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Global Trends in Leveraged Lending

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In last year's edition, we anticipated 2023 to continue largely the trends seen in late 2022 – particularly through amend and extend transactions (A&E) to address looming maturities and opportunistic add-ons for private equity sponsors in light of continuing pricing dislocation. Following one of the largest contractions of leveraged loan activity since the global financial crisis in 2022, the road to recovery was always going to be tough.

With the bottom of the market for both equity and debt largely seen as October 2022, the start of 2023 saw continued volatility and supply shortages. While overall volumes increased through the beginning of the year, European and U.S. bank collapses and rescues, notably Silicon Valley Bank and Credit Suisse, alongside market unfriendly comments from the Fed led to unease in bond and syndicated loan markets. With M&A activity historically being the key driver behind leveraged loan activity, such activity was weakened through the first half of the year in light of decreased underwriting appetite and higher spreads as a result of volatility on one hand and general hesitancy to seek exits out of fear for failed processes on the other. Sponsors sitting on valuable portfolio companies looked to preferred equity and other structured solutions to create interim off-ramp solutions to generate cash returns to LPs.

With the market backdrop strengthening through the first of half of 2023, loan volumes still lagged behind a highly disrupted 2022. Borrowers and sponsors instead focussed on pushing out maturity walls, particularly with respect to 2024 and 2025 maturities, which provided plenty of opportunities for CLO managers to fill their books in light of syndicate attrition in these A&E processes, including by reason of WAL or maturity constraints for existing CLOs. By 30 June 2023, extension activity had already reached €25.7 billion according to LCD data. This A&E activity was driven by need to address looming maturities but also in the hope that interest rates have topped out, which showed its effect in yields throughout the end of the year.

While choppier waters were seen in terms of loan defaults, the market saw mainly out-of-court consensual restructuring processes and continued liability management (LM) transactions. Threading the needle in existing debt documentation to create material value via a LM transaction continues to be a complex and refined art, with attendant litigation risks. An uptick in special situations financings was also seen, including increased focus by firms in the market looking to secure the expertise to address their clients' expected need in this area through 2023 and 2024.

In terms of outlook, recession fears remain across developed economies and, at least in the Eurozone, market contraction is expected until the end of Q1 2024. A key focus will be on central bank attitudes towards interest rates cuts to provide positive news to the markets and impetus for deal-making. Pricing dislocation in M&A markets remains a key factor in addition to the cost of capital in limiting M&A activity – with markets cautiously optimistic at resolution.

Overall, total leveraged loan volumes were down against a disrupted 2022, particularly tailing off in Q4 against a flurry of Labor Day deal activity – institutional activity was stronger due to the very active refinancing and extension market:

Jurisdiction	Volume 2023	Volume 2022	Approximate Change in Volume
U.S. (*US$bn*) – Total	327.41	447.61	-27%
U.S. (*US$bn*) – Institutional	233.92	225.37	+4%
Europe (*€bn*) – Total	47.28	58.07	-26%
Europe (*€bn*) – Institutional	32.52	34.87	-7%

Source: Leveraged Commentary & Data (LCD), PitchBook Data, Inc.

Institutional Volume of European Loans (by country)	2023
U.S.	9.8%
Benelux	13.2%
United Kingdom	31.56%
France	20.27%
Germany	5.78%
Nordic	3.96%
Spain	3.30%
Other	8.35%

Source: LevFinInsights, a FitchSolutions Company

We discuss below specific trends in leveraged lending from 2023.

Extend, Extend and Add-On

The leveraged loan market continues its road to recovery. Buyout activity alongside corporate M&A is the key driver behind leveraged loan issuances and while making up roughly 66% of the use of proceeds in 2022, the combined volume for LBOs and M&A was down to just 17%. While there is plenty of dry powder that sponsors would be capable of deploying, and will need to deploy sooner or later to generate their returns, market conditions both in terms of costs of funding but also general macroeconomic uncertainty coupled with pricing dislocation have seen subdued M&A volumes. The awaited price contraction in private markets many anticipated for 2023 has still not materialised in the form required to buoy markets and while overall EV/EBITDA multiples continue to come down from their 2021 heights, it is clear that the market continues to be hamstrung by dislocation on one hand and high cost of capital on the other – the latter potentially not being resolved until central banks start lowering rates. As a consequence, M&A activity largely focussed on smaller add-ons.

Overall leveraged loan volumes were slightly down in 2022, but this is not due to a lack of supply from CLO volumes, which make up roughly 70% of the liquidity base in Europe for single-B European loans and were higher than expected. The healthy CLO volumes generated a tailwind for leveraged loan issuances and supported significant A&E activity. Recovery in the Morningstar European Leveraged Loan Index (ELLI) throughout the year signaled returning investor confidence through the middle of the year and CLO issuance picked up after the summer though CLO economics largely remained unchanged. The European CLO volume of €26.2 billion was in line with the five-year volume average in a year where M&A activity was near absent. One area to watch is CLO equity demand, which continues to be low. CLOs have been able to pick up new stakes in refinancing and extension deals but analysts nevertheless estimate that a record 30% of CLOs are out of their re-investment period due to a lack of resets and that this figure is only likely to increase further. WAL tests will also be an important consideration for CLOs in the A&E environment.

Dividend recap activity remained at the same low levels seen in 2022, with sponsors being required to write larger equity cheques in connection with buyouts and also having to inject additional cash in connection with extensions and refinancings. For performing credits, sponsors will likely look at recap activity when market activity returns to healthier levels.

Volume by Purpose	Approximate Use of Proceeds (Global) – 2023	Approximate Use of Proceeds (Global) – 2022
M&A (non-LBO)	7.6%	15.5%
LBO	9.4%	50.6%
Dividends	5.4%	5.9%
General Corporate Purposes	1.0%	0.0%
Recapitalisation	1.8%	3.5%
Repricing	25.8%	19.8%
Extension	2.7%	1.6%
Other	46.3%	3.2%

Source: LevFinInsights, a FitchSolutions Company

U.S. market trends (given its disproportionate share of leveraged finance issuance) continue to be the key determinant of global trends. Sector wise, professional and business services financings grew significantly year on year. Otherwise, levels remained largely stable, suggesting that no particular sector struggled more than others, a concern many had regarding the ability to pass on cost inflation to their customers. As in 2022, the most active sectors for issuances in 2023 were business services followed by the technology sector.

