

Crescent Capital Group is a leading specialist focused exclusively on credit. We invest in debt securities in both private and public markets, across company sizes, with a track record spanning more than three decades of market cycles. We target consistent, attractive returns with less volatility, lower default rates and higher recovery rates than the market average.

Private & Public Market Commentary – 3Q23

Join Lynsey Fitzgerald, Head of Consultant Relations and Mark du Four, Managing Director, Head of Private Capital Markets, as they provide a brief recap below of third quarter market activity.

October 2023

Lynsey Fitzgerald: A lot happened this past quarter, especially around rates with treasuries rates climbing to levels not seen since 2007 after the Fed meeting in August. What was the impact on leveraged credit markets, both public and private?

Mark du Four: The direct impact on both the public and private credit markets is that deals that were closed prior to the beginning of the rate hikes now have a significantly higher interest expense burden than was projected when those deals were originally structured. As rates have risen over the past year, the full effect of these rate increases are working their way into companies' annualized numbers, and cash flows have been impacted by the higher rates. As a result, new deals and add-on acquisitions to existing portfolio companies have had to adjust capital structures (specifically lowering the amount of leverage) to service the higher level of interest expense.

On a broader basis, at the beginning of the year the impact of the rate increases on mortgages, consumer debt and potential unforeseen lag effects from the rapid rate increases combined with inflation and the ongoing war in Ukraine created a significant amount of uncertainty in both the equity markets and the credit markets in the first half of 2023. In addition, many were predicting a recession in 4Q 2023. This uncertainty carried into private credit fundraising and the public CLO markets and as a result lenders were cautious on the amount of capital they wanted to deploy and required higher spreads as well.

The combination of lower leverage, higher rates and uncertainty over where the economy was going in the first half of the year had a major effect on the LBO market – specifically purchase price multiples. The LBO market is one of the main drivers of deal flow and buying and selling sponsors were both trying to figure out what the appropriate multiple was for a particular transaction. If you were a sponsor that was buying a company, you didn't want to pay up if you thought the economy was going into a recession in 4Q 2023 and growth would be slowing. If you were a selling sponsor, you didn't want to sell into a declining market at a low price if you didn't have to. Another factor that affected purchase price multiples was the decline in leverage which reduces the buying sponsors overall return over the life of the loan. As a result, a number of sales processes that started during the first half of 2023 ended up falling apart as the sponsors could not agree on a selling price.

LF: Did deal flow pick up over the past quarter and did that result in attractive deals? Specifically, have sponsors favored one side of the market vs another this time around? (i.e., public vs private)

Private & Public Market Commentary – 3Q23

MdF: Given the rapid increase and uncertainty in rates, lingering inflation and a projected recession in 4Q 2023, deal flow in the first half of 2023 was down almost 50% year over year, per Refinitiv LPC, as both lenders and sponsors adjusted to a new pricing and purchase price multiple environment.

The third quarter, however, saw a pickup in activity with institutional loan volume reaching its highest monthly level of 2023 in the month of September at \$38bn, per Pitchbook LCD. Additionally, the private market saw record jumbo unitranche issuance in 3Q 2023, with volume of \$26bn versus the previous record of \$24bn in 2Q 2022, per KBRA DLD. There are a number of factors that helped to drive the increased activity including:

- i. Expectations of a mild recession or “soft landing” in 2024 versus the recession that was previously projected at the end of 2023.
- ii. The Fed getting closer to its terminal rate.
- iii. Private credit lenders increasing hold levels given the slow first half of the year and a more favorable fundraising market.
- iv. Fewer transactions falling apart as sponsors came together on purchase price multiples that provided necessary market data points which were lacking in the first half of the year.

Even with the pickup in deal flow, volume was light by historical standards but the transactions that came to market were of high quality. In addition, due to the significant increase in rates, leverage on these transactions needed to come down in order for borrowers to service their cash flows. As a result, leverage was down 1x or more on many transactions compared to levels at the beginning of the rate hikes which provided enhanced structures for lenders. Additionally, with the increase in SOFR rates, senior yields for unitranche deals were over 12%. This combination of lower leverage and high returns could make for a very attractive vintage of loans.

