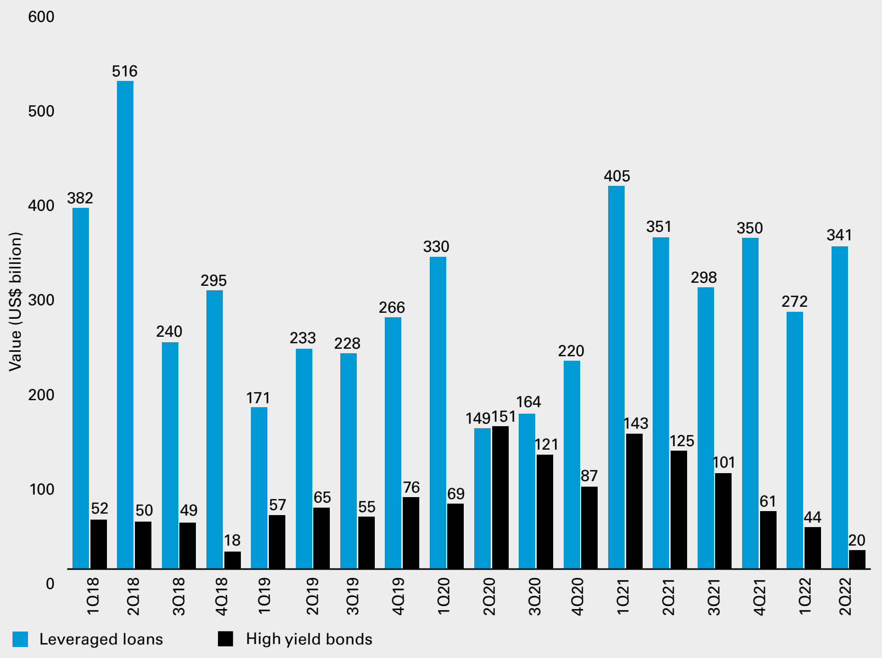
By Brenda Dieck, Eliza McDougall, Jonathan Michels and Justin Wagstaff—partners, White & Case

Issuance across US leveraged loan and high yield bond markets cooled in the first half of 2022, but the market has proven resilient in the face of rising interest rates, inflationary pressures and geopolitical headwinds.

After a frenetic period of activity in 2021, when issuance pushed up against all-time highs, spurred on by a post-pandemic bounce and bountiful liquidity, the market was already preparing to take a breath. The challenging macro-economic backdrop has given lenders and borrowers further reason to shift gears and adjust to the changing landscape.

As a result, issuance across US leveraged loan and high yield bond markets eased, with leveraged loan issuance dropping from US$755.5 billion in H1 2021 to US$612.5 billion in H1 2022 and high yield bond issuance dropping from US$267.6 billion to US$63.6 billion in the same period.

US leveraged loan versus high yield bond quarterly issuance (2018 – H1 2022)



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

Volatility upends status quo

In response to this volatility, cautious investors have pulled back from leveraged loans and high yield bonds in favor of safe haven assets like US Treasuries, which are providing higher yields as interest rates rise.

In the leveraged loan market, these factors contributed to some transactions being put on hold, including the proposed loans for Callaway Golf and Goodnight Midstream, while Covis Pharma sweetened its loan issuance with an issue price of 90 to help push a prolonged syndication process over the line.

US high yield bond markets issuance meanwhile, ground to a halt, particularly in the second quarter of the year. This prompted several issuers—including nutrition company BellRing Distribution and Tesla—to pull bond offerings from the market.

According to Bloomberg, approximately 80 companies

-19%

The decline in leveraged loan issuance in H1 2022 year-on-year

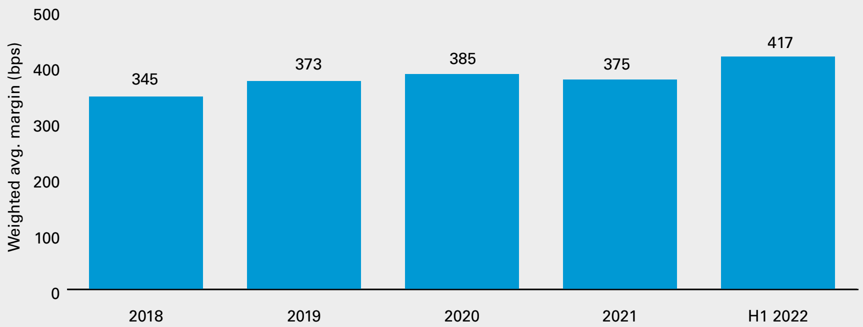
worldwide (with nearly half of them in the US) paused about US$25 billion worth of capital-raising plans between the last week of February and the last week of March.

Stubbornly high inflation and rising interest rates contributed to this abundance of caution.

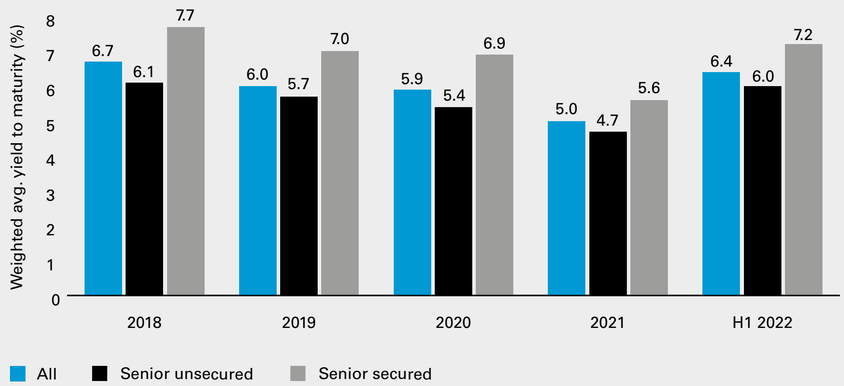
In March 2022, the US Federal Reserve approved its first interest rate increase in more than three years, raising rates by a quarter percentage point. At the beginning of May, the Fed proceeded with a 0.5 percentage point increase to its benchmark interest rate and outlined a program to reduce its bond holdings by US$95 billion a month. By June, as inflation reached a 40-year high, interest rates were increased by another 0.75 percentage points—the third increase of the year and the largest hike since 1994. This was followed by another 0.75 percentage point hike in July. More hikes are expected this year, with liquidity also expected to tighten as the US Central Bank reduces its US$9 trillion balance sheet.

There are positive signs, however, that high yield investors are adjusting to the shifting interest rate backdrop. In the first ten days of June, issuers secured US$5 billion in high yield funding (versus just US$4 billion for all of May). The pipeline of high yield deals at the time was healthy too, including a US$750 million note intended to back Brookfield's buyout of CDK. According to *Debtwire Par*, issuance reached US$8.6 billion by the end of June—still down on monthly averages, but more than double the issuance seen in May.

US institutional loan pricing (2018 – H1 2022)



US new issue high yield bond pricing (2018 – H1 2022)



Source: *Debtwire Par* – where yield to maturity available, US$ facilities only

Issuers recalibrate expectations and strategies

These profound changes in the market have prompted many issuers in the US to reassess their capital requirements as well as their financing strategies.

Higher pricing has seen several borrowers kick planned issuance down the road into the second half of 2022 or even 2023. With transaction volumes down, pricing has proven choppy, with little visibility on where the market will settle as pricing moves from week to week.

This unpredictability around pricing, combined with increasing flex and wider uncertainty, has seen more issuers turn to direct lending options, even for sizeable credits that would historically have defaulted to syndicated loan and high yield bond markets. (See "From rising costs to ESG ratchets: Five trends that will drive leveraged finance in 2022" for more.)

