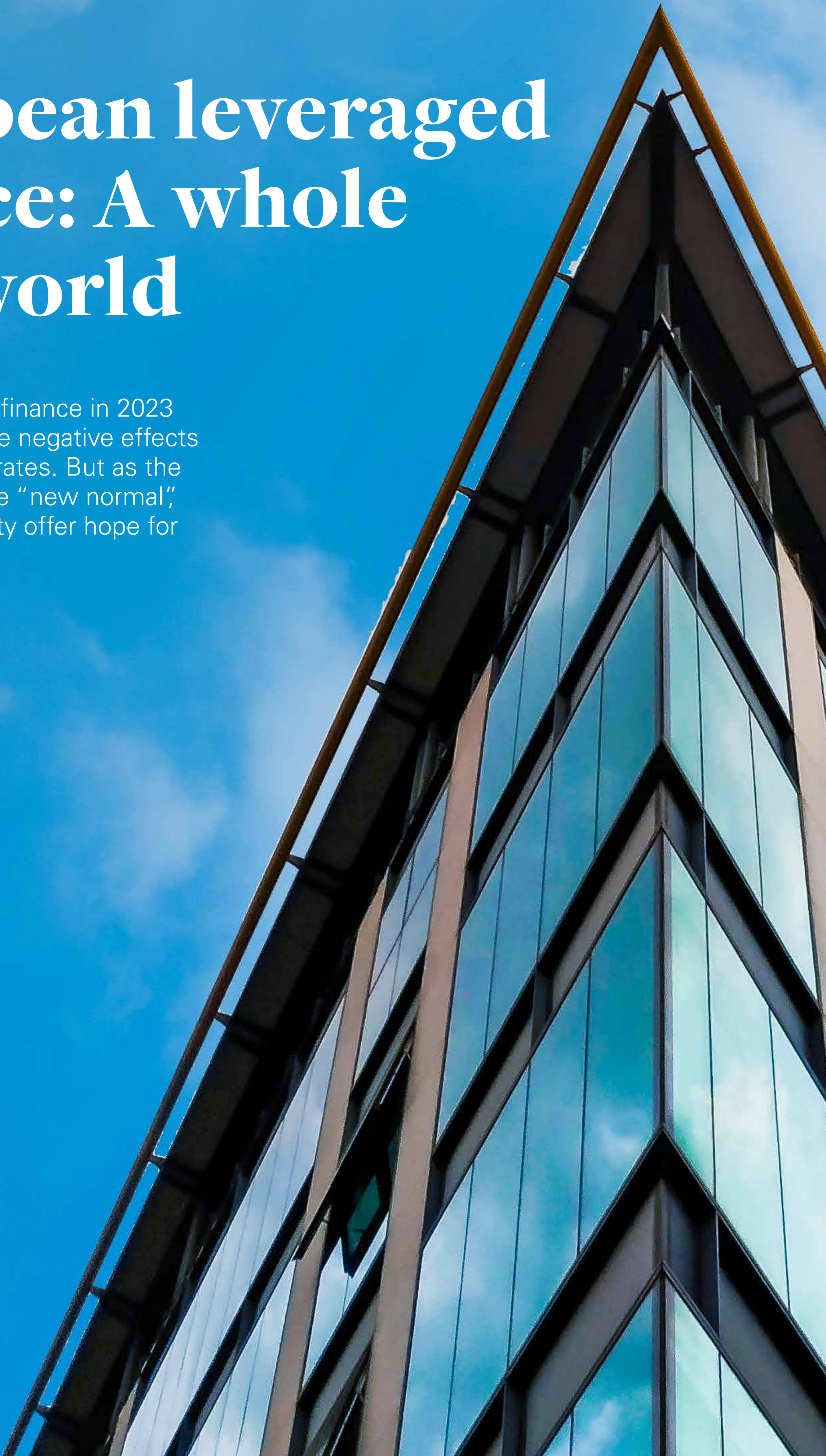
WHITE & CASE

European leveraged finance: A whole new world

European leveraged finance in 2023 was saddled with the negative effects of elevated interest rates. But as the market adjusts to the "new normal", rate and price stability offer hope for a brighter 2024.



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Elevated view of the 'Walkie-Talkie' skyscraper officially known as '20 Fenchurch Street' in the City of London

European leveraged finance overview

HEADLINES

■ Rising interest rates have pushed up borrowing costs and constrained issuance activity ■ Subdued M&A pipeline and cautious underwriting by banks limit buyout financing opportunities ■ Where transactions have progressed, the bulk of activity has been propelled by refinancing deals ■ Private credit proves resilient in the face of wider dislocation, attracting banks into the segment ■ Jumbo Worldpay financing shows that investor appetite for high-quality credits remains strong, with a potential warming for backdrop in 2024

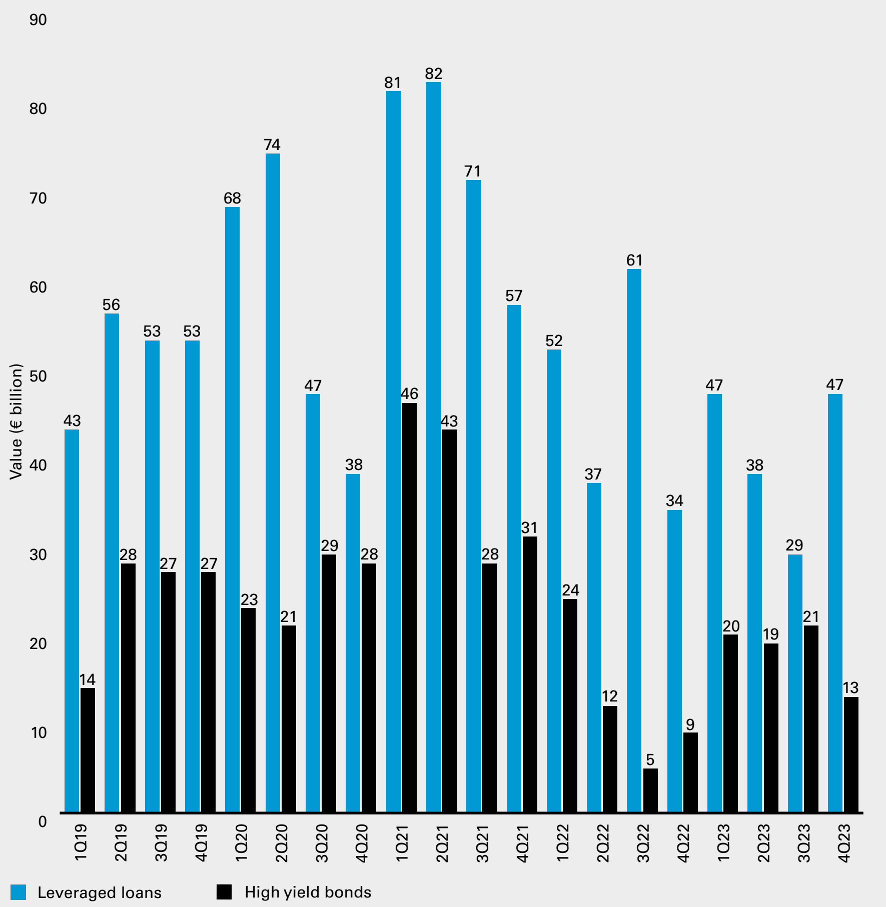
European leveraged finance has had a bumpy ride over the past 12 months. But after a difficult run, markets are hoping for more stable conditions in 2024.