Sector	Approximate Share of Loan Issuances in 2023	Approximate Share of Loan Issuances in 2022
Prof. and Business Services	26.97%	10.23%
Computers and Electronics	22.47%	25.00%
Healthcare	14.61%	14.77%
Other	16.85%	34.09%
Manufacturing	5.62%	3.41%
Aerospace/Defence	2.25%	2.27%
Real Estate	3.37%	2.27%
Insurance	2.25%	4.55%
Building Materials	2.25%	1.14%
Food and Beverage	2.25%	1.14%
Printing and Publishing	1.12%	1.14%

Source: LCD, PitchBook Data, Inc.

A&E transactions addressing looming maturity walls will likely be a continuing feature of 2024. The 2024 needs were almost entirely addressed in 2023 with the remaining deals looking to consensual or non-consensual workout processes to resolve themselves. Maturities in 2024 have been reduced by 88%, maturities in 2025 by 58% and maturities in 2026 by 25% year on year (as at the end of December 2022 and 2023) according to LCD. Near term maturities remain high, with $92.4 billion's worth of loans due to mature within two years, compared to only $8.95 billion in 2024 (which has already fallen to $6.14 billion as at the end of January 2024). Extending the maturity horizon out further, the amount maturing in the next three years jumps to $253 billion *vs.* $177 billion as at the end of 2021 (which at that time represented a record high) – the figure is lower than last year, however, which stood at $285 billion (*LCD, PitchBook Data, Inc.*).

Conditions for private credit were excellent and with hesitant banks, private credit supported the majority of LBOs that came to market. According to LCD data, only two LBO loans emerged in the syndicated market in the fourth quarter *vs.* 20 in the private credit market. Sectors that continue to be of particular interest for private credit were electronics, healthcare and professional and business services, which accounted for 64% of deals done in by credit funds in 2023. This is an increase of 14% on levels that have been relatively consistent from 2020. It will be interesting to see whether such sector focus will create new opportunities for banks in areas from which credit funds are withdrawing.

Share of LBOs financed via broadly syndicated lending *vs.* direct lending (deal count)			
Quarter	Syndicate loan issuances	Private credit issuances	Ratio
1Q21	15	26	1.7

Share of LBOs financed via broadly syndicated lending *vs.* direct lending (deal count)			
Quarter	**Syndicate loan issuances**	**Private credit issuances**	**Ratio**
2Q21	16	23	1.4
3Q21	13	20	1.5
4Q21	20	12	0.6
1Q22	10	14	1.4
2Q22	6	11	1.8
3Q22	10	17	1.7
4Q22	3	12	4.0
1Q23	3	8	2.7
2Q23	3	15	5.0
3Q23	5	13	2.6
4Q23	2	20	10.0

Source: LCD, PitchBook Data, Inc.

Macroeconomic conditions are unlikely to improve very quickly against the backdrop of geo-political tensions in the Middle East and ongoing war in Ukraine. Years of borrower-friendly documentation mean that default rates, while having seen an uptick, are still fairly low with credit markets sympathetic to address maturity walls, which in addition to liquidity crises are a key trigger for reorganisations and restructurings and which have not materialised to a significant extent.

Investors remain cautious and selective and the heyday of free money (e.g., 2021) is disappearing further in the rear-view mirror. This also has an impact on documentary terms as we examine below.

Exits

While 2023 has seen windows of opportunity for M&A, sponsor-to-sponsor exits have been few and far between due to continued pricing dislocation, although analysts report gaps are closing. By deal count, PitchBook reports private equity exits fell 32% with total exit value down 27%.

The question of when M&A activity is going to pick up is sharpened by the significant amounts of dry powder which will need to be deployed sooner or later in order to create returns or otherwise be returned to investors. Analysts point to an uncertainty on rates as a key factor for hesitancy in the market – rates will need to come down to improve cost of capital and for sponsors to generate their target IRRs. It remains to be seen whether significant change will be seen before the second half of 2024.

Recurring Revenue Loans

Whilst the recurring revenue loan (RRL) market continued to see growth in 2023, the market experienced increased caution from lenders towards prospective borrower valuations; this became acute during the fall of Silicon Valley Bank in March.

Direct lenders have generally spearheaded the RRL market, most popular among high growth subscription revenue-generating businesses (most commonly associated to the technology sector which operate software-as-a-service (SaaS) business models), the RRL is a well-established finance product for companies lacking positive EBITDA (or at least with a history thereof) where revenue is strong and relatively consistent. Recurring revenue loans are structured off multiples of annualised recurring revenue (ARR – also annual contract value (ACV)), with many structured to switch (or "flip") over to an EBITDA-based leveraged structure during the life of the loan as the business matures and generates positive EBITDA.

Whilst the RRL market saw popularity in previous years supported by increased appetite for investment in the technology sector, 2023 saw an overall 38% drop year on year in venture capital investment according to Crunchbase. Interest rate hikes and rising inflation put pressure on the predictability of customer receivables which, together with the failure of Silicon Valley Bank, has dampened confidence in the venture debt space. Looking ahead to 2024, a more cautious approach to risk is expected in early-stage venture capital and RRLs as a related financing product (albeit 2023 saw increased interest in RRLs from banks looking to diversify their portfolios).

With tighter liquidity reported at recurring revenue companies in late 2023 into 2024, (*KBRA*) companies who had drawn under RRLs during the pandemic may shortly experience liquidity squeezes and knock-on effects on their ability to service their debt obligations and meet EBITDA-based financial covenants (once such testing begins under their debt document) in a stagnant to negative economic outlook, which sets the stage for a rise of defaults. That being said, confidence in the product remains, as exemplified by Francisco Partners and TPG's $6.5 billion acquisition of New Relic in November 2023 which was backed by a RRL facility.

In 2024, we expect to see ARR financings increasing in popularity across the European leveraged finance market, which has lagged behind the U.S. when it comes to RRLs. With competition among private lenders increasing in Europe, and the technology sector in Europe proving successful in the implementation of SaaS models, as well as embedded finance FinTech companies providing financing to companies based on recurring revenue on a B2B basis, and with sponsors from across the Atlantic endorsing such ventures with seeming success, we expect to see continued development of RRL products in Europe.