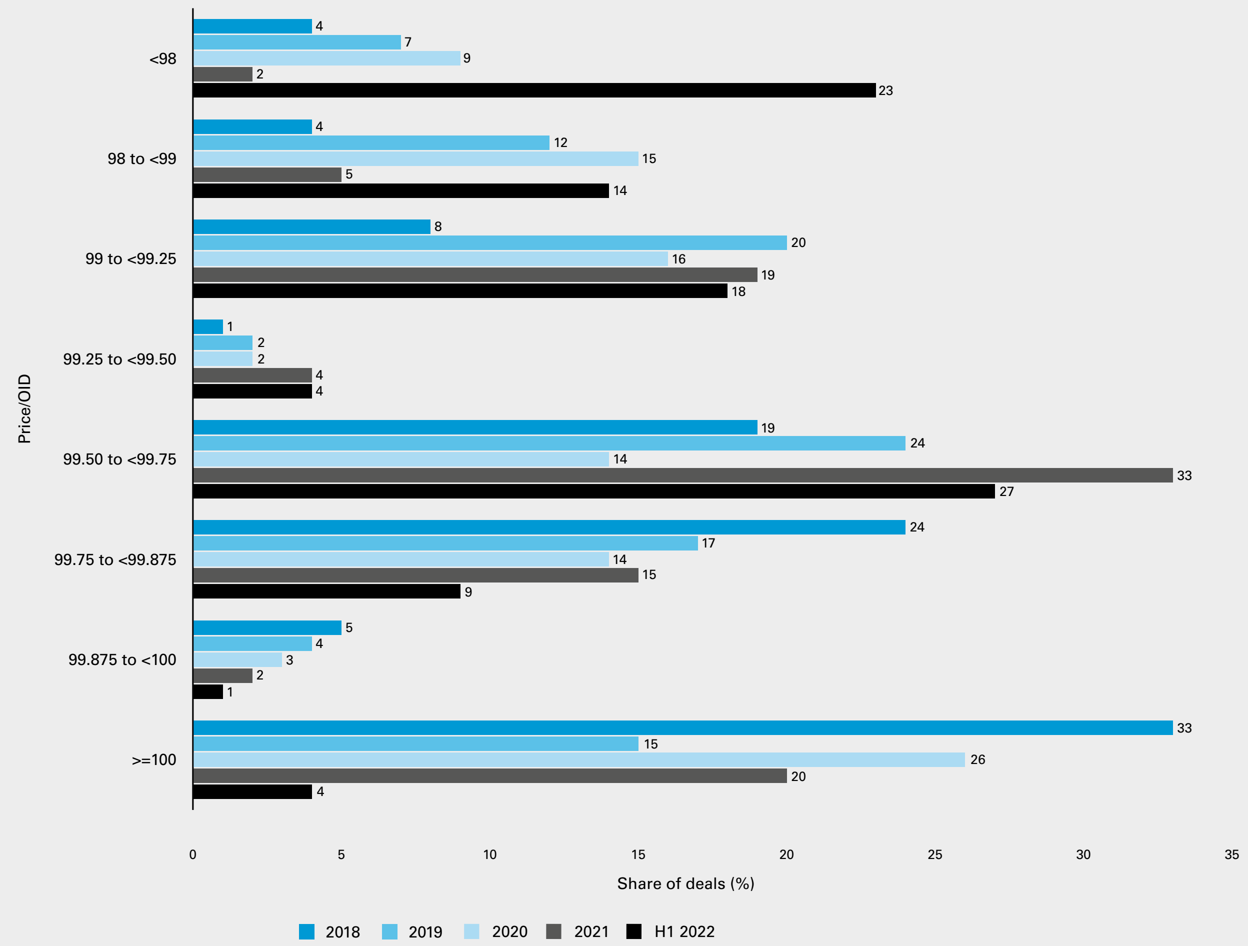
As the dry powder available to direct lenders has grown, they have been able to team up and fund increasingly larger transactions. While direct loans are typically more expensive than traditional loans, direct lenders have been able to win more deals in 2022 as they underwrite and hold debt themselves.

This puts direct lenders in a position to remove syndication risk and uncertainty for borrowers, placing them in a strong position to take market share from traditional leveraged loans and bonds.

The growing prominence of direct lenders has been especially strong on the financings of buyout deals. Private equity firm Thoma Bravo, for example, secured a US$2.6 billion financing package from direct lenders for its US$10.7 billion buyout of software company Anaplan, bypassing leveraged finance markets entirely, according to Pitchbook.

Another notable change in the market has been easing refinancing and repricing activity, which was

US original issue discounts (OIDs)* (2018 – H1 2022)



Source: *Debtwire Par*

*Based on universe of deals where OID data available

expected after the high volume of opportunistic activity observed in the first half of 2021.

Leveraged loan issuance for refinancings, repricing and amendments is down almost 30 percent year-on-year in 2022. High yield bond issuance for refinancings, meanwhile, dropped by more than 80 percent in the same period—Q2 2022 was the quietest quarter for high yield bond issuance for these purposes on *Debtwire Par* record.

In the first half of the year, investors have favored secondary markets, where the drop in prices for existing credits has offered attractive valuations, over refinancings.

According to *Debtwire Par*, the average prices for US high yield bonds trading in the secondary market have gone from a high of 3 percent above par in January down to 85.58 percent of par in June. This represents the biggest shift in pricing since the most uncertain period of the pandemic in May 2020.

In loan markets, meanwhile, weighted average bids in the secondary market shifted from 97.72 percent of par in January to 91.48 percent of par by the end of June.

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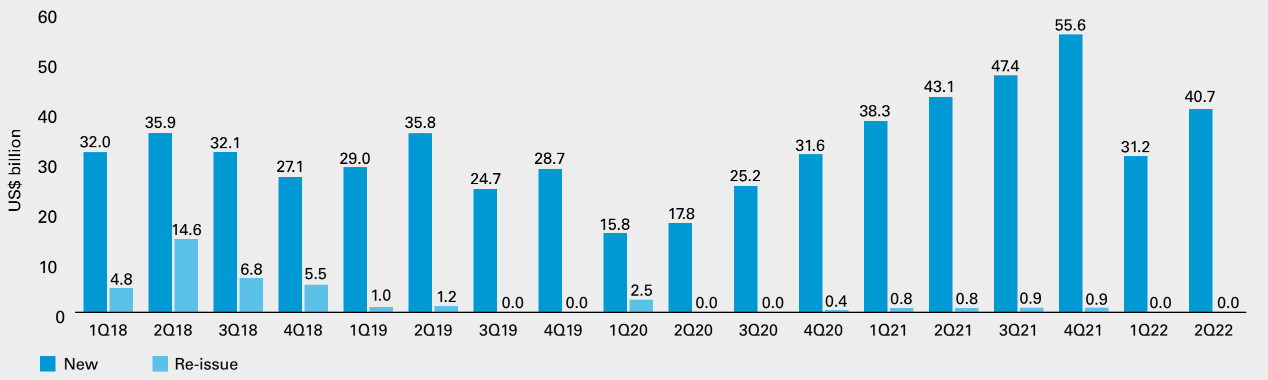
According to *Debtwire Par*, the average prices for US high yield bonds trading in the secondary market have gone from a high of 3 percent above par in January down to 85.58 percent of par in June.

US CLO quarterly new issuance versus re-issuance (2018 – H1 2022)



Source: *Creditflux*

For loan and bond issuers, the fallout of lower pricing in secondary markets has meant higher pricing for new primary issuance.

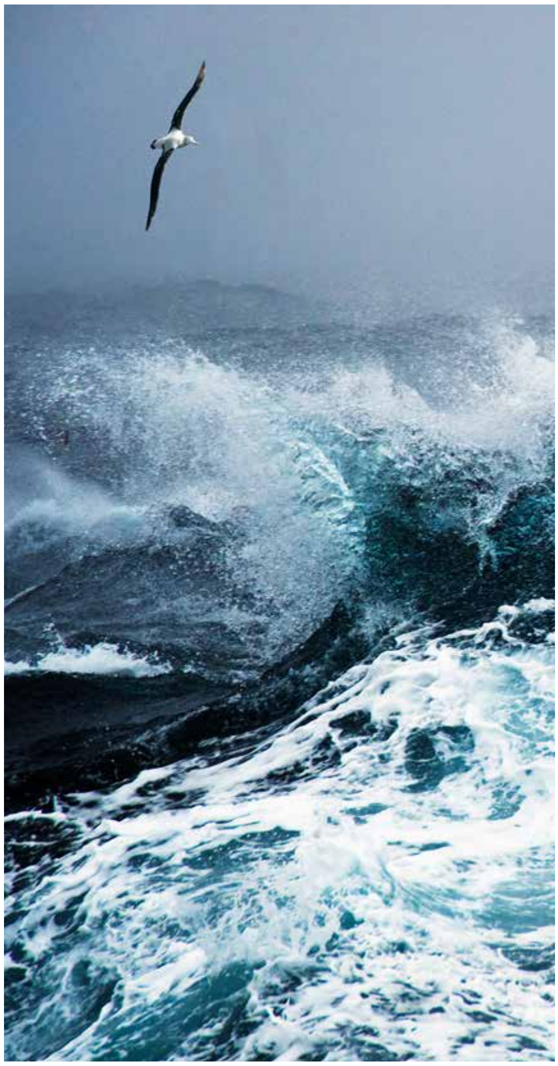
According to *Debtwire Par*, average margins on US institutional loans widened from 3.73 percent in Q4 2021 to 4.31 percent in Q2 2022. In the high yield market, the weighted average yields to maturity on senior secured and senior unsecured high yield bonds widened from 5.85 percent and 4.79 percent in Q4 2021, respectively, to 8.46 percent and 7.89 percent by the end of Q2 2022.

In the loan space, more deals are also flexing in favor of lenders as borrowers face greater scrutiny in a tougher market. Pricing flex allows the arrangers of loans to adjust pricing in line with investor demand. Depending on market conditions, pricing can rise, requiring borrowers to pay higher interest rates on loans, or fall, reducing borrowing costs.

Figures from *Debtwire Par* show that, in Q1 2022, there were roughly the same number of price flex increases and market-driven pricing decreases on execution. This represents a significant rebalancing of the market from the 94 downward adjustments and 22 upward flexes recorded during the same period a year earlier. In June, *Debtwire Par* recorded two upward flexes and one downward adjustment.

Issuers are starting to accept that debt has become more expensive. Used car retailer Carvana, for example, was able to price a US$3.27 billion bond to finance its acquisition of ADESA's physical auction business but had to offer investors a coupon of 10.25 percent to land the package. This compares to a bond the same company issued in August of last year at 4.8 percent.

With half of the year still to go, the outlook for the US leveraged finance market remains uncertain, as lenders and borrowers continue to adapt to a challenging market backdrop and expected ongoing volatility.



