Credit Market Conditions

Pent-Up M&A Activity and Significant Lending Dry Powder Expected to Drive Borrower-Friendly Market in 2025

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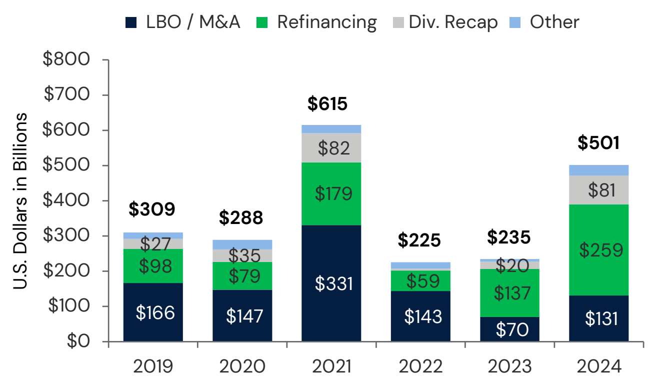
2024 Year in Review. Institutional loan volume (excluding repricing and extensions) more than doubled in 2024, reaching $500 billion in total volume, the highest level since 2021, according to PitchBook LCD.[1] On the surface, it should have been a banner year for lenders. However, digging below the surface, new deployments were difficult to come by given a still muted merger and acquisition (M&A) environment. Refinancing and repricing transactions drove the majority of loan activity and represented more than 50% of institutional loan volume in 2024. As refinancings are typically a dollar-for-dollar replacement of outstanding loans, this activity resulted in almost no change to private credit dry powder, which has remained at record levels heading into 2025.

M&A Loan Activity. While M&A financing volume grew in 2024, it remained below 2019-2022 levels. Further, sponsored middle market loan activity, while resilient during the past year, was heavily supported by demand for incremental or add-on financings, which represented almost 50% of new sponsored M&A financing activity. While the M&A market has been depressed for roughly two-and-a-half years since the Federal Reserve began hiking rates, recent trends indicate strong momentum entering 2025. After troughing at 225 deals in Q4 2023, the number of leveraged buyouts (LBOs) financed in the Broadly Syndicated Loan (BSL) and Private Credit markets increased steadily throughout 2024, ending the year at 294 deals (up 30.7%), according to PitchBook LCD.[2] Finally, despite small market share gains by the BSL market over the past two years, private credit lenders overwhelmingly remained the preferred lender for sponsored M&A activity, completing more than 80% of sponsored M&A financing deals in 2024 (up from 65% in 2021).

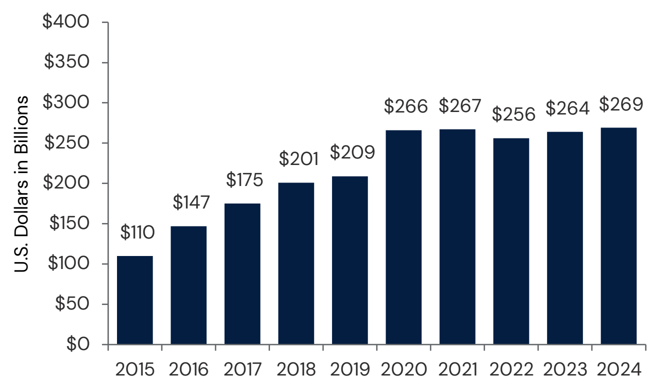
Pricing & Leverage. Senior/unitranche loan borrowing rates continued to decline based on the tandem impact of secured overnight financing rate (SOFR) reductions and spread compression.

U.S. Institutional Loan Volume



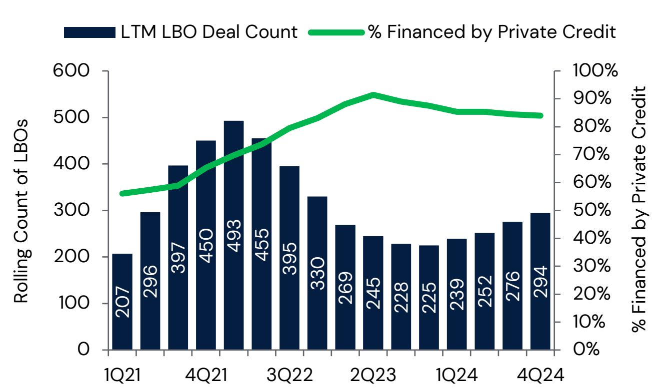
Source: PitchBook LCD and Capstone Partners

