



Corporate Debt

Newsletter Q4 2022

Corporate Debt Markets in Q4 2022 – Overview

- > In the third quarter of 2022, European corporate bond markets improved their deal activity despite macroeconomic and geopolitical stress factors. Even though deal volumes were lower than in 2021, they improved compared to the previous quarter in 2022.
- > PwC reported 26 high yield bond deals amounting to EUR 8bn (QoQ: -38%), compared to 37 deals with a volume of EUR 13bn in Q2 2022. The performance in Q3 2022 was the lowest since 2018.
- > Driven by two large issuances: Koninklijke KPN NV with EUR 496m and Patagonia Holdco LLC with 492m, a new sector, communication services, emerged with a 12% market share.
- > In the German senior debt and unitranche market, 31 transactions were closed in Q3 2022. This is 28% less than in Q2 2022, but the performance in the previous quarter was remarkably strong given the geopolitical and macroeconomic stress factors.
- > Factors such as the economic outlook and banks’ lower risk tolerance continued to have a strong impact on corporate loans. Therefore, credit standards tightened further, which will most likely continue in the final quarter of 2022.

European Sub-IG Market

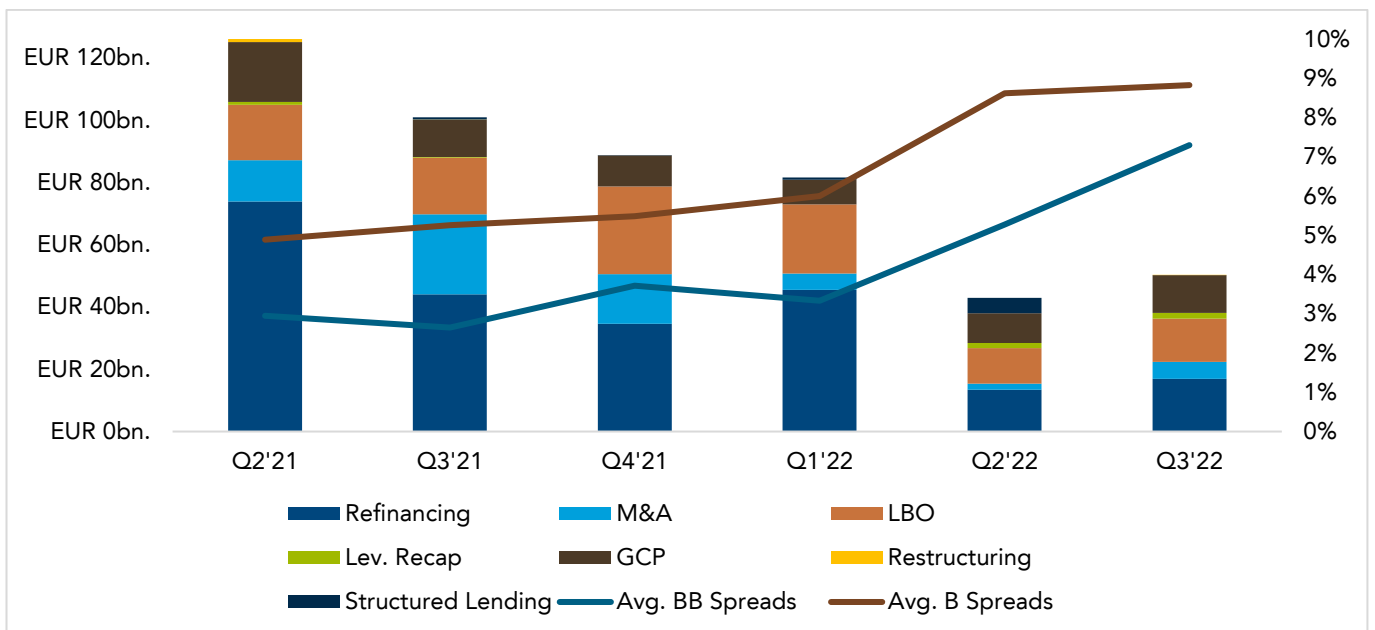


Figure 1: Volume of Sub-IG European debt markets (incl. leveraged loans and bonds) and average spreads*