From rising costs to ESG ratchets: Five trends that will drive leveraged finance in 2022

HEADLINES

■ Pricing will increase, but issuers will continue to seek borrower-friendly terms and documentation ■ Lenders and investors will pause to assess the impact of inflation and ongoing interest rate rises ■ Direct lenders will take advantage of the volatile backdrop to grab market share from broadly syndicated leveraged loans and high yield bonds ■ ESG opportunities will persist, but lenders will ask more questions

By David Bilkis, Brenda Dieck, Brett Pallin, Jacob Schtevie, Kerrick Seay and Justin Wagstaff—partners, White & Case

The first half of the year has marked an inflection point for US leveraged finance markets. After a buoyant but brief post-pandemic period in 2021, the combination of surging inflation, rising interest rates and events in Ukraine put the brakes on US activity. Overall leveraged loan and high yield bond issuance for H1 2022 was down by 19 percent and 76 percent, respectively, year-on-year.

Moving into the second half of the year, lenders and borrowers will be looking for direction on debt pricing—specifically where it will settle after a volatile first six months—and the long-term impact of rising interest rates on investor appetite for riskier sub-investment-grade debt.

As the market navigates this uncertain period, the following five trends are expected to influence the shape of the market in the second half of the year.

1. Debt is going to become even more expensive

The era of historically low interest rates and abundant liquidity has come to an abrupt end, and borrowers will have to adjust to higher pricing as a result.

US inflation reached a 40-year high this year and the Federal Reserve has lifted benchmark interest rates four times in 2022—by 50 basis points (bps) in March and May and then by another 75 bps in July—laying out a roadmap for scaling back its bond holdings by US$95 billion a month.

The moves from the Federal Reserve and geopolitical uncertainty following events in Ukraine have driven an uplift in interest costs for high yield bonds and leveraged loans.

According to *Debtwire Par*, original issue discounts (OIDs) averaged 48 bps in January 2022, but jumped to 473 bps in June as the average issue price of new loans slid to 95.27 percent of par.

Investors still have cash to deploy but, with the Federal Reserve pulling back liquidity from the market and increasing rates, the direction of travel is firmly toward a higher cost of capital for borrowers.

2. Terms will remain borrower-friendly

Lenders and investors may secure higher pricing when backing new credits, but the borrower-friendly covenant-lite documentation that characterized deals through the red-hot run of issuance in 2021 may remain a feature of the market.

Financial sponsors have grown accustomed to covenant-lite terms, generous grower baskets and a degree of flexibility around unrestricted subsidiary structures and are likely to continue securing financing along similar lines.

Investors will remain focused on securing higher pricing as they adjust to the shifting risk backdrop, which means they will be less inclined to push back on terms.

At the same time, the quality threshold for credits and sponsors that can secure favorable documentation will be higher than ever. Credits with any wrinkles will find it difficult to lock in the same documentation as strong credits backed by blue chip sponsors.

3. Buyouts could continue to drive issuance

Buyout-linked financing activity will likely be an important driver of leveraged finance issuance in the second half of the year. Private equity (PE) firms with large war chests have continued to pursue deals in the first half of the year despite the challenging macro-economic landscape. According to Bain & Co., PE dry powder has reached record levels, pressuring financial sponsors to sustain deployment despite the uncertainty of the past six months.

As a result, the market has shown a consistent appetite for buyout deal financing, even as the market overall stalled—at the end of Q1 2022, leveraged loan and high yield bond issuance for buyouts was showing significant gains, year-on-year. Buyout loan issuance, in particular, has remained steady in H1 2022, year-on-year—a remarkable achievement at a time when every other category has seen significant decline.

Demand from buyout deals is likely to keep issuance ticking over in the months ahead.

4. Direct lenders will come to the fore

The slowdown in high yield bond and leveraged loan issuance in the first six months of 2022 opened a window of opportunity for direct lenders to fill in the gap and gain market share.

Unlike broadly syndicated leveraged loan and high yield bond markets, where loans are packaged by underwriting banks and sold down to investors, direct lenders hold credits through to maturity. This has proven highly attractive to borrowers—execution is swift and there is no syndication risk.

The growth in private debt dry powder also means that direct lenders have the financial muscle to fund jumbo credits. A rarity a few years ago, US$1 billion-plus credits funded by direct lenders are becoming increasingly common.

Pricing and covenant differences between direct lending and broadly syndicated leveraged loans are also narrowing. Direct lending finance has historically been more expensive, and covenants were tighter than broadly syndicated leveraged loan capital. Syndicated leveraged loan investors, however, are pushing for higher pricing and wider OIDs when backing loans, while some direct lenders have been willing to issue debt on covenant-lite terms for selected credits.

As pricing and terms between direct lending and broadly syndicated leveraged loans converge and the market remains choppy, direct lenders will be well placed to continue taking market share and provide a compelling alternative to syndicated loans and high yield bonds.

5. ESG issues will continue to dominate discussions, but lender scrutiny will intensify

The issuance of environmental, social and governance (ESG)-linked debt—financing where the interest payable is tied to the delivery of ESG targets—saw a four-fold increase to US$530 billion in 2021, according to Bloomberg.

Momentum behind ESG-linked debt has built further in 2022, particularly in the US market, and is now a consistent discussion point in loan and high yield bond negotiations.

As enthusiastic as lenders and investors are about providing ESG-ratchet structures in documentation, there has been a pause to reassess how ESG key performance indicators (KPIs) are set as well as their relevance to the credit. There is also a renewed focus on how ESG performance is benchmarked and independently verified, with lenders making certain that ESG-linked facilities are credible, and that greenwashing risk is minimized.

In a still nascent market, there has been divergence around how KPIs are selected and measured, but industry bodies are stepping in to provide guidance and frameworks for lenders and borrowers to follow.

The Loan Syndications and Trading Association, for example, recently released Guidance for Green, Social, and Sustainability-Linked Loans External Reviews, a document that outlines best practice on the external review process for borrowers, lenders and third-party assessors.

As more issuers look to include ESG ratchets in borrowing documentation, guidelines around ratchets and ESG reporting will become more rigorous and standardized. Borrowers will need to do more work to take advantage of the opportunity.

The fund finance market takes flight

HEADLINES

■ Fund finance activity soars as PE managers access facilities in ever-greater numbers ■ The market is positioned to grow seven-fold by 2030, reaching an estimated US$700 billion ■ Fund finance products are rapidly evolving from simple bridging facilities into increasingly sophisticated tools used for NAV and GP financing ■ New entrants are growing market and broadening provision to more PE sponsors

By Tom Falkus, Kerrick Seay and Sherri Snelson — partners, White & Case

Fund finance is positioned for record levels of growth as private equity (PE) general partners (GPs) tap traditional subscription and net asset value (NAV) financing lines in greater numbers.

This market—which began with simple bridge-type subscription lines—is rapidly developing into an increasingly sophisticated product, offering GPs a series of financing options at the fund level.

As fund finance offerings have evolved, more GPs have used the product and valued the liquidity it provides for portfolio companies and investors at key stages in the fund life cycle. This has driven up demand and encouraged new providers to enter the market alongside incumbent bank and alternative debt providers, making fund finance available to a wider pool of GPs.

Fund finance is also gaining traction across a wider set of private market funds as providers become adept at structuring collateral packages around the different profiles of various alternative asset strategies. Fund finance is now a regular feature in private credit, the PE secondaries market, real estate and buyout funds, with venture capital managers beginning to explore how the product could be used in their funds.

7X

17Capital forecasts show that NAV finance is on track to grow from US$100 billion today into a US$700 billion market by 2030

NAV financing spurs market growth

A primary driver of fund finance growth in recent years has been the development of NAV facilities, which enable GPs to borrow against the NAV of the assets held in their funds.

By borrowing against portfolio companies at the fund level, managers have been able to make distributions to their limited partners (LPs) earlier without having to exit crown jewel assets, and to provide additional financing to portfolio companies after fund investment periods have expired.

Managers and lenders have also found ways to use NAV facilities to enhance returns by back-levering assets, whether as part of the original acquisition financing or on a post-deal basis.

NAV facilities have been applied with increasing frequency in GP-led fund restructurings. In these GP-led deals, managers extend holding periods by shifting assets from a current fund into a new vehicle, giving LPs the option to roll their stakes or cash out. Secondaries investors (managers that trade stakes in private capital funds) funding these transfers are using NAV credit lines to finance a portion of their equity investments and boost returns.

With investment bank Jefferies recording growth of 94 percent in GP-led deals in 2021, there is strong underlying deal flow available to NAV lenders active in this area.

Such has been the growth of NAV financing that investors are now clamoring for exposure to the strategy. For example, 17Capital—one of the first NAV finance providers in the market—closed an inaugural NAV fund in April 2022 at a hard cap of €2.6 billion, well ahead of the €1.5 billion targeted by the firm on launch. 17Capital forecasts show that NAV finance alone is on track to grow into a US$700 billion market by 2030, up from US$100 billion today.

The bright prospects for NAV lending have been further underscored by the fact that asset manager Oaktree acquired a controlling stake in 17Capital earlier this year in a high-profile deal in the market.

As fund sizes and the market grow, NAV lenders will be able to finance larger portfolios and tailor loan-to-value (LTV) ratios to the particulars of the portfolio.

The typical LTV ratio for NAV facilities issued to portfolios has been between 20 percent and 30 percent, but higher LTVs are not unheard of. When it comes to back-levering deals with credit support from the relevant fund, LTVs can run substantially higher.

