The State of the Leveraged Finance Market in 2023

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Introduction

It has been a tumultuous recent couple of years in the leveraged finance space.

In 2021 it looked like the party would never end, as money was cheap and deals were plentiful. Total leveraged loan volumes reached an astonishing USD1.24tn-equivalent from 1331 deals, as the market rebounded from the coronavirus pandemic in fine style.

The Morningstar/LTSA (then the S&P/LTSA) indexes reflected the white-hot market at the time. Having plunged to huge depths at the start of the coronavirus pandemic, both the euro and dollar indices saw their lowest prices of the year on 1 January (97.56 and 96.22 respectively) before rebounding to average 98.65 and 98.06 for the year.

The party came to abrupt halt on 24 February 2022, the date Russia began its invasion of Ukraine. This catastrophic event spurred on a whole host of issues in the following 18 months. Inflation, driven by the huge increases and volatility in energy prices, as well as supply chain issues due to China's still harsh lockdown policies, rose dramatically across EMEA and North America. This, in turn, precipitated the cost-of-living crisis for citizens across the continents.

Having ridden that wave, the banking sector was then rocked in March this year as Silicon Valley Bank and First Republic Bank collapsed in the US, whilst Credit Suisse ran out of road and was subsumed by UBS. It seemed that only a plague of frogs, locusts and boils was left to hit a battered market.

Take a Hike

To contain the inflation contagion, central banks began to raise interest rates, first in 25bp steps before more dramatic 50bp and 75bp increases. The US Federal Reserve has now hiked rates eleven times in 2022 and 2023 with short rates moving to a 16 year high of 5.30% by the summer.

Following the last 25bp hike in July, and despite the Fed's dot-plot showing another rate hike by the end of this year, the Fed has not yet hiked again with Chairman Jerome Powell hinting that the September dot-plot may not be accurate anymore.

Kevin Cronk, US Liquid Credit Portfolio Manager at Alcentra/BSP, told *LeveragedRadar*: "If you look at the Federal Funds Futures Market, an active market for speculators, they're betting on the next moves of the Fed and they're clearly showing that the Fed is done […] they're actually showing an 84% chance of the first cut at the 12 June 2024 meeting."

Cronk, who recently wrote a paper on the compelling yield opportunity for leveraged loans, added: "when we published our paper [in September], the graph we showed for Fed Funds Futures which went out to September 2024 was suggesting a Fed Funds Rate of 4.69%, as of 02 November that was 4.89%, even with the rally we saw in rates, Fed Funds Futures are still showing that higher-for-longer thesis."

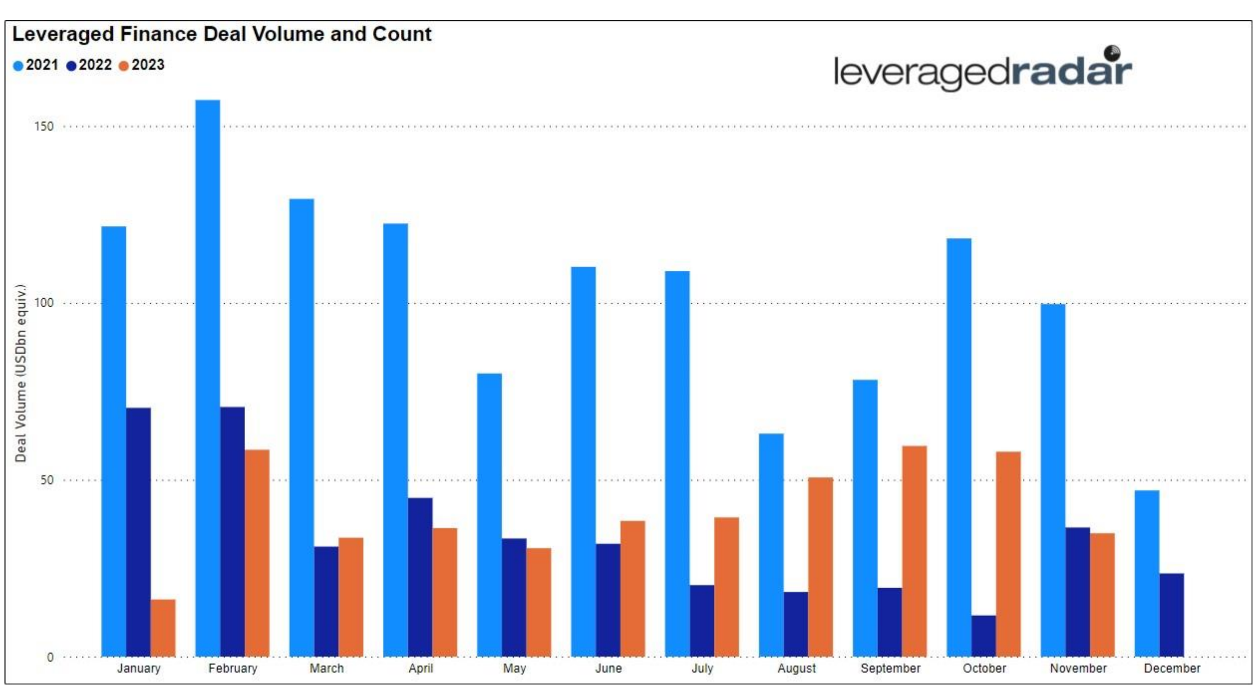
Reflecting on the EMEA side, Ross Curran, European Liquid Credit Portfolio Manager at Alcentra/BSP said: "The Bank of England is similar enough to the Fed in terms of the inflationary picture in the UK. The macro data hasn't been as impressive as we've seen in the US, but I do think there are specific challenges within the UK that probably means the UK has to keep rates higher for longer."

