Mesirow

2022 Debt Market Year in Review

2022 Recap and what's ahead for 2023

This year has certainly been a tumultuous one. Between rising inflation, falling stock prices, and, most importantly for the debt markets: rising rates, 2022 was not for the faint of heart. As we look ahead to 2023, most are expecting a bumpy start, but all is certainly not lost.

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This piece walks through our outlook and expectations for the year ahead.

1. The Fed (driven by inflation concerns) will continue to be the primary driver in the market. The Fed Funds rate currently stands at 4.25-4.5%, with most expecting further rates hike to 5-5.25% by the end of 2023 before returning to a more moderate 4-4.25% by the end of 2024, 3-3.25% by the end of 2025, and 2.5% over the long run. Any change from these predictions (positive or negative) will immediately impact the credit markets.
2. Most companies are well equipped to handle these hikes. Proskauer estimates the default rate to climb to 5% from 1.5% today, well below the default rate during both COVID and the Great Recession.
3. While 1H may be slow, most market participants are expecting a pick-up in the 2nd half of the year. As with any market correction, it never lasts forever, as painful as it may feel at the time.

Ability to support increased interest: At the beginning of 2022, 3-month SOFR was near 0%, with most credit facilities containing a floor (typically 1%) to ensure lenders at least received a modest funding cost. With unitranche spreads in the S+550-650 ballpark, this meant the average borrower was paying 6.5-7.5% (inclusive of the 1% floor).

With 3-month SOFR now closer to 4.5% and spreads closer to S+750, the average borrower is now paying closer to 12%, not including any additional upfront fees (typically in the 2% area).

This begs the question: can borrowers afford 12% paper in a soft economy, and what will be both the short-term and long-term effects?

1. **Effects on leverage multiples:** If a business is overleveraged, an extra ~5% of interest will undoubtedly push companies over the edge. Using a very simplified model below (7% interest at the beginning of the year vs. 12% interest today and $5 million of annual paydown), a 5x levered company on January 1, 2022 ($100 million of debt on $20 million of EBITDA) could paydown the same amount of debt as an ~4x levered company today over a five year period (~$80 million of debt on $20 million of EBITDA) solely by using the difference in interest to pay down debt. In other words, in this example, a Company can paydown an additional ~$20 million (or ~1x of EBITDA) in interest over the five-year period.

Debt	EBITDA
$100,000,000	$20,000,000

	Interest	
	1.1.2022	12.31.2022
Margin	S+6.00%	S+7.50%
Floor	1%	1%
SOFR	0%	4.50%
Rate	7.00%	12.00%

	2023	2024	2025	2026	2027
Beginning of Year Debt	$79,756,188	$74,756,188	$69,756,188	$64,756,188	$59,756,188
Paydown	($5,000,000)	($5,000,000)	($5,000,000)	($5,000,000)	($5,000,000)
	$74,756,188	**$69,756,188**	**$64,756,188**	**$59,756,188**	**$54,756,188**

	2023	2024	2025	2026	2027
Beginning of Year Debt	$100,000,000	$90,000,000	$80,500,000	$71,475,000	$62,901,250
Paydown	($5,000,000)	($5,000,000)	($5,000,000)	($5,000,000)	($5,000,000)
Additional Paydown from Interest Savings	($5,000,000)	($4,500,000)	($4,025,000)	($3,573,750)	($3,145,063)
	$90,000,000	**$80,500,000**	**$71,475,000**	**$62,901,250**	**$54,756,188**

Factor in EBITDA softness, anticipated future rate hikes, and overall market softness, and **companies are getting 1.5x+ less leverage than they got at the beginning of the year**.

2. **Structural Changes:** With leverage multiples lower, borrowers have a few choices. New borrowers (i.e., through LBO or M&A activity) have the ability of simply lowering or deferring purchase prices. However, existing borrowers who are refinancing need to look elsewhere to fill the gap. Generally, options include raising equity in lieu of debt, offering equity upside (warrants or otherwise), or deferring interest (PIK interest).

