Baker McKenzie.

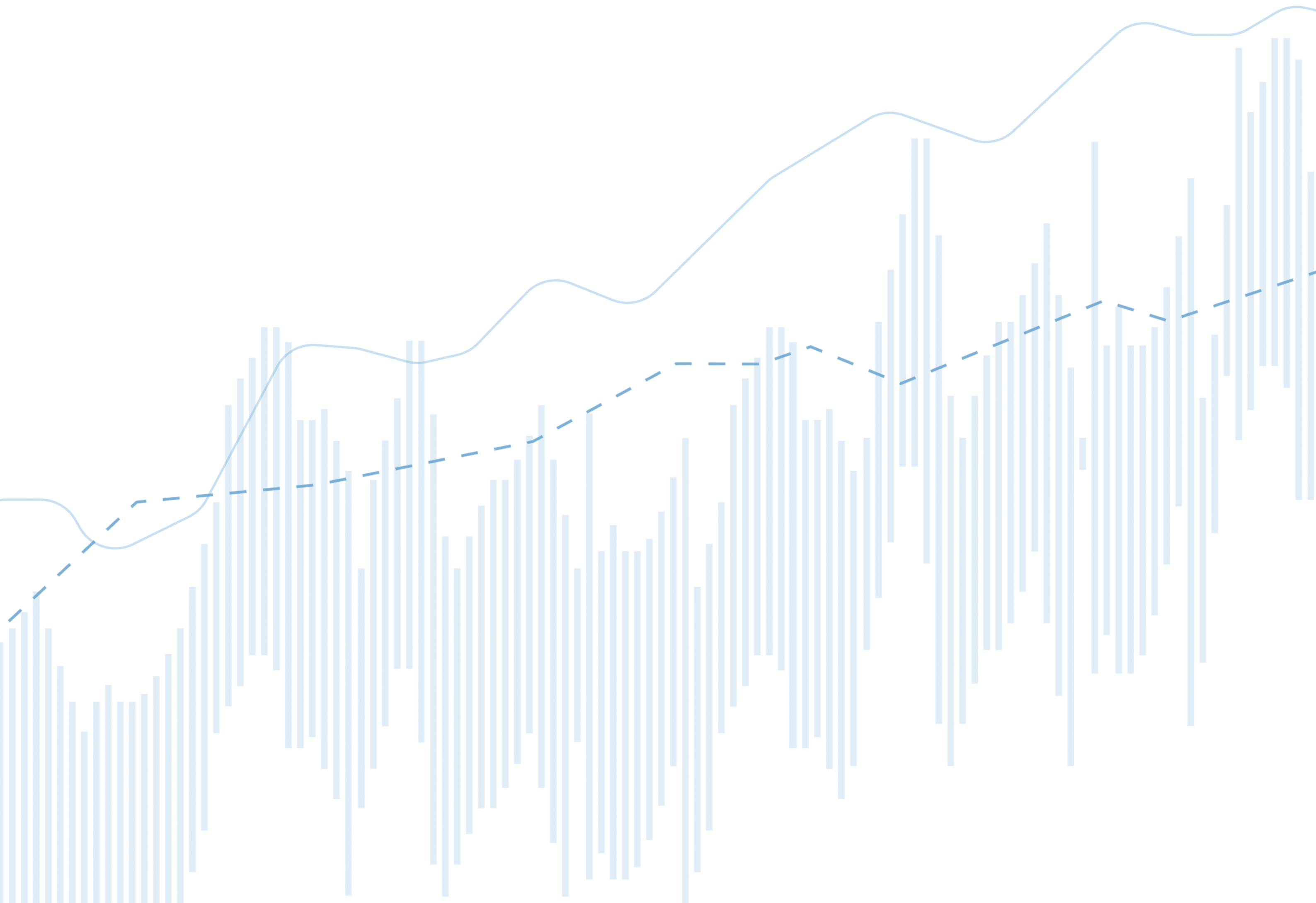
In the Know: Leveraged Finance Annual Report 2023

Our annual review and 10 predictions for 2023

TRANSACTIONAL POWERHOUSE

Leading and closing complex deals – every day

Contents



2022: The Year in Review

In 2022, the leveraged finance market saw one of the largest contractions in high-yield bond offerings and leveraged loans in over a decade. This contraction was mainly due to uncertainty in the global markets caused by factors including interest rate hikes, inflationary pressure and geopolitical unrest. As traditional international capital markets remained mainly closed, market participants turned to alternative sources of funding such as private debt or bespoke local solutions to meet their financing needs. ESG continued to be at the top of everyone's minds, as borrowers continued to enhance their reporting and regulators their scrutiny. Despite the crypto winter, the use of DLT based technology in debt capital markets continued to grow with a number of landmark digital bonds issuances coming to market as the year progressed.

