E | M | B

2023
Debt Capital Markets Report

Key trends that impacted middle-market borrowers in 2023 and implications for next year's financings

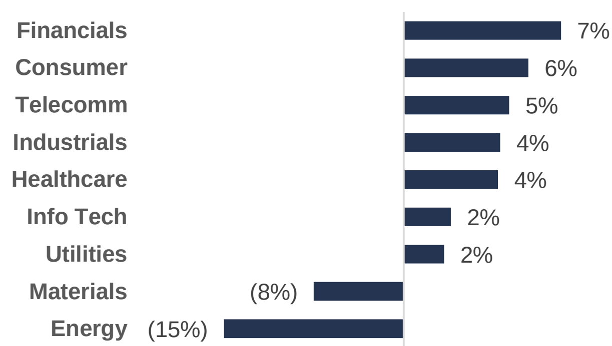
Business Conditions

Business conditions have been challenging in 2023 with lower-than-average economic growth and high inflation. The effects of inflation are still working their way through the system as run-rate costs for crucial business spending categories, such as labor and financing, become fully absorbed and adjusted for. There has been variability in company performance depending on industry / end-market and positioning in a post-COVID world.

	YTD 2023	Historical
GDP[(1)]	3.1%	3.2%
Inflation[(2)]	4.4%	2.0%
Unemployment[(3)]	3.6%	5.7%

(1) Average U.S. GDP growth rate 1Q23-3Q23 vs 1950s-current.
(2) Average U.S. CPI Jan-Sept23 vs. Federal Reserve target.
(3) Average U.S. unemployment rate Jan-Sept23 vs. 1950s-current.
(4) 2023E vs 2022 revenue growth as of Sept23 (Source: FactSet).

2023 Revenue Growth by Sector (S&P 500)[(4)]



Capital Market Conditions

Debt capital market conditions have been tight in 2023 with low loan activity, more conservative underwriting standards and higher borrowing costs (which have put pressure on loan covenants and borrowers' debt capacity). Still, private credit dry powder remains high and continues to grow, leaving financing opportunities for those in a position to accommodate them.

Key Market Trends

Several trends shaped the debt financing market in 2023, including:

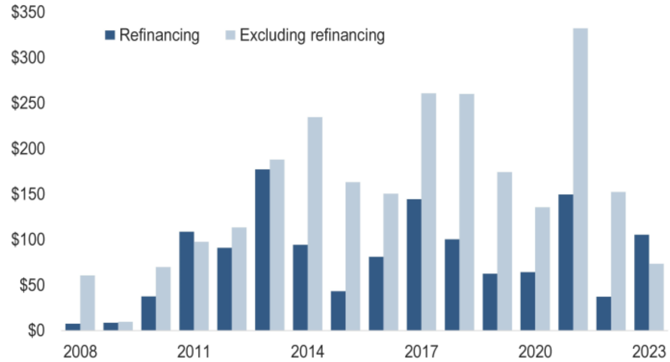
1. Lower loan volume.

Loan activity is down in 2023, with year-to-date (YTD) September institutional loan volume at a 10-year low.

Things started to pick up in 3Q, registering the highest quarterly volume since the Fed began rate hikes last year. Notably, most recent activity has been driven by refinancings, repricings and amend-and-extend transactions as borrowers make go-forward adjustments to their existing financing structures.

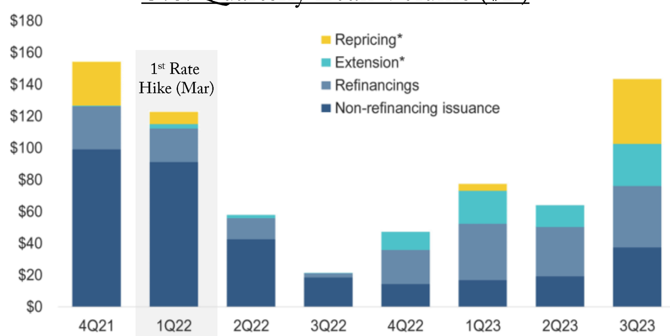
There are multiple drivers of the reduced loan volume, including the softer economic environment, related tighter underwriting standards and higher financing costs (which have reduced borrowers' debt capacity).