Rising interest rates have had the single biggest impact on leveraged finance issuance through the course of 2023, with the European Central Bank (ECB) hiking rates to the highest levels observed since the turn of the century and the Bank of England (BoE) raising its base rate to a 15-year high.

Borrowing costs have increased in line with rising rates, limiting issuers' ability to afford new debt facilities and making refinancing, unless pressing or opportunistic for the right issuers, unattractive. Issuance of floating-rate syndicated loan facilities has been hardest hit, with *Debtwire* figures showing a 10 per cent decline in European leveraged loan issuance in 2023 to US$193.9 billion compared to 2022.

The picture for European high yield bond issuance has been brighter. Issuance climbed 47 per cent in 2023 to reach US$79.4 billion, as issuers pivoted towards fixed-rate, high yield bonds over floating-rate syndicated loans in an unpredictable interest rate environment. But even though high yield bonds have offered more certainty on pricing, the double-digit rise in year-on-year issuance in 2023 has to be placed in the context of exceptionally low levels of high yield issuance in 2022.

European leveraged loan vs. high yield bond issuance (quarterly)



Source: *Debtwire Par—figures rounded up to nearest whole number*

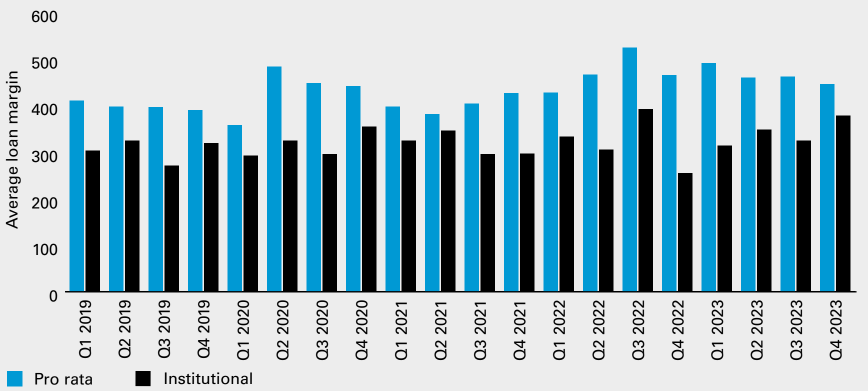
Refinancing drives market
When deals have progressed, the bulk of activity on leveraged capital markets has been driven by refinancing, with combined syndicated loan and high yield bond refinancing climbing 46 per cent in 2023 to account for 58 per cent of overall leveraged capital markets issuance.

In loan markets, large refinancings have included Nord Anglia (€1.51 billion), Leo Pharma (€1.35 billion) and BME Group (also €1.35 billion). Meanwhile big-ticket, high yield bond refinancings included gym chain Pure Gym, which raised €380 million in senior secured notes due in 2028 and priced at 8.25 per cent, and £475 million senior secured notes also due in 2028 and priced at 10 per cent. French-based television production Banijay secured a €450 million senior secured note and a US$500 million senior secured note to repay two existing outstanding high yield bonds in full.

Investors have been willing to refinance well-known credits, albeit at higher pricing, despite volatile markets.

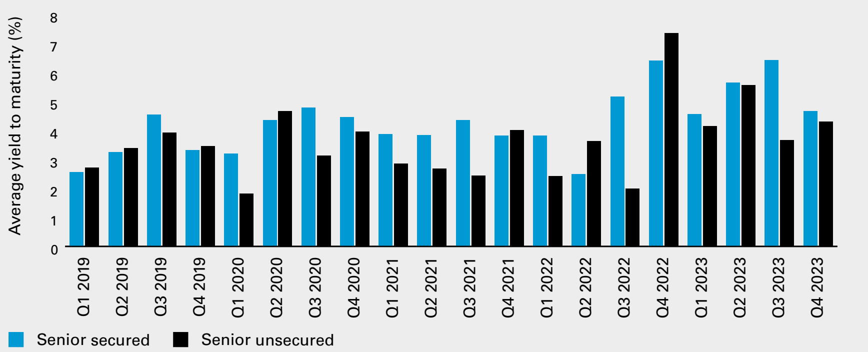
Banks did clear the bulk of syndicated debt overhangs in 2023, which saw a cautious return to markets relative to 2022, but it has remained challenging for banks to underwrite new deals and take on syndication risk. This has contributed to a sharp decline in issuance for

Average leveraged loan margin—pro rata vs first-lien institutional



Source: *Debtwire Par*

Average yield to maturity (%)—quarterly



Source: *Debtwire Par*

new-money buyout deals, with combined syndicated loan and high yield bond issuance for buyouts declining by 69 per cent year-on-year to just US$22 billion in 2023.

This has opened up opportunities for private debt franchises to continue building market share and finance larger transactions that may historically have been financed in syndicated loan or high yield bond markets.

According to *Deloitte*, jumbo financings supplied by direct lenders in 2023 have included packages for engineering materials company Envalior; pharmaceuticals company Dechra; and Swedish web hosting group One.com.

The ability of private debt funds to offer flexible financing packages, provide more leverage and to take and hold credits has helped to accelerate deal execution for borrowers in a choppy market and remove syndication risk.

Signs of stability as market looks to 2024

Looking ahead to 2024, there are some positive signs that loan and bond markets are beginning to stabilise after a challenging few months.

Inflation in the UK and Europe has started to slow, and after months of consecutive hikes there are signals that the ECB and BoE will keep rates stable, or even reduce rates, in 2024. The US Federal Reserve has also signalled that the cycle of rising interest rates is peaking.

