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In the Know: Leveraged Finance Annual Report 2024

Our annual review of 2023 and 10 predictions for 2024

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2023: The Year in Review

After several record years in the high-yield bond and leveraged loan markets (both in terms of value and volume), 2023 largely followed 2022 with lower levels of activity. Market participants held off on financings in light of higher rates and macroeconomic volatility, and M&A activity continued to be subdued. Focus remained on digitization and environmental, social and governance-linked (ESG) financing during the year, as new technology for market and regulatory frameworks continued to progress. Looking forward, as our 10 predictions attest, signs towards the end of 2023 were cause for some optimism for 2024, as markets stabilize, funds look to deploy capital, and 2025 and 2026 refinancing requirements come more into focus.

Last year proved challenging for leveraged finance markets, with international capital markets limited in new issuance for one of the longest periods on record, rivalling the 2008 financial crisis, and, with a few notable exceptions, the bank finance market primarily witnessing amend and extend transactions rather than new money deals. On a brighter note, these slower markets kept the window open for the continued accelerated growth of the private credit market, providing market participants with an alternate source of financing for larger deals in an increased number of jurisdictions. Private credit is here to stay and, even with the public markets normalizing in 2024, will continue to have a prominent place in the product mix going forward.

For traditional markets, rapidly rising benchmark interest rates, sticky inflation, and continuing supply chain and geopolitical shocks resulting from global conflicts are just a few of the trials that tested the leveraged finance market in 2023, leading to a material rise in market risk and volatility. The M&A market also slowed significantly as buyers' and sellers' views on valuations diverged and buyers had to get to grips with the increased cost of capital.

Interest rates remained elevated globally and market volatility reflected the uncertainty as policy makers worked to balance inflationary concerns and recessionary risks. With sponsors and borrowers largely having to face higher debt pricing, market appetite for any opportunistic financings was restricted. However, during the latter part of the past year, some improvement in primary market pricing was recorded, although secondary markets remained affected. As the effects of policy tightening have begun to stabilize inflationary and related concerns, the markets look to be heading into a new phase of the cycle in 2024.

While the leveraged finance market remained relatively quiet compared to historic periods, it still improved in comparison to 2022 — admittedly from a very low benchmark — with the combined volume of the total issuance of leveraged loans and high-yield bonds doubling. That said, with maturities on the horizon and a challenging capital markets environment, a majority of these transactions were implemented to stabilize capital structures rather than for new acquisitions or investments. The market saw a number of deals focused on extending maturities and ensuring ongoing covenant compliance, featuring term loan B amend-and-extend deals, add-ons and refinancings. On the other hand, new issuance volumes were significantly lower, with net new issuance even more subdued. Despite the various headwinds, there were only slightly higher default rates. Instead, the markets saw increased activity in consensual restructurings and special situations financings.

As traditional sources of funding were further restricted in many jurisdictions, borrowers turned more aggressively to alternative sources of funding, including private sources of capital in a step away from the broadly syndicated loan and underwritten high-yield markets. For traditional finance options, while the product mix between high-yield and term loan B borrowings remained in line with past trends, term loan A and asset-backed financings also resurfaced as sources of capital.

The transition to sustainable finance and the pursuit of net-zero emission targets were prominent trends during the past year, especially in EMEA. This shift reflects a growing awareness of the financial sector's role in addressing climate change and promoting a sustainable future. During 2023, market participants remained focused on green and sustainability-linked financing. With more than half of the European leveraged loans now including ESG features, such provisions are becoming more standardized. Corporates continue to evaluate the cost-benefit of new ESG frameworks, measuring the increased complexity of the reporting arrangements and ever-developing regulatory environment against the reputational, pricing and other benefits seen to date.

