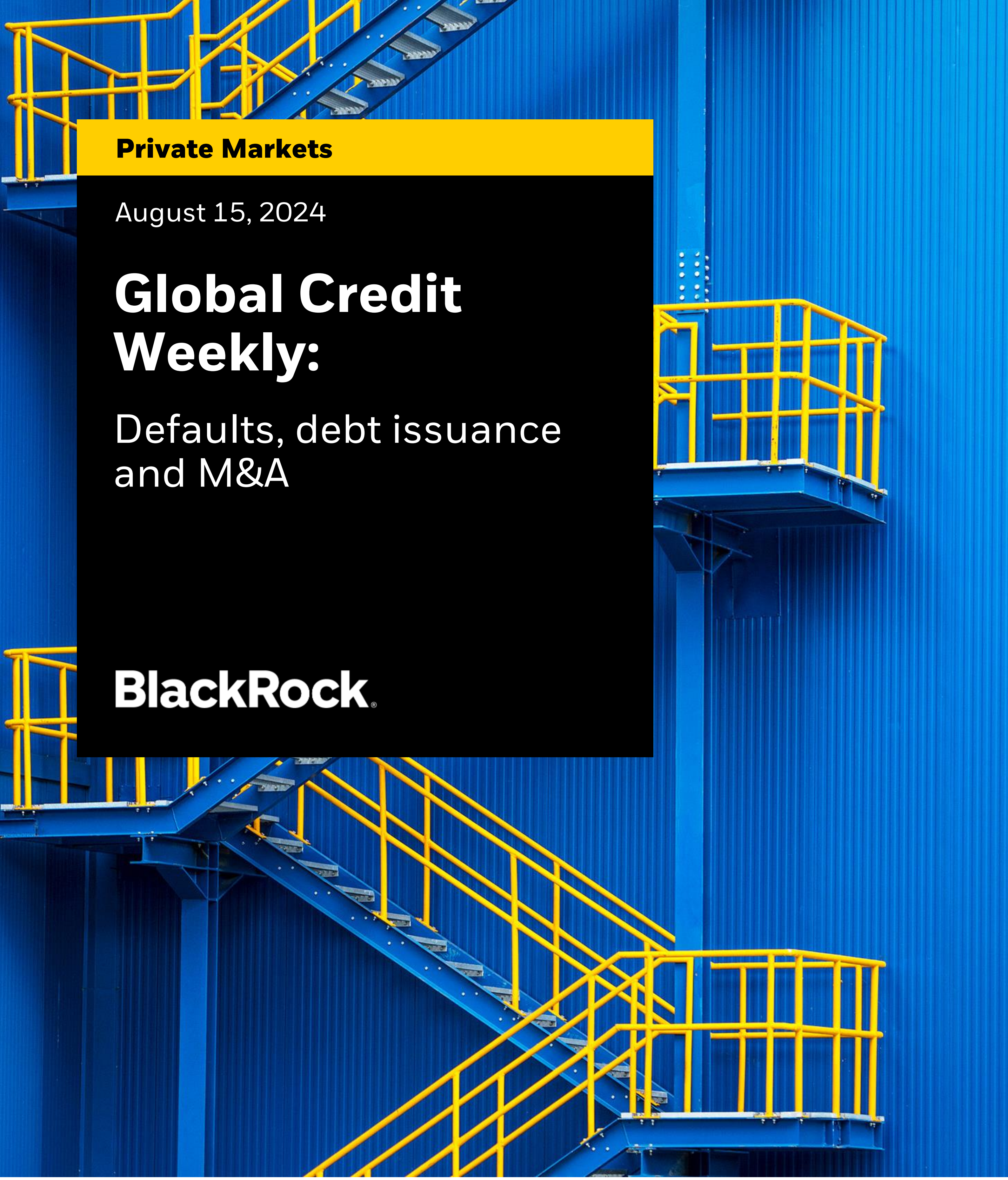

Private Markets

August 15, 2024

Global Credit Weekly:

Defaults, debt issuance and M&A

BlackRock

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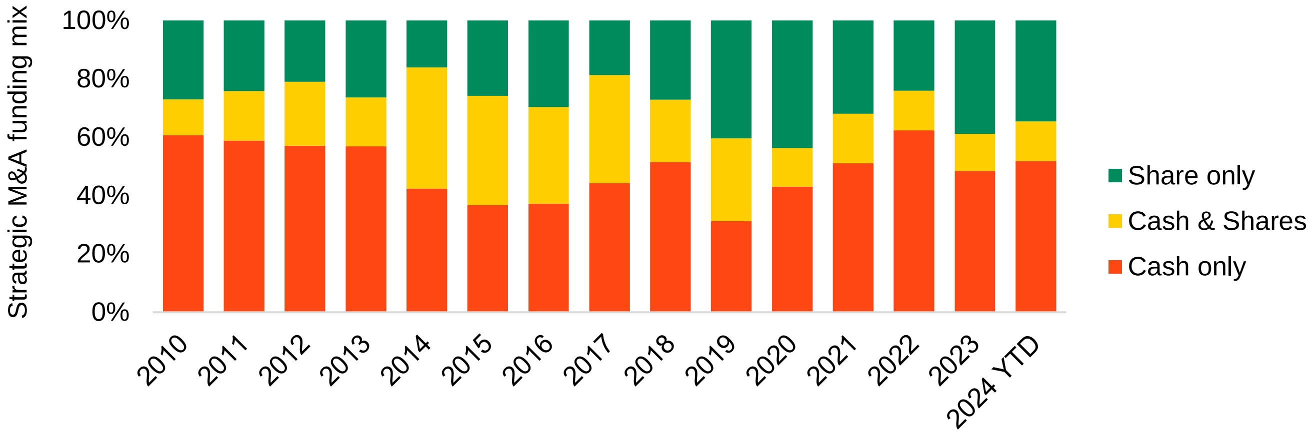
Key takeaways

- Two and a half years after the Federal Reserve began its swift, 525bp rate-hiking cycle – and with investors on the lookout for the start of policy normalization – many market participants are focused on how the private debt asset class is faring amid the higher interest rate environment. In this week's *Global Credit Weekly*, we take stock of key performance indicators – such as default rates, losses, and recoveries – which offer insight into these borrowers' varying degrees of financial strength and ability to adapt to a higher cost of capital.
- Another notable observation vis-à-vis the cost of capital environment, in our view, has been the robust pace of corporate debt issuance and strategic M&A activity. USD IG supply has tracked above the monthly average for *every month so far this year* (with August on pace to do the same). USD HY supply has also exceeded most monthly averages, driven by a focus on refinancing and pre-funding activity. Year-to-date strategic M&A activity is well above the pace of 2022 and 2023, and only 6% below the 10-year average. And as Exhibit 1 illustrates, cash and debt have featured prominently as part of the funding mix of such 2024 transactions, despite the elevated interest rate environment (we explain why this matters for bondholders within).
- With the improvement in inflation and recent softness in the labor market (as shown in the July non-farm payrolls report), the Federal Reserve's dual mandate of price stability and maximum employment has unquestionably become more balanced. We continue to expect the start of a rate normalization cycle at the September FOMC meeting.
- Along those lines, we place more weight on downside risks to growth, as opposed to upside risks to inflation. The financial health of the (bifurcated) U.S. consumer will remain at the forefront of the growth conversation, considering consumer spending accounts for more than two-thirds of U.S. GDP. This is especially relevant, in our view, given the chorus of cautious commentary from consumer-facing companies during the current earnings season, which pointed to deferred purchasing decisions for high ticket items, and more choiceful and value seeking behavior.