How exactly monetary policy will evolve in the year ahead remains to be seen, but with rates at least levelling off towards the end of 2023, loan and bond pricing has settled.

According to *Debtwire*, average margins on first-lien institutional loans reached 4.64 per cent in Q3 2023, down on the 5.23 per cent figure recorded in the same quarter last year. High yield bond yields have also eased over the course of 2023, down by approximately 3 per cent from the highs recorded at end-2022. Secondary market pricing has also settled, as have original issue discounts, giving issuers and lenders a firmer foundation when pricing risk.

The mega-deal financing of GTCR's buyout of US-based payments company Worldpay in the early autumn also sparked hopes that markets could reopen in force, with the company securing an US$8.65 billion loan and bond package that was oversubscribed as well as securing favourable borrower terms. Lenders and borrowers, however, did not get carried away after the Worldpay financing, and markets have remained cautious since that breakthrough deal.

Markets are by no means out of the woods. According to *Fitch Ratings*, European leveraged finance default rates are expected to edge higher in 2024 and 2025 to approximately 4 per cent as more credits approach maturities. Amend-and-extend, debt buybacks, and other liability management exercises are also expected to continue looming over the market.

In the face of these ongoing headwinds, leveraged capital markets may not have a banner year in 2024, but with interest rates and pricing stabilising, and markets adjusting to the "new normal" of higher rates and more selective lenders, the next 12 months should be better than the preceding 12.

69%

The decline in buyout deal value in Europe in 2023, year-on-year

Five factors shaping leveraged finance in 2024

HEADLINES

■ After a slow year, market behaviour will mimic certain human traits, which will act as drivers in leveraged finance markets in 2024, as lenders and borrowers look to increase activity levels ■ Restlessness, imitation, creativity, distraction and optimism will, in their own way, each propel market participant activity levels ■ More banks may move to build out their private debt capabilities, imitating the successful private debt model that demonstrated its resilience through the current cycle ■ In a flat market, creativity will see lenders repurpose existing funding sources and develop new products to unlock liquidity

After a slow 12 months characterised by tepid financing activity, 2024 will be a year when we see human traits defining how dealmakers and investors will return back into the market.

We outline five human behaviours and psychological triggers that could shape European debt capital markets in 2024 after an anxious 2023.

1. Restlessness

Transaction volumes slowed markedly in 2023, with year-on-year European syndicated loan issuance declining by 10 per cent in 2023, and buyout M&A activity dropping by almost three-quarters.

After limited opportunities to transact, restlessness could propel financial sponsors back to the market. Buyout funds still have more than US$1 trillion of uninvested dry powder to deploy, according to *Bain & Co* analysis, with private debt dry powder sitting at approximately US$400 billion, according to *Apollo* figures. There is also growing urgency on the sell-side for sponsors to deliver exits, with Bain & Co estimating that the value of unexited assets in private equity portfolios is at four times the levels observed during the 2008 global financial crisis.

There is a structural imperative to transact built into the private markets model, and with large pools of undeployed capital to invest, sponsors will be obliged to return to dealmaking after pausing for breath in 2023.

There is also pent-up demand on the lender side for more deal and financing opportunities, as seen with the strong appetite in the private debt community to fund Permira and Blackstone's buyout of European online classifieds business Adevinta. The €4.5 billion credit deal to fund the transaction was oversubscribed by approximately €2.5 billion, with direct lenders offering €7 billion.

2. Imitation

Private debt has emerged from the current downcycle in credit market in a strong position, delivering yields on senior secured risk in the region of 10 per cent and continuing to finance deals.

Investment banks have noted the success of the private debt model, and 2024 could see increasing numbers of banks move to imitate this model by launching and expanding their own private credit capabilities.

Citigroup, Barclays, Morgan Stanley and JPMorgan Chase are among the banks that have already moved to build out their private credit capabilities.

Banks that make debt commitments to borrowers when underwriting leveraged loans and high yield bonds, with a view to selling this debt on to investors, have found it harder to syndicate debt in the current market, and have found themselves exposed to more unsold tranches of debt than planned.

> “Private debt has emerged from the current downcycle in credit markets in a strong position, delivering yields on senior secured risk in the region of 10 per cent and continuing to finance deals.

Moving into private credit mitigates syndication risk and also allows banks to compete directly with private debt funds, which have shown their ability to finance larger credits and take market share from the syndicated loan and high yield bond desks of the banks. Expect more banks to make their moves in private credit in 2024.

3. Creativity

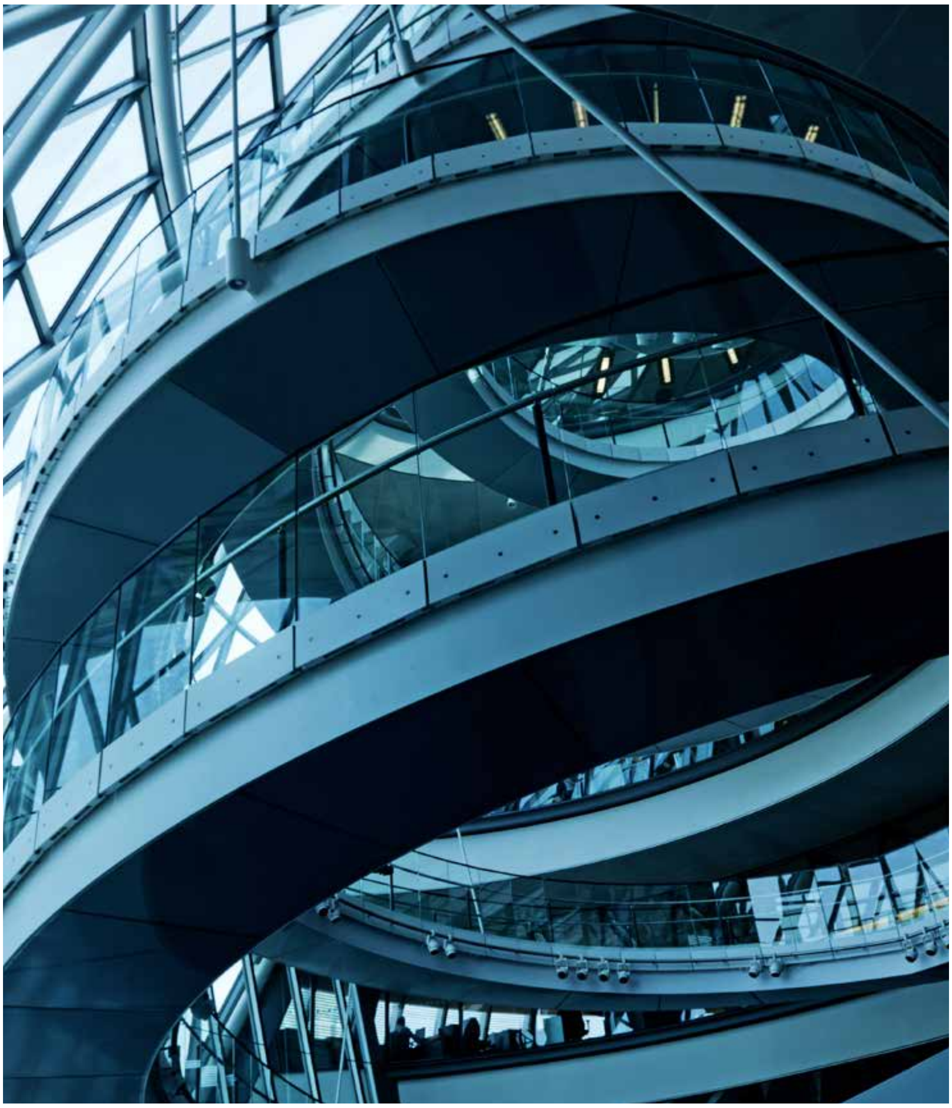
Depressed deal activity and a contraction in mainstream financing issuance has given dealmakers space and time to think of how to repurpose existing funding sources and develop new products to unlock liquidity.