Source: White & Case (Debt Explorer), PwC Debt Watch Europe Q3 2022

*Adjustments to previous quarters based on most recent data from White & Case (Debt Explorer)

Corporate Debt Market Europe

European Debt Market

According to Debtwire, there was a significantly higher deal activity in leveraged loans and high yield bonds in the third quarter of 2022, with a value of EUR 50.3bn compared to EUR 42.9bn in Q2 2022 (QoQ: +17.2%). One of the main drivers was the refinancing sector, with a volume of EUR 16.91bn which is an increase of 26% compared to the previous quarter but a decrease of 62% compared to the same period in 2021. Another main driver was M&A activity, which amounted to EUR 5.49bn, an increase of 177% compared to Q2 2022 (YoY: -79%). M&A deal activity in 2021 was at the highest level since 2007. This year's volume is at much lower levels as factors such as rising inflation and supply chain issues made market participants more cautious and slowed down deal activity. LBO financing increased from EUR 11.4bn in Q2 2022 to EUR 13.83bn in Q3 2022 (YoY: -24%). Furthermore, a significant increase in GCP activity was reported with EUR 12.11bn in Q3 2022 compared to EUR 9.51bn in Q2 2022 (+27%) and EUR 11.91bn in Q3 2021 (+2%). With a deal volume of EUR 1.91bn in the third quarter of 2022, leveraged recapitalisation activity increased by 16% compared to the previous quarter and by 907% compared to the same period in 2021. Lastly, after three quarters in which no deal activity was reported, the volume of restructurings in the third quarter of 2022 amounted to EUR 0.07bn (YoY: -18%).

As reported by Euro area banks in the ECB lending survey, credit standards for corporate loans tightened further in the third quarter of 2022. This was due to several factors, such as the balance sheet situation and funding costs of banks, as well as their decreasing risk tolerance and increasing risk awareness with regard to the company- or industry-specific situation and economic outlook. This effect is expected to intensify in the last quarter of the year. However, net corporate credit demand has increased in recent quarters due to working capital and inventory financing needs, but high interest rates and thus high financing costs have been slowing down demand.

According to S&P, spreads on European loans increased to an average of E+515bps in Q3 2022 from E+448bps in the second quarter. Furthermore, the yield to maturity increased significantly from 5.14% in Q2 2022 to 7.44% in Q3 2022. In the third quarter, spreads and yields reached their highest level in the last ten years.

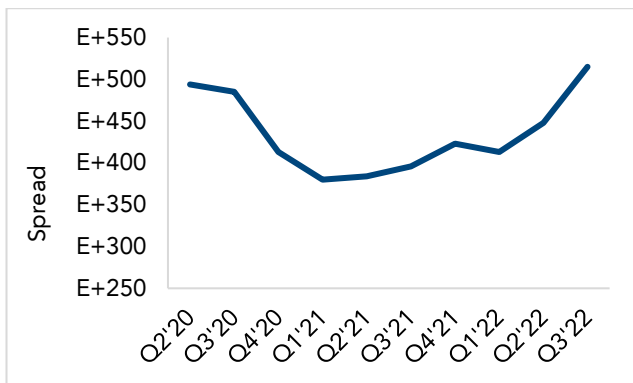


Figure 2: European new issue loan spreads

Source: S&P Global Market Intelligence

In Q3 2022, 129 sponsored European PE deals were closed, a decrease of 4% from the previous quarter. However, this is still a satisfactory result as the market faced several

macroeconomic and geopolitical stress factors, including rising interest rates and thus higher financing costs, increasing energy and commodity prices, as well as the ongoing war in Ukraine.