The past year saw the largest drop in global transactional activity since the 2008 financial crisis across the board, with international capital markets effectively closed to new issuance in Europe for the longest period on record (including following the 2008 financial crisis) following the invasion of Ukraine by Russia. Other macroeconomic factors, such as rapid and steep interest rate hikes throughout the year and inflationary pressures (and the related market uncertainty), also put downward pressure on the markets which had seen a flurry of activity in 2020 and 2021.

Product mix between high-yield and Term Loan B borrowings remained in line with past trends, with high-yield bonds contracting the most (both in terms of value and volume). In light of the mainstream capital markets being mainly closed to borrowers, many corporates turned to alternative sources of funding such as private debt (for larger transactions) or local and more bespoke sources of credit (for smaller capital raises).

Term Loan A (i.e. amortising) also resurfaced in certain discussions as a potential source of capital given current macroeconomic pressures and in some cases a desire for more traditional protections for lenders.

Despite these drops in financing activity in comparison to 2021, M&A continued to be the main transactional driver in the market, especially as those refinancing transactions, which could be put on hold, were postponed awaiting further stability.

From an industry perspective, activity was broadly down across the board, with only a few exceptions. Global real estate (mainly driven by the US), EMEA media and entertainment and US energy and power saw activity in 2022. Despite contractions, we did not observe a significant increase in the number of companies entering formal restructuring processes, in part because current covenant flexibility provides more alternatives for issuers and borrowers to address funding needs. COVID-19 era government relief programmes have slowly been unwinding as well, adding some pressure, especially those in industries most hit by the pandemic that turned to such funding. However, for the time being, corporates have broadly been able to manage their existing capital structures, delaying the impact of increased rates.

Despite the sluggish level of activity observed throughout the market, investors and sponsors did not generally push strongly to amend or change restrictive terms (financial covenants) in existing covenant packages for repeat deals but we did observe a trend where there was increased investor push-back on so called 'bad' credits while 'good' credits continued with their existing covenant packages unaffected. Interest rates however saw sharp increases, back to "high yield" levels observed prior to the financial crisis.

ESG continues to be a main area of focus and is expected to fall under further scrutiny as borrowers are required to test SPTs on instruments dating back two years or more in the initial ESG financing waves. The recent new buzz words in this arena are also ‘transition finance’, which is being seen as a sub-product of sustainability linked loans. As a result of net zero emission objectives, energy transition is arguably the biggest transformational change the world is undergoing right now. The investment required to achieve this objective is estimated to be in the trillions of USD but the underlying nature of transition financing, i.e. providing financing to high emitting industries such as fossil fuel producers, aviation, cement and steel, inevitably brings with it greater legal, regulatory and reputational risks, meaning that its development is currently in its infancy as financial institutions work their way through the issues with caution and scrutiny.

For potential borrowers the focal point will be preparing a credible long term transition plan that can withstand the scrutiny of market participants including lenders and their stakeholders. We can expect to see the finance providers starting to respond to the needs of these transformational sectors and develop new and innovative approaches in documentation to financing these needs.

Digital bonds also emerged, as market participants start wrapping their heads around the potential of blockchain technology in the registration and settlement of bonds. These new technologies have mostly been tested in smaller contexts and are yet to come to the wider syndicated markets.

With these macro-economic headwinds now largely baked into the market and investor expectations, syndicated lending and capital markets are looking to re-open in 2023. The question is just when this will be.

2022 by Product

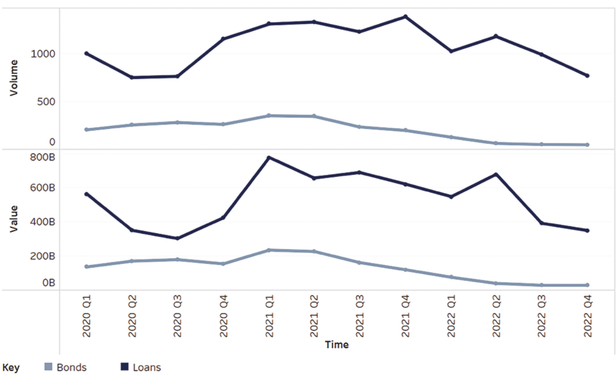
In terms of product mix, in contrast to 2021, which saw a shift from loan-financing to bond-financing, 2022 saw the greatest contraction in the bond market while leveraged loan activity was more resilient. This was mainly due to macroeconomic volatility in international bond capital markets that made it difficult (if not impossible) for unseasoned issuers to come to the market.