Continued "Golden Moments" for Private Credit

Private credit funds continued to gain traction in 2023 – proving to be a "golden moment" for the asset class (as Jonathan Gray, president of Blackstone, put it). Distinguished from banks, direct lenders have the flexibility to provide more tailored lending solutions, and ability to deploy capital quickly in buyout-financings often characterised by unpredictable and fast-moving deadlines, where their institutional counterparts often lag behind due to internal regulatory scrutiny and other red tape (though private credit providers have also been criticised for a lack thereof in the context of the extent of financial stability risks posed by private credit).

With dampened appetite for syndicated lending, the dependency of the LBO market on private credit became even more pronounced in 2023, where traditional syndicated lending shied away and direct lenders backed "108 of the 120 LBO financings" in H1 2023 (*PitchBook*). A notable example of this is the buyout of Adevinta ASA, which was financed by the largest European private credit loan to date of €4.5 billion in unitranche debt, provided by a consortium of private credit funds including Blue Owl Capital Inc., GIC and the Canada Pension Plan Investment Board.

Private credit is not showing any signs of slowing down, with Preqin forecasting global assets under management in private debt to hit $2.8 trillion in 2028 (which it positions as a conservative outlook against other market participants' views) and banks are not agnostic to their shrinking market share either, with banks such as Wells Fargo and Société Générale, amongst others, demonstrating an eagerness to get in on the private credit space (where they have not already launched private credit vehicles) moving away from an arrange-and-sell model to holding substantial participations.

However, acquisitions like Adevinta were an outlier in 2023 in a space dominated by smaller add-ons and refinancings, and whilst the outlook for 2024 and beyond looks positive, the leveraged finance market (in tandem with dried up M&A activity) overall saw a decline of deal volume in 2023, spurred by a difficult fundraising environment due to global shortages in liquidity, and less demand for new money by corporates battling inflation, rising interest rates and increased pressure on earnings.

In turn, private credit funds have been forced to revisit their investment strategies, particularly as valuations continue to be tested in the current economic environment which find it hard to support existing floating-rate debt against the backdrop of continuous interest rate hikes. As with investors generally, private credit funds have also been more discerning as to their investment criteria in 2024.

The rise and focus of distressed, hybrid value and special situations strategies are likely to see an uptick in activity in 2024 to capitalise on the opportunities presented by volatile market conditions. Whether and how banks attack, co-opt or out-manoeuvre private credit is a space to watch in 2025 and beyond.

Liability Management

The endless battle to extract value from complex capital stacks continues unabated. Liability management transactions utilise existing gaps in debt documentation, consents from some but not all classes of debt holders, and new capital from existing or new creditors or equityholders to reshape the debt and equity profile of weaker credits. The mere threat of a LM transaction will often drive stakeholders to launch pre-emptive strikes. The prevalence of these risks, and the heightened perception that typical market conventions may not be abided, has resulted in an increased willingness of debt holders to litigate. While these highly engineered solutions, when executed well, can generate new lifelines for struggling businesses or extract value for equityholders, the attendant risks are not to be lightly dismissed. From "double dip", "J Crew", "pari plus", "Simmons/Serta" to the "golden egg", the number of variants continues to grow. Finding the optimum path and viable commercial solution to each idiosyncratic existing structure remains complex, time-consuming and often requires developing a plan that spans several years.

ESG Loans

Environmental, social and governance (ESG) features of loans in the European leveraged loan market remained a topic of conversation this year. However, the number of loans linked to sustainability (SLLs) decreased on a year-on-year basis by 29% and overall credibility has been called into question, including by the UK Financial Conduct Authority (FCA).

ESG adjusted loans are structured such that borrowers are financially incentivised to comply with set ESG targets based on either an external ESG rating or performance against agreed key performance indicators (KPIs), by way of pricing, commonly known in the market as an "ESG margin ratchet", whereby a margin-adjustment mechanic is tied to a borrower's sustainability performance. In turn, such sustainability efforts are hoped to have a duplicate effect beyond loan pricing by enhancing the reputation of the investors, borrowers and sponsors alike. In 2023, sustainable loans and bonds in the materials/industrial sector accounted for 50% of those issued (down from 67% in 2022) followed by the consumer sector which accounted for 17% of those issued.

Macroeconomic factors such as inflation and higher interest rates have played a part in seeing a year of A&Es and refinancings with new issuances at a low. Whilst this should be taken into account when considering the dwindling level of SLLs in the market (half the amount entered into back in 2022), it should be acknowledged that some commentators are attributing concerns with transparency, reporting and greenwashing risks, i.e., the making of exaggerated, misleading or unsubstantiated claims about ESG credentials under these loans, as reasons for borrowers and lenders potentially not favouring this type of financing as much in 2023.

In terms of E, S or G, environmental KPIs continue to be the most popular reporting benchmark – likely because of their measurability and direct link to climate change, a key global challenge and focus that continued into 2023. According to Reorg, governance KPIs were entirely absent from deals this year and whilst social KPIs such as air quality and health and safety are becoming more prevalent, they still only feature in 7% of the deals reviewed by Reorg. The general consensus appears to be that even though borrowers are concentrating more on the way businesses are being run rather than just focusing on environmental and diversity matters, the lack of transparency in terms of how these KPIs are defined and met continues to cause concerns.

In June, the FCA published a letter to the market identifying a "number of weaknesses" including doubts over KPIs not being "robust" enough. Despite some statistics showing an enhanced level of transparency, the FCA continues to point to the Loan Market Association (LMA) guidance on social loan principles to help address the concerns – guidance that has been in place since 2022. The EU commission have also pushed forward developments through their introduction of the Corporate Sustainability Reporting Directive (CSRD) which requires companies to include details of the impact of sustainability on the company's business in its management reports. The UK government confirmed its intention to create UK Sustainability Disclosure Standards in August 2023, which would mirror the CSRD under UK law. Time will tell whether greater regulatory oversight will dispel the issues around measuring performance under these loans and greenwashing concerns.

