Mesirow

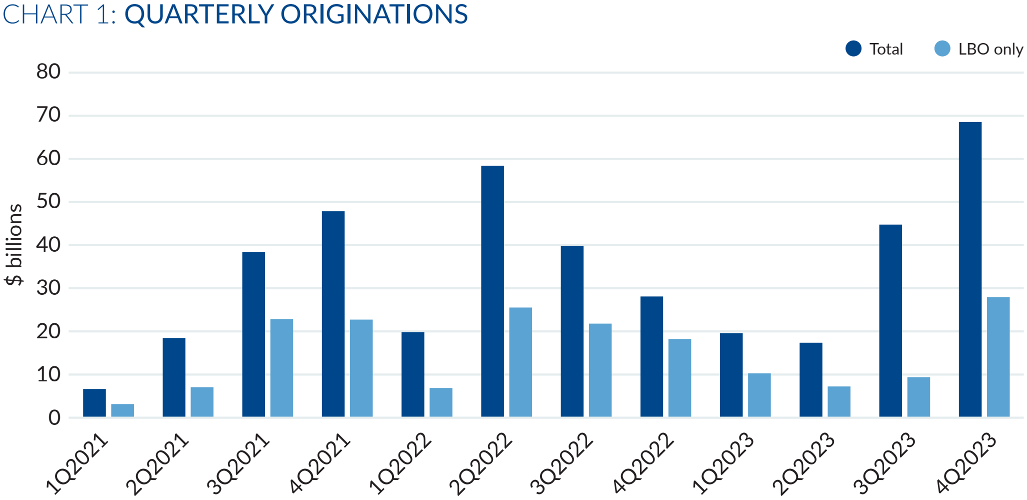
2023 Debt Market Year in Review

2023 Recap and what's ahead for 2024

2023 certainly didn't get off to the strongest start, but a Q4 surge left market participants salvaging what otherwise could've been a painful year. Despite continued uncertainty around inflation and what action the Federal Reserve will take, a lack of M&A / LBO volume has lenders getting very competitive over the few deals in market (especially the better credit quality ones). Lenders almost universally remain cautiously optimistic for things to pick up in 2024. However, the markets still face geopolitical risk in Europe and the Middle East as well as uncertainty around the pending US Presidential election.

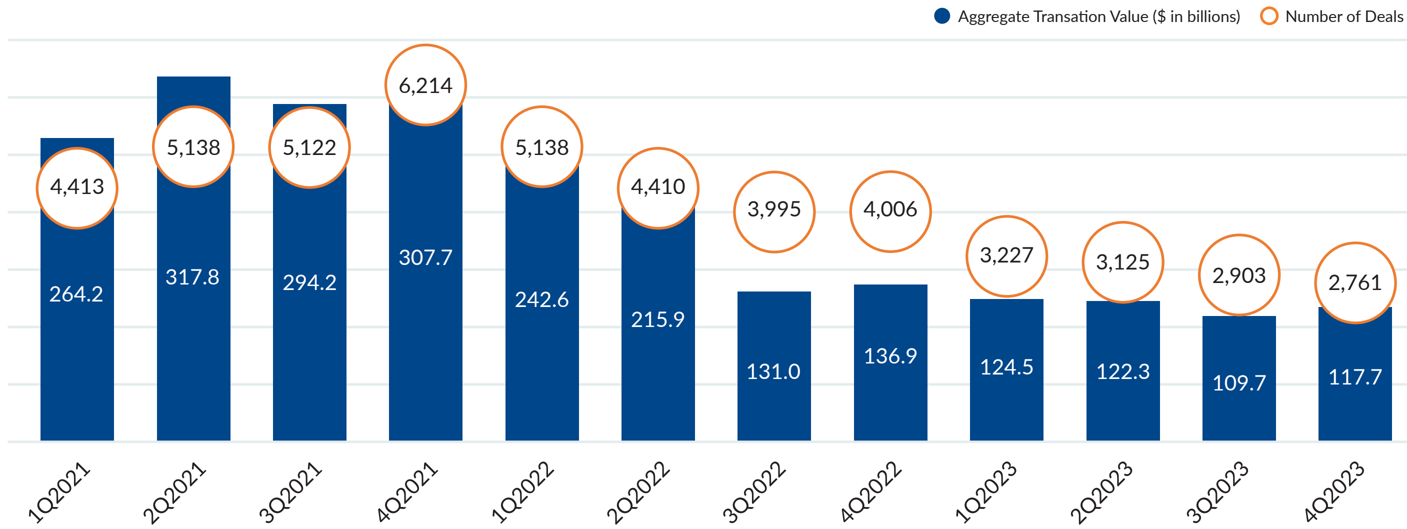
Volumes and Proceeds: DLDeals estimated direct lending ended 2023 with $148.9 billion in new issue volume. Despite the feel of a low volume year, this was actually up 2.8% from 2022 (albeit on better tracking methods and increased reporting from issuers and lenders). Most transactions came in 2H ($44.3 billion in Q3 and $67.9 billion in Q4) as lenders saw an end in sight for the Fed's battle against inflation culminating with a predicted 2–3 rate cuts in 2024. However, despite the higher volume, only 36% ($54.3 billion) was for new LBOs, down 25% from 2022, with most of the remainder from add-ons (33%) and refinancings (26%).

