Credit Market Conditions
Improving Tone & Tempo

Kent Brown,
Managing Director
Head of Debt Capital Advisory Group

Improved Market Tone & Tempo. We continue to see indicators of improved conditions in the Middle Market (MM) Leverage Loan market. Lenders report a healthy uptick in the number of deals being previewed in credit committees, term sheets being issued, spreads ticking downward, leverage inching upward, and competition rising, especially for better quality credits. The sunnier outlook is being driven by receding fears of a recession, steady corporate earnings, rising confidence of consumers and businesses alike, and a building backlog of sponsors looking to sell aging portfolio companies. The pendulum seems to be moving back towards "normalized" levels as lenders seek to *grow* the portfolio (not just *protect* the portfolio). Additionally, The Conference Board's Measure of CEO Confidence rose in Q1 2024, the first time in two years that CEOs noted more optimism than pessimism about what's ahead for the economy, according to The Conference Board.[1]

Middle Market Borrowers Remain Surprisingly Healthy. MM private companies generally fared well in 2023, having experienced year-over-year (YOY) revenue growth of 7.4% and earnings growth of 16.3% as of Q4 2023, the highest YOY earnings growth since Q2 2021, according to Golub Capital.[2] Despite concerns about high interest rates and economic uncertainty, earnings growth has given investors a reason for cautious optimism.

Defaults are Running Below Expectations. Across the credit market, default rates are trending below early 2023 expectations. Defaults in the private debt market were about 2.1% in 2023, better than in the high yield (HY) bond market (4%) and broadly syndicated loan (BSL) market (5.8%). Expectations for 2024 are for private debt market defaults to remain benign, ticking up modestly to 2.75% with the Healthcare, Software, and Consumer sectors comprising some 60% of the total, according to KBRA Analytics.[3] The private debt market is projected to outperform the BSL market in 2024 (i.e., lower defaults and loss rates). Furthermore, recoveries on private loan defaults are projected to be greater than 75%, versus 40%-60% among BSL loans, due to better loan structures, deeper diligence, more restrictive covenants, and tighter control over workout processes, according to Blue Owl Capital.[4]

Private Debt Continues to Surge. The private debt market today is estimated at $1.6 trillion (2x from 2018) and is projected to exceed $3.5 trillion by 2028 at an annual growth rate of 15.8%, driven by continued contraction in the bank market, the migration of public (syndicated) markets towards larger borrowers, and other factors, according to BlackRock (NYSE:BLK).[5] Bank lending standards (especially for cashflow loans) have continued to tighten over the past few quarters and are approaching levels last seen in recessionary episodes such as 2001, 2008/09 and early 2020, according to a recent U.S. Federal Reserve Survey.[6] Furthermore, since the Great Financial Crisis, regulators have discouraged banks from holding leveraged loans on their balance sheet, pushing them to serve as a distributor (not owner) of loans. Accordingly, the public BSL and HY bond markets have increasingly focused on larger borrowers–with the average leveraged loan deal size now at ~$470 million (up from ~$325 million in 2010) while the average HY bond issue is well over $700 million (up from ~$500 million in 2010), according to BlackRock. The private market was an outsized beneficiary of market volatility in 2023 having financed 86% of Leveraged Buyouts (LBOs) and 65% of non-LBO deals in 2022-23, both up meaningfully from 2019-21 averages, according to Blue Owl Capital.

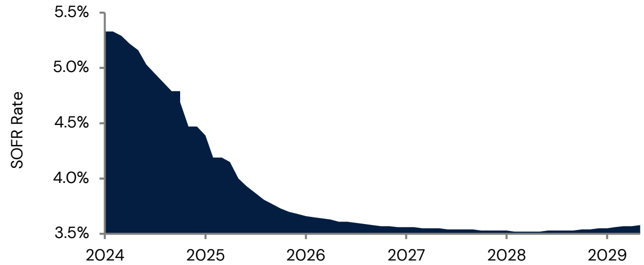
Rates are Heading South. While the Secured Overnight Financing Rate (SOFR), the new Libor, stands near its peak at 5.3% today, the market expects a meaningful decline over the next year as the Fed eventually cuts interest rates several times throughout 2024, mostly in the second half. Today's forward curve projects an 86-basis point (bps) drop by December 2024 and another 77 bps in 2025, eventually bottoming out near 3.5% in late 2026. Today's swap markets incorporate this forward curve and allow most borrowers to actually *reduce* their loan rates by ~1% to 1.2% by converting floating-rate SOFR to fixed, depending on term. Furthermore, loan spreads have declined steadily since Q2 2023—lenders are now quoting first-lien spreads of 6% (or below) on larger A-quality sponsored transactions, down from a 6.5%-7.3% context in the first half of 2023.