YTD U.S. Institutional Loan Volume ($B)



Source: PitchBook | LCD • Data through Sept. 30, 2023

U.S. Quarterly Loan Volume ($B)



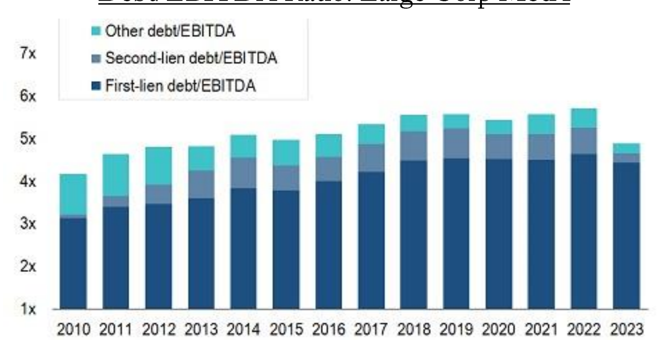
Source: PitchBook | LCD • Data through Sept. 30, 2023
*Reflects repricings and extensions done via an amendment process only

2. Tighter underwriting standards.

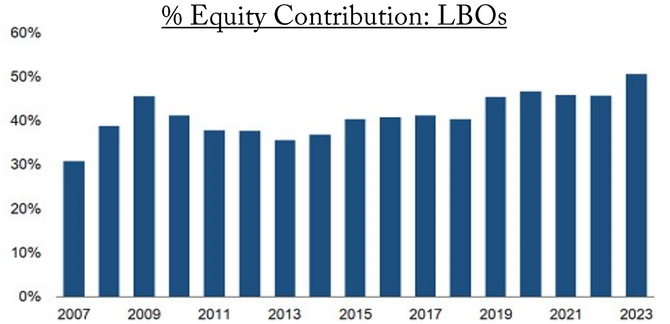
As a protective measure amid greater economic uncertainty, lenders have adopted a more conservative approach regarding who they extend credit to and how much is appropriate. These tighter underwriting standards have translated into lower loan volumes through fewer financings (given a higher bar) and smaller financings (given more conservative leverage).

YTD September 2023 lenders have extended large corporate borrowers ~1x less debt (as a ratio to EBITDA) to fund M&A relative to last year, marking the lowest level in nearly a decade (4.9x). Further, lenders have required the highest amount of cash equity contribution from sponsors for large LBOs (i.e., non-debt financing) on record at 51% of the total purchase price.

Debt/EBITDA Ratio: Large Corp M&A



% Equity Contribution: LBOs



Source: PitchBook | LCD • Data through Sept. 30, 2023

Key Market Trends (Cont.)

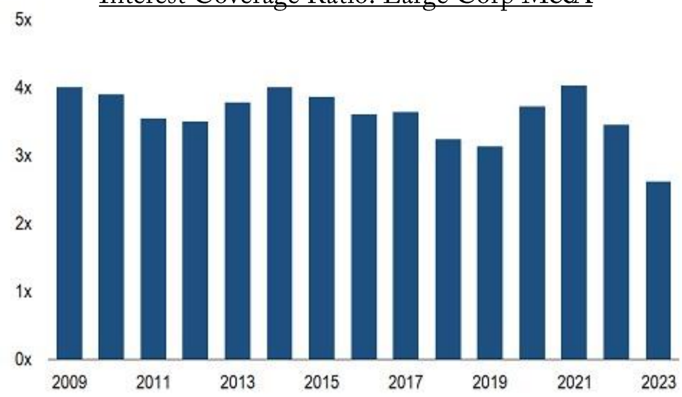
3. Higher interest costs & reduced debt capacity.

Lower leverage has not only been a protective lender effort but also a consequence of higher financing costs.

With interest costs nearly doubling year-over-year – due to Fed rate hikes and widening loan pricing spreads – the amount of debt financing a given company can comfortably manage (without straining cash) has decreased. The resulting pressure can be seen in the decrease in interest coverage (EBITDA-to-interest cost) for large corporate M&A to ~2.5x YTD 2023, the lowest recorded level despite the leverage step-down.