Another common theme, particularly in the US market, was the use of more aggressive liability management exercises, with several uptiering (i.e., improving an instrument's place in the capital structure) and drop-down (i.e., moving debt closer to the operating assets) deals taking place last year. Although uptiering transactions are more difficult to implement in Europe, with the approaching debt maturity wall in 2025 and 2026, stressed issuers are expected to engage in further liability management exercises to entice investors.

Elevated post-pandemic public debt levels saw debt-for-nature swaps, although not a new concept, gaining real traction during 2023. In May 2023, Ecuador launched the largest ever debt-for-nature deal, while in August 2023, Gabon announced a USD 500 million swap.

With generative artificial intelligence (AI) revolutionizing whole industries, its prospects and applicability became apparent in the financial sector as well. In 2023, several market participants started implementing AI across a range of products and services. Additionally, we saw landmark issuances of digital bonds, which are designed to forgo the traditional clearing systems and provide a permanent and robust platform for executing and tracking exchanges through the use of blockchain technology. While the respective regulatory framework is still evolving and the relevant regulatory bodies are still harmonizing standards for these issuances, this innovation potentially reflects a broader trend in the financial industry toward digitization and blockchain integration.

As policy tightening has started to ease as inflation has stabilized, aggregate demand has started rebalancing and price pressures have been accepted as a reality. The global economy has outperformed many predictions for 2023, with real GDP rising above pre-pandemic levels in most advanced economies and labor markets strengthening significantly. Leveraged finance markets are trending positively and we expect markets to improve significantly over the course of 2024 and beyond into 2025 and 2026.

2023 by product

During 2023, overall leveraged loan volume was down compared to 2022, with only institutional volume being slightly elevated, as a result of the very high refinancing activity in the market. Most borrowers turned to term loan B amend-and-extend deals, add-ons and refinancings.

Term loan A and asset-backed financings also resurfaced as sources of capital and, in the case of term loan A facilities, were used as an instrument to ease the issues in the syndicated term loan B market. Other borrowers turned to alternative sources of funding, including private credit. Term loan B facilities did increase compared to 2022, but this was mainly due to refinancings and amendments.

The product mix between high-yield and term loan B borrowings remained in line with past trends during the year. In the US market, high-yield bond issuance volume in 2023 was about double compared to 2022, but the total bond volume marked one of the lowest annual levels recorded, as a result of the lack of new money activity. Likewise, in the European market, bond volumes remained extremely low compared to historic levels, with half of issuance resulting from refinancing activity and only 15% resulting from M&A activity.

Yields on institutional facilities have been declining progressively over the past year, with the average margin in term loan B facilities tightening almost a full percentage point. Bond yields have been continually rising, but loans and secondary bond prices have remained flat since 2022. CLO activity was slow during the past year, and relatively muted compared to past years, both in the US and Europe.

The charts below show deal volume and value by quarter, and growth relative to Q1 2020, for the period 2020-2023 for high-yield bonds and leveraged loans:

Source: Refinitiv

2023 by Industry

During the past year, although the leveraged loan market saw a broad contraction in the US, apart from the financials, materials and retail sectors, it was relatively active in Europe and the UK, compared to 2022.

The global leveraged loan market witnessed the following:

- Retail sector financing increased globally by approximately 45% in value, despite the drop by 15% in activity in Europe.
- Financial sector financing increased globally by approximately 10% in value despite the sharp drop in the US, driven by a significant increase of 55-60% in value and 5-10% in volume in Europe.
- Product and services sector financing contracted globally by approximately 10% in value, mainly driven by a significant drop in activity in the US, despite an increase in the aggregate value of financing of approximately 40% in Europe.
- Materials sector financing increased globally by approximately 10% in value, despite the drop by around 5% in activity.
- Defaults are anticipated to be driven by sector-specific issues in the healthcare, pharmaceutical and telecom sectors in Europe and real estate and technology sectors in the US.

The chart below shows deal volume and value growth from 2022 to 2023 of leveraged loans broken down by sector:

Source: Refinitiv

The high-yield bond market saw a significant increase in activity, with issuances, as noted above, almost doubling in 2023 compared to the previous year.