CHART 1: **QUARTERLY ORIGINATIONS**



Source: KBRA DLDeals.

CHART 2: **GLOBAL PRIVATE EQUITY AND VENTURE CAPITAL ENTRIES WORLDWIDE | 2021–2023**



Source: S&P Global.

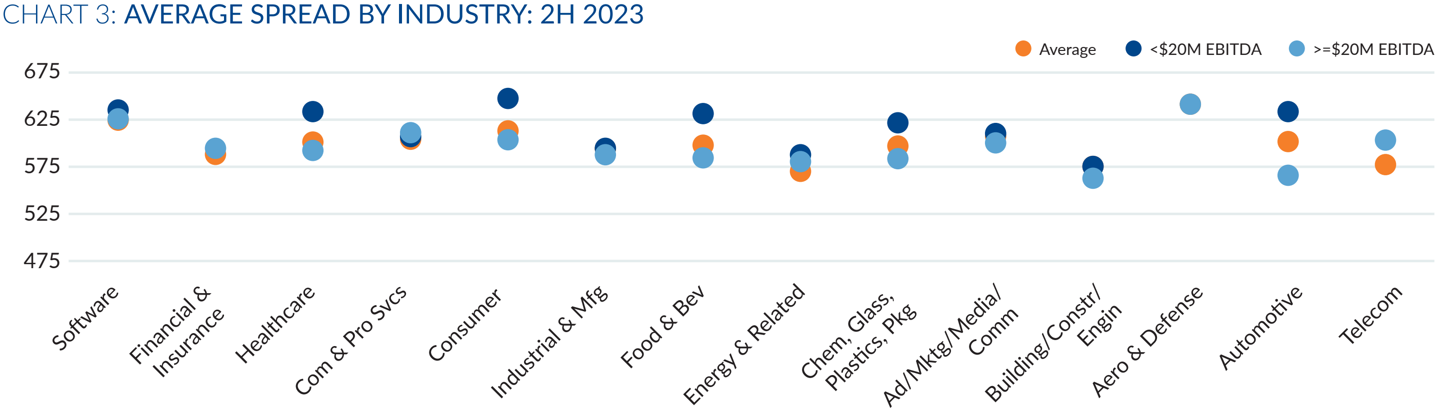
Lenders are expecting M&A volume to pick up as private equity firms continue to get pressured by their LPs to return capital after an 18-month M&A drought. Global private equity and venture capital deals were at their lowest in 5 years in 2023. Transaction value declined 34.7% year-over-year to $474.14 billion, while deal count fell to 12,016 from 17,549, according to S&P Global Market Intelligence. This is well short of 2021's record of $1.2 trillion across 20,887 transactions.

Pricing: Given the dearth of M&A volume, borrowers continue to take advantage of lower spreads. Unitranche spreads ended 2023 at S+588 on average compared to S+642 at the end of 2022. Underlying SOFR rose from 4.3% at the end of 2022 to 5.38% at the end of 2023, but markets believe that rates have topped out and will start dropping in 2Q 2024 as well as throughout the next 3 years.

Fed-watchers are expecting 2–3 rate cuts to the Federal Funds rate in 2024 to end the year near 4.5–4.75% from 5.25–5.5% today. SOFR should closely mirror the Fed Funds rate.

Given the reduction in spreads, lenders have been proactively reaching out to reduce spreads on transactions with little to no call protection with the logic that they would rather be paid a reduced rate than lose the loan to a different lender. BeyondTrust Software recently obtained a $1+ billion refinancing at S+500, with an OID of 99, which is amongst the lowest-priced unitranche deals of the year. With spreads still above pre-rate hike lows, many lenders believe spreads can still drop a little bit more (perhaps an additional 25–50 bps). Additionally, mezzanine debt issuance levels, which had been on the rise due to mezz debt's fixed rate nature in a rising rate environment, have started to normalize a bit.

CHART 3: **AVERAGE SPREAD BY INDUSTRY: 2H 2023**



Source: KBRA DLDeals.

