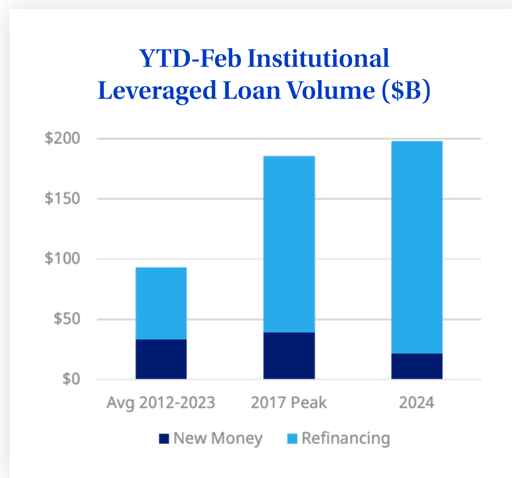
Tighter spreads bode well for interest coverage and M&A; middle market yield premium holds up well.

Surging refi/repricing activity brings borrower relief



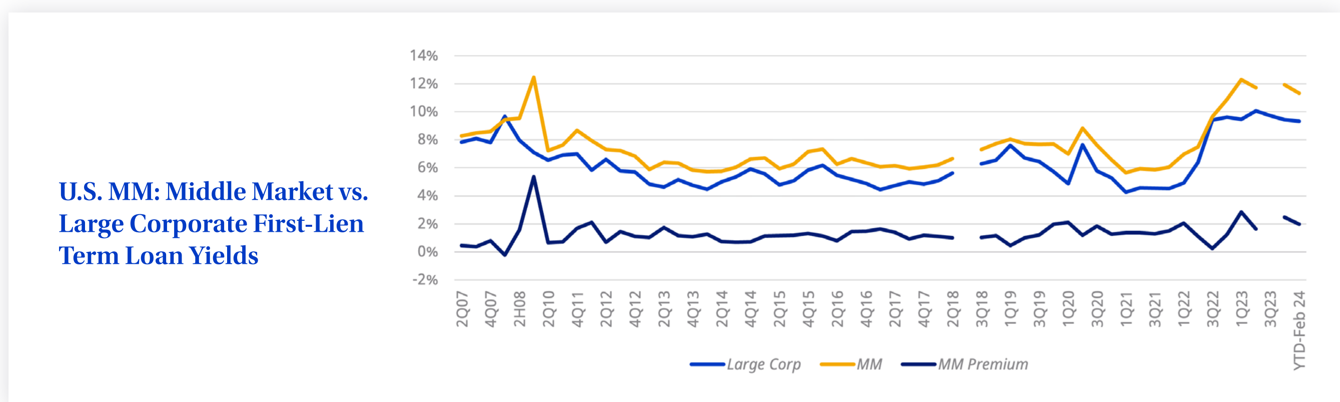
Source: LSEG LPC

The year has kicked off on a strong "risk on" note in the wake of positive economic data, expectations of forthcoming Fed interest rate cuts, continued earnings growth and a buoyant stock market. Rising optimism has in turn led to spread compression with "all in" B/B+ broadly syndicated loan spreads having dropped to near 400 bps so far on average in 1Q24 vs. over 470 bps in 4Q23[1]. This in turn has driven a spike in refinancing and repricing activity that has lifted institutional leveraged loan volume to $190 billion YTD-February 2024 – the highest on record for this period.[2]

Rising syndicated market appetite and related spread compression has come as welcome relief to borrowers. Lower financing costs coupled with continued earnings growth (3.4% YoY estimated for the S&P500 for 1Q24 as of March 21 according to FactSet) suggests favorable prospects for improvement in interest coverage ratios ahead.