The necessity for creativity has already seen the emergence of new financing structures, as lenders and borrowers adapt to changing circumstances.

Examples include the rapid expansion of NAV financing—credit facilities issued against the funds of financial sponsors. This once esoteric corner of the financing market is expected to expand sixfold to US$600 billion by 2030, according to *Pitchbook*, as sponsors explore different ways to fund portfolios and make distributions, and banks see an opportunity to keep putting money to work when other deal pipelines are constrained.

Private debt players, meanwhile, have not only grown market share by underwriting ever-larger ticket sizes, but are now also bundling portfolios of loans and selling on these tranches of assets to investors in the first private debt CLOs.

These CLOs, a significant development in private credit, illustrate the creativity and innovation that is set to drive lending activity and provide more liquidity in the next 12 months.



4. Distraction

Financial sponsors and lenders will be preparing for higher volumes of new deal activity in 2024, but time and resources allocated to new deals will have to be balanced with ongoing obligations to manage out legacy assets that have underperformed and haven't yet been restructured or dealt with via continuation funds. Stewarding portfolios of underperforming assets could remain a distraction through the course of 2024.

Indeed, ratings agency *Fitch* expects the sustained period of elevated interest rates to continue filtering through markets during the next 12 months, driving further increases in leveraged finance defaults in 2024. According to *Fitch*, European default rates for high yield bonds and leveraged loans are forecast to reach 4 per cent in 2024 and 2025.

Liability management exercises and amend-and-extend deal volumes are set to remain a feature of the market for the foreseeable future, and could continue to absorb lender and borrower bandwidth, diverting focus and attention from pursuing new deals.

5. Optimism

After a challenging 2023, there is cautious optimism that M&A activity and debt issuance volume will begin to rebound in 2024.

Leveraged finance stakeholders have noted a growing consensus that interest rates are expected to flatten out during the next 12 months. A stabilising interest rate backdrop will provide greater certainty on financing costs and availability. This in turn will make it easier for buyers and sellers to price risk, which will help to narrow the gap between buyer and seller asset valuation expectations, which hindered deal progress in 2023. Gains in European stock markets (the Stoxx Europe 600 Index climbed by more than 10 per cent in 2023) also serve as a positive, forward-looking indicator for deal activity.

After a year of focusing on downside risk and waiting for markets to show clearer direction, borrowers, investors and lenders will be gearing up teams in preparation for an anticipated uptick in deal activity.

Q&A explainer: Private debt in a changing market

HEADLINES

■ Among alternative assets, private debt has matured rapidly and is enjoying a 'golden moment' as a markedly attractive floating-rate product ■ In 2024, a mounting interest burden will give rise to novel debt structures for LBOs ■ As a typical credit is held by a single lender or small club, the private debt model enables providers to move more quickly than their peers ■ Not wishing to miss this golden opportunity, investment banks are quickly establishing or building up their private debt desks, introducing another valuable option to the funding mix

Private debt has been one of the most resilient asset classes through the current cycle of rising interest rates. Portfolios have performed well and returns have been excellent. Investor appetite for private debt strategies is strong and managers in the space have continued to grow market share.

But how has the private debt model been able to navigate market headwinds so well? How will managers react if portfolios do start to come under pressure and what will happen when syndicated loan and high yield bond markets rally?

In this Q&A explainer, we provide an overview of what has been driving the private debt space and what lies ahead for the asset class in 2024 and beyond.

How has private debt as an asset class come through the rising interest rate cycle?

Private credit is booming as an asset class. It is probably the great story of alternative assets in the current market. People are calling it a golden moment. Some of the biggest private markets platforms in the world now have more dry powder in private debt than in private equity.

Across the investment market, private credit is now a primary source of finance, and not just in the mid-market, as it used to be, but all the way up to large-cap deals. Not every large-cap deal can be financed in private credit, but you can get well north of €1 billion. There are lots and lots of providers in the market, and they now club together regularly.

This means a sponsor can raise an awful lot of money in the private markets without taking flex risk.

What have rising interest rates meant for private credit funds? Have the criteria to finance a deal changed?

There have been fewer deals this year than there were in, say, 2021, but that has to be placed in context. Remember that 2021 was the most active year since the global financial crisis in 2008, so it is not too surprising that deal volumes have come down.

High interest rates will affect the way M&A acquirers think about deals, and it has had an impact on the number of deals.

That said, everyone is really busy right now, and has been throughout the second half of 2023. There has been plenty of deal flow. The deals that do happen get done in the private markets.

What will be interesting, as we move into 2024, will be how sponsors and private lenders go about setting up an LBO model for good companies with cash flows that don't support high cash-pay leverage multiples.

These companies will have to meet a higher, ongoing interest

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burden, and the challenge will be how to structure satisfactory interest cover. It is difficult to do that with six turns of leverage priced at SONIA plus a margin of 5.5 per cent.