Notwithstanding the above, standardisation is seen in the ESG margin ratchet adjustments and number of KPIs. In 2023, according to Reorg, there continued to be generally three KPIs (present in 44% of relevant loans, up 2% from 2022). KPI-based approaches were a consistent favourite against external ESG scoring/rating or hybrid approaches in 2023 with 90% of sustainability-linked loans featuring KPIs. Amendment provisions (also known as "*rendez-vous*" clauses), which allow borrowers to update KPIs and sustainability performance targets with majority lender consent, are becoming more prevalent with 89% of all sustainability-linked loans featuring them (an increase of 15% from the number in 2022). The year 2023 saw a slight decrease in adjustment to the ESG margin ratchet down 2.5 bps from 2022 to 7.5 bps.

Cumulative Margin Adjustments	2023	2022
2 bps	0%	0%
5 bps	25%	0%
7.5 bps	40%	13%
10 bps	25%	47%

Cumulative Margin Adjustments	2023	2022
12.5 bps	0%	0%
15 bps	10%	7%

Source: EMEA Covenants by Reorg

ESG will continue to develop in 2024 with the focus placed on it by governments, regulators, LPs and consequently managers and borrowers. Developments are likely going to be impacted by the progress that can be made in defining and refining KPIs and enhancing transparency of information to address credibility concerns. Time will tell if the inherent difficulties with transparency impact the popularity of these loans over time.

Leverage and Pricing – The Stats

European loans were one of the best-performing asset classes for investors globally through 2023, returning 12.43% according to LCD. While returns have been bolstered by higher rates, prices generally recovered throughout the year with the Morningstar European Leveraged Loan Index (ELLI) starting at 91.34 early in the year to finish around 96 by December, down from a 96.69 high in September. This record year for investors stands against a forecast of 6% returns for next year and central bank activity with respect to interest rates will play a large part in influencing returns.

With A&Es dominating the supply, loan spreads and yields continued the theme of late 2022 in Q1 of 2023 with average YTM issues for single-B euro-denominated TLBs up from 8.21% in Q4 of 2022 to 8.61%. Spreads also rose for the same loan-type to 488 bps from 474 bps in the same period, while OID contracted to 114 bps from 185 bps according to LCD. Funding costs for single-B borrowers ended the year at a new issue yield of 9.88%, up from 8.79% in Q3 and 9.08% in Q2 of 2023.

Loan spreads in the U.S. remained below European issuances through the year and did not see the same upward trend through Q4 as their European counterparts, whereas YTM in the U.S. were generally higher. European single-B YTMs increased by 146 bps year on year whereas U.S. yields for the same cohort dropped by 12 bps year on year.

Quarter	Average Single-B Primary Spread (bps) (Europe)	Average Single-B Primary Spread (U.S.)
Q4 2022	473.9	461.5
Q1 2023	499.3	423.5
Q2 2023	465.4	436.0
Q3 2023	452.2	418.0
Q4 2023	477.6	414.0

Source: LCD, PitchBook Data, Inc.

Quarter	Average Single-B Primary Yield-to-Maturity (%) (Europe)	Average Single-B Primary Yield-to-Maturity (%) (U.S.)
Q4 2022	8.21%	10.35%
Q1 2023	8.79%	10.01%
Q2 2023	9.32%	10.39%
Q3 2023	9.10%	10.35%
Q4 2023	9.67%	10.22%

Source: LCD, PitchBook Data, Inc.

Pricing flexes through the year were generally more investor-friendly with upward flexes outweighing downward flexes and generally similar levels observed across the U.S. and barring a few outliers.

Quarter	Ratio of Downward to Upward Institutional Flexes	
	U.S.	Europe
July 2023	4.2	8.0
August 2023	18.7	10.0
September 2023	12	12.0
October 2023	6.5	2.75
November 2023	4.1	3.75
December 2023	5.0	4.0

Source: LCD, PitchBook Data, Inc.

Furthermore, according to LCD, 2023 saw sponsors contributing higher portions of equity in connection with leveraged buyouts, reaching a record level of 50%. This stands against 43% in Europe and 46% in the U.S. in 2022. Sponsors may look to pursue dividend recaps in the medium term to bring debt-to-equity ratios to more "usual" levels, but apart from select names, it is probably unlikely that 2024 will see a significant uptick in dividend recap levels through the first half of the year.

Trends in Fund Finance

Fund finance continues to grow beyond subscription facilities provided by bank lenders to new types of financings with a broad spectrum of different investors. The combination of higher interest rates, market uncertainty, depressed M&A activity and the slower fundraising environment in 2023 accelerated growth and increased the demand for asset-based fund financing solutions to generate liquidity from existing assets and structures. Net asset value (NAV) loans and management company loans are increasingly becoming mainstream, with a variety of banks, funds, insurance companies and asset managers coming into the space both as borrowers and investors.

Asset-backed fund loans with security being taken over the fund's assets and/or their rights to cash flows and distributions are increasingly popular. While the terms of such loans are still very bespoke, we are seeing an increasing number of collateral-lite structures with enhanced cooperation and cash sweeps providing protection to lenders during periods of credit stress. Key negotiation items in these loans include the frequency and types of disclosures, valuation rights (and when value is tested), the existence of pledges and collateral and the right to reinvestment. We are also seeing convergence with more structured solutions, including an increasing number of rated structures, special purpose vehicles and other securitisation-like features. These structural developments reflect, among other trends, the fact that these loans are increasingly being marketed to the insurance and fixed income markets. With increased competition and pricing pressure among providers, coupled with a need for more immediate or short-term solutions, single asset alternatives in the form of single-asset back leverage, repos, season and sell, warehousing and similar strategies also seem to be gaining traction. The use of proceeds across these types of transactions is quite varied, including everything from portfolio support, to new growth, to facilitating succession planning at the fund level.

We expect to continue to see growth in the fund financing market and continuing changes in limited partnership agreements, and other fund offering documents to account for the use of NAV facilities and other asset-based leverage as part of portfolio liquidity management in the coming months and years. Market forces, fund needs and lender complexion and capacity will continue to spur innovation and change in the rapidly evolving fund finance space.