Upper MM Refinancing Trend. More than 20 existing second-lien term loan tranches in the private debt market have been refinanced at lower rates through the BSL market through February, according to PitchBook.[7] Nearly all have involved large-size junior loan tranches (averaging ~$400 million) of lower-rated (most were B-/B3) sponsored private companies with established track records in the syndication market. Pricing has averaged SOFR +420 bps, driving some 2%-4% in rate savings. If such momentum continues, the private-to-BSL trend may well migrate to smaller deals and borrowers.

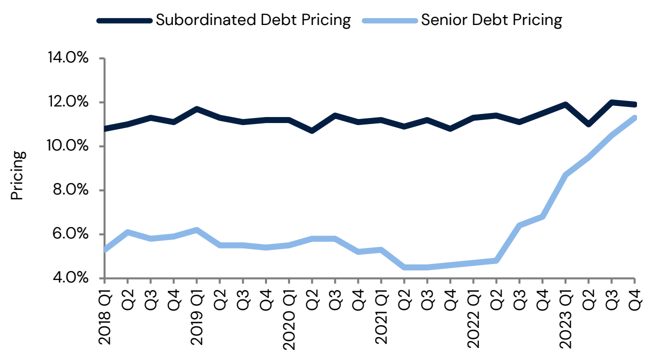
FCCR and LTV Driving Leverage Capacity. Given the unprecedented rise in nominal loan rates over the past two years, lenders today have been focusing heavily on projected fixed charge coverage ratios (FCCR) when underwriting new loans, seeking 1.2x at the least (and a pathway towards >1.5x within two years post-closing) and EBITDA/Interest ratios above 2.25x. Further, most new loans are issued in the 45%-50% loan to enterprise value (LTV) range, depending on the use of subordinated debt, rollover equity, etc., according to GF Data®.[8] Combined, these two factors are driving debt capacity levels today.

Opportunistic Deals Rising. Given the improving market conditions, refinancings, and dividend recaps are once again finding receptivity in today's market. Within the primary leverage loan market, January was the busiest month in almost 11 years for refinancings with 3x the average volume seen in 2023, according to PitchBook LCD.[9] While verboten during tight credit markets, dividend recaps for sponsor-owned companies re-emerged in the second half of 2023 and are continuing into 2024. Sponsor hold-times have lengthened over the past several years (now 6.4 years vs 5.1 in 2021) due to challenging M&A conditions, and recaps allow them to extract some liquidity today while extending the runway towards higher valuations at the eventual exit. Recent dividend recaps have been closed some 4-4.5 years from the original acquisition date and levered more conservatively than LBOs (by ~0.5x-1x), according to PitchBook.[10]