Does that mean we will see more deals done at lower leverage? Will sponsors make more use of payment-in-kind (PIK) debt to help them push leverage up, or will the cost of PIK debt erode equity returns too quickly?

It is going to be very interesting to see how dealmakers get transactions done next year and what debt structures they use.

Has there been any sense of a shift from new money deals to doing more working capital and add-on acquisition financing for existing portfolios?

There was a high volume of add-on acquisitions in the first half of 2023, which ran in tandem with a shortage of new LBO activity in the first half of the year. In the second half of the year, however, particularly in Q4 2023, it felt like the market was back to its normal run rate. There has been a constant flow of LBOs in recent weeks.

What movement has there been with respect to financing terms and credit selection from sponsors?

The market is mature now. People used to talk about private debt as an alternative funding source, but don't anymore. It is now the default way of financing a buyout at all but the very largest sizes.

What the market has taken on-board as it has matured is that you can't turn a bad business into a good business with tight legal documents. Private debt managers are focussed on quality assets backed by quality sponsors. The right deals will get the right terms.

What about pricing? How are managers pricing risk, especially given the volatility on pricing in syndicated loan and high yield bond markets?

Funds set their unitranche pricing to deliver the right returns for their investors, but also have to factor in that they are operating in a competitive environment. What that all means is that pricing isn't determined by what is going on in syndicated debt markets. It is drawn from what they can get in the market and what returns they are required to deliver for investors.

How are private debt returns shaping up?

In short, very well. Private credit offers a very attractive floating-rate product. If you are an investor in a private fund at the moment, you could yield approximately 10 per cent on senior secured risk. It is quite remarkable.

How have private debt portfolios held up through the cycle? How are private debt managers responding to stress in portfolios?

There have been examples of stress and distress in some portfolios, but no more than you would expect. There is no difference in default risk between private credit and syndicated loans and bonds, and private credit default risk is not any higher than the long-term average. Portfolios have been stable and we are not anywhere near the default levels of 5 to 6 per cent you see in really bad periods for the market.

In terms of how managers are responding when there is a stressed or distressed credit, the approach will vary from manager to manager, but on the whole managers have been quite supportive, negotiating amend-and-extends and even putting in additional capital for liquidity when necessary.

What makes the private debt model so effective is that a credit is held by a single lender or a small club. It means private debt providers can move quickly and decisively.

You don't need to form a committee. You don't have to worry about trying to corral 50 to 60 per cent of lenders. You don't have institutions in the debt that can't make decisions because they are mandated to be passive. You have lenders that can think quickly and make decisions quickly, and they don't have layers and layers of approvals they need to go through.

Private debt managers will behave in different ways in distressed situations, but the one thing they have in common is that they can all make decisions very fast, and they can all move. The people who did the deal at the front are often still involved. The sponsor is usually still interfacing with the people they always deal with, and that person is often empowered to speak for the firm. It is an invaluable point of distinction.

To what extent are bank-led and private credit financings converging? What does this mean for the private credit model?

Banks have noted the success of private debt, so have naturally wanted to move into that part of the market. We have the leading investment banks establishing private credit desks, and they will no doubt be very successful as they have access to different sources of capital. It adds another option into the funding mix.

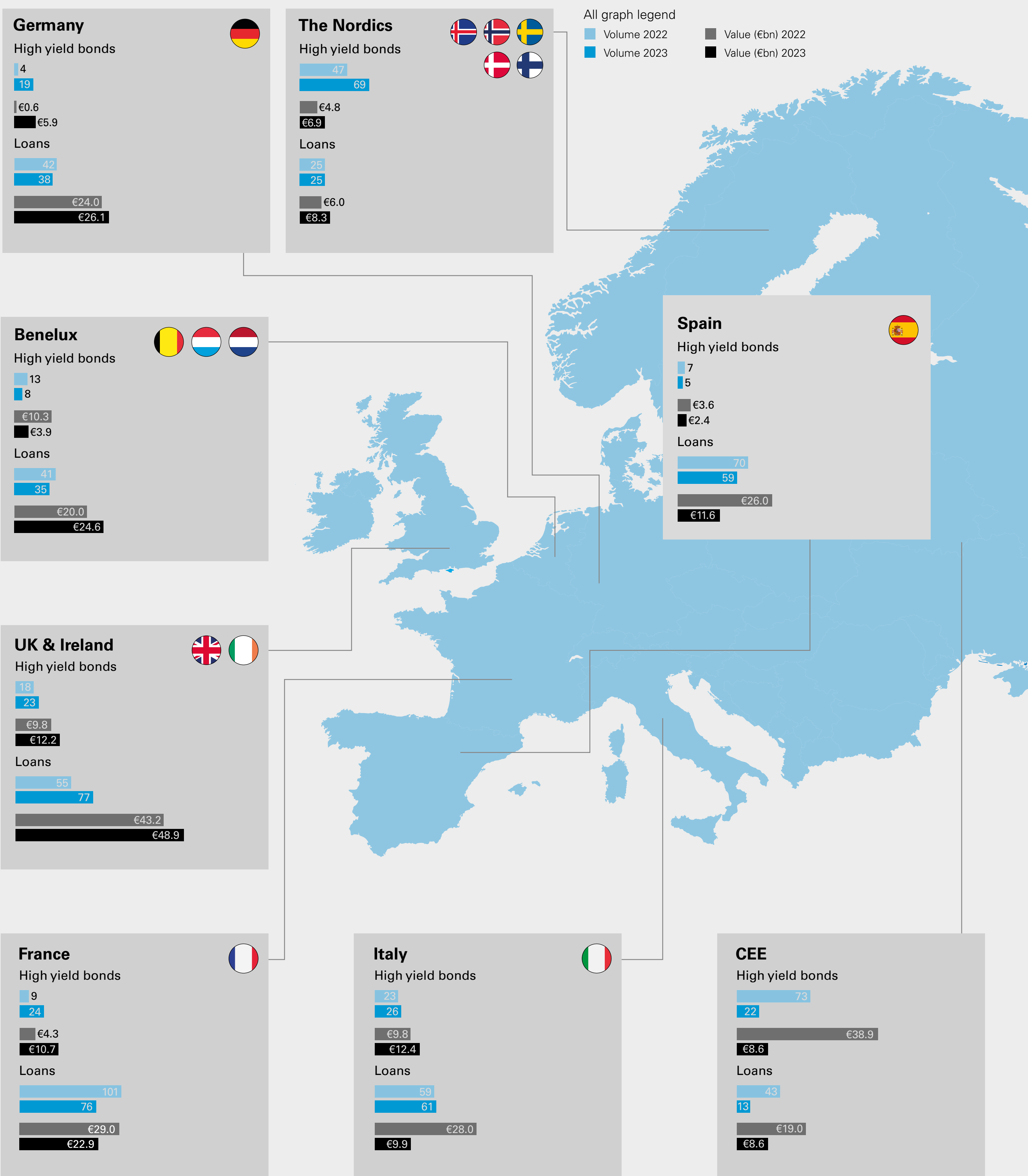
What has been interesting to observe is the emergence of the first private debt "CLOs"—where managers are packaging up their loans and then selling tranches of these loans to investors according to their risk. The one nuance is that in a traditional CLO, the equity tranche will be sold, but in a private debt structure the manager will often retain the equity tranche.