This was all but confirmed by Bank of England Governor Andrew Bailey on 08 November, who told a conference in Dublin that "it's really too early to be talking about cutting rates" from a 15 year high of 5.25%.

Moving on to the ECB, Curran added: "I would say that the ECB is slightly different in the sense that the data we've seen from Europe has been weaker than the US […] if we [Europe] do have a recession I would expect it to be a rather mild one, but it does mean that maybe at some point there would be some divergence between the ECB and the Fed".

[…] "Even if there are rate cuts, I wouldn't expect them to get anywhere back to where they were over last few years, I would expect those rates to stay higher for quite a while."

The Leveraged Loan Market in 2022/2023



LFRD data shows the drop off in issuance from the highs of 2021 through to this year

Within this chaotic climate, the leveraged loan market declined precipitously. Volumes in 2022 were USD412bn-equivalent from a total of 533 deals (a near 67% year on year decrease).

Volumes have steadily picked up in 2023, as the market has absorbed all the shocks that have hit it in recent times. Deal volumes currently stand at USD459bn-equivalent from 585 deals as of 14 November, which is already ahead of last year's total.

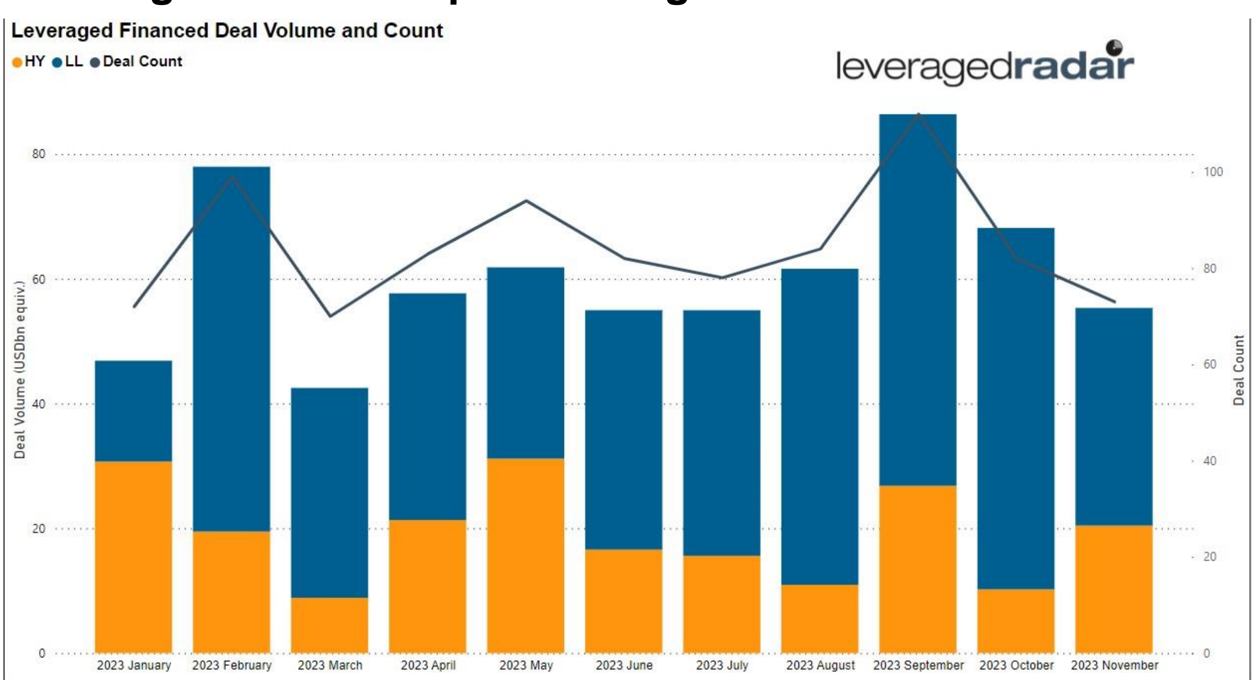
Spreads have also tightened in both North America and EMEA. According to the Credit Suisse Leverage Loan Index, with an average price in the 95 area, North American average spreads tightened from 651bp to 556bp by the end of August, with coupons over 9% and yields approaching 10%.