Direct Lending Markets vs. Broadly Syndicated Markets: 2023 also saw the continuation of a decade-long trend of issuers migrating from the broadly syndicated markets to the private debt markets. Nearly 90% of new LBOs were completed in the private debt markets in 2023 given the certainty to close and the tighter lending relationships available in the direct lending markets. While many of these deals are just too small for the broadly syndicated markets (typically reserved for borrowers with $40–50 million of EBITDA and above), jumbo private market deals continue to grow in popularity.

Private credit has been around for decades, but really took off following the Global Financial Crisis as banks (the dominant force in the broadly syndicated markets) saw an increase in regulations and restrictions, which pared down their lending and underwriting capabilities. Direct lenders began to fill in the void and have been growing ever since.

However, that broadly syndicated to private credit migration appears to be on a temporary pause in early 2024 as several issuers have migrated back to the broadly syndicated market. The spread between unitranches and broadly syndicated term loans increased to 213 bps from 150 bps in December and 116 bps in November. While this is not exactly an apples-to-apples comparison, as pricing is not the only difference between the markets, it does give an overview of the overall sentiment. As a result, several issuers such as Cotiviti, who issued a $5 billion TLB in the broadly syndicated market, are taking advantage.

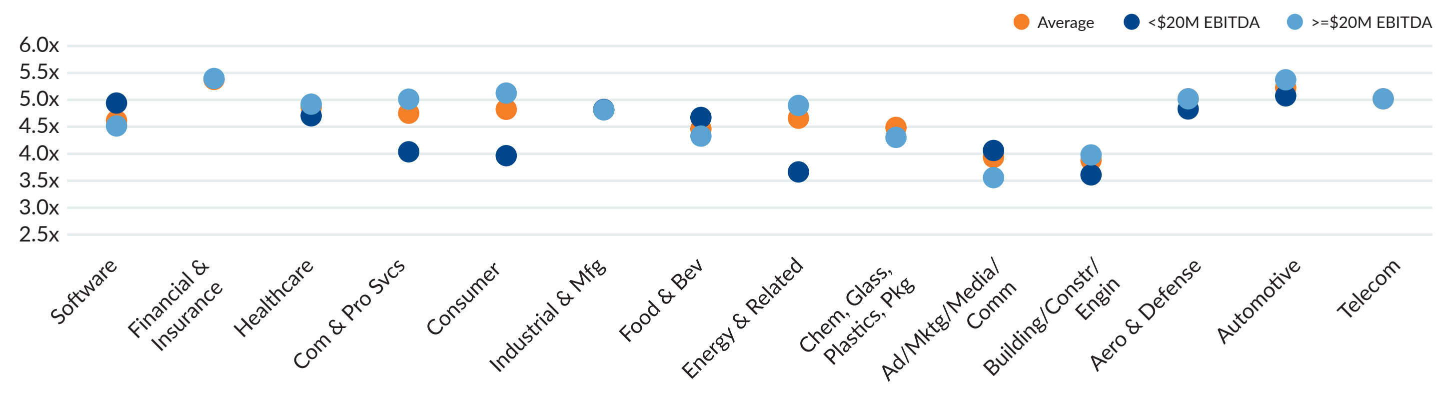
With over $130 billion of broadly syndicated debt maturing in the next 2 years, market participants will remain keenly focused on which market this debt gets refinanced in. Combined with an increase in banks offering both broadly syndicated and private credit options, many borrowers are dual tracking loans to see where they can ultimately receive the best execution.

Structural Considerations: As interest rates began to increase in 2022, borrowers saw a corresponding reduction in leverage (approximately one turn of leverage for most fully levered borrowers to compensate for the additional 5%+ interest increase). With rates stabilizing and anticipated to drop, unitranche leverage has inched up towards 5.6x compared to 5.0x a year ago for borrowers with over $25 million of EBITDA. Even smaller issuers are seeing leverage inch up to 5.4x.

Covenant packages have remained standard with smaller issuers requiring both a fixed charge coverage and leverage test and larger issuers getting by with just a leverage test or no maintenance covenants at all. However, especially for smaller borrowers, lenders continue to scrutinize both interest coverage ratios and fixed charge coverage ratios to ensure borrowers can handle higher interest levels.