The private markets were the first to open as the market began to improve. Sponsors wanted certainty and speed of execution and a smaller number of lenders to negotiate with as initial deals came to market. Additionally, with the amount of dry powder available in the private markets, deals of \$6bn+ were able to be financed in this market which would not have been possible a couple of years ago.

At the end of the quarter as the public markets began to tighten, we started to see that market become more constructive – particularly for B3 rated credits. As a result, there were a number of transactions that were able to get tighter pricing in the public markets than the private market and successfully clear market. The public markets are hoping to continue to capitalize on the tight market given that volumes are still relatively

Private & Public Market Commentary – 3Q23

light and there is significant investor demand from the CLO market. However, given the volatility we have seen in the market over the past year, some borrowers will elect for certainty of execution that is provided by the private market.

LF: Higher for longer has become a much more plausible scenario since the last Fed meeting, with the likes of Jamie Dimon now even talking about 7% rates. Tell us about how that is likely to impact capital structures and the demand for senior vs junior debt going forward? Bank loans vs HY?

MdF: As previously discussed, the main impact on capital structures has been lower leverage given the impact of higher interest payments on companies' free cash flows.

For some existing portfolio companies that were leveraged for a lower base rate environment, cash flow coverages are tight. Sponsors looking to grow these companies through acquisitions have had to contribute more equity or raise PIK Holdco debt to finance these acquisitions and improve the fixed charge coverages.

For new deals, leverage levels have been set to reflect the new base rate environment which could result in leverage being a full turn lower than they were previously. In addition, some transactions have added a PIK option where a sponsor can elect to PIK part of the spread for a specified period in exchange for paying a premium to the cash spread.

With the higher for longer rate environment, the senior unitranche could continue to be an attractive financing option to sponsors – especially during volatile markets when the public markets are shut down. Additionally, with a smaller group of lenders in a private market transaction, negotiations on amendments or potential changes to capital structures are able to be implemented in a more constructive and timely manner.

From a junior capital perspective, there should continue to be a need for PIK Holdco debt at the upper end of the middle market as the full effect of higher interest rates begin to work their way into companies LTM numbers over next couple of quarters. At the lower end of the middle market, we started seeing more first lien/mezzanine transactions as rates began to rise earlier this year. Sponsors favored mezzanine due to the flexibility it provides, including deferring a portion of the interest rate. This is important in the event that higher than expected rates continue or economic conditions worsen.

For the public markets, Broadly Syndicated Loans have the same floating rate benefit as private loans and similar to the private credit market, the deals that have come to market recently have been of higher quality and have had more conservative leverage structures given the high current interest rate environment. The high yield market unfortunately has not benefitted from the rising rates given their fixed rate nature, and high yield bond returns have lagged both Private Credit and BSL. Over time as rates come down, these returns

Private & Public Market Commentary – 3Q23

will improve.

LF: Crescent has been in the marketplace since 1991 and has seen a number of these cycles. Tell us about what you think is similar to the past vs different based on today's initial conditions of higher inflation, higher rates following an unprecedented era of easy money, and a large footprint of cheap senior debt that few are willing to completely reprice.

MdF: While the causes of the past couple of cycles were all different, the common theme from the dot.com bust to the Great Recession to our current situation is that they were all sudden, unexpected outcomes based on certain drivers of a robust market that ultimately failed and caught the economy and the credit markets by surprise.

One of the other similarities is that rates today are not that different from where they were going into the last two cycles. We have been at these levels before.

Two major differences are a better capitalized and regulated banking system and a much deeper private capital market.

After the Lehman bankruptcy and resulting bailout of the major banks by the government, stress tests and other regulations were put in place to prevent such a collapse from happening again. Currently the banking system is in a better position to handle volatile market conditions than it has in the past.