Ongoing innovation

The uptake of NAV funding lines, however, has not limited the pursuit of new and innovative developments among providers. Hybrid facilities, single fund and asset deals, and GP financing are some of the additions to the suite of fund finance options.

In hybrid facilities, the size of a fund finance package will be determined not just by the NAV

of a fund's portfolio, but also any uncalled commitments still available to the manager from LPs.

Structuring these deals has proven challenging due to the different types of collateral involved, but lenders have navigated the differing credit review requirements to lay on hybrid facilities across the life of a fund.

Lenders have also responded to the growth of special accounts and single-asset deals in private markets by tailoring loans for these situations.

For NAV and subscription lines provided to funds with a single LP, lenders have gotten comfortable with LP concentration by enhancing the due diligence process. Lenders have also taken a granular approach to appraising the creditworthiness of portfolios to provide NAV facilities to single assets within a portfolio, but not others.

These innovations are driving expansion in the uses of fund finance and the types of assets it can cover, and bodes well for the market's growth trajectory.

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The uptake of NAV funding lines has not limited the pursuit of new and innovative developments among providers. Hybrid facilities, single fund and asset deals, and GP financing are some of the additions to the suite of fund finance options.

Buyout issuance leads the way despite a choppy M&A market

HEADLINES

- In the US, buyouts totaling US$235 billion were announced in H1 2022, far above pre-pandemic levels, year-on-year, going back to 2007
- Loan issuance for buyouts climbed in the first half of the year, reaching US$94.5 billion
- High yield buyout issuance enjoyed a strong first quarter, hitting US$7.4 billion, before bond market activity decreased in Q2

By Christoffer Adler, Brenda Dieck, Rob Morrison, Brett Pallin and Justin Wagstaff—partners, White & Case

Lender appetite for US buyout opportunities remained resilient in the first half of 2022 despite a volatile macro-economic backdrop and a decline in activity across the wider leveraged finance market.

Loan issuance for buyouts came in at US$94.5 billion in H1 2022, up from the US$79 billion secured in what was already considered a red-hot market in H1 2021.

The high yield bond space did not fare quite as well, as inflation and climbing interest rates pushed many investors to find safer alternatives. After a very strong first quarter, in which there was US$7.4 billion in high yield bond buyout issuance—up more than 80 percent, year-on-year—the second quarter saw just US$1.7 billion in additional issuance for these purposes.

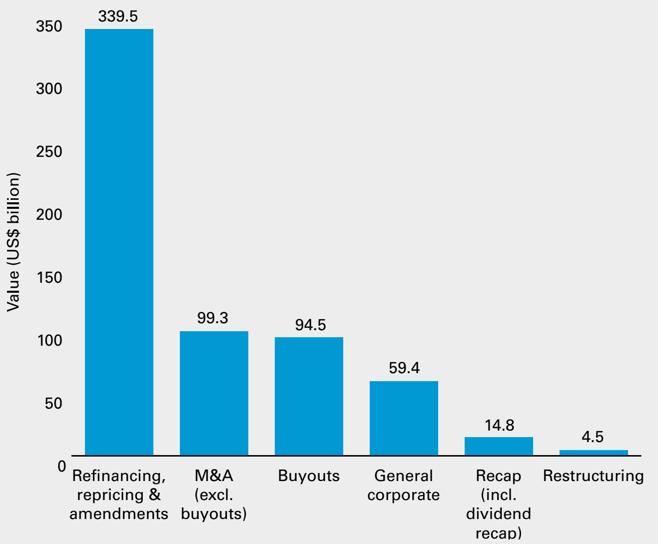
Despite a tougher market, buyout deals of significant scale were completed in the first half of 2022. In February, 3G Capital priced a US$5.36 billion-equivalent loan package to fund its buyout of window coverings manufacturer Hunter Douglas.

That same month, government contractor Amentum progressed with a US$2.26 billion term loan facility to finance its purchase of fellow contractor PAE from Platinum Equity and the Gores Group.

20%

Loan issuance for buyouts reached US$94.5 billion in H1 2022, up 20 percent year-on-year

US leveraged loan use of proceeds (H1 2022)



Source: *Debtwire Par*

Market looks for direction

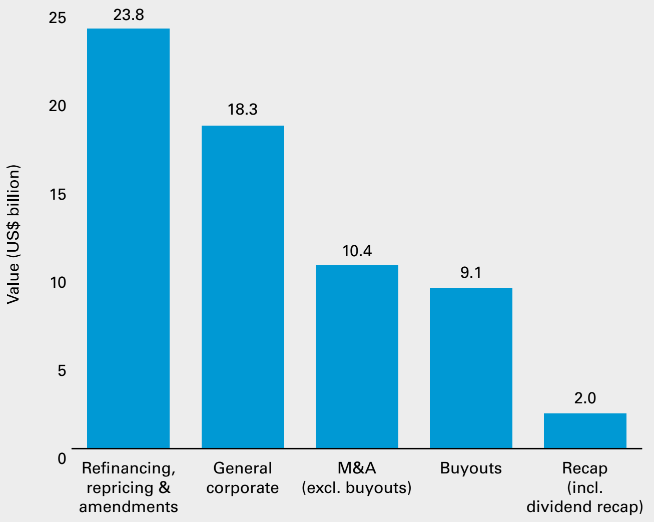
Loan and bond issuance linked to buyouts, however, has not been immune to market uncertainty sparked by events in Ukraine and rising inflation and interest rates. While buyout issuance figures recorded in the first half of 2022 look good, they benefited from a pipeline of deals launched in 2021 that closed in the first three months of 2022.

As geopolitical and macro-economic risk intensified, however, getting buyout debt packages over the line has become more challenging. Underwriting banks and institutional investors, as a whole, have taken a somewhat more conservative stance on funding highly leveraged, sub-investment-grade buyout credits.

Leveraged loan and high yield investors, meanwhile, are asking for higher pricing and wider original issue discounts (OIDs) to gain the necessary comfort against a shifting risk backdrop.

According to *Debtwire Par*, both average OIDs and loan margins have widened materially since the start of the year, and this pricing pressure can be seen in several

US high yield bond use of proceeds (H1 2022)



Source: *Debtwire Par*

deals that have closed in the first half of the year. For example, Syniverse Technologies completed a US$1.025 billion term loan B (TLB) to refinance debt in connection with the company's minority stake acquisition by Twilio. The TLB, due in 2027, priced at SOFR + 700 bps, up from initial guidance of SOFR + 500–525 bps.

Lightstone Generation completed an amend and extend of its US$1.463 billion TLB, pricing the TLB at SOFR + 575 bps—up 200 bps on the existing loans, which priced at LIBOR + 375 bps in 2018.

Dry powder may sustain buyout appetite

According to Bain & Co., private equity dry powder still sits at record levels, compelling buyout firms to maintain deployment. This has sustained buyout deal volumes even as wider M&A markets have cooled and may well drive additional buyout issuance in H2 2022 if financing sources come to the table.

While M&A deal value in the US, excluding buyouts, slid by more than 20 percent in H1 2022, year-on-year, buyouts worth US$235 billion were announced during the same period, according to *Mergermarket*—still far above pre-pandemic levels going back to 2007.

Even though leveraged finance markets have cooled, investors remain on the lookout for high-quality credits backed by familiar sponsors. Deals can still be financed, but the quality bar is higher, and financing is likely to be pricier.

Direct lenders gain prominence

The most significant shift in buyout deal financing since the start of the year, however, has been the growing prominence of direct lenders on deals of increasing scale.

Direct lending's roots lie in smaller, mid-market deals and packages characterized by higher pricing and tighter covenant packages. For jumbo deals, sponsors historically would almost always default to cheaper, more liquid leveraged loan and high yield bond markets, which also offered looser covenants.

In the past couple of years, however, the direct lending option has become increasingly compelling for financial sponsors in a volatile market, and this trend has accelerated in 2022.

Unlike leveraged finance markets, where banks underwrite loans and then sell down tranches to investors, direct lenders underwrite and hold credits. For sponsors, this removes syndication risk and delay, with direct lenders providing greater certainty of execution and terms.

Sponsors have also noted that the gap in pricing between the two products has narrowed. Direct lenders may ask for a higher price up front but, once OID and price flex in syndication are factored in, the gap in pricing is often minimal, with many sponsors finding that any direct lending premium is worth paying to remove syndication risk.

Direct lenders have also grown their assets under management in the past decade. With Preqin putting private debt dry powder above US$1 trillion (up from US$400 billion in 2008), these lenders have more firepower at their disposal and are capable of digesting much bigger credits.

It has become increasingly common for financial sponsors to run dual-track processes looking at both leveraged loan and bond options alongside what direct lenders can offer.

In some cases, buyout firms are bypassing syndicated loan and high yield bond markets altogether. In 2021, Thoma Bravo financed 16 of its 19 buyouts with direct lenders, according to *Reuters*. It secured a US$2.6 billion debt financing deal in March from a club of direct lenders, including Owl Rock Capital, Apollo Global Management, Golub Capital and Blackstone Credit, to fund its US$10.7 billion buyout of Bay Area software company Anaplan.

Direct lenders have also become more comfortable with providing financing on looser, more flexible terms tailored to borrower requirements for bigger deals. Sponsors pursuing buy-and-build strategies, for example, can turn to direct lenders for delayed draw term loans that allow borrowers to draw down cash over a long hold period to fund add-on acquisitions.