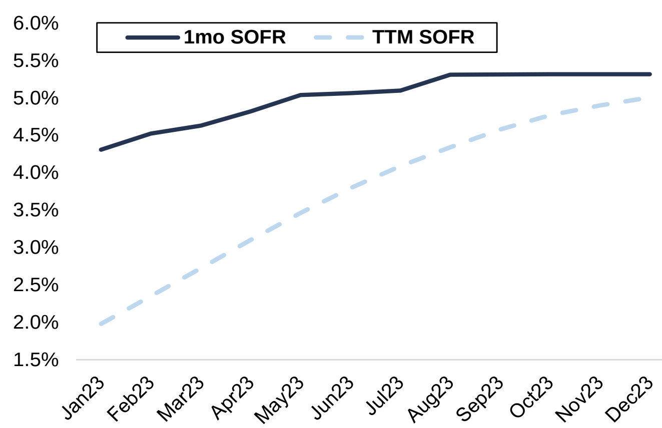
Fixed charge coverage has become the governor on debt capacity for borrowers in 2023 (see our article on FCCR's Comeback). Given the pace and magnitude of rate hikes, trailing interest costs have lagged run-rate levels. As rate increases have leveled off, trailing twelve month (TTM) interest costs have caught up meaningfully – reflecting 85% of run-rate as of 3Q23 vs. 60% as of 1Q23. However, even with no further hikes, it won't be until 2Q24 that 100% of run-rate costs are reflected.

Interest Coverage Ratio: Large Corp M&A



Source: PitchBook | LCD • Data through Sept. 30, 2023

2023 SOFR Progression



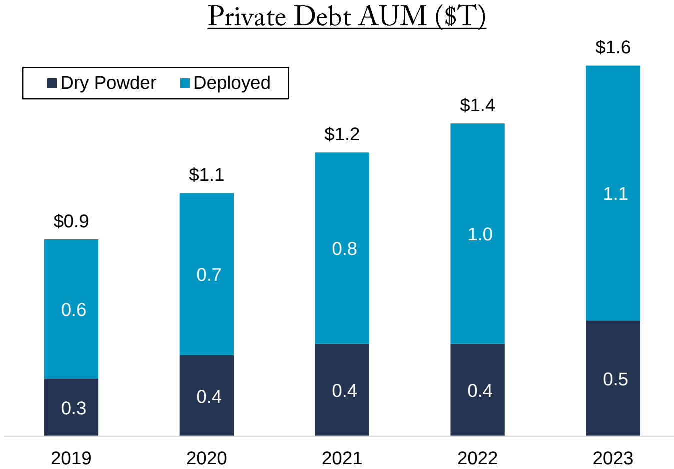
Source: Federal Reserve.

4. Ample financing dry powder.

Private credit continues to grow, and opportunity remains with the amount of "dry powder" (cash available to be loaned out to companies) sitting at over $500 billion, twice what was present in 2019.

The areas of the debt financing market where capital is being raised and strategies under which it's being actively deployed are evolving, increasing borrowers need to broaden their knowledge of the financing landscape.

Private Debt AUM ($T)



Source: Prequin.

Implications for 2024 Financings

More planning is required, including:

1. Forecasting & pressure-testing requirements

With rate hikes and inflation still leveling off, the metrics determining borrowers' financing capacity and covenant compliance (e.g., interest, EBITDA, etc.) are in flux. As are the market standards and expectations for borrowers as the business environment evolves. Companies must forecast and pressure-test steady-state, run-rate performance to effectively evaluate borrowing capacity and covenant cushion and stay ahead of future requirements.

2. Front-running higher lender expectations

Given the broader economic uncertainty, the bar for borrowers is higher, particularly regarding reporting and forecasting. Borrowers can put their best foot forward by establishing the systems to meet lender expectations and ongoing requirements.

3. Adapting to the changing market landscape

Shifting underwriting standards have changed how much some lenders can comfortably extend, the structure under which they can do so or the terms they expect. It is important for borrowers to evaluate changes in financing availability and runway.

With borrowing capacity impacted, adapting may require accessing a broader range of solutions, such as junior/mezzanine debt to help manage cash interest expense or asset-based debt to access borrowing capacity less tied to cash flow fluctuations.

Conclusion

Changing economic and debt capital market conditions created new challenges for borrowers in 2023. By spending more time forecasting and pressure-testing financing requirements, front-running lender expectations and evaluating / adapting to the shifting market landscape, companies can make better-informed financing decisions going into 2024.

EMB Advisory (EMB) helps companies raise and manage debt financing so leadership can spend more time growing their business. Through a comprehensive system and full-time focus on debt capital, EMB delivers deep technical and real-time market knowledge to tailor solutions to client's unique financing situations. EMB has supported over $1.3 billion in debt financings to fund acquisitions, refinancings, shareholder dividends and corporate growth investments.