We have seen the first of these CLOs in the US. There hasn't been one in Europe yet, but people are certainly thinking about it. The challenge is size. You must have a very big portfolio to be able to do this, so currently it is realistically only an option for a limited group of managers.

The main point is that these CLO structures create a distributable private debt product for the first time. It is going to be very interesting to see how these structures continue to develop in the year ahead.

European leveraged debt in focus

Selected European leveraged loan and high yield bond markets by volume and value



German debt markets ready to reset after a challenging year

As has been the case across all European jurisdictions, elevated interest rates have taken a heavy toll on German debt markets over the past year.

A series of rate hikes by the ECB, which pushed up base rates to the highest levels observed in more than two decades, have hindered syndicated loan and high yield bond issuance across the continent, with the German market being no exception.

According to *Debtwire Par* data, syndicated leveraged loan issuance in Germany rose by 10 per cent year-on-year in 2023 to US$28.1 billion. High yield markets fared better, with issuance rising from just US$612 million in 2022 to US$6.5 billion in 2023. In 2022, however, German high yield issuance was the weakest on record since 2015, making for flattering comparisons. When compared to other years, high yield activity in 2023 has underwhelmed.

In a challenging market, refinancing has been the dominant driver of what issuance has proceeded. Refinancing accounted for 42 per cent of all syndicated loan issuance in 2023 and 35 per cent of high yield bond issuance. Financing for buyouts, by contrast, has been limited. High yield buyout financing reached just US$484 million in 2023, while loan financing for buyouts reached US$2.4 billion, accounting for less than 8 per cent of overall syndicated loan issuance.

Growth pains

German syndicated loan and high yield bond activity has been blunted not only by higher interest rates, but also by anaemic GDP growth.

Germany's economy stagnated in 2023, shrinking by 0.4 per cent, according to forecasts from the *ifo Institute for Economic Research*. The International Monetary Fund has forecast another difficult year for the German economy in 2024, with growth expected to lag behind the US, UK, France and Spain.

Germany's economy was impacted markedly by Russia's invasion of Ukraine in February 2022. Subsequent spikes in energy costs hit the country especially hard, as Germany's industrial sector uses almost twice as much energy as the next biggest industrial sector in Europe, according to *The Economist*. Meanwhile Germany's exports to China—for years one of the single biggest export markets for German manufacturers—declined by 8 per cent in 2023, according to *BNP Paribas*, as China continued to invest in more local production to replace imports.

Higher cost bases resulting from rising energy prices, coupled with soft exports and weak GDP growth, have squeezed company EBITDA figures. Add in higher borrowing costs, and securing new financing packages has become close to unaffordable for many companies.

Financing markets have also been impacted by distress in the German real estate sector. After a period of consolidation in German real estate, funded by loans and bonds issued at low rates, climbing debt servicing costs and corrections in property valuations have left real estate companies with high debt burdens and mushrooming financing costs. According to *Savills*, this has seen German real estate transactions fall to their lowest levels since 2014 on a 12-month rolling basis.

A number of high-profile developers, including Gerch, Euroboden and Project Immobilien Group, have borne the brunt of the dislocation. There have been significant knock-on effects in the adjacent construction and infrastructure sectors, where financing markets have all but shut as lenders step back from any assets exposed to real estate risk.

Adapting to change

In the face of these headwinds, borrowers have responded by either holding out as long as possible before refinancing, in the hope that fundamentals improve, or making add-on acquisitions of smaller assets with high EBITDA in an effort to boost earnings and build headroom into capital structures.

As mainstream loan (i.e., TLBs) and bond issuance has declined, however, the German market has proved relatively flexible, with other lender groups stepping in to fill financing gaps.

Direct lenders have remained open for business, although on a selective basis. Borrowers have also noted the reappearance of bank club deals, which have accounted for an increasing proportion of acquisition finance in the mid-market. This reflects how companies and sponsors have relied on their relationship banks, as well as the fact that bank clubs have been able to provide capital at lower cost when compared with direct lending and the capital market alternatives of TLBs and bond issuance.

Direct lenders were able to offer more leverage at the peak of the market on deals than banks, and with base rates low, the cost of this debt was manageable. As base rates have climbed, however, taking on additional turns of leverage has become less appealing, and the lower-cost lower-leverage structures offered by bank clubs have moved back into the frame.

German mid-market financial sponsors have also benefitted from increasing appetite from the country's regional savings banks or Sparkasse (which have traditionally focused on serving households and local businesses) to do buyout financings. According to *Bloomberg*, Kreissparkasse Biberach and Sparkasse KölnBonn are among the regional savings banks that have picked up business from larger peers that scaled back their leveraged finance teams.

Brighter prospects

Although bank clubs and increased activity from Sparkasse have helped to provide new pools of financing in tough conditions, companies and sponsors will nevertheless be hoping that mainstream loan and bond markets rebound quickly.

Hopes that interest rates have peaked, as well as the very healthy refinancing pipeline, have already given stakeholders a degree of optimism that German leveraged loan and high yield bond issuance will recover in 2024.

Credits in favourable, non-cyclical sectors, such as pharmaceuticals, B2B technology and travel (which is still benefitting from a post-lockdown boost), will be particularly well-placed. Advisers are also reporting an increase in work related to preparing prospectuses and due diligence ahead of potential bond issuance in Q1 2024.

Borrowers will also be encouraged by expectations of a rebound in the Schuldschein market (privately placed, unsecured debt instruments governed by German law). According to a *Bloomberg* survey of Schuldschein arrangers, roughly two-thirds expect issuance to climb by as much as 10 per cent in 2024, with refinancing driving the upturn.