Despite a volatile and uncertain market, financial sponsors are finding that they still have several options available when it comes to funding deals.

ESG: A sustainable approach in turbulent times

HEADLINES

■ ESG-linked debt issuance reached record levels in 2021 before macro-headwinds slowed issuance levels ■ ESG-linked KPIs are increasingly a feature in debt structures ■ ESG debt facilities, historically more common in the European market, are expanding rapidly in North America ■ Lender and regulatory scrutiny of ESG compliance and benchmarking is intensifying

By Mark Holmes, Elizabeth Kirk, Daniel Nam and Sherri Snelson—partners, White & Case

Environmental, social and governance (ESG)-linked debt issuances have been negatively impacted in 2022 after reaching all-time global highs last year.

According to Bloomberg, by the end of April 2022, global sales of sustainability-linked loans had dropped by just under a third (32 percent), year-on-year, reaching US$91 billion. Sustainability-linked bond issuance during the same period fared better, rising more than 70 percent, year-on-year, to US$36.4 billion—although activity dropped off significantly between March (US$15.2 billion) and April (US$4 billion) as investors retrenched following events in Ukraine and an increased focus on greenwashing concerns in Europe.

Here to stay

Despite recent volatility, the outlook for growth in ESG-linked debt remains positive. Borrowers continue to successfully secure ESG and green finance. In May, for example, American Express raised US$1 billion for its first-ever ESG bond, with proceeds earmarked for improvements to its office energy efficiency, as well as investing in renewable energy and making a higher proportion of credit cards from recycled plastic.

Fighting climate change and pursuing the transition to sustainable energy sources have become key policy priorities for governments worldwide, while consumers and retail investors are paying closer attention to the environmental and social impact of their spending. These factors are driving private sector institutions to embed ESG criteria in capital allocation and investment decisions.

Challenges around inflation and energy prices have checked momentum to a degree, but the long-term direction points to ongoing integration of ESG into investment decision-making and a long runway for future growth of ESG debt issuances.

70%

By the end of April 2022, sustainability-linked bond issuance was up more than 70 percent, year-on-year, to US$36.4 billion

Is ESG becoming the new normal?

Among leveraged loan and high yield bond stakeholders, the emergence of sustainability-linked debt facilities has been a valuable tool for accelerating the ESG transition in debt markets.

Unlike green loans and bonds, where use of proceeds is limited to specific qualifying green projects (like renewable energy developments), sustainability-linked facilities have been available to all issuers across all sectors. Sustainability-linked debt puts a ratchet mechanism in place where the margin on a corporate loan or bond can move up or down depending on compliance with a set of pre-agreed ESG key performance indicators (KPIs). These KPIs are tied to the company's ESG goals rather than the features of a specific project being funded with the proceeds of the loan or bond.

Even issuers in industries like oil & gas have been able to tap into sustainability-linked debt markets, demonstrating the broad reach of the structure. In February, for example, Canada's Tamarack Valley Energy became the first upstream oil & gas producer in North America to raise bonds tied to environmental and social goals. Tamarack raised a CAD200 million bond maturing in 2027 with a coupon of 7.25 percent. The interest rate payable on the bond will step up if the company does not achieve cuts to scope 1 and scope 2 carbon emissions and fails to increase the number of indigenous workers on its payroll.

In addition to making ESG-linked lending available to a broader pool of borrowers, the market in North America is also positioned to expand as it catches up with the more established ESG debt market in Europe.

According to analysis from Nordea, Europe is the largest market for ESG debt in the world, with European issuers accounting for approximately half of global activity. Other markets, however, are closing the gap, and it's become more common for leveraged loan and high yield bond deals to include some discussion around ESG KPIs as issuers consider their options.

Tightening up standards

As the ESG-linked debt market matures and consolidates, investors and lenders want to ensure that the KPIs linked to margin step-ups are meaningful and measurable.

With the market pausing in February due to events in Ukraine, lenders had the opportunity to pay closer attention to both the materiality and reporting of KPIs. The means by which KPIs are set is varied, but lenders now want KPIs that are appropriate for each credit and agreed upfront.

The market has also moved to ensure that borrowers are reporting on KPI compliance and that there is third-party verification of KPI performance.

In 2021, the Loan Syndications and Trading Association (LSTA) updated its Sustainability Linked Loan Principles to include tighter standards for selecting KPIs and mandatory independent, external verification of performance against KPIs. As the market has expanded, the LSTA has continued to refine its guidelines and recently released additional guidance outlining best practices for the external review process.

The LSTA's focus on improving industry standards has coincided with closer regulatory scrutiny of all ESG financial products and greenwashing risk. In the ESG funds space, for example, the Securities and Exchange Commission is developing so-called nutrition label rules that will require disclosures on how ESG funds are marketed and how ESG is built into investment decisions. Regulation of the ESG-linked debt space could follow suit.

"With the market pausing in February due to events in Ukraine, lenders had the opportunity to pay closer attention to both the materiality and reporting of KPIs. The means by which KPIs are set is varied, but lenders now want KPIs that are appropriate for each credit and agreed upfront.

Inflation and increasing interest rates reshape US leveraged finance markets

HEADLINES

■ US inflation for consumer goods hit a 40-year high in June 2022 of 9.1 percent ■ Since January, the US Federal Reserve has raised interest rates four times ■ High yield issuance for the half-year was down 76 percent year-on-year as investors exited fixed-rate debt instruments ■ Loan markets have also been affected, as pricing and original issue discounts widen

By Joseph Brazil, Binoy Dharia, Eric Klar, Rafael Roberti and Nicole Rodger—partners, White & Case

Lenders and borrowers in US leveraged finance markets have had to recalibrate pricing and issuance volume expectations in 2022 in the face of rising inflation and interest rates.

The abundant liquidity that stoked red hot leveraged loan and high yield bond markets in 2021 dried up through the first half of 2022, as macro-economic uncertainty, events in Ukraine, soaring energy prices and-COVID-19 supply chain bottlenecks drove up prices for goods and services and left central banks worldwide with limited alternatives to maintain low interest rates.

US Labor Department figures showed inflation for consumer goods rising by 8.5 percent in March, representing the largest year-on-year increase since 1981. In response, that same month, the US Federal Reserve raised interest rates for the first time in three years to fight inflation, upping rates by 0.25 percentage points.

At the beginning of May, the Fed proceeded with a 0.5 percentage point increase and in June, as inflation reached a 40-year high, interest rates were increased by another 0.75 percentage points—the largest hike since 1994. By July, with inflation remaining stubbornly high, the Fed raised rates once again by 0.75 percentage points.

Further rate increases are in the pipeline, with liquidity also expected to tighten as the US Central Bank scales back its US$9 trillion balance sheet.

2.25%

Since January, the US Federal Reserve has raised interest rates four times, taking its benchmark funds rate to a range of 2.25 – 2.5 percent

High yield bonds take strain

The impact of climbing interest rates and inflation on US leveraged finance markets has been most keenly felt in the high yield bond space.

As fixed rate instruments, high yield bonds are vulnerable to rate hikes, which eat into bond investor returns. This has resulted in material amounts of capital being pulled out of high yield bonds—data from Lipper shows that, in the first four months of the year, US$27 billion flowed out of the asset class.

This has resulted in a challenging market for issuers. According to *Debtwire Par*, high yield bond issuance was down 76 percent in H1 2022, year-on-year, to US$63.6 billion.

High yield bond issuers that have come to market have paid higher rates to convince investors to back their offers. Used car retailer Carvana, for example, paid a 10.25 percent coupon to land a US$3.27 billion unsecured eight-year bond in April to fund the acquisition of ADESA's physical auction business. By comparison, eight months earlier, in August 2021, Carvana had tapped the market for an unsecured eight-year bond priced at 4.875 percent.

Dallas-based glass and glazing manufacturer Oldcastle, meanwhile, paid a 9.5 percent coupon and offered a discounted issue price (92.12 percent) to investors on a US$585 million secured bond used to fund a portion of its leveraged buyout by KPS Capital Partners.

Carvana and Oldcastle both received ratings in the lowest bracket (CCC+ or lower) and, in a market characterized by thin volumes, accounted for more than half of monthly issuance in April. As a result of these two bond issues, average yields on senior secured and unsecured bonds spiked from 5.71 percent in Q1 2022 to 8.07 percent in Q2, according to *Debtwire Par*.

Even higher-rated credits have been affected by the volatile inflationary environment. BB-rated engineering and construction company Global Infrastructure Solutions, for example, priced a ten-year US$300 million senior unsecured note at 7.5 percent and par, but has seen pricing in the secondary market drop to 88.7 percent of par, for an implied yield of 9.25 percent.

Leveraged loans face challenge

The leveraged loan market has been shielded from macro-economic headwinds to a degree, as the floating rate structures on loans rise in line with increasing interest rates, but it has not been immune from the impact of these market fluctuations.

Up to May 2022, leveraged loan funds had enjoyed a run of 18 months of consecutive growth in assets under management, according to S&P and Lipper. From the beginning of May to the end of the week ending June 22, however, more than US$6 billion has exited the market as investors have become more risk-averse.

Activity in the collateralized loan obligation (CLO) space—the largest pool of investors in leveraged loans—has also eased, particularly in refinancings. New CLO issuance is down 12 percent year-on-year for the year to the end of May 2022, while CLO refinancing issuance has dropped by 94 percent. This may pivot again as and when things improve, however, as CLOs have proven to be resilient throughout the worst of the pandemic to date.