According to PWC, activity in high yield bonds has been slowing down with only 26 deals amounting to a raised volume of EUR 8bn (QoQ: -38%, YoY: -79%) in Q3 2022. This was the lowest performance since 2018. Investors have become more cautious, not issuing any bonds with a triple-C rating or below in this quarter. The increasing risk awareness has also become evident in credit spreads between BBB- and BB-rated bonds increasing by 80bps to 3.1% from the previous to the current quarter (+150bps YoY).

DACH Debt Market

According to the European Central Bank lending survey, banks continued to tighten their credit standards in Q3 2022. Credit standards were tightened slightly more for SMEs than for loans to large companies and more for long-term loans than for short-term loans. The decisive factors included a lower risk tolerance of the banks as well as the company- or firm-specific situation and the economic outlook.

In the third quarter of 2022, the Houlihan Lokey MidCap Monitor reported 31 transactions for the German senior and unitranche debt market. This is 28% less than in Q2 2022, but the performance in the previous quarter was remarkably strong given the geopolitical and macroeconomic stress factors. Debt fund and bank activity was relatively similar. Banks accounted for 45%, while debt funds were responsible for 55% of deals closed in Q3 2022. These figures are also very close to the breakdown of the first nine months of 2022 (42% and 58% respectively). Looking at the different sectors, the breakdown of market shares was relatively similar to the previous quarter. Half of the market was made up by the software and tech sector with a share of 26% and the healthcare sector with a share of 24% for the first three quarters of 2022. The industrial products and manufacturing sector increased its share from 9% in the first half of the year to 14% in the first nine months of 2022. The financing purposes in the German senior and unitranche market are also similarly distributed as before. One of the main purposes were add-on deals, which accounted for 35% of all financings in the first three quarters of 2022 and 29% in Q3 2022. Another main purpose were new financings (primary), which also accounted for 35%. The German LBO market for medium-sized companies is very resilient and less volatile compared to the liquid market. Banks have become more conservative, but are still open to provide financing solutions.

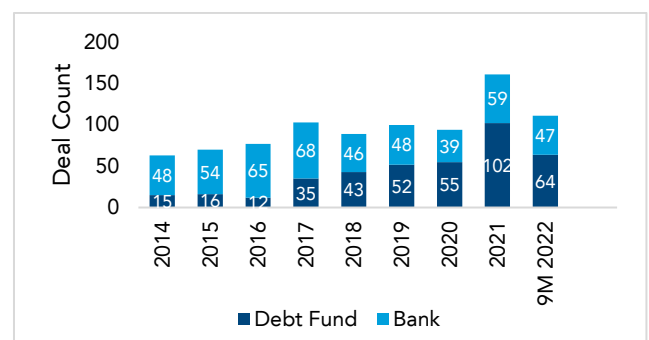


Figure 3: German mid-market financings 2022

Source: Houlihan Lokey MidCap Monitor Q3 2022

Senior and unitranche debt fund financings remain the financing form with a higher market share in the first nine months of the year 2022. In total, 64 debt fund financings with a market share of 58% and 47 bank financings with a market share of 42% were completed. Overall, LBO banks and regional banks are more conservative but still ready for transactions and have proven their strength compared to debt funds.

Looking at the European market as a whole, Germany is among the most active regions for unitranche financings. With 23 deals closed in Q3 2022 it was the third most active region, thus behind France with 29 closed deals and the UK with 36 closed deals.

Financing Conditions

One of the European Central Bank’s current priorities is to bring inflation back to its medium-term target of 2%. Part of this process is the increase in interest rates that the ECB implemented in July and September of this quarter. The refinancing rate reached 1.25%, the marginal lending rate climbed to 1.50% and the deposit rate was raised to 0.75%. Geopolitical stress factors, which include supply shortages, demand pressures and rising costs in various sectors such as energy, commodities and food, have pushed up inflation. According to Eurostat, inflation was already at a high rate of 9.1% in August, but the estimate of annual inflation increased further to 10% in September 2022.