North American Private Credit Dry Powder



Source: Prequin and Capstone Partners

LBOs Financed in BSL & Private Credit Markets



Source: PitchBook LCD and Capstone Partners

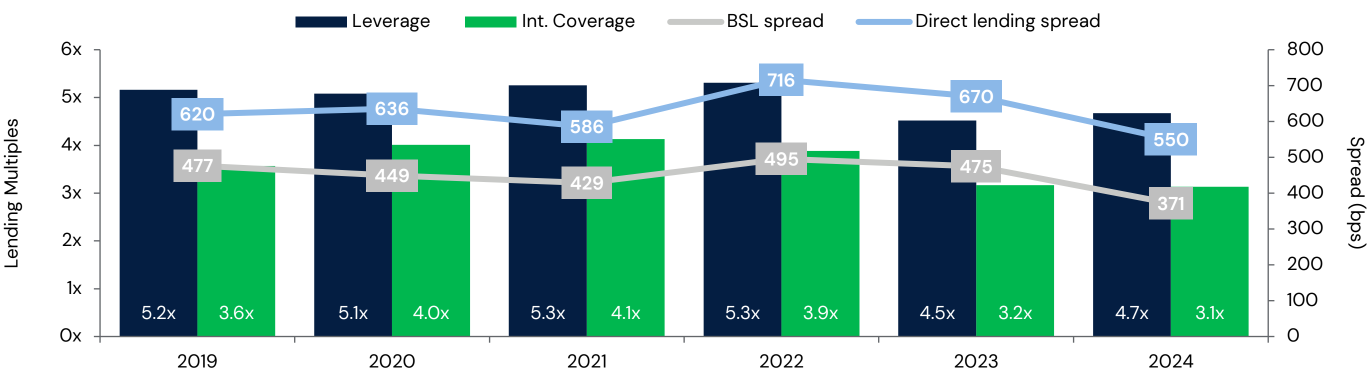
After peaking in 2022, SOFR spreads compressed for most borrowers by ~125 basis points (bps) in 2024. Notably, many market participants believe spread levels may now be approaching the bottom. Spreads on strong (or well rated) private credit deals have stabilized, at least for now, at the S+4.25%-4.75% level for sponsored upper middle market deals and 50-100 bps higher for core middle market credits.

In a recent survey, 72% of market participants expect the average leverage multiple supporting LBOs to increase in the first half of 2025, with 51% expecting rate spreads to moderately tighten, continuing a trend that began in 2023, according to PitchBook LCD. Nevertheless, given today's still-elevated rate levels (see next page), debt capacity is often range-bound by projected interest coverage ratios (not EBITDA). For all deals (LBOs, refinancings, etc.), the average EBITDA/interest ratio fell to 3.1x this year, well below the 4.0x+ levels experienced in 2019-2022 (when SOFR was lower).

Banks Return to the Market? The collapse of Silicon Valley Bank in early 2023 caused a significant ripple effect through the bank lending ecosystem. Regulatory oversight increased as a result of the financial market turbulence and; banks tightened lending standards and increased spreads. The result was a significant pull-back in bank lending and a windfall for private credit lenders, which happily stepped in to fill the void.

