Global perspectives: current trends and outlook for the leveraged loan market

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The obvious statement that 2020 was a year of unprecedented challenges needs no explaining. Just like other industries, the leveraged loan market felt the impact of Covid-19 outbreaks and lockdowns (especially in the first and second quarters), as global travel ceased and businesses in certain sectors ground to a halt, making due diligence, valuation and private equity deal-making all but impossible. This suppressed activity in 2020 caused pent-up demand, which together with cheap financing costs, led to predictions of a busier year for sponsor backed M&A in 2021.

Below, we look at the current trends and market outlook for leveraged loan activity in each of the Asia Pacific, European and North American regions. With market leading banking and finance lawyers working from nine offices throughout these regions, Ogier is well placed to provide expert advice on the laws of the British Virgin Islands, the Cayman Islands, Guernsey, Jersey and Luxembourg in relation to leveraged finance transactions.

Asia Pacific

After a slow start in Q1 and Q2 (for the reasons mentioned above), whilst the second half of 2020 did not quite see a return pre-pandemic deal volumes, during this period the Asian leveraged loan market showed its resilience. Indeed, some big ticket event-driven financings, notably in South East Asia, helped keep overall aggregate deal value in line with 2019 levels. Other contributors to leveraged loan activity in the Asia region in 2020 were financings for private equity backed take privates of Chinese companies from public stock exchanges and the real estate sector in China.

Market participants predicted a stronger start to 2021 as Covid-19 vaccine roll-outs began, a more sanguine view of the geo-political backdrop prevailed and lending rates remained low. So far, Asia-Pacific M&A activity in 2021 has lived up to these expectations and, according to an EY press release dated 23 August 2021, "Asia-Pacific M&A activity hit an all-time high in the first six months of 2021. M&A values targeting the region increased to US$535 billion, up from US$284 billion in the same period last year". [1]

There have been a number of sponsor backed acquisition processes in Asia so far this year. Strong liquidity both in the private equity and bank sectors means these have been highly competitive, with sponsors often paying historically higher multiples for assets and, at the same time, demanding higher leverage ratios from their financiers and an increase to the debt portion of their acquisition consideration.

An improved exit environment, which has been challenging for private equity in recent years, means some of these deals have related to sponsors divesting of existing investments. However, sectors such as technology, fintech and healthcare, which are seen as Covid-resilient and future-proof, are some of those receiving interest from private equity houses seeking out new targets.

General sentiment is that (outside the slowdown in the Chinese real estate sector) Asia-Pacific leveraged loan activity will remain buoyant through to the end of the year.

Europe

Leveraged loan market activity in Europe has rebounded strongly in 2021 following the challenges of 2020. A combination of pent-up demand caused by deal activity stalling as a result of the well-documented Covid-19 pandemic, coupled with continued low interest rates, are driving private equity activity across the region and with that demand for leveraged loans continues to grow.

The low interest cycle we are currently in bears further consideration. It appears to be driving activity on two fronts. Firstly, by pushing institutional investors to seek higher yields, and secondly, by making borrowing as attractive as perhaps it has ever been. It will be interesting to see how inflationary fears across Europe, and particularly in the UK, are addressed by central banks in the coming months with some believing that increases in base rates are inevitable.

It also appears that the continued development of the private credit market may be driving activity in the European leveraged loan market. An increasing amount of 'non-traditional' debt is available, including some through private equity funds established with an investment strategy of challenging traditional debt providers, which adds pricing competition and further increases the projected yields for leveraged buyout transactions.

Further fuel to the fire, at least in H1 2021, was the perception that share prices of many listed companies were depressed, leaving them attractive propositions for private equity managers. In the UK, particular focus has been placed on supermarket chains, not least because of their generally sizeable real estate footprints and the opportunities to create efficiencies in their supply chains. Asda and Morrisons are both high profile examples. Although it is specific to the UK, there continues to be a perception that asset values are attractive as a result of Brexit and a relatively affordable Great British Pound too, perhaps leading private equity managers to deploy capital in the UK market rather than the US or Asia.