   Additionally, the mezzanine market continues to offer a modest arbitrage compared to other markets. Despite the 3-5% increase in floating rate debt, the mezz market has increased a much more palatable 1-2% and is generally a fixed rate vehicle. Earlier this year, mezz rates were 10-12% cash pay with 2% PIK. Now they are either on the higher end of that range or just outside that range and not subject to the risk of future rate hikes.

When will the market normalize?

Inflation and the Fed Funds rate: The question on everyone's mind is when will the market stabilize? While the Fed certainly has not stopped inflation, there are signs they are starting to get it under control. After peaking at 9.1% in June 2022, the CPI has continued to drop, standing at 7.1% in November.

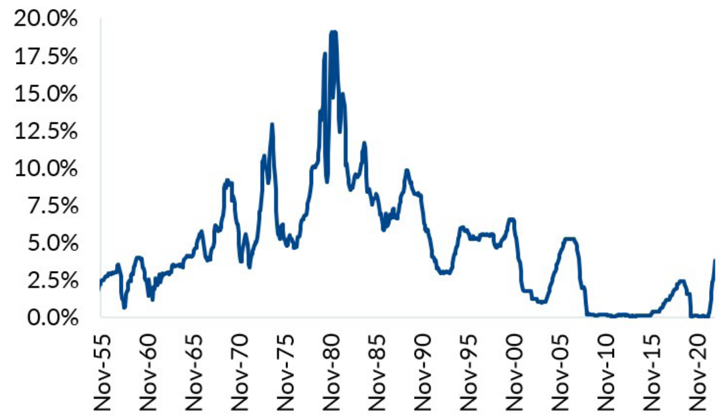
CHART 1: **CONSUMER PRICE INDEX – 12-MONTH PERCENTAGE CHANGE**

Data through November 31, 2022 | Source: U.S. Bureau of Labor Statistics

As a result, the Fed has (slightly) slowed its rate hikes with a 50 bps hike in December following four consecutive 75 bps rate hikes leaving the current Fed Funds rate between 4.25-4.5% from 0.0%-0.25% in January 2022. Economists are currently projecting further rate hikes to 5-5.25% by the end of 2023 before returning to a more moderate 4-4.25% by the end of 2024, 3-3.25% by the end of 2025, and 2.5% over the long run.

Assuming SOFR follows suit, it has an additional ~0.75% to go before peaking. While it's true that a Fed Funds rate of 5-5.25% will certainly crimp investment and ability to service debt, the financial history buffs amongst us will point to the fact that near 0% rates are a recent and historically unheard-of phenomenon. From the 1960s through 2000, the Fed funds rate was consistently around or above 4%, including a few-year stretch into the double digits in the early 80s.

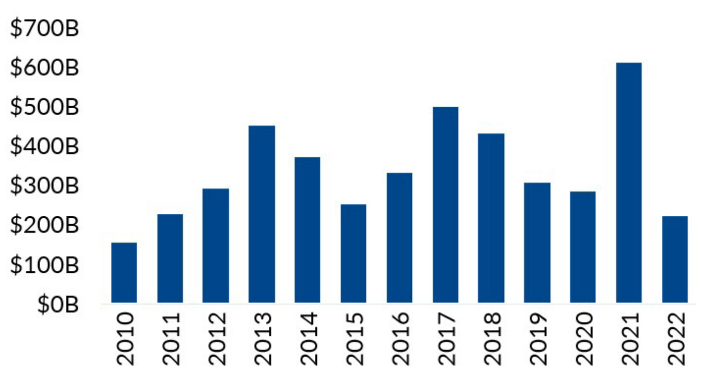
CHART 2: **FEDERAL FUNDS EFFECTIVE RATE**



Data through November 31, 2022 | Source: Federal Reserve Bank of St. Louis (FRED)