The global high-yield bond market grew by at least 40% across most sectors, as follows:

- Products and services grew by approximately 45% in value, despite the drop in the US, driven by an 80% increase in Europe and a 100% increase globally in activity.
- Both real estate and energy doubled in value last year, driven by a significant increase in activity both in the US and Europe.
- Retail saw a sharp drop of approximately 50% in value and 25% in volume, despite the activity doubling in value and volume in Europe.
- Industrials grew by approximately 50% in value, driven by an increase of 50% in value and 95% in volume in Europe.
- High tech and consumer staples contracted by approximately 20% and 30% respectively in value, despite the increase by approximately 15% and 30% respectively in global volume, and the doubling both in value and volume in Europe.
- Telecoms grew by approximately 10% in value, driven by an increase of 85% in volume and 100% in value in Europe.
- Materials grew by approximately 50% in value and 40% in volume, mainly driven by an increase of 80% in value and 100% in volume in Europe.

Trends in the US market (which represents more than two-thirds of global leveraged finance activity) remain the main factor affecting global market trends.

The chart below shows deal volume and value growth from 2022 to 2023 of high-yield bonds broken down by sector:

Source: Refinitiv

2024: 10 predictions

01 Wave of refinancing

After several record years in the high-yield bond and leveraged loan markets (both in terms of value and volume), 2023 saw lower levels of activity. In an environment of rising interest rates, high inflation and geopolitical turmoil, corporates and sponsors had little incentive to opportunistically go to market, preferring to wait for an appropriate window of opportunity to do so. These factors have created a market environment in which borrowers that delayed coming to market are facing maturity walls and will have no option other than to refinance (or otherwise repay) their outstanding debt with 2024-2026 maturities.

A significant number of outstanding CMBS loans are also due to mature in 2024 and the market appetite for rollovers is limited. If alternative ways for refinancing are not found, regional banks holding mortgages where the collateral value is below the loan amount might be at risk.

Prediction

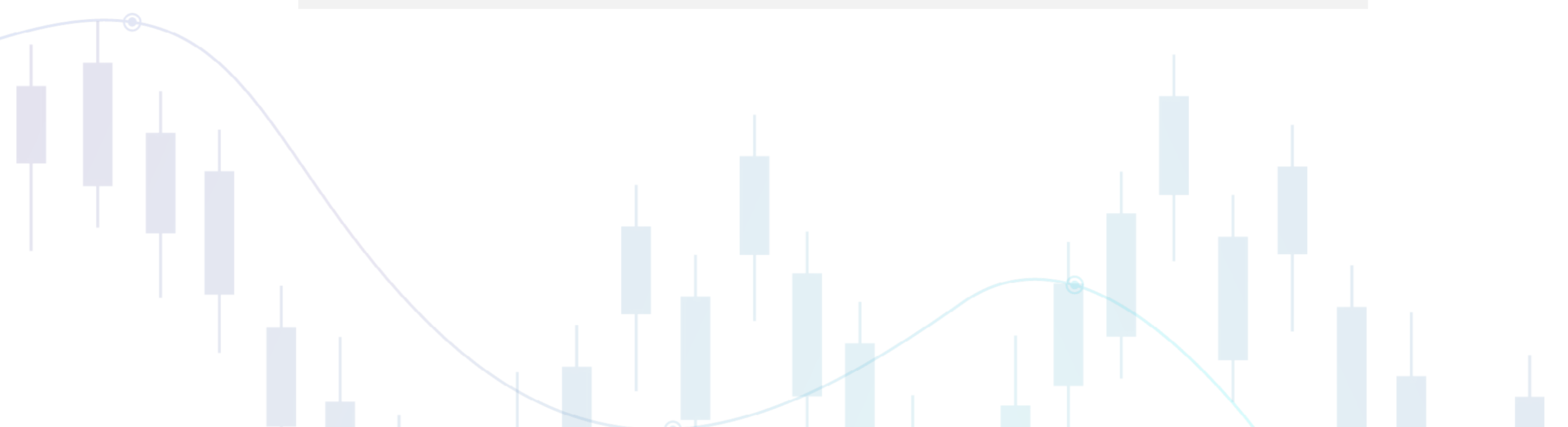
The market is coming back with a bang! We are approaching a maturity wall for five-year debt instruments dating back to the 2020/2021 wave. Although we helped certain borrowers manage their capital structures by amending and restating their existing debt instruments or relaxing covenants, many need to come to market to refinance as maturities approach. Higher interest rates are now the new norm to which market participants have adjusted their expectations. Inflation is stabilizing, volatility is reducing and interest rates are expected to remain stable or even to start to lower in the year to come. These factors are all conducive to more robust market activity.