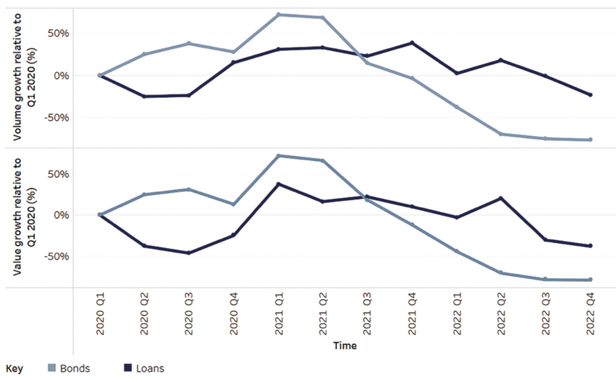
In 2022, the global leveraged finance market contracted significantly as interest rate hikes and economic uncertainty pervaded the markets. The high-yield bond market saw more of a contraction than the Term Loan B market, but market participants broadly put transactions on hold awaiting more stability and visibility on macroeconomic factors. Most of the transactions that went to market over the course of the year were M&A driven, whereas refinancing transactions were postponed in light of capital injections over the past couple of years. Although in the short run, corporates were able to weather the storm, higher interest rates are here to stay and market participants are adjusting to the new normal.

With syndicated capital markets effectively closed for capital raising, as market participants grew accustomed to the higher rate environment, borrowers turned to alternative sources of lending. Direct lending saw another strong year of growth across the board, as direct lenders were able to accommodate tailored solutions on a case-by-case basis. Borrowers also turned to local sources of funding such as local bank-led syndicates in the loan market and bespoke local bond solutions (such as the Schuldschein in Germany, Nordic bonds in that region and the sukuk in MENA) that also became viable sources to a minimum allowing borrowers to bridge their financing needs until capital markets open again.

Similar trends were seen in the US, which in 2022 saw a sharp contraction in leveraged financing across the board. A strong dollar in the second half of the year fuelled opportunistic cross-border M&A activity, which provided some transactional activity (e.g. for takeovers of UK public companies), but still saw a drop in comparison to the record high levels in past years. ESG-linked financing in the US still lagged behind the EMEA region, but saw a strong growth over the year as US reporting requirements and investor base increased focus.

The charts below show deal volume and value of high-yield debt and loans by quarter since 2020:





Source: Refinitiv

2022 by Industry

Transactions by industry saw a broad contraction across the board in the past year, apart from global real estate, EMEA media and entertainment and US energy and power.

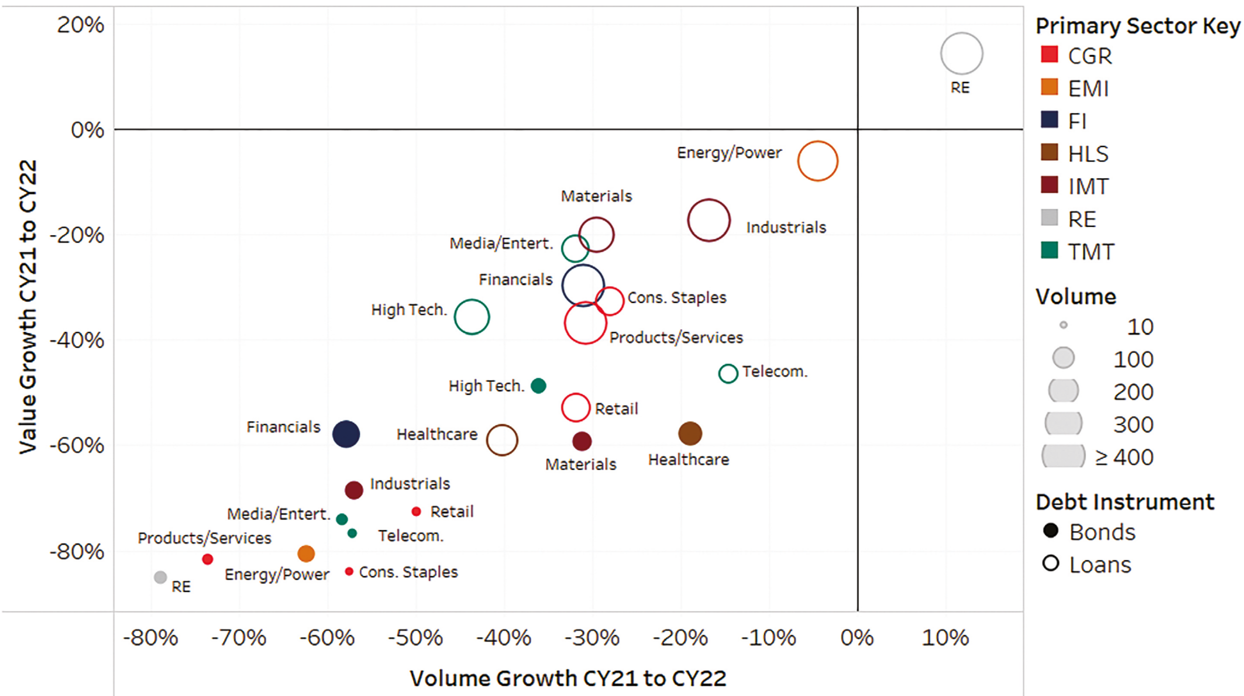
The global leveraged loan market witnessed the following:

- Real estate industry financing grew by approximately 10-15%, mainly driven by a significant increase in the US of approximate 30% in volume and 50% in value.
- Energy and power industry financing remained stable, with a 10-20% increase in the US offsetting a sharp drop of 30-50% in the rest of the world.
- Media and entertainment industry financing contracted by approximately 20-30%, mainly driven by a significant drop in activity in the US despite an increase in the aggregate value of financing of approximately 20% in Europe.

The global bond market contracted by 50-80% across all industries in the market.

US market trends (which represent 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 2021 to 2022 of high-yield debt and loans broken down by industry:



Source: Refinitiv

2023: Ten Predictions for the EMEA Leveraged Finance Market

01 Rebounding high yield bond and leveraged loans market

2022 saw one of the largest contractions in the high-yield bond and leveraged loans market in over a decade. In light of the financing wave in 2020-2021 and the slower M&A market, corporates and sponsors didn't readily feel pressure to go to market, at least in the short term. Interest rate uncertainty, inflationary concerns and geopolitical issues all gave pause to issuers and borrowers in 2022.

Prediction

Even though higher interest rates are here to stay (at least in the medium term), we expect the markets to rebound in 2023. M&A activity is still expected to drive transactional leveraged debt requirements, although this activity will likely come later in the year as purchaser and seller expectations of purchase price multiples equalize to the wider economic backdrop and higher rate environment. While issuers and borrowers pushed out their maturities with financings in 2020/2021 a number of issuers/borrowers still need to refinance existing debt, we expect market participants will adjust to higher yield expectations, particularly once inflation stabilizes and there is less volatility in the debt capital markets. We are already seeing pipelines building as we enter 2023, and expect that trend to continue.

02 Into the future with digital bonds

2022 saw new digital bond issuances by a number of issuers, of particular note were the issuances by European Investment Bank (EIB) and UBS which deployed blockchain technology on novel permissioned DLT based systems. We are at the leading edge of the developments in the digital bonds space having acted for UBS on their recent issuance and believe that digital bonds represent an exciting new stage in the evolution of securities issuance and trading. There are significant opportunities for the use of blockchain and DLT-based technology across the bond and wider leveraged finance markets.

Prediction

While regulatory uncertainty exists as regulatory bodies work to develop and harmonise standards for these digital bond issuances, we still expect to see blockchain technology move into more deals in the market — particularly the use of private blockchain ecosystems for private offerings as issuers and investment banks test the benefits of blockchain technology before it is adopted more widely in the syndicated markets. What is clear, is that market participants and their advisers should keep an eye on this space and continue to develop their understanding of the role that digitisation can have for efficient operation of our markets.

03 ESG and transition financing is here to stay

Over the past decade, the leveraged finance market has seen a proliferation of green and sustainability-linked instruments. In the past couple of years in particular, our leveraged finance team has not worked on a mandate during the course of which ESG was not at the very least considered (and more than half of our transactions had an ESG component).

