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Macroeconomic Headwinds Slowing Down U.S. Leveraged Lending Market

Is the next big wave of defaults about to begin?

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“Be fearful when others are greedy and greedy when others are fearful.” – Warren Buffet

This quote by famous billionaire Warren Buffet is quite apt for the leveraged lending market. On one hand, the market is going through a period of uncertainty and, on the other, is providing attractive opportunities to yield-hungry investors as it offers the highest yields in a decade.

Despite the high yields, investors should carefully consider their risk tolerance as the leveraged lending asset class is extremely risky, and with global economies potentially heading into a recession in the second half of 2023, defaults are expected to increase in the near-to-medium term.

In this article, we’ll discuss the key risks and recent trends in the leveraged lending market.

Introduction to Leveraged Lending

Leveraged lending is financing extended to companies with pre-existing leverage on their balance sheet and a speculative-grade credit history or rating. Leveraged financing carries a significant risk in comparison to traditional financing. It is more rewarding as lenders charge higher interest rates.

There is no universal definition for leveraged debt. Still, it can be categorized based on certain conditions, such as high interest rates compared with investment-grade debt, highly leveraged borrowers, and low credit ratings from credit agencies (BB+ / Ba1 or lower by S&P / Moody's). Companies use leveraged debt to primarily finance:

- **Mergers and Acquisitions (M&A):** Leveraged financing is mainly used for M&As that require market funding and are typically financed through leveraged buyouts (LBOs).
- **Recapitalization:** Companies use leveraged debt to meet their recapitalization needs, such as dividend payouts, stock repurchases, equity infusions, and IPOs.
- **Debt Refinancing:** Companies use leveraged financing to refinance existing debts.
- **General Corporate Purposes:** Companies usually use leveraged debt to meet requirements related to working capital, general operations, and other business-as-usual tasks.

Leveraged Lending: Classification and Key Characteristics
Pro Rata Loans
Floating-rate revolving credit and amortizing term loans (TLA)
Senior secured (first-lien)
Typically syndicated to banks
Institutional Loans
Floating-rate term loans with bullet payment at maturity (TL-B, C, D)
Secured (first- and second-lien)
Structured for institutional investors
Leveraged Loans
High-Yield Bonds
Speculative-grade or Junk Bonds
Fixed-rate bonds with bullet payment at maturity
Unsecured (senior and subordinated)
Call protected with high call premiums
Less restrictive covenants
Actively traded in secondary market
Structured for institutional investors
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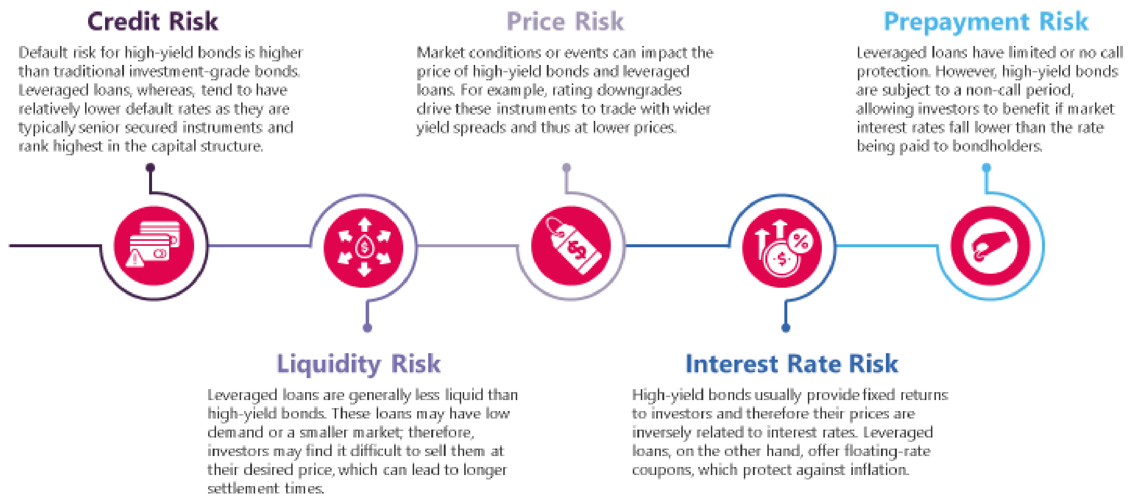
Key Risks Associated with Leveraged Lending
Credit Risk
Default risk for high-yield bonds is higher than traditional investment-grade bonds. Leveraged loans, whereas, tend to have relatively lower default rates as they are typically senior secured instruments and rank highest in the capital structure.
Price Risk
Market conditions or events can impact the price of high-yield bonds and leveraged loans. For example, rating downgrades drive these instruments to trade with wider yield spreads and thus at lower prices.
Prepayment Risk
Leveraged loans have limited or no call protection. However, high-yield bonds are subject to a non-call period, allowing investors to benefit if market interest rates fall lower than the rate being paid to bondholders.
Liquidity Risk
Leveraged loans are generally less liquid than high-yield bonds. These loans may have low demand or a smaller market; therefore, investors may find it difficult to sell them at their desired price, which can lead to longer settlement times.
Interest Rate Risk
High-yield bonds usually provide fixed returns to investors and therefore their prices are inversely related to interest rates. Leveraged loans, on the other hand, offer floating-rate coupons, which protect against inflation.
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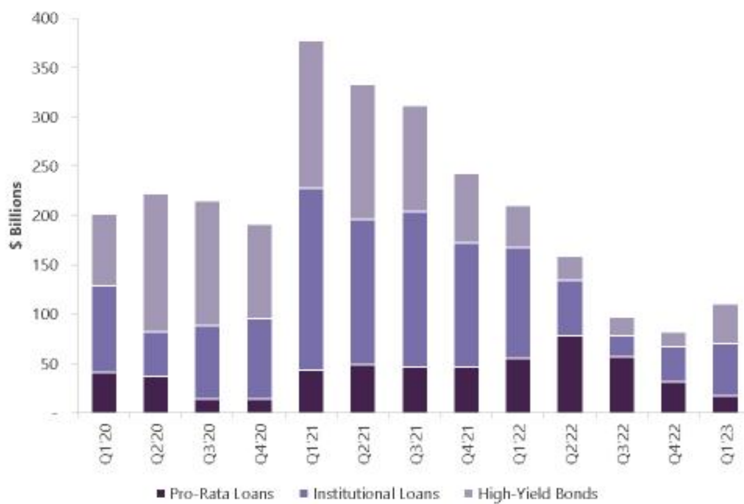
Slowdown in U.S. Leveraged Lending Market Amid Macroeconomic Uncertainty