02 M&A activity returns with a vengeance

The last two years have also seen the lowest M&A activity in recent times. Higher cost of capital has made leverage significantly less attractive to sponsors. When matched with a lack of a "meeting of the minds" around valuations in many transactions, M&A activity came to a halt.

Prediction

M&A activity is expected to rebound. Market participants have adjusted to the new norm of higher interest rates and their impact on valuations. Although interest rates are "high" in comparison to those observed since the GFC, when looking back to the pre-GFC era, interest rates actually are at standard (even normal) levels. As interest rates stabilise, we expect that views around valuations will align and M&A activity will be rekindled throughout the markets. We expect leverage to remain a key tool for sponsors in their acquisition financing.



03 Post-interest rate hikes era

At the risk of prompting a recession and in response to the surge in inflation, the Federal Reserve and the ECB, as well as the Bank of England, implemented very aggressive monetary tightening policies. Since April 2023, the Federal Reserve has raised the target range for the federal funds rate by 50 basis points to 5.25–5.50%, while the ECB has hiked policy rates by 100 basis points. According to the IMF, advanced economies' central banks have delivered a combined 3,915 basis points of policy rate hikes since September 2021.

Prediction

Several central banks across emerging markets, such as Brazil and Poland, have already started cutting policy rates and others may follow suit. Although we expect less scope for short-term pre-emptive easing in the US and Western Europe, and particularly cautious major central banks may follow a tight monetary policy for longer, rates will at a minimum stabilize to provide for greater market certainty. Once inflation normalizes, rate cuts are likely.

04 Economic growth outweighs recession

Despite gloomy 2023 predictions, the global economy has proved resilient. Not only did the US economy avoid recession, but on the contrary, it grew at a 5.2% annualized pace and has grown by 25% since the pre-pandemic era. Likewise, Europe seems to have dodged the bullet of natural gas shortages and soaring inflation.

Prediction

Market commentators are split in the debate over growth versus recession in 2024. Recessionary fears still linger, but the risk seems to have substantially abated. US GDP growth of 0.8% is anticipated, while EU GDP growth is forecasted to improve to 1.4% in 2024, even though world growth is expected to fall to 2.1% next year.

Although the uncertainty around the 2024 US elections and the very different fiscal policies of the main political parties could increase short-term volatility, there should not be any severe impact on the economy in the long run. Regardless of whether the House of Representatives and the Senate are all controlled by the same party, or if the power is divided, markets tend to react similarly in the long run and investors stick to their long-term plans.

05 The future: artificial intelligence and digital bonds

In 2023, digital disruption and AI have started reshaping the market, with advancements in machine learning, improved language processing and enhanced computer-vision capabilities. AI is integrating more in healthcare and finance, and autonomous systems are making significant strides. AI is already one of the key drivers of corporate growth.

On the digital bond front, several banks have issued digital bonds, with the EIB taking an institutional lead, having issued bonds on the blockchain. Offering several advantages such as efficient issuance and settlement, cost savings, enhanced security, bondholder identification, and automation of compliance processes, digital bonds had quite a few landmark issuances in 2023.