In addition, the private credit market was a fraction of the size that it is today. The \$200bn of dry power in private credit today is roughly 20x that prior to the Great Recession. This has not only provided financing for transactions over the past year when the public markets were shut down but also provides a cushion for a higher rate environment and any unexpected consequences that could result from it.

While cash flows were adversely impacted by rapidly increasing rates which had to be managed by sponsors and their lender groups, the floating rate nature of private debt has delivered great returns to investors. Unlike the high yield market where rates were fixed, assets in the private credit market were able to get the benefit of the increase in SOFR.

Although there were a number of deals in the private market that had lower spreads when the market was tighter prior to the rate hikes, the private credit market had a couple of options that allowed lenders to increase the pricing on these loans.

The first option came in the form of an MFN provision built into the credit agreement that allows lenders to increase pricing on existing loans when pricing an incremental or add-on loan. While the current loan

Private & Public Market Commentary – 3Q23

couldn't be repriced on a standalone basis, the sponsor investment thesis for most transactions is to make acquisitions to grow the business through incremental debt financings. Any incremental debt financing would be priced to today's market and there would be a corresponding option to increase the spread in the existing facility if the price of the new facility is beyond a defined threshold.

The second option to reprice an existing transaction is provided when sponsors want to extend a maturity, which gives lenders the option to reprice the existing facility. With the slow LBO market over the past year, many sponsors have held onto companies longer than they have wanted to. Given the uncertainties in the market going forward, a number of sponsors are looking for maturity extensions that will give them the flexibility to sell the company when they feel the market conditions are optimal. Providing this extension gives lenders the opportunity to reprice the existing facility to market.

About Crescent Capital

Crescent is a global credit investment manager with over \$40 billion of assets under management as of September 30, 2023. For over 30 years, the firm has focused on below investment grade credit through strategies that invest in marketable and privately originated debt securities including senior bank loans, high yield bonds, as well as private senior, unitranche and junior debt securities. Crescent is headquartered in Los Angeles with offices in New York, Boston, Chicago and London with more than 200 employees globally. Crescent is a part of SLC Management, the institutional alternatives and traditional asset management business of Sun Life. For more information about Crescent, visit www.crescentcap.com.

Legal Information & Disclosures

This document expresses the views of the author as of the date indicated and such views are subject to change without notice. Neither the author nor Crescent Capital Group LP (“Crescent”) has any duty or obligation to update the information contained herein. Further, Crescent makes no representation, and it should not be assumed, that past investment performance is an indication of future results.

Crescent makes this document available for educational purposes only and should not be used for any other purpose. The information contained herein does not constitute and should not be construed as an offering of advisory services or an offer to sell or solicitation to buy any securities or related financial instruments in any jurisdiction. Nor is the information intended to be nor should it be construed to be investment advice. Certain information contained herein concerning economic trends and performance may be based on or derived from information provided by independent third-party sources. The author and Crescent believe that the sources from which such information has been obtained are reliable; however, neither can guarantee the accuracy of such information nor have independently verified the accuracy or completeness of such information or the assumptions on which such information is based.

This document, including the information contained herein, may not be copied, reproduced, republished, or posted in whole or in part, in any form without the prior written consent of Crescent.

Contact Crescent Capital Group LP

**Los Angeles
(Headquarters)**
11100 Santa Monica Blvd
Suite 2000
Los Angeles, CA 90025
Tel: (310) 235-5900

New York
299 Park Avenue
33rd Floor
New York, NY 10171
Tel: (212) 364-0200

Boston
100 High Street
18th Floor
Boston, MA 02110
Tel: (617) 854-1500

Chicago
110 N. Wacker Drive
Suite 2500
Chicago, IL 60606
Tel: (312) 237-2100

London
2 Cavendish Square
London W1G 0PU
United Kingdom
Tel: (44) 20 3696 5420