Prediction

As investors' demand for ESG reporting and accountability increases, so will the need for issuers/borrowers to very seriously account for these considerations in their capital structure and, more broadly, their whole business. Furthermore, as a result of net zero emission objectives, energy transition is arguably the biggest transformational change the world is undergoing right now and we expect transition financing to become prevalent throughout the markets. ESG is and will remain one of the most important leveraged finance topics in years to come.

04 Continued growth of direct lending market

As market participants worked through the implications of higher rates in 2022, syndicated lending and international capital markets transactions saw a sharp contraction in terms of both aggregate value and volume. As a result of less supply in sources of funding, borrowers turned to alternative sources such as direct lending.

Prediction

Syndicated lending and international capital markets will return to normal levels, but borrowers will continue to consider direct lending as a viable alternative source of capital and dual track syndicated and direct lending options as a source of capital, particularly in certain industries traditionally favoured by direct lenders such as healthcare and tech and certain jurisdictions in Europe where regulatory actions (e.g., increased capital requirements) have put further constraints on traditional bank lending.

05 Financial stress and restructuring as a result of the challenging interest rate environment

Given the sharp recent interest rate hikes around the world, corporates have seen a great increase in their cost of funds throughout the capital structure. Particularly in Europe, where international capital markets were effectively closed in the middle of 2022 for a longer period than following the 2008 financial crisis, while market participants wrapped their heads around the new rate environment.

Prediction

Borrowers and issuers will need to adjust to the new rate levels as they need to refinance their current outstanding debt. Although certain groups will have built in buffers, for others the new cost of funding may not be sustainable, requiring restructuring of capital structures. However, given recent trends in bank and bond covenants (e.g., fewer maintenance covenants in bank facilities and similar credits), such reorganisations of restructurings may tend to be more consensual as traditional EoD triggers will be less prevalent.

06 Evolution of alternative sources of funding

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 CLO/PMO, factoring and receivables securitization financing 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 existing alternative sources of funding and liquidity to continue evolving and to see new even more bespoke sources emerge across markets.

07 Increased scrutiny of ESG instruments as testing dates approach

Green and sustainability-linked financing is a recent trend that has evolved and grown significantly in recent years. Although green financing looked to the use of proceeds (and was more prevalent in the early stages of ESG financing), sustainability-linked instruments looked at ESG performance over time (and usually to be tested at a future date).

Prediction

As testing dates approach for sustainability-linked financings dating back two or more years, issuers/borrowers will be required to report on their ESG performance and whether targets have been met (customarily leading to interest rate hikes or redemption premiums in the event targets are missed). This in turn will lead to investor-led actions in case of disagreements and enhanced regulatory scrutiny.

08 Possible further interest rate hikes followed by stabilisation

In November and December 2022, the Federal Reserve raised the target range for the federal funds rate by 50 basis points and 75 basis points, respectively to 4.25%-4.50%, marking its seventh consecutive rate hike and putting borrowing costs at a new high since 2008. The Federal Reserve has been tightening monetary policy as rapidly as it has ever done before, concurrent with quantitative tightening by selling back treasuries and mortgage-backed securities at a pace of USD 95 billion per month, reducing liquidity in the economy as investors absorb assets sold off from the Federal Reserve's balance sheet. Although less aggressively, the ECB has also followed suit in terms of rate hikes and monetary policy broadly.

Prediction

Central banks in the US and EMEA to increase rates further this spring, bringing the final US fed funds target range around 5% and maintaining these high levels until inflation retreats to its targeted 2% level. We expect that these high levels of interest will be maintained in the short- to medium- term, likely through 2023.

09 Opportunities and challenges in the real estate financing market

Real estate investments are broadly viewed as a good hedge against high inflationary environments as hard assets tend to appreciate during periods of high inflation. On the other hand, a high interest rate environment has put pressure on the cost of funding in the real estate finance market and on valuations.

Prediction

Although inflation is expected to fall back to target/normal levels in the course of 2023, high interest rates may remain the "new normal" for a longer time. When inflation is back to normal but interest rates are high, the real estate market may contract, especially in markets that are seeing recessions.

10 The COVID-19 wildcard

Global markets are open for business again at the end of 2022, with a perception that COVID-19 is in the rear view mirror. However, as we enter 2023 with a continuing outbreak in China, and combinations of flu and COVID-19 leading to health warnings, health will be on the top of the agenda in 2023.