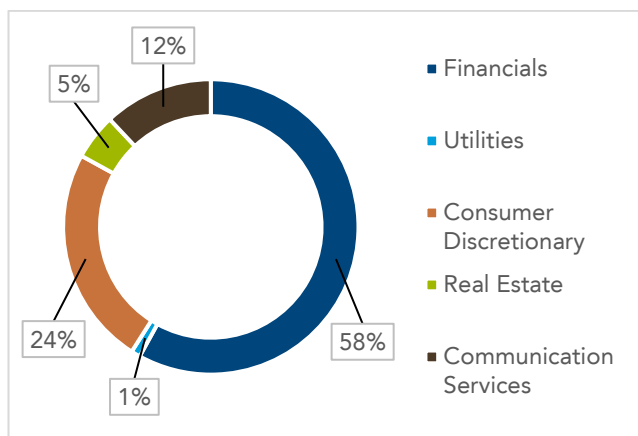


Figure 4: High Yield Volume Europe, Q3 2022 Sectoral Split
Source: PwC Debt Watch Europe Q3 2022

In the third quarter of 2022, the financial sector’s market share increased by 14 percentage points to a total share of 58%. Consumer discretionary also increased slightly to a market share of 24%. Moreover, utilities, for which no share was reported in Q2 2022, are back in the overview with a market share of 1%. On the other hand, there are two new sectors in the distribution. For one, the real estate sector has been included in the distribution with a small share of 5%, and also communication services with a market share of 12%. No shares were reported in Q3 2022 for the basic materials, healthcare, industrials, consumer staples and energy sectors, which were included in the distribution of the previous quarter.

The fight against inflation

Fighting inflation is currently a top priority of the European Central Bank. One of their tools to do this is to set the key interest rates for the euro area, which they have done multiple times this year. The first raise happened in July, followed by another increase in September. Within three

months, the rates increased by 2%, which has never happened before in such a short period of time. However, inflation expectations still increased from 9.1% in August to 10.0% in September (Eurostat). Inflation further rose to 10.6% in October but for November a small decline back to 10.0% was reported (below expectations). To continue fighting this still very high rate, the ECB decided on another key interest rate hike, which took effect in November.

The key interest rates are the main refinancing rate, the marginal lending rate and the deposit interest rate. When commercial banks borrow money from the ECB in the medium term, they do so at the refinancing rate. As this rate is rising, loans become more expensive but at the same time, interest on savings increases. If they borrow it in the short term, the marginal lending rate is applicable. Inflation can be slowed down, when this rate is higher. When banks store excess money at the ECB overnight, the deposit interest rate accrues.

In November 2022, the refinancing rate was at 2.0%, the marginal lending rate at 2.25% and the deposit rate was raised to 1.5%. It is expected that interest rates will be increased further in the next rate-setting meeting of the ECB in mid-December. As the inflation was lower than expected in November, an increase of 50 bps currently seems more likely than another 75 bps increase.

Due to fears of a recession, it is questionable how high interest rates can be pushed. On the one hand, rate hikes give a signal that central banks are determined to fight inflation but on the other hand, the risk of a recession increases. Moreover, if interest rates are too restrictive, demand, investments and hiring are constraint, which can impact economic growth. Therefore, it is expected that in 2023 the rate hike will slow down.

Central bankers have warned that fiscal and monetary policies must not work against each other. ECB increases rates to fight inflation whereas governments try to protect households and businesses from rising costs (e.g. energy bills). Fiscal policy should not fuel inflation as that would make harder monetary measures necessary.

The central bank has to find a balance between the risk of a recession and its mandate of price stability. As the ECB is an independent institution from member states and is only accountable before the European Parliament it is supposed to be shielded from political interference. Despite euro-area countries with high public debt, such as Italy and France, having reservations about rising interest rates, the ECB will continue using its available tools in its fight against the too high inflation. Therefore, interest rates will most likely remain at high levels for some time as the ECB tries to stabilise prices.

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