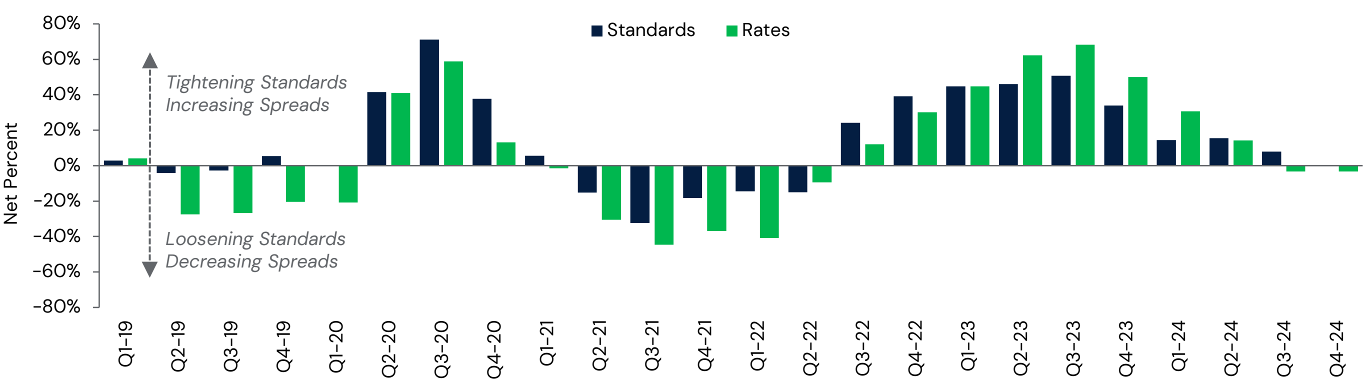
However, the bank lending sentiment shifted drastically to the positive in the back half of 2024, according to the quarterly Fed survey of senior loan officers at medium and large banks.[3] The survey showed that for the first time since Q2 2022, a net percentage of respondents tightening standards on commercial and industrial (C&I) loans were at or below zero. This response is a strong indicator of improving sentiment within the banking ecosystem. The potential return of cheaper bank capital to the market would be a further boon for borrowers in an increasingly crowded and competitive Lending market, particularly those not seeking to maximize leverage.

Key Lending Metric Trends



Source: PitchBook LCD and Capstone Partners

Federal Reserve Senior Loan Officer Survey (Medium & Large Banks)



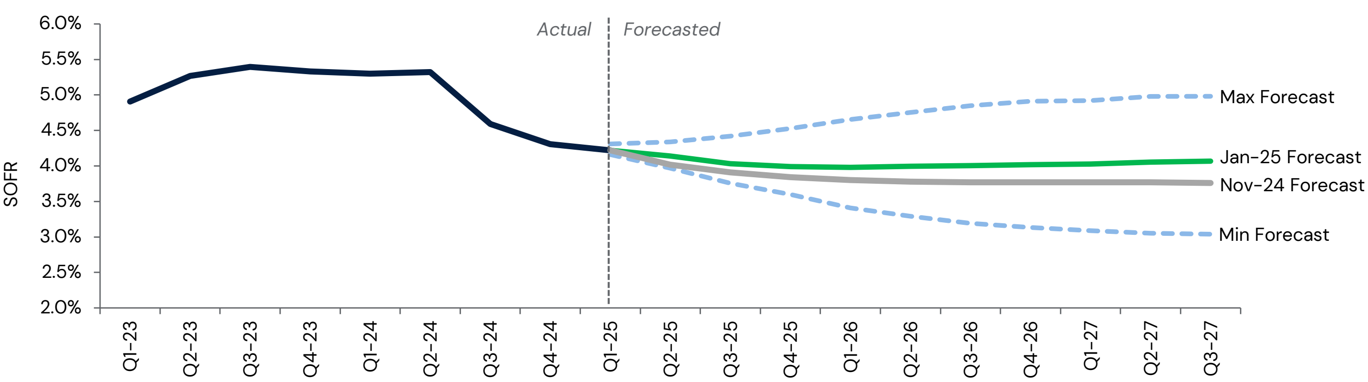
Source: U.S. Federal Reserve and Capstone Partners

Interest Rate Environment. Base three-month SOFR is now expected to remain at ~4.0% through the end of 2027 (~25 bps uptick from November 2024 forecast of 3.75%), with some forecasts calling for an increase in the base SOFR level, according to Atlanta Fed forecasts.[4] Despite the recent reduction in the underlying SOFR rate, the overall heightened interest rate regime is likely to continue to put stress on lower-quality credits as the higher interest costs stress free cash flow. This is particularly the case for many of the credits that were financed at higher leverage levels in 2020-2022 when index borrowing rates were closer to 1.0-1.5% (compared to 4.0% today). Many of these credits will mature over the next one-to-two years.