As a result, UK buyouts were up around 60% in H1 2021 compared to the same period in 2019, and up 14% across the EU[2]. It remains to be seen whether these activity levels are sustainable, both at an economic level and a political level. In terms of the latter, there appears to be little appetite to temper activity through political intervention for the time being.

For now, the European leveraged loan market continues to bustle with activity and a strong finish to 2021 is anticipated.

North America

When the pandemic first took hold in March 2020, the US leveraged finance market felt the immediate impact with sectors such as airlines, lodging and leisure, gaming, non-food retail and auto supplies being hit hard. As the year continued, the market made a steady recovery. The Coronavirus Aid, Relief and Economic Security (CARES) Act, was passed which protected many businesses from the immediate impact of the pandemic and also a number of businesses shored up their finances, locking in debt to provide liquidity given the uncertainly faced.

The start of 2021 saw this recovery accelerate. Leveraged loan issuance was up 60% in H1 2021 compared to the same period in 2020. Much of the market activity in Q1 2021 involved repricing and refinancing transactions which, according to Fitch, made up 74% of Q1 total issuance[3]. Activity did fall slightly in Q2, however, the market did see a notable increase in new money deals (a 42% increase compared with the previous quarter).

In terms of sectors, technology, media, telecommunications and healthcare have performed relatively well during the pandemic. Even sectors that were initially hit hard such as those described above have shown signs of recovery. Vaccine rollout and the opening up of the economy has undoubtedly driven matters. In addition, it appears that the drawbridge has been lowered, and banks have moved away from protecting against downside risk to offering competitive pricing. This shift has occurred in a low interest rate environment and has led to borrowers taking advantage of favourable market conditions.

There are other factors aiding the recovery in the US leverage loan market in 2021. Institutional investor appetitive for a steady yield is high in this long running period of low interest rates. This has been seen in the collateralised loan obligation (CLO) market which itself has made a recovery since being initially impacted by the pandemic. For H1 2021, US CLO new issuance has totalled $82.35 billion (versus $91.76 billion for full-year 2020)[4]. This is important since CLOs own a significant chunk of the leveraged loan market and clearly one market drives another.

The market outlook going into the last quarter of 2021 remains positive. At its September meeting, the US Federal Reserve held benchmark interest rates near zero but it has indicated that rate hikes could come sooner than expected and tapering could begin as early as November this year. This could lead to an end of year rush on leveraged finance deals as businesses seek to protect against interest rate rises. Another important consideration as we go into next year is the increasing rate of inflation. Most commentators agree that this is likely to be driven by pandemic related factors and should subside over time, however, the extent of this remains to be seen.

Finally, one interesting development in the leveraged loan market to watch in 2022 is the impact of the Biden administration's focus on climate change. Most market participants agree that we will see a rise in the inclusion of so-called "ESG clauses" in debt documentation. Over the past couple of years ESG has become embedded in both lenders and borrowers strategic business plans and priorities. This is a trend that will become increasingly important as we go forward.

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[1] Asia-Pacific M&A hit highest value on record fueled by technological innovation and ESG agendas | EY Finland.

[2] Source: Refinitiv.

[3] Source: Fitch U.S. Leveraged Finance Market Insight Report

[4] S&P Global "U.S. CLO And Leveraged Finance Quarterly Key Themes: Q3"

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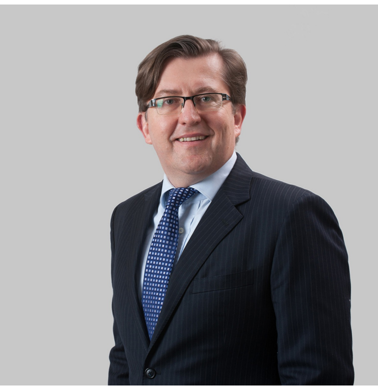

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