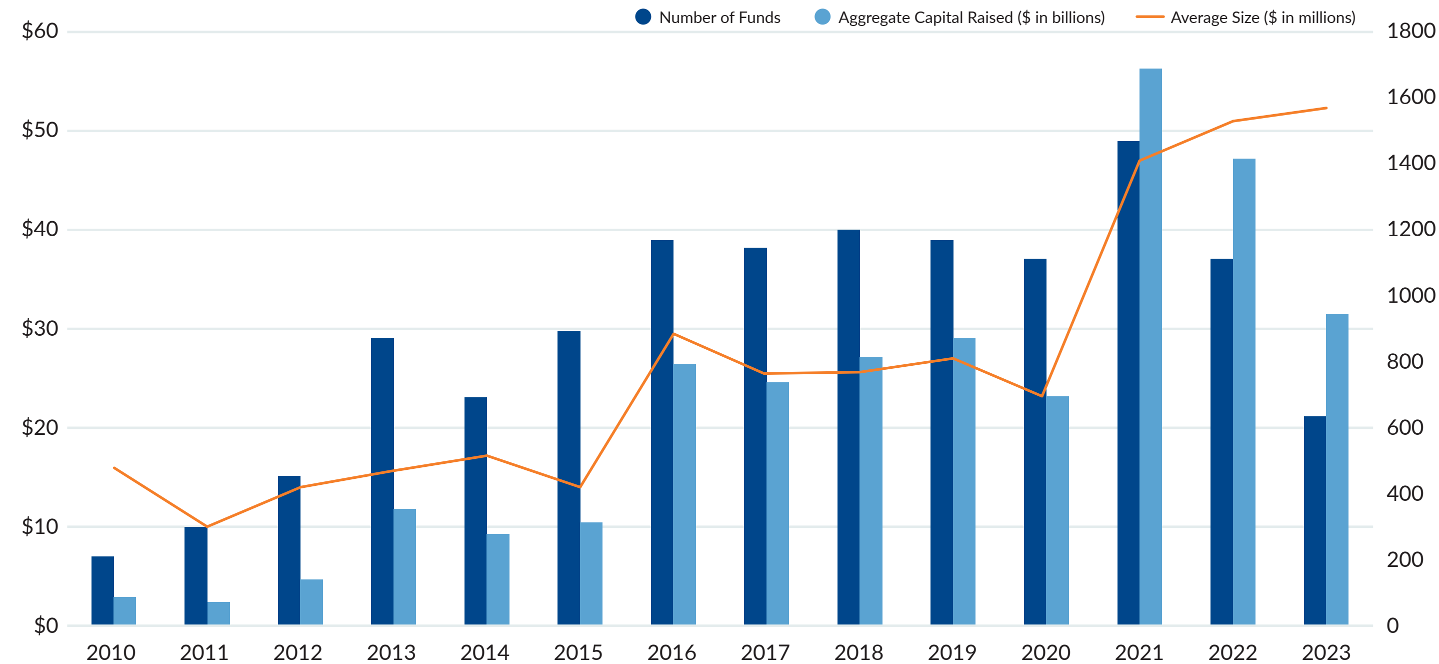
With 2023 focused on add-on activity as opposed to new issue LBOs, borrowers looked towards delayed draw term loans and accordion facilities to accomplish their financing needs.

CHART 4: **TOTAL LEVERAGE BY INDUSTRY: 2H 2023**



Source: KBRA DLDeals.

CHART 5: **NORTH AMERICAN DIRECT LENDING: SENIOR DEBT AND UNITRANCHE STRATEGIES**



Source: KBRA DLDeals.

Fund Raising: While the private credit markets continue to get significant headlines for the amount of money flooding into them, 2023 actually saw a decrease in fund raising from $47.25 billion to $31.38 billion. Undoubtedly, much of the drop has to do with expectations for a decrease in interest rates. Regardless, this remains the 3rd highest total ever with 2021 and 2022 being the other two largest. Market experts put the current value of the private debt markets at ~$1.4 trillion (~$110 billion from Private Credit CLOs, $290 billion from BDCs, $800 billion from Direct Lending Funds, and $200 billion from other sources). Most market participants believe there will continue to be a healthy amount of money allocated to private credit to go to the space, although 2021's record may not be topped any time soon.

About Mesirow

Mesirow is an independent, employee-owned financial services firm founded in 1937. Headquartered in Chicago, with locations around the world, we serve clients through a personal, custom approach to reaching financial goals and acting as a force for social good. With capabilities spanning Global Investment Management, Capital Markets & Investment Banking, and Advisory Services, we invest in what matters: our clients, our communities and our culture.

To learn more, visit mesirow.com and follow us on LinkedIn.

1. Statistics according to KBRA DLDeals. Given the nature of the private markets data around volume and pricing is incomplete and missing many deals that aren't reported. | Mesirow refers to Mesirow Financial Holdings, Inc. and its divisions, subsidiaries and affiliates. The Mesirow name and logo are registered service marks of Mesirow Financial Holdings, Inc., © 2024, Mesirow Financial Holdings, Inc. All rights reserved. Mesirow does not provide legal or tax advice. Securities offered by Mesirow Financial, Inc. member FINRA, SIPC. Some information contained herein has been obtained from sources believed to be reliable but is not necessarily complete and its accuracy cannot be guaranteed. Any opinions expressed are subject to change without notice. It should not be assumed that any historical market performance information discussed herein will equal such future performance. This report is for information purposes only and should not be considered a solicitation to buy or sell any security.