With demand for loans tightening, loan prices have moved higher. According to *Debtwire Par*, average margins on first-lien institutional term loans climbed to 4.31 percent in Q2 2022, well above the Q1 2021 average of 3.96 percent and the 3.74 percent average recorded in Q2 2021.

Despite some bleak headlines, the market is still open for business—Refresco Gerber raised a US$4.1 billion-equivalent multi-currency loan package to back its buyout by KKR, while Therm-O-Disc secured a US$360 million term loan B for its buyout by One Rock Capital Partners. While the loan space will no doubt recover its momentum in the months to come, interest rates and inflation are resetting market expectations.

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The leveraged loan market has been shielded from macro-economic headwinds to a degree, as the floating rate structures on loans rise in line with increasing interest rates, but it has not been immune.

SOFR transition progresses despite volatile markets

HEADLINES

■ Almost all new activity in the US leveraged loan market has transitioned from LIBOR to the new SOFR benchmark ■ The Alternative Reference Rates Committee endorsement of Term SOFR in 2021 provided a solid foundation for this transition ■ Attention now turns to how legacy loans tied to LIBOR will handle the SOFR switch

By David Ridley (partner) and Graham Silnicki (associate)—White & Case

During 2021, after months of regulatory pressure to end reliance on the London Interbank Offered Rate (LIBOR), concerns were mounting that the US leveraged loan market was being too slow to adopt the Secured Overnight Financing Rate (SOFR) as the new benchmark for pricing loans.

However, much to the relief of regulators, lenders and borrowers have handled the transition with minimal disruption. Fears that the market would not be ready to meet the January 2022 deadline for US regulated banks to cease using LIBOR on new loans have not materialized.

The success of the transition can be attributed in large part to the endorsement of Term SOFR by the Alternative Reference Rates Committee (ARRC), a group convened by the Federal Reserve Board and the New York Fed to guide the switch from LIBOR in the US.

Prior to this endorsement, the US loan market had displayed little enthusiasm for switching to SOFR. While LIBOR is a forward-looking rate that is known in advance for a given interest period (or tenor), SOFR is inherently a backward-looking rate, based on overnight transactions in the repo market for US Treasuries. Therefore, the amount of interest due on a loan tied to daily SOFR cannot be known until on or near the payment date.

Because the US loan market had relied on LIBOR for decades, market participants were accustomed to knowing the interest rate that would apply to their loan at regular intervals in advance, and loan documentation was structured accordingly. The shift to a backward-looking, "in arrears" rate such as SOFR would have required substantial changes to loan document conventions and operational systems.

96%

***Debtwire Par* estimates that, by the end of April 2022, approximately 96 percent of recently issued loans had adopted SOFR**

Term SOFR, however, uses data from the SOFR futures market to generate a forward-looking rate reflective of market expectations for SOFR's trajectory. This rate operationalizes much like LIBOR, giving parties certainty over the interest rate that will apply for the chosen tenor, and slots into LIBOR-based loan documentation with relative ease. It is now the dominant benchmark in the US loan market, with *Debtwire Par* estimating that, by the end of April 2022, approximately 96 percent of recently issued loans had adopted SOFR.

To further assist with the transition, the Loan Syndications and Trading Association (LSTA) published a model Term SOFR credit agreement containing defined terms and operative provisions for Term SOFR, which has been adopted by many market participants in the interests of using a single, consistent approach.

Moving forward and falling back

While the switch to SOFR for new loans has gone as planned, new issuance is only a small portion of the overall loan market. There are still a large number of existing LIBOR-based loans that have yet to transition to the new benchmark.

While US-dollar LIBOR can no longer be used for new loans funded by US-regulated banks (and many non-regulated institutions have adopted policies supporting this approach), the most popular tenors of the rate are still being published and can be used for loans funded prior to 2022. However, by June 2023, all tenors of US-dollar LIBOR will be discontinued, and a new benchmark will need to apply to all loans that still use LIBOR. Documentation for most of these loans will include some variation of fallback language, which allows parties to agree on what basis a LIBOR-linked loan will transition to an alternative benchmark.

The two primary categories of fallback language are the amendment approach and the hardwired approach.

Under the amendment approach, the loan agent and the borrower can agree on a rate to replace LIBOR and the related mechanics. The "Required" or "Majority" lenders are typically granted a negative consent right, and if they do not object to the amendment within a specified timeframe, the rate switch becomes effective.

The hardwired approach, meanwhile, specifies the choice of the replacement rate upfront (typically pursuant to a waterfall of possibilities starting with Term

SOFR) and typically uses the spread adjustment values recommended by the ARRC.

With the replacement rate and spread adjustment set in advance, the hardwired approach requires no further consent from lenders. However, despite a common misconception in the market, the presence of hardwired fallback language alone is not sufficient to implement the replacement of LIBOR. There are a number of technical, administrative and operational changes that need to be made to the loan agreement in order to implement the replacement rate, which means an amendment (typically signed by the agent and borrower without lender consent) will still need to be completed even when hardwired fallback language is used.

Coming to grips with these details and formulating a clear transition strategy will be key to clearing the June 2023 LIBOR discontinuation deadline for pre-2022 loans with minimal disruption.

Thinly spread

Developments around the application of credit spread adjustments (CSAs) to SOFR loans are also high on the transition priority list.

CSAs are used to address the gap between LIBOR and SOFR when pricing a loan with a margin that is not otherwise adjusted. LIBOR is a forward-looking unsecured rate that factors in counterparty credit risk and has therefore historically tracked higher than SOFR, which is a backward-looking secured rate that does not carry any element of credit risk. For any lender switching from LIBOR to SOFR on a loan with the same pricing margin, the upshot is that the lender would likely receive a lower all-in yield without the application of a CSA.

For legacy LIBOR loans that include the ARRC's hardwired fallback language, fixed CSAs will apply, based on the historical difference between USD LIBOR and SOFR over a five-year period preceding March 2021 (when the cessation dates for LIBOR were formally announced). These CSA values are approximately 11.4 basis points (bps) for one-month interest periods, 26.2 bps for three-month interest periods and 42.8 bps for six-month interest periods.

There has been, however, a noticeable variation around CSAs on new loans in 2022, as it is typically a negotiated point between borrowers and lenders. To-date this year, publicly available data indicates that the CSAs on most new SOFR loans have come in below the fixed CSAs recommended by the ARRC, with either a 10/15/25 bps CSA scale for one-month, three-month and six-month interest periods, or a flat 10 bps CSA for all interest periods being most common. There have also been a growing number of transactions where borrowers have received SOFR loan pricing without any CSA or discernable adjustment to the margin.

For borrowers with pre-2022 debt that may convert to SOFR at the ARRC-recommended CSA rates pursuant to a hardwired adjustment, this means the market for a new loan might be more favorable (although of course other broader market considerations may weigh against that approach).

As a result, some borrowers may be holding off on the work of switching to SOFR to assess whether a broader amendment and/or refinancing transaction could allow them to secure better all-in pricing. But a cliff edge is approaching—all deals must be amended before June of next year.

The longer market participants play this waiting game, the greater the risk of a transition bottleneck.

Documentary developments in tighter times

HEADLINES

- Investors are focusing on pricing and original issue discounts to manage risk, but are starting to push back on documentation
- The flight to quality among investors is driving bifurcation between the terms available to higher and lower-rated credits
- Direct lenders are offering flexible structures to win deals

By Jessica Ball, Eric Klar, Brad Laken, Eric Leicht and Vincenzo Lucibello—partners, White & Case

Risks posed by rising inflation, concerns about a global recession and the lingering impact of the war in Ukraine are seeing lenders and investors start to chip away at the loose, borrower-friendly terms that have characterized loan documentation in recent years.

According to *Debtwire Par*, covenant-lite loans still accounted for 84 percent of institutional loan issuance in the year to the end of June 2022 (only 2 percent less than observed in the bull market of 2021 and equal to or higher than in any other year going back to 2013), but a tougher syndication market is prompting borrowers to move on terms to get deals done.

Analysis by *Covenant Review*, which scores the covenant strength of loan documents on a 1 (most protective) to 5 (least protective) scale, meanwhile, provides some evidence that lenders are securing more protection in documents. In May, the score on loans reviewed by *Covenant Review* moved to 3.39, representing the most protective score since August 2020. This compares to scores earlier in the year of 4.14 in February and 3.93 in March.

84%

Covenant-lite loans accounted for 84 percent of institutional loan issuance in H1 2022

Familiar terms

The lender pushback on documentation, however, has not been wholesale. High-quality credits and private equity (PE)-backed deals are still able to secure borrower-friendly features like unrestricted subsidiary terms and generous grower baskets embedded in loan documentation. (Grower baskets—typically structured as the greater of a fixed dollar amount and an equivalent percentage of closing date LTM EBITDA—allow borrowers to incur additional debt or take certain other actions, which would otherwise be restricted by lenders, within a set limit or percentage of earnings.)

Borrowers may not be pushing for loose documentation with the same intensity as observed last year, but high-quality credits backed by repeat blue chip sponsors continue to receive favorable terms.

For repeat PE issuers, there has been more flexibility on the lender side. According to *Covenant Review*, PE-backed loans were able to secure looser terms on loans than other issuers, with a score of 3.51 on the *Covenant Review* scale in May 2022.