Proliferation of Payment-In-Kind Interest. Despite concerns about high interest rates, defaults in the predominantly floating-rate Institutional Lending market have been surprisingly low (1%-2%). Strong earnings growth and cost management have been identified as the primary drivers. However, another contributing factor is the increase in the use of payment-in-kind (PIK) interest structures, which helped borrowers conserve cash and avoid defaults. While historically a "defensive" structural provision, Capstone has witnessed PIK facilities utilized offensively to increase leverage for LBOs and add-on acquisitions without compromising a borrower's ability to make its ongoing debt payment requirements. As rates are now only expected to decline moderately, and as 2020-2022 interest rate hedges roll off in the next 12-18 months, we believe the use of PIK structures will grow to support both LBOs and refinancing transactions. Despite its higher cost, PIK interest can be highly attractive due to its inherent flexibility, but its use is dependent on the rationale, business fundamentals, and the underlying capital structure.

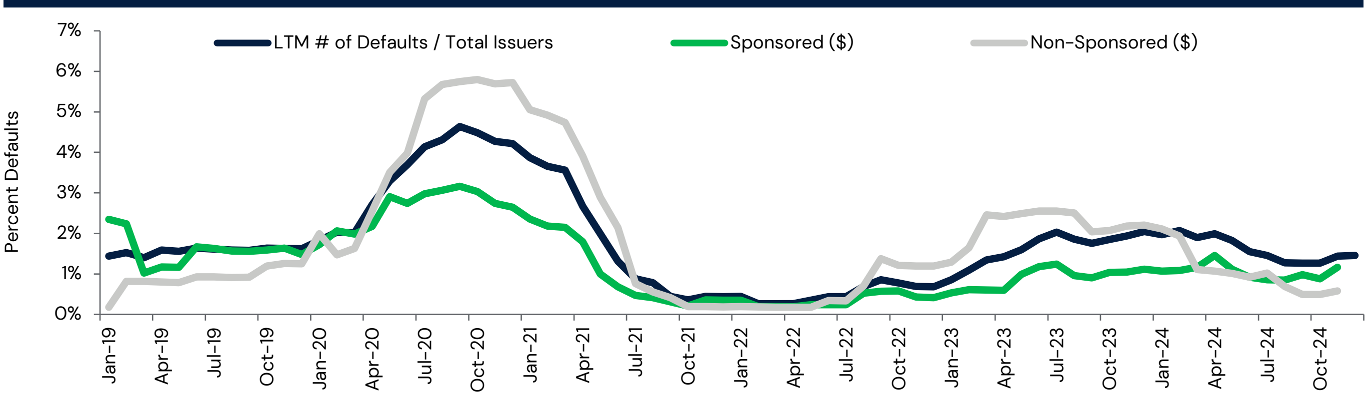
What Borrowers Can Expect Heading into 2025. The U.S. Debt market is firmly in "borrower-friendly" territory marked by institutional lenders that are competing heavily to win loan mandates. Lackluster M&A activity over the past several years, improving corporate performance, and ample dry powder have resulted in heightened pressure among lenders to deploy growing capital into new opportunities heading into 2025.

Historical and Forecasted SOFR (Three-Month)



Source: Atlanta Federal Reserve and Capstone Partners

Institutional Loan Defaults



Source: PitchBook LCD and Capstone Partners

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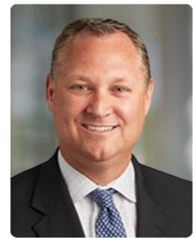

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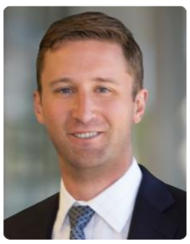

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Endnotes

1. PitchBook, "U.S. Private Credit & Middle Market Quarterly Wrap," https://files.pitchbook.com/website/files/pdf/Q4_2024_US_Credit_Markets_Quarterly_Wrap.pdf, accessed February 18, 2025.
2. PitchBook, "U.S. Private Credit & Middle Market Weekly Wrap," https://files.pitchbook.com/website/files/pdf/January_16_2025_US_Private_Credit_and_Middle_Market_Weekly_Wrap.pdf, accessed February 18, 2025.
3. Federal Reserve, "Senior Loan Officer Opinion Survey on Bank Lending Practices," https://www.federalreserve.gov/data/sloos/sloos-202410.htm, accessed February 18, 2025.
4. Federal Reserve Bank of Atlanta, "Market Probability Tracker," https://www.atlantafed.org/cenfis/market-probability-tracker, accessed February 18, 2025.

Disclosure

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