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Corporate Debt

Newsletter Q1 2023

Corporate Debt Markets in Q1 2023 – Overview

- In the fourth quarter of 2022, the European corporate debt market remained under pressure and declined compared to the same quarter of 2021 and the full year, reflecting the weak macroeconomic conditions and increased interest rates.
- PWC reported 37 high yield bond deals amounting to EUR 18bn (QoQ: +100%), compared to 78 deals with a volume of EUR 45bn in Q4 2021. Even though this was a QoQ improvement, activity has been strongly depressed throughout the whole year with a 70% drop compared to 2021.
- In the German senior debt and unitranche market, 40 transactions were closed in Q4 2022. This is 29% more than in Q3 2022, but strongly pushed by add-on financing rather than completely new deals.
- With lower risk tolerance across the board and most of the macroeconomic stress factors not resolved yet, the credit tightening will most likely continue in 2023.

European Sub-IG Market

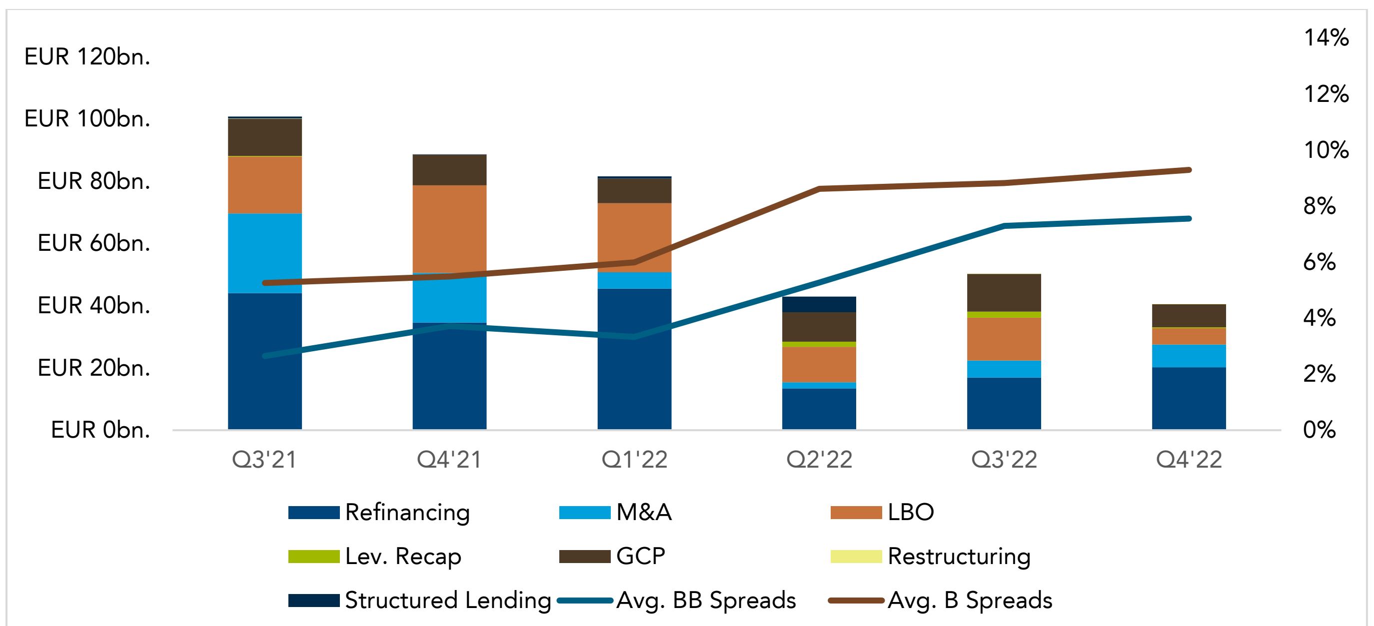

Figure 1: Volume of Sub-IG European debt markets (incl. leveraged loans and bonds) and average spreads*

Source: White & Case (Debt Explorer), PwC Debt Watch Europe 2022 Annual Review
**Partial adjustments to previous quarters based on data from White & Case (Debt Explorer)*

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European Debt Market

According to Debtwire, European leveraged loan and high yield bond activity has reached a new low in Q4 2022 with a value of EUR 40.6bn, decreasing by 19.3% QoQ. (Q3 2022: EUR 50.3bn). The YoY drop is even more significant at 54.2% similar to the one in Q3 2022 before.