The U.S. leveraged lending market, the largest globally, has grown considerably over the last two decades, fueled by an expanding economy and a very low interest rate environment. According to an estimate by PitchBook Leveraged Commentary & Data (LCD), total outstanding institutional loans in the U.S. grew from ~$100 billion in 2000 to ~$1.4 trillion. Including high-yield bonds, the market size is estimated to be over $3 trillion. The estimate would increase further if pro rata loans are also considered.

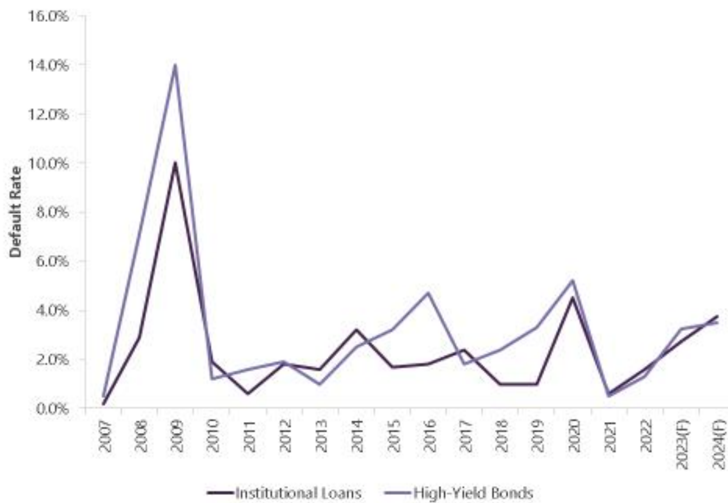
After a record-high issuance in 2021, the U.S. leveraged finance market witnessed the most significant contraction since the Global Financial Crisis (2007-2008) in 2022, as borrowing costs hit multi-year highs due to macroeconomic uncertainty. The tightening of monetary policy by the U.S. Federal Reserve to keep inflation under control weighed on M&A deals and debt refinancing activity last year. New leveraged loan issuances declined by 44% year-over-year to $447 billion in 2022. High-yield bonds suffered an even steeper decline, with 2022 issuance dropping by 78% year-over-year to $102 billion.

Although there are some signs of revival, as the first quarter of 2023 saw sequential volume growth for the first time in the last two years, the market still has a long way to go. There are expectations that deal flow will gain traction in the second half as market conditions normalize, but it will certainly remain below the historical levels.



Is the Next Big Wave of Defaults About to Begin?