Core middle market spread premium holds up well

The allure of as much as 200-300 bps of spread relief for some borrowers has led to over $10 billion of BSL refinancing of private credit loans across 25 companies YTD-March 18; however, most of this volume – some of which has been second lien - has been for companies in the large corporate segment (i.e. mostly companies with well over $150 million in EBITDA) where direct lenders tend to compete more directly with the BSL market.[3] To defend their portfolios and hold on to assets, direct lenders focused on the upper middle market and large corporate segments have reportedly been proactive in repricing loans on their book down by 50-75 bps (often with an extension of call protection) while also offering delayed draw terms loans in some cases.[4] In contrast, spreads in the more insulated "core" middle market have held up better, implying a continued attractive spread premium that remains well above the long term average vs. "Large Corporate" BSL spreads.[5]



Source: LSEG LPC

1. *Pitchbook LCD LoanStats Trendlines 3/21/24*
2. *LSEG LPC Leveraged Loan Monthly Feb 2024*
3. *CreditSights March 20, 2024*
4. *Pitchbook LCD March, 20, 2024*
5. *LSEG LPC and LevFin Insights Weekly March 22, 2024*

M&A activity to pick up

We believe the resurgence of the broadly syndicated loan market is another positive catalyst that will likely help jump start depressed sponsor-related M&A activity. The reopening of the syndicated market to second lien loans that enable large LBO financings is a particularly notable development of late with YTD-mid March syndicated second lien volume exceeding all of 2023. Additionally, secondary buyouts, which are viewed by some as a first step in the resurgence of the M&A market, have started to gain traction as sponsors seek to monetize portfolio assets. As noted in our 2024 Asset Management Outlook: Perspectives On Private and Liquid Credit, the reopening of the syndicated market along with lower expected base interest rates, record high PE dry powder, and increasing demands from LPs for return of capital all suggest a pickup in M&A activity ahead, with a potential for a boom in 2025-26.

Trailing 12-month PE buyout fund distributions as a percentage of beginning NAV

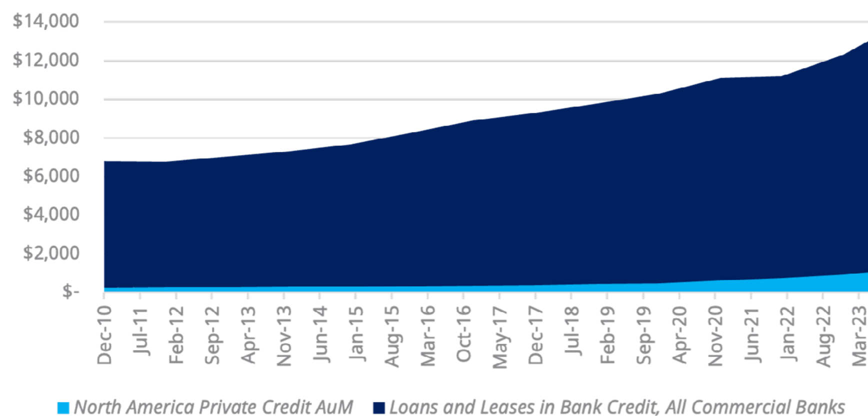
Source: PitchBook LCD

Secular trends still favor private credit

We believe the resurgence of the syndicated market is a healthy cyclical development. Direct lenders may give back some share gains in the large corporate segment to the BSL market based on price in the near term; however, we believe that secular tailwinds continue to favor private credit share growth over the longer term. Even in the current market, direct lenders continue to convert some syndicated deals reflecting what we think are key advantages of direct lending including speed and simplicity of execution (e.g. no need for ratings and roadshows), more assured executions (e.g. no-flex pricing), and other factors such as confidentiality. Some sponsors/borrowers also remain mindful of their preference for dealing with a small club of lenders during periods of stress when bank capital may dry up (e.g. during Covid and regional bank crisis), or in workout where dealing with a syndicate of shifting players with varying agendas can pose challenges.

From an investor perspective, we believe the current market underscores that a best-in-class lender/GP should be able to 1) provide best execution for sponsors/borrowers be it direct or syndicated given ever shifting market dynamics and 2) maintaining a core middle market focus while also having the capability to go "up market" to grow with existing portfolio companies and to provide financing solutions to new large borrowers when relative value is attractive.

Private Credit Still A Small Component of U.S. Financial System ($B)



Source: Federal Reserve Assets and Liabilities of Commercial Banks; Preqin

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