NASHVILLE NOTES

Liquidity Rules

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By Jeff K. Davis

Jeff Davis is a veteran bank analyst. The views and opinions expressed in this piece are those of the author and do not necessarily represent the views of S&P Global Market Intelligence; Mercer Capital, where Davis is the managing director of the financial institutions group; or StillPoint Capital, where Davis is a registered representative.

I have a friend who had a professor at Southern Methodist University who described leverage as the difference between living well and sleeping well. Many and perhaps most corporate borrowers who are levered but operate good businesses are living and sleeping well; many commercial real estate borrowers with near-term debt maturities are neither sleeping nor living well.

The comment was made in the mid-1970s, when few probably anticipated a bull market in bonds that ran roughly from 1982 to 2020. Few also likely foresaw the rise of capital markets, private equity, private credit and the magnified importance of liquidity to the financialized US economy.

Liquidity, like leverage, is a two-way street — though the two are opposites as they relate to potential credit losses.

Whether a calculated move or sheer luck, Federal Reserve Chair Jerome Powell's verbal pivot at his December press conference, in which he guided to three rate cuts in 2024, helped light a fire in the leveraged finance markets after a tough 2022 and 2023. And the irony of the current market mantra of "how many if any" cuts the Fed might make this year is that floating-rate leveraged loans and private credit have become more attractive for investors, all else equal.

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The market that Powell indirectly supported is huge. Ares Management Corp. estimates that the addressable market for direct lending in the US is $5.4 trillion, consisting of middle market companies with revenues of $100 million to $1 billion and those above $1 billion that are financed in the leverage loan and high yield markets.

According to Pitchbook, $412 billion of leveraged loans were refinanced, repriced and/or extended this year through May 16, which is the highest year-to-date amount since 2009 and 20% greater than the second-highest level, from 2017. Included in the 2024 year-to-date total is $126 billion of new loans issued to refinance existing debt, the highest issuance level since 2013. High yield bond issuances have taken-off this year, too, with much of the issuance slated for refinancings since M&A related issuance is in the doldrums.

As a result, the 2024 and 2025 leveraged loan maturity wall that created some market concern last year has been pushed out several years.

Borrowers were able to take advantage of the situation and either refinance at lower spreads or extract rate concessions from existing lenders via amend-and-extend modifications. Golub Capital BDC Inc., Blackstone Secured Lending Fund and Blue Owl Capital Corp., among others, noted a reduction in loan yields during first quarter earnings calls due to rate

concessions, lest existing performing loans be refinanced elsewhere. Likewise, spreads on fixed-rate high yield bonds compared to US Treasuries have continued to tighten this year.

> ***The beauty of private credit is in its greater flexibility to restructure problem credits compared to leveraged loans and bonds.***

My colleagues and I periodically provide solvency opinions and other advisory work for levered corporate entities, often backed by private equity. It is a small sample, but we do not see distress with our clients — at least not yet.

The aggregate data looks good, too. Defaults remain low, at about 2.0% based upon the number of leveraged issuers (1.3% based on dollar value), compared to the 10-year average of 1.6% and all-time average of 2.5%. Including out-of-court restructurings, the adjusted default rate is 4.3%. Realized losses remain low.

What the default rates do not speak to is the degree of bad businesses vs. bad balance sheets (or both). Ample capital availability should suppress default rates, and ultimately losses, for the time being. And the beauty of private credit, aside from long-term capital commitments from its limited partner investors, is greater flexibility to restructure problem credits compared to leveraged loans and especially compared to bonds that are governed by indentures.

The rise of private credit as an alternative capital source may be one reason corporate credit has not cracked so far, despite 525 basis points of Fed rate hikes.

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