Since then, with an average price of around 95.5, a three-year discount margin gives a slightly tighter spread of 546bp, with an average coupon of 9.2% for a yield of 9.6%.

The story is similar in EMEA, where average spreads have also tightened to 560bp, Curran stated: "We've seen spreads contract somewhat throughout the course of the year."

"If you think about the underlying fundamentals of the company or the sectors we are lending to, they're very defensive in nature, so 560bp credit spreads are attractive. If you add on the base rate, you get an all-in yield of more than 9% in Euro terms."

Leveraged Loans Outperform High Yield Bonds



LFRD data shows that as well as outperforming high yield bonds, there has been more leveraged loan than high yield bond issuance this year (aside from January)

As an asset class, leveraged loans have outperformed their high yield bond cousins throughout the year.

Cronk explained: "If you look today [03 November] at current yields [coupon over price] of the North American loan market it's 9.6% and high yield is 6.9%."

"If you look at year-to-date, loans have outperformed high yield and every fixed-income asset class just because, as rates were rising, coupons were increasing and that was driving the better total return."

On the EMEA side *LeveragedRadar* was told: "If you look at year to date performance of the European loan market to the end of September, European loans have generated returns of over 11%, compared to 6% for European high yield bonds."

There are a couple of reasons for this. Like in North America, coupons have played an important part, as running yields [coupon & assets/divided by average price] for leveraged loans are 8.5% whilst high yield bonds are at only 4.5%, giving a 4% pickup on coupon.

Not only this, but if you look at the sector profile for leveraged loans vs high yield bonds, the leveraged loan market is more defensive in nature with 65% of borrowers in this sector deemed to be "defensive", compared to 45% in high yield bonds.

This is because the European high-yield market includes financial borrowers, especially Southern European banks, which were heavily impact by the aforementioned volatility in the banking sector this March.

The European high-yield market also features more retail and more cyclical sectors compared to the leveraged loan market.

Default Risk?

Looking ahead to 2024 and beyond, there are a few potential challenges facing the leveraged loan market - one being the spectre of increasing default rates, something which the ratings agencies have raised the alarm on.

In EMEA, Fitch cut its leveraged loan default rate to 3% to the end of 2023, way down from its previous base-case expectation of 4.5%. However leveraged loan default rates had actually jumped to 2.9% from 2.4% by the end of August.

The agency also expects higher default rates in 2024 in both leveraged loans and high yield bonds (4%).

Meanwhile Moody's September 2023 Default Report stated that global speculative-grade trailing 12-month default rates rose to 4.5%, the highest since May 2021.

Despite these concerns, Cronk remains relatively bullish on North American default rates, arguing: "We've definitely been moving higher, the long-term average is about 3.5%, JPMorgan continues to think we will get to that at the end of the year, and then a little bit higher than 4% in 2024."

"It's definitely elevated, but we think we're being compensated for higher default rates with where spreads and yields are […] it brings in the point that active management is critical to avoid defaults."

EMEA default rates have actually outperformed ratings agencies expectations for 2023 according to Curran. Looking ahead to 2024, he added: "Default rates will pick up, but I would say they will probably peak somewhere in the 2-3% range."

"Even if we do get into the higher end of default rates, historical recoveries for the loan market, because they're senior secured assets, means that you're first in the queue for the assets of a company, so recoveries tend to be in the 60-70% range."

CLOs and Private Credit

Two other potential areas of concern revolve around the shrinking CLO market and the continued rise of the private credit market.

Recently described as "one of the hottest finance products around" in the low-rate era, the USD1.3tn market is shrinking in the "higher-for-longer" period.

A recent *Bloomberg* article dated 23 October noted that about 40% of the securities' issuers have yet to price a new deal this year. As such, lower CLO demand would lead to lower demand for leveraged loans which, with half a trillion dollars of leveraged loans due in the next three years is not a good sign. However, issuers in the loan market have been quite proactive in pushing out near term maturities. Assets maturing in the next 2 years represent just 8% of the market compared to nearly 20% in the HY market.

Not only this, the private credit market has also presented a challenge to the traditional bank-led market. Red hot again following a quiet period, the market has recently refinanced some massive syndicated loans.

In September for example, Golub Capital led a USD3.4bn unitranche facility for Thoma Bravo backed software developer Hyland Software to refinance its existing bank debt (the borrower tapped the loan market in March 2021).

In the same month, global financial technology company Finastra tapped the burgeoning market for a USD5.32bn credit facility from over twenty private credit funds.

The deal, split between a USD4.82bn senior secured unitranche facility and USD500m multi-currency revolving credit facility, is the largest private credit deal in US history.

These blockbusters deals have so far been more of a US phenomenon as EMEA has not seen as many deals switch over to the private credit side.

War, interest rates, default rates and the private credit markets have cast doubts on the leveraged loan market to an extent, it is still open for business and provides a tantalising yield for investors compared to other asset classes.

All data, unless otherwise stated, sourced from the Bond Radar Ltd Data Wizard and API

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