General Comments on Terms – Discerning Investors, Effect on Terms

Investors continued to take a cautious approach in 2023 and whilst this did not lead to a clear turning of the tides with respect to sponsor/borrower friendly covenants, there was regular (and successful) pushback on some of the more aggressive terms in new money deals. This is in part attributable to the prevalence of A&Es and partial refinancings in the market with such deals often recycling covenants from the existing documentation rather than negotiating a wholly new covenant package, which can make it difficult to ascertain the true state of the market for new money issuances. While investor push-back on terms generally held steady in 2023, some of the more aggressive trends of the 2022 market reverted to a more investor-friendly position as a result of discerning investors and supply challenges.

As background, generally, covenant-lite (or cov-lite) loans do not have maintenance covenants and therefore make it more difficult for lenders to crystallise defaults, despite the worsening financial condition of a borrower. These loans (which have become an embedded feature of the leveraged loan market over the past 20 years) rose against the 2022 numbers (but remain lower than 2021). The accumulated impact of years of cov-lite proliferation generally made it more difficult in 2023 for lenders to latch on to actionable defaults, absent a liquidity crisis or near-term maturity. The predominantly out of court restructuring trend in 2023 was, in part, a result of sponsors having the runway to undertake consensual liability management transactions ahead of projected liquidity defaults or scheduled maturity dates; we expect to see more consensual processes in 2024 rather than full-blown in-court restructurings.

Jurisdiction	2023 Cov-Lite Share of Total New-Issue Volume	2022 Cov-Lite Share of Total New-Issue Volume	2021 Cov-Lite Share of Total New-Issue Volume
U.S.	66%	47%	71%
Europe	69%	60%	83%
Global	66%	49%	73%

Source: LCD, PitchBook Data, Inc.

Last year saw a general, albeit moderate, shift in favour of investors as covenants tended to be more protective of lenders' interests than in 2022. In particular, investors sought to wind back erosions to value leakage protections by pushing for leverage ratio tests to be met before accessing builder baskets, as well as successfully reversing the rise of dividend-to-debt toggles and acquired/acquisition debt freebie baskets, each of which declined year on year. It remains to be seen whether these trends will hold as more new money deals come to market in 2024 as such deals will provide a more fulsome picture of the market and readers should view the overall analysis below in that light.

The following are headline examples of the (partial) success of investors in moderating more borrower friendly terms and continued convergence between high-yield and leverage loan markets:

- credit/facilities agreements increasingly include both a high-yield-style "builder basket" based on (usually) 50% of CNI being available for dividends, distributions and other restricted payments over the life of the deal, plus an additional "available amount" basket based on retained excess cash flow. According to Reorg, 42% of 2023 deals had both features which is a marked decline from 2022, where 67% of deals had both features giving rise to concerns that the "double builder basket" was becoming an increasingly permanent feature of the leverage loan market. It is, however, worth noting that the prevalence of double builder baskets rose in H2 2023, featuring in half of all deals compared with H1 2023. Given the re-emergence of the double builder basket in H2 2023, investors will be mindful of key protections with respect to both baskets, being (i) no double-counting of components that feature in both baskets, (ii) the "available amount" basket use (whether for RPs or RDPs, and, in some instances, investments) being subject to a leverage condition, and (iii) permitted financial indebtedness being excluded from the "available amount" concept for making restricted payments (if not excluded correctly, this can give rise to borrowers and sponsors having a free path to dividend recaps);
- the other key area of focus for investors as regards the CNI builder basket was in the context of A&Es and partial refinancings where 17% of all 2023 deals (i.e., including new money deals) saw the CNI builder basket start date reset. The reset is important to investors to limit the sponsor's ability to take advantage of historic retained cash flow/EBITDA and equity contributions that "build" the CNI basket and to create additional capacity to make restricted payments;
- dividend-to-debt toggles nearly halved from 2022 levels and reverted to levels consistent with 2020 and 2021, and there was an even sharper collapse in the number of dividend-to-debt toggles that applied to all restricted payments baskets with Reorg reporting that this was present in only 11% of 2023 deals, down from a high of 77% the year before;
- the vast majority of 2023 deals with CNI builder baskets contained default blockers though lenders should be wary of a growing trend for the ratio condition and/or default blocker to be weakened where such baskets are being used for investments rather than distributions. The rationale for such weakening is that investments are for business purposes and the value of such investments ought to remain in the credit group. Nevertheless, less restrictive investment permissions should be greeted with caution by lenders given sponsors can use such permissions to invest in unrestricted subsidiaries and then make distributions from such entities;
- standalone ratio-based permitted investment baskets continued to feature in the market, with Reorg reporting that such baskets featured in 42% of deals that contained a leverage ratio-based restricted payments basket. That being said, the number of such deals that included day one headroom fell year on year with 53% of 2023 deals that contained such investment baskets providing headroom on day one which is 6% less than 2022. The contrast with 2022 is made even more stark when A&Es and partial refinancings are excluded, with the 2023 figure falling to 20% of deals;
- *J Crew* blockers further increased in 2023 to prevent hive-outs of material assets to unrestricted subsidiaries, in a clear sign that incurrence of priming debt is on investors' radar – the use increased from 19% in 2022 to 31% in 2023 according to Reorg;

- calculation flexibility is a key borrower/sponsor tool to avert defaults and was tightened somewhat over the course of 2023, particularly in the exclusion of revolving credit facilities and working capital debt which fell by almost 10% year-on-year according to Reorg. Likewise, fewer deals allowed for uncapped cost savings and synergies addbacks with nearly all new money deals including such a cap;
- a relatively new feature are sunsets on event of defaults – seen at two years from occurrence. This has receded from the market after featuring in 35% of 2022 deals, it was only present in 19% of 2023 deals. Though this may not be a key consideration for investors given lenders' preference to rely on material defaults to lead into a restructuring it is nevertheless representative of a wider trend of lender pushback across 2023 deals; and
- "Super-grower" or "high-water mark" baskets, whereby the fixed element of the soft-capped grower basket is permanently increased in line with EBITDA growth, but conversely is not required to proportionately decrease with any reduction in EBITDA, fell slightly, breaking with a trend of increasing prevalence over 2021 and 2022.