Once again, refinancings were the largest contributor to total volume with EUR 20.2bn (49.8% share) followed by GCP and M&A with EUR 7.3bn (18.1% share) each. The largest YoY drop was attributable to LBO financings with a decline of 81% from EUR 28.2bn to 5.2bn in Q4 2022. This was due to the manifold stress factors for the takeover industry such as rising inflation and supply chain issues as well as the resulting higher interest rates.

According to S&P, spreads on newly issued European loans decreased to an average of E+470bps in Q4 2022 from E+515bps in the third quarter due to very small issuance volume. At the same time, the yield to maturity increased by 77 bps to 8.21% after 7.44% in Q3 2022, which is due to the once again increased base rates. With the decrease in spreads overcompensated by the increase in base rates, Q4 yields were at a new record level since the global financial crisis. After the continuous increase in base rates throughout the whole year and the additional uptick in spreads, yields on leveraged loans have roughly doubled throughout 2022, significantly dampening the outlook for LBO activity in 2023.

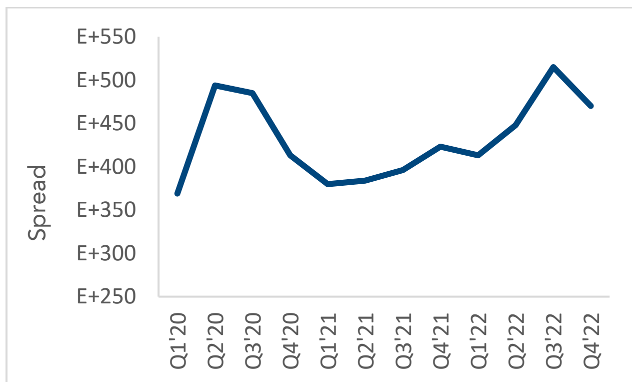

Figure 2: European new issue loan spreads
Source: S&P Global Market Intelligence

In Q4 2022, 129 sponsored European PE deals were closed, a decrease of 28% from the previous quarter. This is the result of several macroeconomic and geopolitical stress factors seen before, including rising interest rates and thus higher financing costs, increasing energy and commodity prices, as well as the ongoing war in Ukraine.

According to PWC, activity in high yield bonds has been picking up QoQ but slowing down YoY with 37 deals amounting to a raised volume of EUR 18bn in Q4 2022, after Q3 was the lowest since 2018 (QoQ: +100%). Investors have become more cautious, not issuing any bonds with a triple-C rating or below since January 2022.

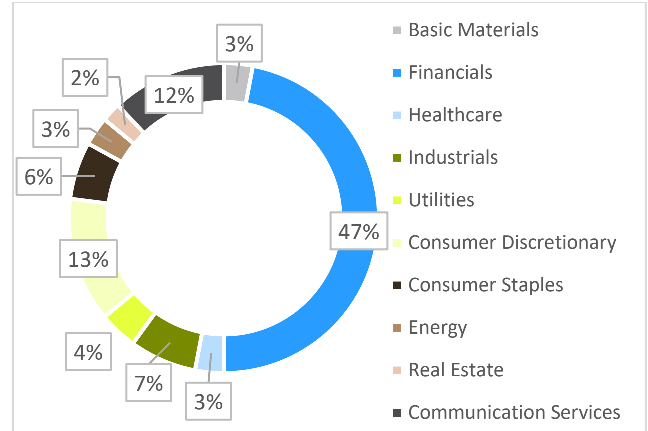

Figure 3: High Yield Volume Europe, Q4 2022 Sectoral Split
Source: PwC Debt Watch Europe Q4 2022

Compared to 2021, the largest shift in the sector distribution was the 19% market share increase of the financial sector to 47% in 2022 (as shown in Figure 3) after 28% the year before. Most of the other sectors have been slightly declining with no change larger than +/- 4%. The technology sector, which had a share of 3% in 2021, dropped out of the market completely.