Over the years, the shift in lending activity from regulated traditional banks to non-bank financial institutions has increased the competition and risk for leveraged transactions. Non-bank financial institutions have a greater tolerance for credit risk, evidenced by the rising share of covenant-lite transactions, which has currently surpassed 80% of the outstanding leveraged loans in the U.S. from less than 20% at the end of 2009, according to LCD. The less restrictive structure gives borrowers higher leverage on their balance sheet and removes an early warning system for lenders, implying that a default may not occur until a very late stage in a borrower's declining financial performance. Further, most leveraged loans have been issued to borrowers rated single-B or below in recent years. All these factors could extend the loss on leveraged debt beyond historic levels in the next default cycle. Defaults in the U.S. leveraged lending market have increased recently after remaining close to historic lows in 2021-2022, but it is still trending below the 10-year historical average. At the end of May 2023, the Morningstar LSTA US Leveraged Loan Index's default rate, broadly used as a proxy for institutional loans, increased to its highest level in the last two years.



We believe the next wave of debt defaults is imminent because a slowdown in the U.S. leveraged lending market and increasing borrowing costs make it difficult for borrowers to refinance maturing debt and address their liquidity needs. According to Fitch Ratings, by the end of 2023, the default rate will be 4.0-4.5% for institutional loans and 4.5-5.0% for high-yield bonds, reflecting stress on the U.S. banking sector, tighter lending conditions, and growing macroeconomic headwinds. The anticipated institutional loan default rate for the same year is roughly $60 billion in volume. However, it is well below the

record set in 2009. It is expected that 2023 will witness about 75 defaults, a sharp rise from 21 and 26 in 2021 and 2022, respectively. The default rate of high-yield bonds in 2023 equates to roughly $53 billion in volume. The cumulative default rate for 2022-2024 is approximately 10% for both institutional loans and high-yield bonds, which is higher than that in 2019-2021 but below 13% and 22%, respectively, in 2007-2009.

How Evalueserve Can Support Banking and Financial Institutions

The leveraged lending market has experienced significant transformation in recent years. Geopolitical uncertainty has resulted in declining lending activity and heightened concerns about potential defaults. Banks must enhance their risk assessment processes to improve the overall quality of their leveraged lending portfolios, especially as the global economic outlook worsens. Evalueserve plays a pivotal role in assisting banks' risk management teams by offering comprehensive solutions for new money underwriting and monitoring their leveraged finance portfolio. Our team of leveraged finance experts provides in-depth credit research reports, forward-looking models, relative valuation analysis, and regular sector updates. These invaluable resources empower banks to make better and faster credit decisions, enabling them to navigate the challenges of an evolving market landscape.

How Evalueserve can support banks in managing their leveraged lending portfolio

Credit Risk Management

- Rigorous portfolio monitoring
  - ✓ Financial models update and risk ratings (DCF and EBTDA reconciliation)
  - ✓ Covenant compliance review
  - ✓ Scenario analysis and stress testing (debt service analysis)
  - ✓ Cash flow projections (De-lever test)
- Collateral / airball analysis (historical and projected)
- Credit risk assessment (including market conditions, industry trends, and borrower's financial analysis)
- Early-warning indicator monitoring

Other Support Areas

- Deal origination support (potential scanning and deal assessment)
- Industry outlook and research
- Portfolio reporting and dashboarding (comprehensive health report)
- Due diligence support (including legal, regulatory, and environmental assessments)

Value Addition

- Portfolio managers can focus on new business opportunities
- Adherence to regulatory requirements
- Improved time to market for time-sensitive deals

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About Evalueserve

Evalueserve harnesses insights from data and research with the efficiency of digital tools and platforms to design impactful solutions. Its global team of 4,000+ experts collaborates with clients across 15+ industries. Evalueserve's Corporate and Investment Banking line of business works with bulge bracket banks, commercial banks, and boutique advisory firms. Our key practice areas include sector and product support, lending and credit support, business information/library services, presentation support services, and business reporting. Our proprietary technology platform helps streamline and automate workflows and repetitive tasks and reuse work products through knowledge management. For more information, please visit: https://www.evalueserve.com/industry/financial-services

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About Lending Services

The corporate and commercial banking industries are undergoing seismic changes due to increased competition, reduced net interest margins, growing market share of fintechs, the need to adopt new technology, and ever-increasing regulatory requirements. Banks must re-evaluate their operating models to keep pace with this changing environment.

With 10+ years of domain experience, Evalueserve is a leader in transforming banking operations. We have provided the right solutions to clients across the entire value chain through our focus on digitalization, process re-engineering, insightful customer analytics, operational flexibility, and customized solutions. We support major banks globally and have delivered significant cost and time savings via our proprietary Credit Review Automation Suite, including our automated spreading tool, Spreadsmart, which makes the credit approval cycle more efficient.

Authors

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Vivek has over 17 years of experience setting up offshore support teams for global investment banks and managing delivery.

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