Incremental Debt, Most Favoured Nation (MFN) and Maturity Exceptions

Leveraged loan terms continued to offer numerous avenues for borrowers seeking to incur additional debt, both under and outside the facility agreement on a *pari passu* and/or subordinated basis, and in certain cases, senior or super senior basis. Sponsors have continued to seek to hard-wire such additional debt capabilities into credit/facilities agreements from the outset and to reduce (or otherwise make flexible) the number of conditions which must be met in order to do so. As discussed above, the use of dividend-to-debt toggles generally decreased in 2023 and investors also focused particularly on limited structurally senior debt incurrence, which is reflective of a wider picture of terms swaying more in lenders' favour in 2023. With debt capacity for borrowers being key not only for add-on activity but also to address liquidity squeezes and increased cost bases in choppier market condition, any meaning impact of that tightening remains to carefully observed.

In addition to increasingly common "freebie baskets" for debt incurrence (an entirely separate basket, permitting additional *pari passu* (or junior) debt incurrence up to a fixed quantum, regardless of leverage/other ratio tests) sized at around one turn of leverage, documentation has seen the introduction of smaller acquisition/acquired debt freebie basket, the use of which declined from 77% in 2022 to 20% in 2023, according to Reorg, albeit an uptick in usage was seen in H2 2023. This is alongside a reduction in sizing from 0.25x of leverage to around 0.20x on a median level. On the other hand, ability of borrowers to incur acquisition/acquired debt through a 2x FCCR or "no worse" test increased year on year with 53% of deals surveyed by Reorg seeing the FCCR-based permission and 64% featuring the "no worse" test, which borrowers will welcome in an environment favouring add-ons.

As is typical in a volatile interest rate environment, MFN protection (which limits the amount by which the pricing on certain types of additional debt exceeds the pricing of the original debt) continues to be in flux. Consistent with other terms, the use of more borrower favourable margin MFNs (*cf.* yield) declined year on year from 52% to 27%. Investors will welcome the drop in margin MFNs, which leave the provisions with limited application, particularly in a period of deeper original issue discounts (OID) seen at the beginning of the year or the use of base rate floors. A 94 OID would convert to a 2% *per annum* margin on a typical European three-year convention.

MFN pricing protection generally was extended in both A&Es and new money deals with 12-month sunsets being more established and 8% of deals surveyed by Reorg featuring a 24-month sunset, but against a background of expected rate cuts, MFNs would not bite on cheaper debt.

Other carve-outs to MFNs were pared back consistent with the general picture. Whereas 2022 saw the first year in which the majority of loans did not see MFN protection for debt incurred outside of the relevant senior facilities agreement (i.e., so called "side car" debt aka equivalent debt), such deals now represent a minority. Carve-outs include:

Carve-out	2023	2022	2021	2020
Monetary carve-outs – a specified amount of debt can be incurred during the sunset period outside of the MFN protections.	17%	54%	38%	10%
Maturity condition exclusion – carve-outs for debt that have maturity after final maturity of the existing TLB.	31%	73%	62%	61%
Sidecar exclusions – MFN protection will not apply to debt incurred outside of the existing SFA.	46%	65%	41%	29%
Inside maturity baskets – permissions for *pari passu* debt to be incurred with an earlier maturity date (i.e., it is temporally senior) with a number of loans also exempting such debt from MFN protections.	31%	28%	25%	7%

Source: Reorg

Alongside MFNs, a key yield protection against repricing are soft or non-call provisions, with 82% of deals surveyed by Reorg including a soft call 101 provision in 2023 – most often seen with a six-month sunset in 73% of deals. As set out above, an extension of MFN periods may have been an easy give by performing borrowers in light of the expectation that interest rates have topped out and future financings would be capable of being incurred at better pricing that would not run up against the MFN provisions.

Chewy protections – a requirement that a release of an entity from security is for *bona fide* commercial purposes – featured in 25% of deals. *Chewy* protections establishing themselves in this way are another sign (alongside the inclusion of *J Crew* blockers) that investors want to mitigate borrowers priming them – in this case through making an entity a non-wholly owned subsidiary that would typically be excluded from a requirement to give guarantees or transaction security – thereby freeing its assets up to provide credit support to other indebtedness.

Investor Pushback on New Money Terms

Investor pushback was down slightly in 2023 with overall levels falling to 51% in 2023 deals, down from 56% in 2022 deals according to Reorg. This picture of falling investor pushback should not, however, be taken as evidence of substantially more permissive market conditions for borrowers/sponsors as the number of 2023 deals with investor pushback jumps to 81% when only LBOs and full refinancings are included (i.e., excluding A&Es and partial refinancings). This reflects the general trend of A&Es and partial refinancings taking place with limited changes to the underlying documentation rather than the comprehensive updating of covenants that occurs in a new money deal, although, as you would expect, sponsors have been putting out aggressive grid terms.

The key areas of investor pushback last year were value leakage, leverage risk and pricing/yield protection whilst pushback on transferability and calculation flexibility fell significantly year on year. Investors remain focussed on value leakage given the potential for (and historic use) of permissive terms to take cash and other assets out of the credit group even where stressed credits would have historically tripped maintenance covenants.

Pushback on loose value leakage terms is reflected in the fact that there was around half a turn of leverage less day one capacity for dividends and investment across 2023 deals than in 2022 (as reported by Reorg). Similarly, as noted above, there was a fall in both "double builder baskets" and dividend-to-debt toggles across 2023 deals as compared to the previous year. More broadly, Reorg reports that only 70% of deals included a CNI builder basket, down from 92% of deals in 2022 and 55% of such baskets included a starter amount which again was down from 2022 where 81% of deals had a starter amount.

One area, however, where investors have been less successful in pushing back on value leakage and leverage risk than in 2022 is in resisting the 2x contribution debt basket, with Reorg reporting that 6% of deals have this feature in 2023, compared to none in 2022. Contribution debt baskets allow for additional borrowing for borrowers/sponsor for an amount of equity contributed post-closing. This generally tracks on a $1 for $1 basis (1x) or a $1 of equity to $2 of debt basis. The 2x metric can be justified to the extent it keeps the debt-to-equity ratio aligned (at a notional 50%; whether or not that is the actual metric for the particular deal), but in an environment with higher equity contributions and focus on leverage risk, investors will likely continue to push back on the 2x feature and did so successfully on selected 2023 deals.