Prediction

The EU adopted the Markets in Crypto-Assets Regulation, which came into force in June 2023 and will begin to take effect in stages from June 2024. A structured market aligned to those of more traditional financial instruments is being established. Furthermore, the DLT Pilot Regime Regulation, which has been applied since March 2023, gave market participants an opportunity to test new digital technologies that might otherwise be restricted or prohibited under existing regulations. As the respective regulatory frameworks and digital technologies continue to evolve, more issuers are expected to embrace digital bonds.

AI is here to stay — and grow! As the financial services markets have already started embracing digital processes, we expect to see very soon the application of AI in bond origination and bond OTC trading.

06 Direct lending market continues to grow

The lack of availability of traditional funding sources on acceptable economic and commercial terms during 2023 led many borrowers and sponsors away from the wider leveraged finance markets, seeking tailored funding solutions. With syndicated markets under pressure, direct lenders filled the void by offering additional flexibility, reliability and speed of execution (including in new markets), as well as the ability to continue to finance larger transactions.

Prediction

The balance between syndicated loans, high-yield bonds and direct lending can be expected to fluctuate over time, with direct lending continuing to grow and take a larger piece of the market, and provide financing for larger deals than in prior cycles. As public markets normalize and direct lenders continue to demonstrate the ability to provide financing solutions for transactions that would have traditionally gone to the public markets, sponsors/borrowers will likely run dual-track processes — public and private market options —– in order to find the best financing options.

07 ESG financing is here to stay, with more options on the way

The increased stakeholder scrutiny and demand for ESG products has positioned the future of sustainable financing for significant growth. With zero emissions targets, diversity and social equity at the forefront, transition finance has been a hot topic over the past few years. A significant number of financial instruments have incorporated ESG-linked features as financial institutions continue to incorporate ESG criteria in relation to their risk assessments and investment strategies.

Furthermore, in 2023, there were some notable regulatory developments in the ESG sector, including the adoption of the Carbon Border Adjustment Mechanism (CBAM) Regulation and the European Green Bonds Regulation.

Prediction

The demand for green bonds, sustainable financing products and, more broadly, ESG-linked instruments is expected to increase. Companies, their stakeholders and governments will continue to focus on funding environmentally friendly projects. Furthermore, the evolution of the respective regulatory frameworks reflects the continuous transformation of the global economy towards sustainable finance, and ESG reporting and accountability are increasing. Transition finance and ESG features are here to stay.

08 Financial stress and restructurings are unavoidable in this interest rate environment

Given the sharp interest rate hikes around the world in 2023, corporates have seen a great increase in their cost of funds throughout their capital structures. Borrowers in financial distress have therefore been required to actively manage their cost of capital in order to manage their prospects through operational turnarounds and balance sheet restructurings.

Prediction

With approaching debt maturities in 2025 and 2026, some borrowers and issuers may need to refinance their current debt, despite the higher interest costs. Although certain borrowers will have bought themselves time through amend-and-extend exercises, for others, the new cost of funding may not be sustainable, requiring restructuring. However, given recent trends in bank and bond covenants (e.g., fewer maintenance covenants in bank facilities and the general flexibility creep in covenants), such reorganizations may tend to be more 'consensual' as performance- based event-of-default triggers are less prevalent.

09 Alternative sources of funding continue to evolve

Given the current state of the primary debt finance markets (for bonds and loans) over the course of the year, we have observed an increased consideration for alternative debt products in local markets, such as the Schuldschein in Germany, Nordic Bonds in that region, the Sukuk in MENA and, particularly in more recently emerged markets like the CEE and CIS, local-bank-led credit facilities. Sponsors and corporates have also turned to other sources of liquidity such as CLOs/PMOs, factoring, receivables financings, securitizations, and sale and leasebacks.