The German market is not out of the woods yet, and more insolvencies and restructurings are anticipated in 2024 as issuers come up against maturity walls, but after a bumpy 2023, welcome signs of a market recovery are finally emerging.

Gherkin building, London, exterior abstract

PE deal financing in 2024: Better times ahead?

HEADLINES

■ After a challenging period for sponsor deal activity and limited access to finance, the outlook for the year ahead is improving ■ Expectations of interest rate stability are raising hopes that pricing and modelling capital structures will be easier and allow gaps in pricing expectations between buyers and sellers to narrow ■ High levels of dry powder and unexited assets will put structural pressure on managers to do deals, improving prospects for deal financing pipelines ■ Private debt has gained market share and will remain a key part of the acquisition finance mix, but loan and bond markets are rallying, providing sponsors with a wider set of financing options

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Over the past 12 months, financial sponsors have been confronted with one of the toughest deal financing markets since the 2008 financial crisis. But, as interest rates stabilise, brighter days may be on the horizon.

Elevated interest rates—which have climbed to a 15-year high in the UK, and the highest levels in the European Union since the launch of the euro in 1999 —have had a significant impact on leveraged buyout deal structures.

Making the leveraged finance model work in an environment where capital costs have been rising, but where the vendors of high-quality companies have been reluctant to sell at discounted valuations, has been difficult for sponsors, who have had to be more careful about when to transact and which assets to target.

This gap between buyer and seller valuation expectations has had a chilling impact on transaction and deal financing activity. According to *Mergermarket* data, Western European buyout deal value declined by more than two-thirds (69 per cent) in 2023.

The double-digit slide in buyout value has meant limited buyout financing transaction flow, with *Debtwire Par* figures highlighting cratering syndicated loan financing for buyouts, which has fallen by more than 73 per cent in 2023. High yield issuance for buyouts has fallen by a third over the same period.

69%

The decline in buyout deal value in Western Europe in 2023, according to *Mergermarket* data

Improving outlook as rate rises peak

However, as grim as the headline numbers for buyout transactions and buyout financing have been in 2023, there is cautious optimism that conditions for dealmaking and deal financing will improve in the year ahead.

Hopes for a rally in activity in 2024 come as signs emerge that central banks are approaching the end of the recent cycle of rate hikes. After raising interest rates consistently during the preceding 18 months, the US Federal Reserve, ECB and BoE all stopped hiking at their most recent meetings, raising expectations that interest rates have reached their peak.

Even if rates remain at current elevated levels over the medium to long term, as several economists anticipate, a clearer picture on where interest rates will settle will give financial sponsors comfort when pricing deals, modelling appropriate leverage levels and, ultimately, in determining how close to sell-side price expectations they are willing to get.

The private equity industry is now more than 40 years old, and the model has worked in periods where interest rates have been higher than they are now. As interest rates have been so low for so long and debt has been freely available on attractive borrower-friendly terms as to leverage and otherwise, it has taken more time for buyer and seller pricing expectations to recalibrate and converge than in previous cycles. Interest rate stability will go a long way toward building a consensus around realistic capital structures for acquisitions, putting buyers and sellers back in sync.

The building pressure on private equity firms to transact will also be a strong factor driving activity in 2024. According to *Bain & Co* analysis, there is a record US$1.1 trillion of uninvested dry powder sitting in buyout funds, with buyout firms also holding an all-time high US$2.8 trillion worth of assets in portfolios—more than quadruple the levels seen during the 2008 financial crisis. After a slow year for dealmaking in 2023, the clock is ticking—deals will have to be brought to the table.

Refinancing and dealing with distress

Another driver of activity in the sponsor market will be refinancing and managing assets that require new capital structures.

For companies that have traded well through the past 12 to 24 months and/or are in popular sectors, refinancing markets have been very much open, as seen in the case of deals like Pure Gym and Zentiva Group, which enjoyed strong support from investors.

Debt costs have increased, but within manageable thresholds, and investment banks have been ready to put together refinancings for familiar credits on a best-efforts basis. It has been easier for arranging banks to support refinancings on best efforts than to provide the underwritten commitments required for new deals. Interest rate headwinds may be easing, but there is still a degree of caution around syndication risk after many banks found themselves exposed to debts that ended up stuck in syndication a year ago.

There is another cluster of sponsor-backed companies, which took on high levels of leverage at near-zero interest rates, that will find it challenging to refinance existing capital structures in the current environment. In these scenarios, sponsors will have the option of either paying a fee to lenders to amend-and-extend the terms on current borrowings, or look to sell on the asset in an M&A deal to a new owner that can put a new capital structure in place.

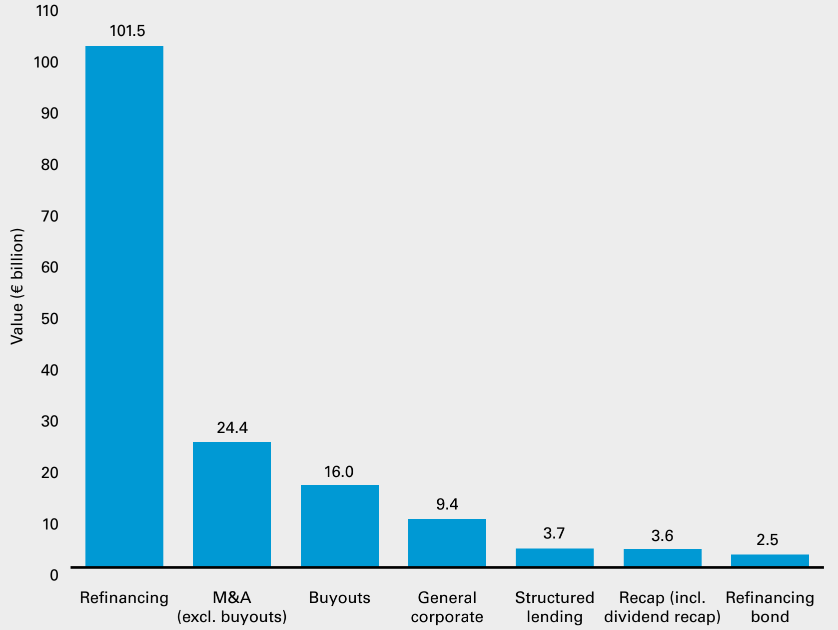
Keeping options open

As the market reopens for new deals, and momentum behind refinancings continues to build, sponsors will keep all their options open when deciding on what financing routes to go down.