Successful investor pushback was also seen in the tightening of permitted investment ratio basket tests with only 20% of 2023 deals (excluding A&Es and add-ons) including headroom on closing. Likewise, the inclusion of an alternative "no worse" test for ratio investments (i.e., where leverage ratios cannot be met, the borrower may still be permitted to make the investment provided that the relevant ratio does not worsen) was present in 10% of 2023 deals down from 23% in 2022 which again reflects investor concern about value leakage and leverage risk.

We have set out the year-on-year changes on investor push-back alongside further examples of changes made below:

Areas of Investor Push-back	2023	2022	Examples of Changes Made
Pricing	60%	60%	■ Fewer margin step-downs/increased holiday period ■ Ticking fee added or time shortened
Value Leakage	60%	73%	■ Leverage ratio test for restricted payments and/or investments reduced and, in some instances, removed entirely ■ Baskets for repayment of subordinated debt removed or tightened ■ General restricted payments basket reduced in amount and/or converted from "*per annum*" basket to "for lifetime" basket ■ Tightening of CNI builder baskets by: removal/reduction in starter amounts; reduction of ratio test; and removal of zero floors ■ A&Es/refinancings: CNI builder basket commencement dates reset to amendment date ■ Default blockers continue to feature in the majority of deals ■ Ability to make restricted payments/investments using Available Amount basket removed or tightened ■ *J Crew* blockers and anti-*Chewy* protective provisions introduced/strengthened

Areas of Investor Push-back	2023	2022	Examples of Changes Made
Leverage Risk	43%	73%	■ 2x contribution debt basket reduced to 1x ■ Dividend-to-debt basket toggle ("pick your poison" provision) removed ■ Ratio cap reduced for ratio debt basket/ incremental facilities leverage test, or ratio debt tests otherwise made less permissive ■ Incremental "free and clear" amount reduced ■ "Inside maturity" basket for incremental facilities reduced or removed ■ General liens basket reduced ■ Acquired/Acquisition Debt Basket: "No worse" ratio test for incurrence of acquisition debt removed ■ Non-obligor debt caps introduced or reduced
Calculation Flexibility	17%	53%	■ Synergies and cost savings: cap introduced or reduced; and time limit introduced or reduced ■ "Super-grower" or high water mark basket flexibility removed
Transferability	7%	40%	■ Deemed consent period introduced ■ Reasonableness requirement introduced
Margin/Yield Protection	38%	40%	■ MFN changed from margin to a yield cap ■ Scope of MFN extended to other debt baskets, including incremental "free and clear" debt basket, incremental acquisition or investment debt ■ MFN sunset period extended ■ MFN protection renewed or extended ■ MFN cap reduced from 1% to 0.5% ■ Soft call prepayment fee protection period extended

Areas of Investor Push-back	2023	2022	Examples of Changes Made
Asset Disposals	14%	27%	■ Introduction of a 75% cash consideration requirement in the general FMV basket ■ Asset sale leverage step down levels reduced and/or step down percentages increased

Source: Reorg

Investor pushback will be a very interesting space to watch in 2024 with Q1 seeing more full refinancings than A&Es which should provide more colour on the true state of the market as there will not be the same reuse of existing covenants that is commonplace in A&Es. Given the limited number of new issuances coming to market, sponsors may look to pushback on lender protections for select premium transactions as investors chase such allocations – perhaps needless to say, 2023 data is to be viewed with caution given the effect of A&Es and add-ons on the investor pushback dataset.

Asset Disposals

In terms of value leakage risk through asset sales, the use of leverage-based grids to determine the amount of prepayment has firmly established itself, seeing only a minor decrease from 54% of 2022 deals to 53% of 2023 deals. The concept is akin to the commonplace leverage-based grid used for the mandatory prepayment of IPO proceeds (where such IPO did not result in a change of control). Without a leverage-based grid, 100% of the net proceeds would need to be prepaid, or, as more often the case, reinvested or committed for reinvestment within a specified time period, e.g., 12–18 months. With the leverage-based grid, any amount not required to be prepaid will not have to be re-invested but can instead be used at the borrower's discretion for general purposes, including for restricted payments – a key asset stripping and value leakage risk.

"Specified Asset Sales" permissions have sharply declined in 2023. These allow borrowers to sell assets provided that the EBITDA attributable to such assets does not exceed an agreed percentage of EBITDA, the proceeds of which can then typically be used to make restricted payments in compliance with a leverage ratio. Reorg reports that only 16% of 2023 deals saw this feature against 35% of 2022 deals. Basket sizing was seen between 10% and 27% of EBITDA with a median of 20% with proceeds typically being freely available to the borrower for general corporate purposes, including restricted payments.

The use of *J Crew* blockers, limiting a borrower's ability to leak material assets to unrestricted subsidiaries or joint venture entities beyond the security net of lenders to incur priming debt, featured in 27% of deals surveyed by Reorg in 2023, with investors demanding such provisions even in cases where there is no ability to designate unrestricted subsidiaries – showing that investors remain concerned with dropdown transactions and the flexibility provided to borrowers to prime existing lenders.

Transfers

Transfer provisions play a key role in the current market environment given that they determine whether a borrower can control the make-up of their syndicate, in favour of less aggressive lenders, and for lenders to trade out of positions that no longer reflect their risk-appetite or as a result of over-exposure to certain sectors as a result of falling market conditions.

With transfer restrictions in the European market generally only falling away on a material event of default, such as non-payment or insolvency, and blanket carve-outs for transfers to loan-to-own players or industry competitors (and increasingly net short lenders), transfer protections have become increasingly borrower friendly over the past years.

A development seen through the last couple of years was a cap on commitments by transferee lenders. While in the ordinary course lenders are entitled to vote in proportion to their commitments, a cap disenfranchises lenders with respect to holdings above a specified percentage in order to reduce potential for disruption or hold-out rights in favour of borrowers. The prevalence of this feature remained consistent with 2022 levels, being seen in 8% of deals. This remains an uncommon feature in the U.S. markets.