How this affects the debt markets: While the underlying economic trends are certainly worrisome, the uncertainty itself is one of the most significant issues (markets hate uncertainty almost as much as negative news). After speaking with several lenders, the common theme is "it's difficult to give an accurate leverage indication since we can't get comfortable on what true EBITDA will be." And given the tightness in the credit markets, few are in a hurry to be aggressive simply because they don't need to. However, tough times never last, and most market participants expect a rebound in the 2nd half of 2023. New-issue volume for 2023 remains favorable for private credit both on an opportunity and yield basis. In the broadly syndicated markets, leveraged-loan issuance is expected to rebound slightly to the $240-300 billion range next year (a significant amount in the 2nd half of the year) after dropping to $225.1 billion in 2022.

CHART 3: **US INSTITUTIONAL LEVERAGED LOAN VOLUME**

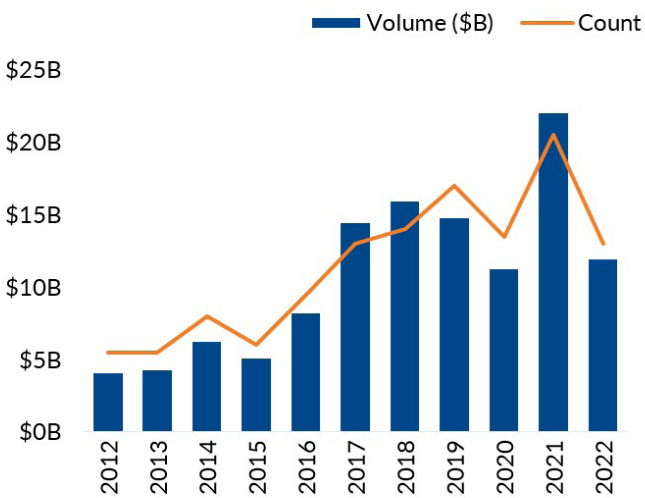


Data through December 13, 2022. | Source: Leveraged Commentary & Data (LCD)

Broadly syndicated markets: Throughout the 2nd half of 2022, banks moved most of the inventory stuck on their balance sheets. While they took significant losses on transactions such as Citrix (upwards of a $1 billion loss), Intertape Polymer (upwards of a $100 million loss), and others, they can now focus on new transactions.

However, any meaningful rebound in the broadly syndicated market will rely on the CLO market. Despite printing $130 billion of transactions in 2022 (its 2nd highest year ever), the market limped into year-end with a significant drop-off in the 2nd half of the year. Most market participants predict that the CLO market will pick back up in the 2nd half of 2023 once some of the uncertainty in the market clears. They are expecting ~$100 billion of issuance in 2023.

CHART 4: **US MIDDLE-MARKET CLO ISSUANCE – ANNUAL**



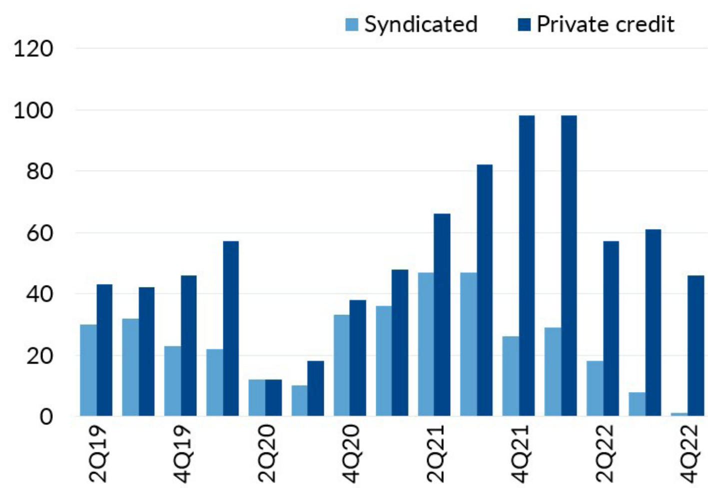
Data through December 22, 2022. | Source: Leveraged Commentary & Data (LCD)