DACH Debt Market

The Houlihan Lokey MidCap Monitor reported 40 German senior and unitranche debt transactions for the fourth quarter of 2022. This leads to a slight YoY increase and another record year for the mid-market with 159 transactions compared to 158 in 2021. Although this looks very active on surface level, a large part of deals, especially later that year, were add-ons and refinancings which increased their share from 50% in 2021 to 59%. Debt funds were responsible for 55% of the deals while banks did the other 45% after only 32% in 2021 thus increasing their market share for the first time since 2016. In terms of sectors, software & tech lost 10pp of their market share YoY after 36% in 2021 but was still the dominant sector with 26% in 2022. Healthcare retained the second spot with 21% after 23% in 2021 and industrial & manufacturing at the third spot was also pretty constant decreasing from 19% to 18%. Both consumers and services increased their share by 6pp from 10% to 16% in 2022. Even though financers have become more conservative in terms of relative debt sizes, they remain open for new business overall. The increase of banks' market share in the mid-cap segment is mainly due to two developments: First of all, the sector shift from typically expensive tech / software companies to larger shares of consumers and services, which are typically cheaper, reduces the need for high leverage thus taking away one of debt funds' key differentiators and accordingly justification for their higher margins. Second, the overall smaller ticket sizes allow for smaller bank clubs stemming the financings, which makes negotiations easier and thus increases relative attractiveness of them.

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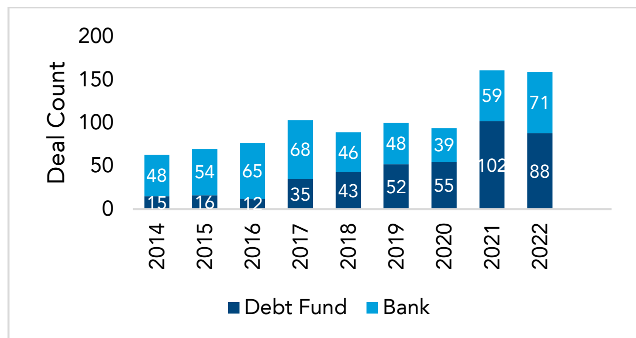

Figure 4: German mid-market financings 2022
Source: Houlihan Lokey MidCap Monitor Q4 2022

Looking at the European market as a whole, Germany remains one of the most active regions for unitranche financings. In Q4 2022, it took the second spot with 21 deals closed only behind the UK with 27 deals out of 91 for Europe as whole.

Financing Conditions

The European Central Bank continued its route of interest rate increases to combat inflation. After the increases in November and December, the deposit facility stood at 2%, the refinancing rate at 2.5% and the marginal lending rate at 2.75% at the end of Q4 2022. On February 8, 2023 each rate was increased by 50 bps once again. On a positive note, however, inflation seems to have peaked in October throughout Europe with inflation rates slightly decreasing since. After the 11.5% peak, inflation rates decreased to 10.4% at the end of the year and went down further at the beginning of 2023 due to the base effect. Additionally, inflation is expected to continue to decline as energy prices keep falling and supply chains relax among lower demand.

According to the European Central Bank lending survey, banks continued to substantially tighten their credit standards in Q4 2022. The decisive factors included a lower risk tolerance of the banks as well as the company- or firm-specific situation and the economic outlook in addition to banks' costs of funds and balance sheet situations.

Continued advance of Private Debt

Due to the quickly changing conditions both in regard to base rates and credit spreads in 2022, the market landscape has also changed quite drastically. However, this was mostly an acceleration of the already prevalent structural trends rather than something completely new.

With economic uncertainty returning, banks generally started to lower their risk appetite and thus lending activities. With higher provisions for possible loan losses, they also had to set aside more equity due to regulation additionally decreasing their capital capacity available for lending. The combination results in banks moving out of riskier loan origination activities into lending that is conceived as safer. This is especially true for leveraged corporate debt, which is one of the reasons for the reduced activity and leverage levels in the last year. However, this trend was generally active already before the war in Ukraine due to long-term regulatory efforts to de-risk banks' balance sheets since the global financial crisis.