For this select group of issuers, concessions have been around the edges, with borrowers only giving ground on some points rather than a retreat across the board.

For now, flexible covenants that allow borrowers to exclude selected liabilities from leverage calculations are still available, as is additional flexibility on baskets, which gives borrowers room to spend higher thresholds of income on dividends or other investments.

Direct lenders to the fore

Borrowers have also benefited from a convergence between terms in the syndicated loan and direct lending markets, with the traditionally more-tightly documented direct lending offer moving closer to the syndicated loan market's approach.

With deal execution risk and pricing flex more of a concern in the current environment, direct lenders have been able to compete with the syndication market by holding credits on their own books and offering borrowers flexible terms.

Some direct lenders are offering debt on a cov-lite basis—a change from the status quo where they would require a financial covenant test at the end of each quarter. Cov-lite deals include one springing financial covenant—typically a leverage test—which only becomes live when a borrower utilizes a revolving credit facility beyond a set threshold, including letters of credit that have been issued.

For financial sponsors borrowing to fund buy-and-build strategies, direct lenders have laid on delayed draw term loans, which give borrowers a credit line that can be drawn down over a long period of time when required to finance add-on deals.

The syndicated market will also provide the flexibility for a delayed draw term loan, but the commitment fee charged by direct lenders is usually much lower and it is also easier for borrowers to extend commitment termination dates with direct lenders, if required.

Basket sizes, calculations of leverage ratios and incremental financing capacity in direct lending documents are also becoming less and less distinct from those in syndicated loans, although direct lenders have begun to hold more ground on terms of late in the wake of the broad disruption in the syndicated markets, which has enhanced their leverage.

Lenders push on pricing

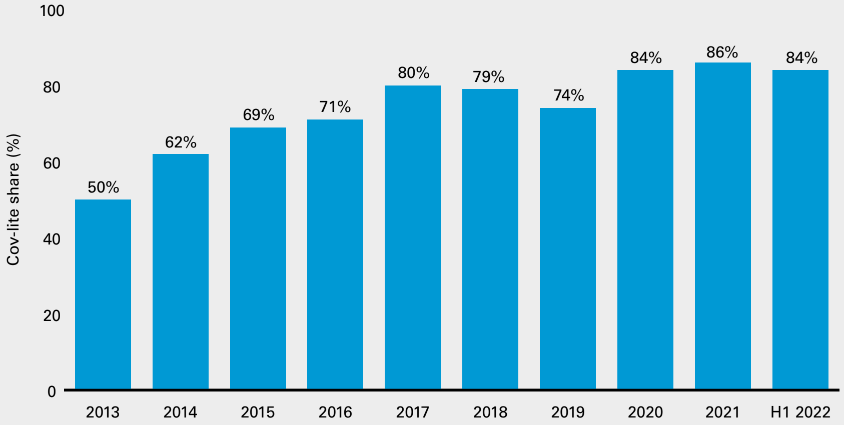
In addition to revisiting some of the flexibility in documentation, lenders have also pushed on pricing as a way to mitigate risk. According to *Debtwire Par*, average margins on first-lien institutional term loans reached 4.31 percent in Q2 2022, well ahead of the first-quarter average of 3.96 percent.

Credit quality has been a key determinant of pricing, with a gap opening between higher and lower-rated credits. For higher-rated borrowers with double-B ratings, margins decreased over April and May. Weaker-rated credits, by contrast, have found it much more challenging to clear syndication and have been forced to price debt generously to persuade investors to come on board. Borrowers with single-B ratings saw margins climb to almost 5 percent in Q2 2022 from 4.18 percent in Q1 2022.

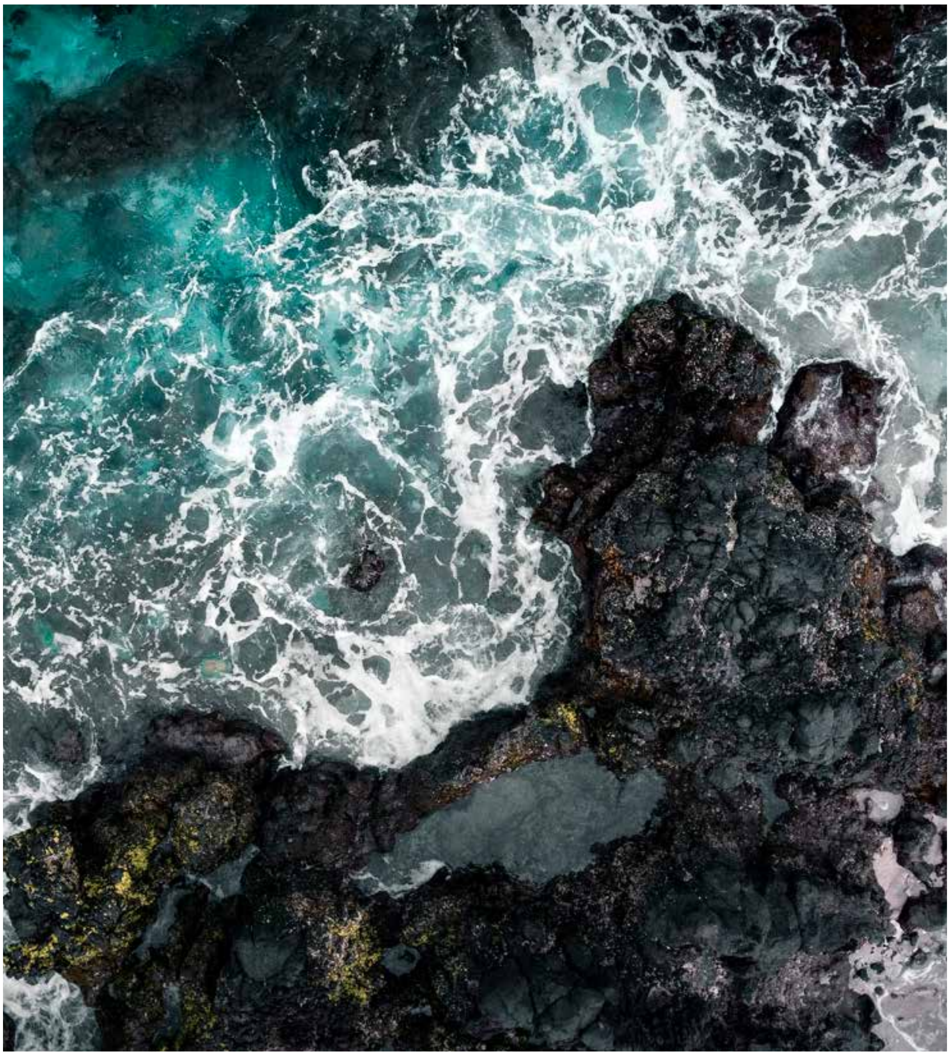
Wider original issue discounts (OIDs) have also become a standard feature of deals in the first half of 2022 to compensate investors for increased risk, and they have moved in lockstep with the falling prices in secondary markets. According to *Debtwire Par*, discounts averaged 48 bps in January 2022, but jumped to 473 bps in June as the average issue price of new loans slid to 95.27 percent of par. OIDs continue to deepen, with some new issues now proceeding with OIDs in the high 80s to low 90s.

With interest rates expected to continue climbing, higher pricing is already becoming established as a feature of the market for the medium to long term. Moves toward tighter documentation could follow suit.

US covenant-lite share of institutional loans (2013 – H1 2022)



Source: *Debtwire Par, Xtract Research*



A volatile situation: Europe versus the United States

HEADLINES

■ Leveraged loan issuance in the US dropped by 19 percent year-on-year in H1 2022 ■ High yield bond activity in the US was down 76 percent year-on-year during the same period, hit by inflation and rising interest rates ■ Combined leveraged loan and high yield bond issuance in Western and Southern Europe was down more than 65 percent year-on-year, as events in Ukraine hit the markets ■ Pricing is moving in favor of lenders across the board

By Christoffer Adler, Joseph Brazil, Eric Leicht, Sherri Snelson and Justin Wagstaff—partners, White & Case

Leveraged finance activity slowed on both sides of the Atlantic in the first half of the year, as a tougher macroeconomic environment and events in Ukraine affected debt issuance in both Europe and the US.

The deeper, more liquid US market weathered market headwinds somewhat better than the smaller European market, where exposure to the Ukrainian situation was more immediate due to energy supply chain disruption and geographic proximity, but both markets have encountered headwinds.

According to *Debtwire Par*, US leveraged loan issuance reached US$612.5 billion in H1 2022, down 19 percent year-on-year. Despite this, issuance remained steady, topping US$100 billion for four months between January and June, peaking at US$113.9 billion in April.

US high yield bond activity, meanwhile, stalled in April and May, as investors sought safer alternatives in the higher interest rate environment. As a result, issuance was down 76 percent by the end of Q2 2022, year-on-year—though recent activity suggests that this trend may have bottomed out. In June, there was US$8.6 billion in high yield bond issuance, more than double the total for May.

Issuance in Europe has proven equally volatile. High yield bond issuance reached US$31.1 billion in H1 2022, down 71 percent year-on-year. Markets came close to shuttering altogether in March and April, with just US$2.2 billion and US$2 billion in issuance, respectively, before climbing back up to US$4.5 billion in May. Many issuers were compelled to offer floating rate bond options to keep markets moving—by the end of May, almost a fifth of European bonds had floating rate coupons, up from 12 percent in 2021 and 8 percent in 2020.