Transfer restrictions requiring borrower consent have generally required borrowers to act reasonably and not to delay consent. While this requirement did not feature in a significant proportion of 38% of deals in 2022, it only did not feature in 18% of deals in 2023. The presence of deemed consent provisions remained consistent with 2022 levels at about 30% according to Reorg, but investors will welcome the increase in deals which include the requirement for borrowers to act reasonably in actually accepting or declining transfer requests.

Cure Rights

"Auto-cures" allow a financial covenant default to be cured at any time (rather than only in the typical 20-business-day period after delivery of a compliance certificate showing a covenant breach), even after the relevant cure period has ended and without necessarily requiring the injection of additional sponsor equity, by simply retesting the covenant with more up-to-date figures such as monthly management accounts. Prevalence of this feature was down from approximately 53% of all 2022 deals in Europe analysed by Reorg to 19% in 2023. Where included, a minority of deals disabled this feature where net RCF outstandings were above the relevant testing thresholds.

The novel feature of cures by way of contribution of property and other assets (including receivables) based on their market value that spiked at use in 20% of loans in 2022, returned to 2021 levels at around 5%.

Security

A consistent feature within European leveraged loans remains a guarantor coverage requirement to capture 80% of the group's consolidated EBITDA (with outliers also basing such threshold on assets and/or turnover) to grant guarantees and security over their assets in favour of the lenders, with an associated requirement for all "Material Subsidiaries" (being those contributing 5% or more of the group's total EBITDA) to do the same, except in each case where certain "agreed security principles" provide otherwise. Only two deals reviewed by Reorg in 2023 did not have this feature and 90% of deals featured a guarantor coverage of 80% and above. U.S. deals generally do not include this metric. For U.S. deals with built up offshore value, investors (especially in club, best efforts and troubled deals) focused on how to get access to this offshore value, in light of U.S. tax considerations (which have trended to a slightly more territorial, as opposed to global, approach in recent years).

Credit support packages in recent years have been weakened, with sponsors being increasingly successful in their attempts to limit the scope of the security package to structural security only in the form of security over shares in the borrowers and guarantors, material bank accounts and material structural intra-group receivables, and through an expansion of the list of jurisdictions where no guarantees and security can be required in addition to the usual few jurisdictions where taking security is known to be incredibly difficult or costly. The "agreed security principles" have become common to form part of commercial grid purposes such that deal lawyers often only get involved after the scope of security principles is agreed – without the ability to review or challenge exclusions. Investors may look to lever their current position to re-negotiate these principles and push for more comprehensive security packages, albeit these principles have been so commonplace in the market that it is unlikely that they will make significant in-roads on performing credits.

Choppier Waters, but No More than Forecast as Yet

According to S&P, corporate default rates increased 80% year on year in 2023, in line with previous predictions of a rise in defaults. S&P predicts that speculative grade default rates will continue to increase in 2024 but should stabilise by Q4 with U.S. speculative-grade corporate default rate expected to be in reach of 4.75% by December 2024, while the European corporate speculative-grade default rate could reach 3.5% in the same period. Default rates are predicted to remain below 2020 levels setting the tone for a modest uptick restructuring activity in 2024 – at least on current predictions.

Region	12-month Trailing Speculative-grade Default Rate – September 2023	12-month Trailing Speculative-grade Default Rate – year end 2022	2023	2022	2021	Leading Sectors 2023
U.S.	4.1%	1.7%	96	36	40	Media
Emerging Market	1.8%	2%	27	26	15	Transportation
Europe	3.1%	2.2%	30	17	14	Consumer products
Other Developed	2.9%	2.3%	8	4	3	Healthcare
Global	13.3%	1.8%	153	83	72	

Source: S&P Global Ratings Research

As is evident from these figures, corporate default rates are continuing to rise (albeit from low levels). A likely brake on this rise is still very loose cov-lite credit documentation in the market, giving borrowers significant wiggle room before they would actually trigger a default under their loans. A key feature in the current documentation is also additional debt capacity which, though less than was seen in 2022 remains high with Reorg reporting that in respect of 2023 loans, additional capacity stood at 2.4x EBITDA of *pari passu* senior indebtedness and 1.6x EBITDA on a structurally senior basis.

Quarter	Lagging 12-Month Default Rate: based on Principal Amount U.S. (Morningstar LSTA U.S. LL Index)	Lagging 12-Month Default Rate: based on Principal Amount Europe (Morningstar European LL Index)
December 2022	0.72%	0.42%
March 2023	1.32%	0.44%
June 2023	1.71%	0.98%
September 2023	1.34%	1.27%
December 2023	1.53%	1.62%

Source: LCD, PitchBook Data, Inc.

The confluence of geopolitical tensions, rising interest rates and stubborn inflationary pressures contributed to a rise in defaults over the course of 2023, with PitchBook reporting that the U.S. leverage loans default rate by issuer count rose to 2.05% at the end of December 2023, a year on year rise of 137 basis points. That being said, default rates remain below pandemic-era highs and it is expected that default rates will start to stabilise by Q4 2024. Nevertheless, the outlook on 2024 must remain cautious given the uncertainty surrounding macroeconomic conditions particularly as inflation remains higher than expected and growth rates continue to lag, particularly in the UK and Europe. Against that backdrop, 2024 is likely to continue to reflect the struggles as regions continue to battle macro-economic headwinds.

Asia Slump Consistent with Tougher Road to Recovery Seen Globally

The slump in M&A transactions and consequently new money financings was also seen in China where transactions decreased in deal count and overall value by 20% compared to 2022. The wave of offshore bond defaults seen in China since mid-2021 continued to slow from mid-2022, however, the liquidation order against Evergrande shows the difficulties in being able to restructure offshore debt, although there have been notable successful schemes of arrangement through 2023.

Private equity fundraising in Asia was generally subdued with 2023 showing the lowest fundraising volume in over a decade. In terms of exit opportunities, sponsor-to-sponsor transactions led with only seven transactions out of the largest 25 being trade sale and only one IPO. Japan, notably, has continued to be attractive for investors making up 27% of Asia deal flow according to Ion Analytics. Global investors continue to be drawn to tech centric countries such as Indonesia and Singapore – and beyond. Notably the Asian manufacturing sector has been closing the gap to tech in terms of investment and deal activity over recent years, a trend that will likely continue alongside a focus on electronics.

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