Prediction

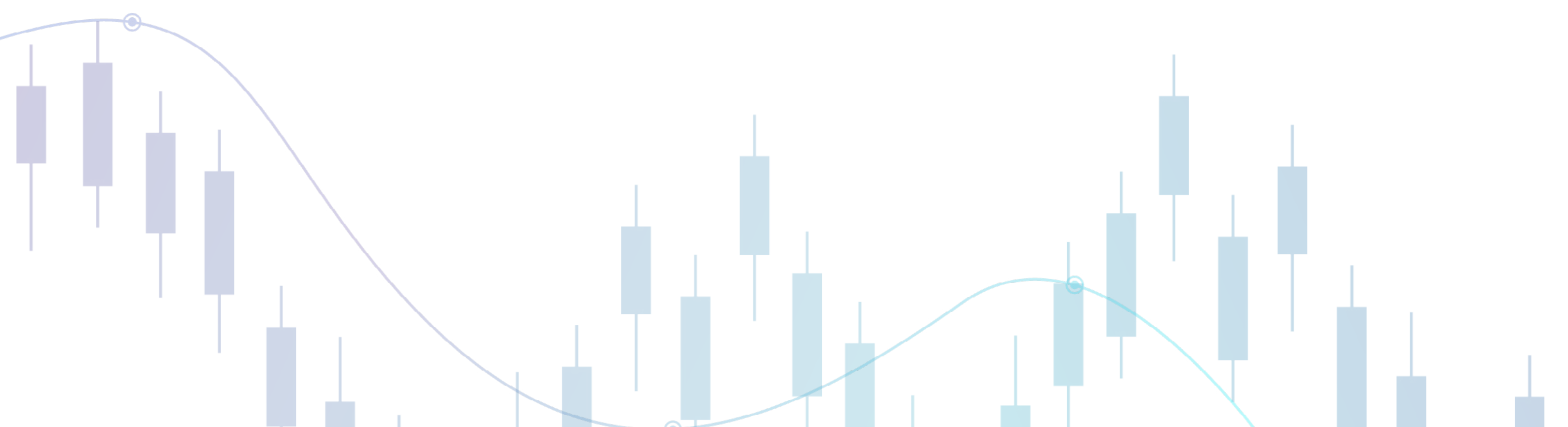
As market participants around the world become more experienced and knowledgeable in debt finance transactions and alternative sources of liquidity, in light of higher interest rates and lack of capital supply, we expect alternative sources of funding and liquidity to continue to evolve and to see new more bespoke sources emerge across markets.

10 More debt-for-nature swaps

In 2023, the Ecuador debt-for-nature swap demonstrated that these transactions (whereby existing sovereign debt trading at a discount is tendered for and retired using funds from new debt issued at par through the use of third-party insurance/guarantees, in exchange for some of the savings to the sovereign being used for conservation-related projects) could be done at a far greater size than before. While many such swaps have been done since the 1980s, the amounts involved have typically been in the low millions of US dollars, rather than the more than US dollar 1 billion involved in the Ecuador swap. Gabon's USD 500 million swap, shortly after Ecuador's, provided an African precedent, whereas such swaps previously have been predominantly in Central and South America.

Prediction

The precedent set by the two "jumbo" 2023 debt-for-nature swaps, combined with the anticipated lowering of interest rates globally leading to favourable conditions for the new debt issuance required to fund such swaps, will lead to a marked increase in these transactions, particularly in Africa. We also see it being highly likely that the sustainability commitments for which part of the savings in such deals is agreed to be used (negotiated as the "quid pro quo" for the third-party insurer/guarantor involvement) will expand in large-scale deals to areas other than nature conservation, being linked instead to other areas targeted by the UN's Sustainable Development Goals (such as education or healthcare). We also see the arranger/underwriter market for such transactions becoming more diverse, as many financial institutions have expressed strong interest in being involved in such transactions going forward.



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