Prediction

While our view (and hope) is that market lockdowns and work from home are things of the past, we will keep an eye out for a resurgence of COVID-19, particularly hitting industries that are rebounding from the last three years (retail, travel, etc.). Less of a prediction than a warning, but one that could upset the recovery we are expecting for the year.

Contributing Authors

OUR TEAM

Lana Ahern
Senior Associate
+44 20 7919 1205
Lana.Ahern@bakermckenzie.com

Hadrien Basso
Associate Director
+44 20 7919 1093
Hadrien.Basso@bakermckenzie.com

Elaine Baynham
Senior Associate
+44 20 7919 1211
Elaine.Baynham@bakermckenzie.com

David Becker
Partner
+44 20 7919 1437
David.Becker@bakermckenzie.com

Ben Bierwirth
Senior Associate
+44 20 7919 1426
Ben.Bierwirth@bakermckenzie.com

Natalie Butchart
Lead Knowledge Lawyer
+44 20 7919 1852
Natalie.Butchart@bakermckenzie.com

Fani Chlampoutaki
Associate
+44 20 7919 1290
Fani.Chlampoutaki@bakermckenzie.com

Matthew Cox
Partner
+44 20 7919 1322
Matthew.Cox@bakermckenzie.com

Rossanna D'Onza
Partner
+34 91 391 59 61
Rossanna.Donza@bakermckenzie.com

Adam Farlow
Partner
+44 20 7919 1514
Adam.Farlow@bakermckenzie.com

Charles Farnsworth
Of Counsel
+44 20 7919 1844
Charles.Farnsworth@bakermckenzie.com

Henry Gee
Associate
+ 44 20 7919 1213
Henry.Gee@bakermckenzie.com

Haden Henderson
Partner
+44 20 7919 1711
Haden.Henderson@bakermckenzie.com

Oliver Jefferies
Partner
+44 20 7919 1644
Oliver.Jefferies@bakermckenzie.com

John Lawlor
Attorney
+1 312 861 2926
John.Lawlor@bakermckenzie.com

Sébastien Marcelin-Rice
Partner
+44 20 7919 1413
Sebastien.Marcelin-Rice@bakermckenzie.com

OUR TEAM

Carlos Martin
Senior Associate
+ 34 91 436 66 85
Carlos.Martin@bakermckenzie.com

Rob Mathews
Partner
+44 20 7919 1832
Robert.Mathews@bakermckenzie.com

Sue McLean
Partner
+ 44 20 7919 1998
Sue.McLean@bakermckenzie.com

Richard Molesworth
Associate
+ 44 20 7919 1310
Richard.Molesworth@bakermckenzie.com

Lisa Nielsen Board
Senior Knowledge Lawyer
+44 20 7919 1755
Lisa.NielsenBoard@bakermckenzie.com

Nick O'Grady
Partner
+44 20 7919 1101
Nick.OGrady@bakermckenzie.com

Ye (Cecilia) Hong
Partner
+1 212 626 4589
Cecilia.Hong@bakermckenzie.com

Mats Rooth
Partner
+46 8 566 177 96
Mats.Rooth@bakermckenzie.com

Aimee Saunders
Senior Associate
+44 20 7919 1591
Aimee.Saunders@bakermckenzie.com

Megan Schellinger
Partner
+44 20 7919 1517
Megan.Schellinger@bakermckenzie.com

James Tanner
Senior Associate
+44 20 7919 1094
James.Tanner@Bakermckenzie.com

Charles Thomson
Partner
+ 44 20 7919 1879
Charles.Thomson@bakermckenzie.com

Mark Tibberts
Partner
+ 1 212 626 4370
Mark.Tibberts@bakermckenzie.com

Priyanka Usmani
Partner
+44 20 7919 1791
Priyanka.Usmani@bakermckenzie.com

Gabby White
Knowledge Lawyer
+442079191891
Gabby.White@bakermckenzie.com

Ben Wilkinson
Partner
+44 20 7919 1782
Ben.Wilkinson@bakermckenzie.com

Leading and closing complex deals - every day

We are a transactional powerhouse providing commercially-focused, end to end legal advice to maximize deal certainty and secure the intended value of transactions. Our 2,500 lawyers combine money market sophistication with local market excellence. We lead on major transactions with expertise spanning banking and finance, capital markets, corporate finance, restructuring, funds, M&A, private equity and projects. The combination of deep sector expertise, and our ability to work seamlessly across each of the countries where we operate, means we add unique value in shaping, negotiating and closing the deal.

bakermckenzie.com/transactional