SOFR Forward Curve



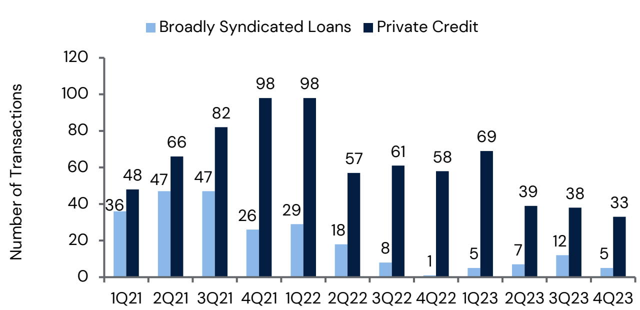
Senior and Subordinated Debt Pricing



Total Debt/EBITDA

Enterprise Value (mm)	2003 -2018	2019	2020	2021	2022	2023	Historical Average
$10-$25	3.3x	3.8x	3.6x	4.0x	3.7x	3.7x	3.5x
$25-$50	3.5x	3.9x	3.4x	3.9x	3.7x	3.3x	3.6x
$50-$100	3.9x	3.9x	3.6x	3.8x	4.0x	3.5x	3.9x
$100-$250	4.4x	4.4x	4.7x	4.4x	4.2x	3.9x	4.4x
$250-$500	4.9x	5.1x	4.8x	5.4x	5.1x	4.5x	5.0x
Overall	3.6x	3.9x	3.7x	4.0x	4.9x	3.6x	3.7x

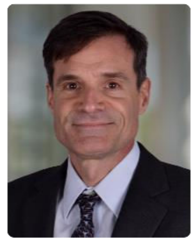
Number of LBOs Financed



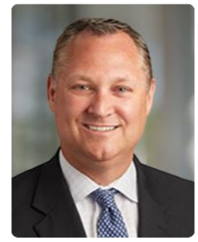
Source: Derivative Logic, PitchBook LCD, GF Data®, and Capstone Partners

Debt Capital Advisory Team Leaders

Kent Brown
Head of Debt Advisory
kbrown@capstonepartners.com
303-951-7127

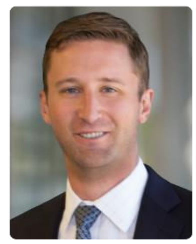


Brad Stewart
Managing Director
bstewart@capstonepartners.com
617-619-3334



Brent Krambeck
Managing Director
bkrambeck@capstonepartners.com
312-399-7977

Brad Harrop
Director
bharrop@capstonepartners.com
303-531-5007



Adam Morris
Director
amorris@capstonepartners.com
720-407-6270

Endnotes

1. The Conference Board, "CEO Insights for What's Ahead," https://www.conference-board.org/pdfdownload.cfm?masterProductID=50115#, accessed February 16, 2024.
2. Golub Capital, "Golub Capital Middle Market Report Q4 2023," https://golubcapital.com/middle-market-report/current-report/#, accessed February 27, 2024.
3. KBRA Analytics, "KBRA DLD Forecasts 4% Broadly Syndicated Loan, 3% High-Yield Default Rates in 2024," https://www.kbra.com/publications/WHsWhrtH/kbra-analytics-kbra-dld-forecasts-4-broadly-syndicated-loan-3-high-yield-default-rates-in-2024?format=file, accessed January 9, 2024.
4. Blue Owl Capital, "2024 Market Outlook," https://docs.blueowl.com/JmqEz7o7N4z?hsCtaTracking=e01cc815-c701-4f4f-8b66-137fe141fbb0%7C05527085-580b-4fdd-b478-88f22357809c, accessed January 18, 2024.
5. BlackRock, "Private Debt: a primer – Unpacking the growth drivers," https://www.blackrock.com/ch/professionals/en/insights/private-debt-primer, accessed February 27, 2024.
6. Board of Governors of the Federal Reserve System, "The January 2024 Senior Loan Officers Opinion Survey on Bank Lending Practices," https://www.federalreserve.gov/data/sloos/sloos-202401.htm, accessed February 5, 2024.
7. PitchBook, "Bank eye low-rated financings to claw back business lost to private credit," https://pitchbook.com/news/articles/banks-eye-low-rated-refinancings-to-claw-back-business-lost-to-private-credit, accessed March 4, 2024.
8. GF Data, "Q4 2023 Leverage Report," https://gfdata.com/, accessed February 27, 2024.
9. PitchBook LCD, "January Wrap: Loans return 0.68% as momentum slows; net supply remains elusive," https://files.pitchbook.com/website/files/pdf/January_2024_US_Leveraged_Loan_Index_Monthly_Wrap.pdf, accessed February 1, 2024.
10. PitchBook, "2023 Annual U.S. PE Breakdown," https://files.pitchbook.com/website/files/pdf/2023_Annual_US_PE_Breakdown.pdf, accessed January 9, 2024.