European leveraged loan markets have also slowed, with issuance of US$67.8 billion in the first six months of the year, down 65 percent year-on-year. The drop was particularly evident from month to month, from a peak of US$16.4 billion in March—prior to the deterioration of the macro-economic and geopolitical landscape—then dropping steadily to US$4 billion in June. Unlike the US, issuance has also tracked lower for all the main uses of proceeds in Europe, from general corporate to M&A activity, including buyouts.

One relatively bright spot has been new issuance of collateralized loan obligations (CLOs) in Europe, which was down just 9 percent, year-on-year, at the halfway mark. In the US, by comparison, CLOs were down 12 percent year-on-year, though activity there also remains consistent.

-65%

Leveraged loan issuance in Western and Southern Europe was down 65 percent in H1 2022, year-on-year, versus a 19 percent decline in the US

Inflation and interest rates

Despite some differences in issuance patterns, US and European leveraged finance markets are nevertheless facing the same inflationary and interest rate pressures. US inflation hit a 40-year high in June, rising to 9.1 percent, while it climbed to 9.4 percent and 8.6 percent in the UK and the EU, respectively, that same month.

In the US, the Federal Reserve moved decisively to try to put a lid on inflation, with interest rate hikes in March, May, June and July. In the UK, the Bank of England (BoE) has upped rates six times since December 2021, reaching 1.75 percent—the highest level in more than a decade. Both bodies are expected to announce further rate hikes this year. In July, the European Central Bank (ECB) raised rates for the first time in more than a decade, by 0.5 percent, with further increases planned later in the year.

Pricing pressures

The medium to long-term outlook is for a higher-rate environment to take hold across all jurisdictions, driving up the cost of capital for European and US issuers.

In Europe, institutional loan pricing has been climbing steadily, with average first-lien margins on institutional loans rising to 4.48 percent by Q2 2022, up from 4.2 percent in Q1 2022. A high volume of low-rated credits has elevated pricing, with higher-rated issuers preferring to delay financings rather than brave a choppy market.

European bond markets have also seen margins swell, with the average weighted yields to maturity on fixed-rate bonds sitting at 6.8 percent by Q2 2022, up from less than 5 percent at the end of 2021.

Pricing has also been trending higher in the US, with overall pricing in high yield markets spiking from 5.71 percent in Q1 2022 to 8.07 percent in Q2. Loan pricing in the US moved upward during the same period as well, climbing from 3.96 percent to 4.31 percent in Q2.

In both the US and Europe, issuers have also been dealing with wider original issue discounts (OIDs) due to the discounts to par available to investors in secondary loan markets. In the US, for example, average OIDs in Q2 2022 climbed to 2.74 percent, up from 0.94 percent in Q1.

Europe leads on ESG

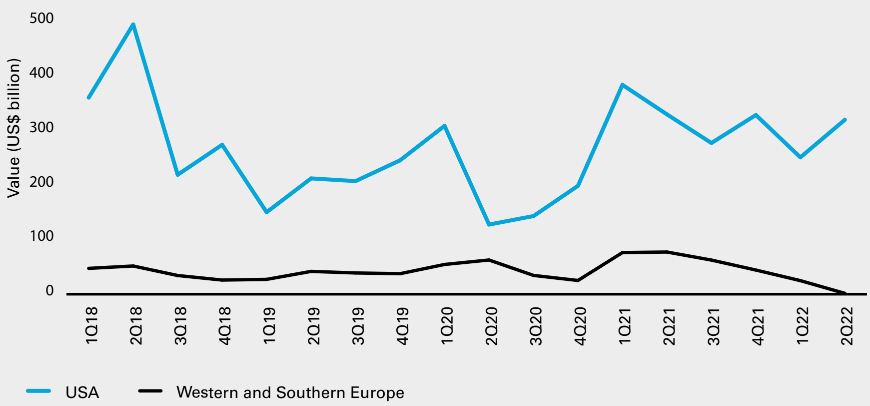
One area where the European market has been more robust is in the ESG-linked loan and bond space. While European leveraged finance markets have been coping with a volatile market environment, the region has retained its position as the largest market for ESG-linked debt, where loan margins are linked to meeting ESG key performance indicators.

According to Nordic bank Nordea, Europe represents half of the ESG debt market, more than any other jurisdiction. Analysis by Bloomberg confirms this perception—only one of the ten-largest corporate borrowers of ESG debt is based in the US, with the other nine all operating in Europe.

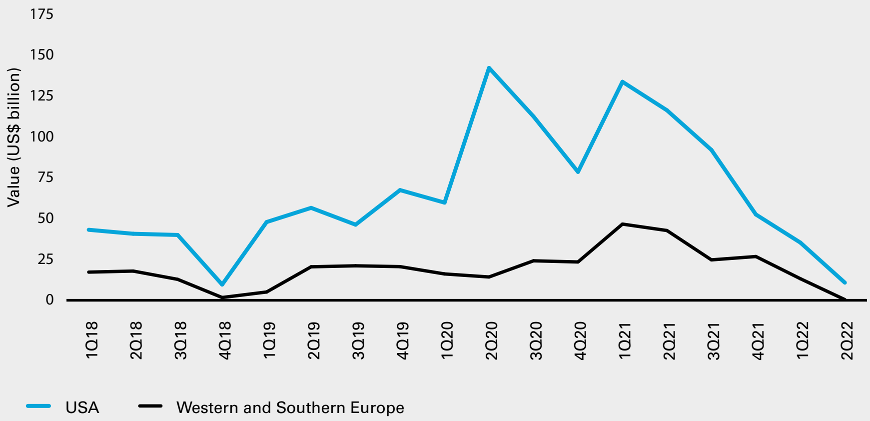
A strong ESG investor base has allowed European issuers of ESG-linked debt to continue to secure financing. For example, Italian power company Enel, an ESG-linked debt pioneer, issued £750 million in sustainability-linked bonds in April. The offer, which is linked to cutting greenhouse gas emissions, is the largest-ever ESG-linked bond package issued in British pound sterling.

The US is moving to close the gap under the Biden administration, but with the product more familiar to European lenders and the EU's Sustainable Finance Disclosure Regulation—which defines criteria to qualify environmental and social assets—gaining traction, the US has some catching up to do.

US versus Europe: Leveraged loan issuance by value (2018 – 2022)



US versus Europe: High yield bond issuance by value (2018 – 2022)



Source: *Debtwire Par*

Conclusion

Taking stock at this point in the year may make for slightly sobering reading for some, but the cyclical nature of the market means that, even as activity slows in one area, it can (and usually does) pick up in another—but what does this mean for leveraged finance markets in the months ahead?

The headlines have looked relatively bleak in recent months, chronicling a mixture of macro-economic headwinds and investor concern. But that's the nature of markets. Rather than focus on the immediate downturn, it's worth taking a step back to look at the bigger picture.

For example, while leveraged loan issuance is down significantly year-on-year, this is by no means the slowest half-year on record. As recently as 2019, leveraged loan totals were lower at the halfway mark than they are today and that was without historic inflation rates, a war or a pandemic.

What's more, the high point for leveraged loan activity in H1 2022 has been buyout activity—issuance reached US$94.5 billion, up 20 percent year-on-year. Private equity firms are likely to continue to pursue opportunities as they deploy the remarkable levels of capital still at their disposal.

On the high yield bond side, while it's been a rough six months, there are also signs of an uptick in activity—for example, there was more than US$8 billion in high yield issuance in June, versus just US$4 billion in May.

Potential for default remains low

On another positive note, default volumes remain historically low despite years of significant market pressures, and credit quality remains fundamentally healthy.

According to *Debtwire Par*, most term loan debt currently bid at a price of 80 or lower—at which point it would be considered distressed—is not due to mature until 2025 – 26. Only a handful of distressed loans, valued at U$7.4 billion, are due in 2023, with a further US$6 billion due in 2024.

By comparison, US$39.6 billion will come due during 2025 and 2026, giving companies ample time to refinance any outstanding debt as needed before maturity.

Default rates in both institutional loan and high yield bond markets stand at 0.8 percent—still low despite remarkable levels of volatility. According to Fitch Ratings, the full-year 2022 default rate in the loan market is expected to reach 1.5 percent, with the bond market hitting 1 percent (before ticking up to 1.5 percent in 2023).

All in all, this paints a very stable picture for the months ahead.

CLO superheroes?

And then there are collateralized loan obligations (CLOs), one of the biggest buyers of leveraged loans.

Amid the drought in the primary loan market, CLO new issuance has remained reassuringly consistent, down just 12 percent year-on-year. May's US$14 billion in new issuance marked the second-strongest month of the year.

It's possible that higher pricing is contributing to this latest activity—spreads on single-B-rated debt jumped to an average of 450 bps in March and continued to climb to 471 bps in April and 599 bps in May, according to *Debtwire Par*.

This activity is keeping things ticking in the leveraged loan market for now, though corporate ratings downgrades due to slowdowns in manufacturing or a recession could force CLOs to sell some of their best-yielding holdings. But, for the moment at least, this is a reminder that every downturn hides an opportunity that just needs to be found.

1.5%

Fitch Ratings anticipates the full-year 2022 default rate in the loan market to reach 1.5 percent—still very low despite market volatility

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