The dislocation in syndicated loan and high yield bond markets during the past 18 months has provided a window of opportunity for private debt lenders. These creditors have expanded beyond the mid-market and are becoming credible options for large-cap credits, which previously would have turned immediately to the syndicated capital markets when seeking financing.

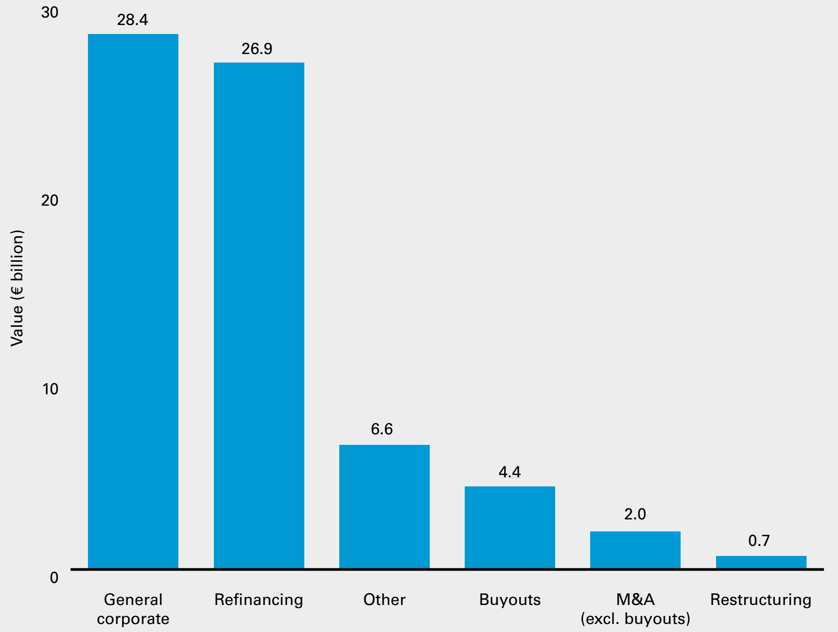
As the sponsor market emerges from a period of volatility, the private debt model is well placed to continue increasing its market share, providing sponsors with flexible financing packages and speedy deal execution with no syndication risk. One caveat to that is the emergence of private debt club deals where, although there may be no syndication risk, the

European leveraged loan use of proceeds (2023)



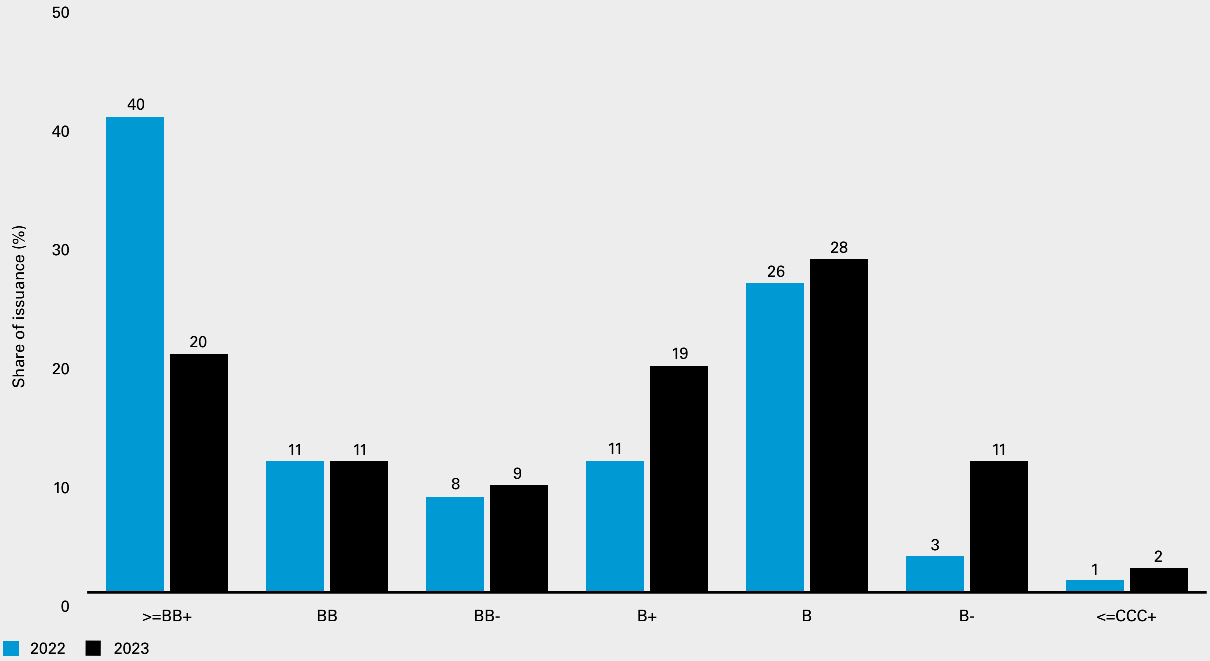
Source: *Debtwire Par*

European high yield bond use of proceeds (2023)



Source: *Debtwire Par*

European leveraged loan issuance by rating*



Source: *Debtwire*

** Based on universe of loans that are rated. Where split-rated, higher rating is used. Only Moody's and S&P ratings are considered.*

challenge of assembling the club on aligned underwritten terms should not be underestimated and can affect speed of execution.

It will be interesting to observe how private debt lenders respond as investor and bank appetite for Term Loan B and high yield bonds rallies.

Early signs that syndicated loan and high yield bond markets are coming back to life for new buyout deals emerged in the late summer of 2023, as GTCR secured an US$8.65 billion bond and loan package to finance its carve-out of payments company Worldpay. According to the *Financial Times*, investors placed orders in excess of US$20 billion for the debt, enabling Worldpay to upsize the term loan part of the package from a starting point of US$3.4 billion to US$5 billion, and to reduce interest rate margins down from 3.75 per cent to 3 per cent.

If loan and bond markets continue to rebound, offering sponsors lower capital costs, more deals will start to revert to these funding pools. This could put pressure on private debt funds to reduce pricing in order to retain the market share won during the past two years, introducing a new competitive dynamic into the financing space.

After a challenging period, deal activity and financing optionality may finally be opening up for sponsors again.

> “
> **If loan and bond markets continue to rebound, offering sponsors lower capital costs, more deals will start to revert to these funding pools. This could put pressure on private debt funds to reduce pricing in order to retain the market share won during the past two years, introducing a new competitive dynamic into the financing space.**

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