Simultaneously, there is another factor benefitting Private Debt solely caused by banks' activities themselves: Hung large-cap financings. In the past years, private debt has continuously increased its market share especially in the mid-market space, whereas large-cap LBOs were financed almost exclusively via bank syndicates. This was due to different factors, but mainly because Private Debt funds were risking large portfolio concentrations when taking on multi-billion deals and banks were much more competitive in terms of pricing and covenant structure. In a typical large-cap process, bank syndicates underwrite the debt and shortly thereafter start syndicating the loans to institutional investors such as Collaterized Loan Obligation vehicles, pension funds, or smaller regional banks. Therefore, banks do not really function as buy-and-hold lenders on these deals but rather as market makers matching the borrower with a large, amassed consortium of smaller lenders and thus want to turn over the underwritten debt as quickly as possible to free their capital for new underwritings.

However, banks have underwritten many large deals in early 2022 before the very quick change of lending conditions. As a result, return levels of the broad market were totally different at the start of the respective debt sales process than at the time of underwriting. As an additional stress factor, the strong increase in inflation also hurt some of the business outlooks of borrowers. Accordingly, prospective investors required much higher returns on the newly issued debt, leaving banks with two options: either selling the debt with huge discounts, resulting in a direct loss, or not selling the debt and waiting for better market conditions, which comes at the cost of tying up capital for new underwritings. In the end, there was a mixture of both, leaving banks' balance sheets with lots of so-called hung debt, which could not be sold due to mismatches in pricing expectations between banks and investors. For example, debt from takeovers such as Citrix, Twitter and Morrison could not be syndicated as planned and some of it is still held by the banks in 2023. Estimates for the amount of hung LBO debt at the end of 2022 range between USD 30bn and USD 50bn.

Nonetheless, large-cap PE still had and still has a lot of dry powder, which has to be put to use in large-cap transactions. As it is very unfavourable for a PE fund to buy targets all-equity in most of the cases, there is still demand for huge financing packages. As banks somewhat retrenched and negotiating power turned to lenders, large Corporate Private Debt funds stepped in to support the large acquisitions. This is possible nowadays due to the ever-increasing Private Debt fund sizes, sometimes exceeding EUR 10bn and thus lowering concentration risk concerns, and covenants and conditions turning in favour of lenders, which converges the competitiveness of bank underwritings to that of Private Debt. For example, the USD 5bn debt package for the Zendesk takeover by H&F and Permira was provided by a Private Debt consortium and for the multi-billion takeovers of Anaplan by Thoma Bravo and of Nielsen by Elliott and Brookfield, Private Debt groups were part of the syndicates taking on large parts of the respective debt amounts.

In conclusion, the recent developments have further increased the competitiveness of Private Debt against traditional lending and alternative lenders have increased their global market share even though the absolute market value has decreased throughout 2022. This development is the same across all Private Debt asset classes and mirrors the original emergence of Private Equity in the 1980s, when funds continuously grew in size and took away market share from more traditional financial services providers.

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About Prime Capital's Private Debt Team

Our corporate debt team has accompanied and executed transaction in excess of EUR 700m. Our Private Debt Team additionally invests into Aviation Debt, Infrastructure Debt and Real Estate Debt. We expect significant further growth in these areas, which provide attractive risk-adjusted returns to our investors.

Prime Capital's Private Debt Team manages assets in excess of EUR 2bn across the aforementioned asset classes on behalf of institutional investors. Further information about Prime Capital AG can be found on our website www.primecapital-ag.com.

Prime Capital Corporate Debt Expertise

- Advice and support for corporate debt investments, portfolio strategy and sector allocation
- Managed accounts and funds with investment expertise in various jurisdictions and markets
- Unique "multi-channel sourcing" with access to transactions via direct lending, bank and advisor sourcing on the basis of longstanding relationships to sponsors, advisors and leading banks

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