THE LEAD
https://theleadpc.com/the-new-order-leverage-finance-in-an-asset-management-world-fourth-of-a-series/

The New Order: Leverage Finance in an Asset Management World (Fourth of a Series)

THE LEAD | March 19, 2024

Now that the liquid loan market is opening, albeit with mostly refinancings, larger issuers have more choices. This is actually a good and natural thing. For those companies willing to go through the ratings and syndication processes in the bank market, terms can be competitive.

Because CLO equity investors benefit from much higher structural leverage, BSL pricing can be cheaper than private debt. This illiquidity premium (or liquidity discount) is historically 100-300 bps, depending on ratings. For quality borrowers, particularly in the tech space, leverage can also be higher. And of course, covenant-lite is the standard for syndicated loans.

The paths borrowers can take depend on a number of factors. Because market and economic conditions have moved to risk-on, liquid loan buyers are positioned to hold single-B, even weak single-B, assets. Retail funds are now seeing cash inflows, with $1.2 billion garnered over the past five weeks, according to Morningstar Direct.

After months on the sidelines, issuers are capitalizing on a favorable environment by refinancing higher-cost structures incurred in the past two years. As our *Chart of the Week* shows, pent-up activity has shifted dramatically from private lenders to the syndicated world.

Legacy BSLs have their own refi rhythms. A lot depends on the secondary market. If prices rise (moving inversely to spreads), as they've been doing for the past twelve months, it's easier to take out the loans with a new cheaper deal. If prices fall, as happened last week on the heels of tougher CPI data, it's a headwind for new primary transactions.

This dynamic underlines the difference between public and private credit and how investment bankers behave differently than asset managers. Rate and economic conditions largely determine BSL appetite. At the moment, those are favorable, so that's good news for issuers. But as we saw in 2022-23 the pendulum can swing back. And when that happens, the liquid market shuts down.

Much has been made in the press of private debt loan spreads contracting in 2024. But during the Fed rate hikes that began two years ago, those same spreads *increased*. How did that happen? Simple supply/demand. Doesn't that same rule apply to BSLs?

In the bull market leading up the GFC, as interest rates rose, loan spreads actually declined. When Libor peaked at about 5.5% in June 2007, single-B large cap spreads were in the 225-250 bps range, roughly half of where they started in 2003. Supply/demand still ruled, but rate hikes then were more modulated, giving borrowers time to shop. Sponsors also pushed hard to keep all-in interest costs within a band over the period.

Financing choices now include leading private credit managers who offer a wide range of credit solutions, including those for borrowers challenged by high interest rates. In some cases, this will be a convenient off-ramp for BSL loans. A glimpse of the future bank/non-bank ecosystem.