Private credit markets: While the private credit markets have taken a little bit of a pause, their rebound should be much quicker than the broadly syndicated markets for a few reasons. For starters, one of the main benefits of the private market is that it isn't subject to the volatility of the public markets. Lenders don't actively trade loans or mark their books to market. They take a 5-7 outlook on credits and are better equipped to handle bumps along the road. Second, the private credit markets have grown to over $1.2 trillion, including nearly $400 billion of dry powder. That money has to be put to work somewhere, or lenders will have to explain to their LPs why they have a 0% return.

To this point, despite market headwinds, two take-private buyouts funded with private debt were recently announced: Thoma Bravo's acquisition of Coupa Software and Advent International's purchase of Maxar Technologies.

As has been the case for the past few years, it is anticipated that the private debt markets will continue to steal market share from the broadly syndicated markets. According to Blackstone Secured Lending CEO Brad Marshall, starting near the end of Q2'22, "…because there's limited capacity to tap the public markets, private lenders are seeing close to 100% market share in new deals." A research note from BofA Securities said that in 2022, private debt experienced the biggest leap forward in its history as the syndicated loan market turned risk-averse.

CHART 5: **COUNT OF LBOS FINANCED IN BSL VS PRIVATE CREDIT**



Data through December 8, 2022 | Private credit count is based on transactions covered by LCD News. | Source: Leveraged Commentary & Data (LCD)

Types of opportunities in 2023: Given the economic backdrop, most market participants aren't expecting significant activity in the traditional LBO and M&A markets. However, people are expecting PE shops to focus on add-ons for their existing healthier portfolio companies and stressed refinancing for their struggling companies.

Regarding the "good company / bad balance sheet," trade lenders expect the private debt markets to pick up the slack for both the broadly syndicated and commercial bank markets. "We believe that the presence of PD (private debt) capital is likely to stave off some default pressures for BSL (broadly syndicated loan) issuers in the next default cycle.

All things equal, it provides an additional avenue for securing financing, albeit at higher costs. As the economy falters and liquidity pressures build up amongst lower quality HY and loan issuers, some could avoid defaults by financing themselves in private markets," BofA Securities said in a research note.

Regarding default, Proskauer's Private Debt Default index currently sits at 1.58%, with most expecting it to climb closer to 5% in 2023 (although a far cry from the 8.1% experienced at the height of the pandemic). Additionally, the loss given default on these names is relatively minimal given their senior secured nature. Kroll Bond Rating Agency (KBRA) recently ran an analysis on private credit fund financing they've rated to see how the entire diversified portfolio held up. They found that fund financing rated investment grade—about 90% of the portfolios they looked at—would be able to, on average, withstand a cumulative default rate of 61% and still meet interest obligations. Meanwhile, non-investment grade fund financing could withstand portfolio default rates with an average of 52% and still meet interest payments.

However, once the markets normalize, M&A should pick back up with buyers circling around the prime assets trading at discounted multiples. This will likely especially be true in the tech sector, where the Nasdaq is down over 30% in 2022. Recurring revenue transactions remain popular after large deals for companies like Coupa Software ($2.6 billion) and KnowBe4 ($1.125 billion) were completed with this structure.

Conclusion: As the books close on 2022, lenders remain in the driver's seat going into 2023, with financing across industries harder to come by for borrowers large and small after an inflation-stoked-year. Albeit a tumultuous year for credit markets, private credit emerged as a durable asset class on all fronts, as broadly syndicated lenders remained on the sideline amid market volatility.

As we enter 2023, analysts are projecting a continued retreat in expected deal volume early in the year, with headwinds easing in the second half of 2023. The timetable for a return to normalization remains open, but with much of the downside, including threats of a recession and weakening in loan fundamentals, already priced into the market many feel we are getting close to the bottom.

About Mesirow

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