Exhibit 1: Despite the higher rate environment, cash and debt has been used for recent M&A

Funding mix of announced strategic M&A, by year. Captures deals announced by North American and European acquirers, valued at $1 billion or more at announcement. Excludes cancelled and withdrawn deals.



Source: Dealogic (ION Analytics), BlackRock. As of August 14, 2024.

Recent inflation data: Not an obstacle to a September cut

This week's Producer Price Index (PPI) and Consumer Price Index (CPI) inflation data highlighted continued moderation in price pressures on a year-over-year basis, as illustrated in Exhibits 2 and 3.

(Note: *Both measures are tracked by the Bureau of Labor Statistics (BLS). PPIs measure price change from the perspective of the seller, while CPIs measure price change from the perspective of the purchaser*).

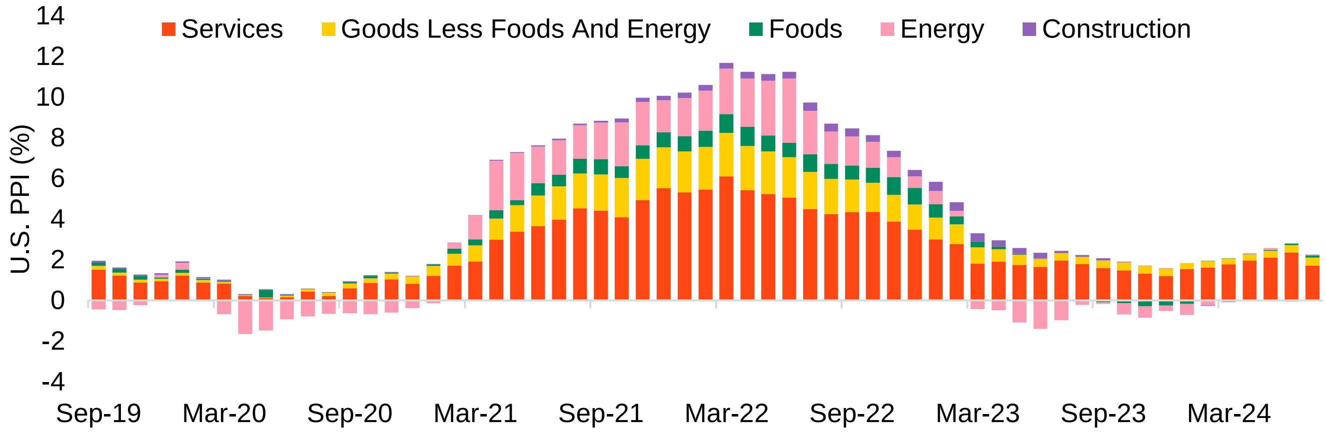
Indeed, the 2.9% and 3.2% year-over-year increases in July headline and core CPI were the smallest 12-month increases since March 2021 and April 2021 (respectively), per the BLS. And when isolating the July *monthly* CPI data, shelter costs – a somewhat backward-looking measure, due to the design of the housing survey which collects a large sample less frequently – accounted for 90% of the increase.

We continue to expect the Federal Reserve will begin normalizing its policy rate at the September FOMC meeting (September 17th – 18th). Now that the recent cooling in the labor market (as shown by the July non-farm payrolls report) has extended beyond rebalancing to the pre-pandemic level, we believe the Federal Reserve's "reaction function" has gained some additional urgency to cut rates. Inflation data is likely *no longer a reason not to cut rates*, in our view, when considered in the context of the dual mandate.

That said, the *drivers* behind future rate cuts remain important for corporate credit investors to monitor. Monetary policy *easing* in response to a sharply deteriorating economy (not our base case) is likely to be accompanied by much wider spreads and higher risk premia. By contrast, monetary policy *normalization* in response to slowing (but still solid) growth and ongoing improvement in inflation would be much more supportive for sentiment in the corporate credit market, in our view.

Exhibit 2: PPI showed moderation in July

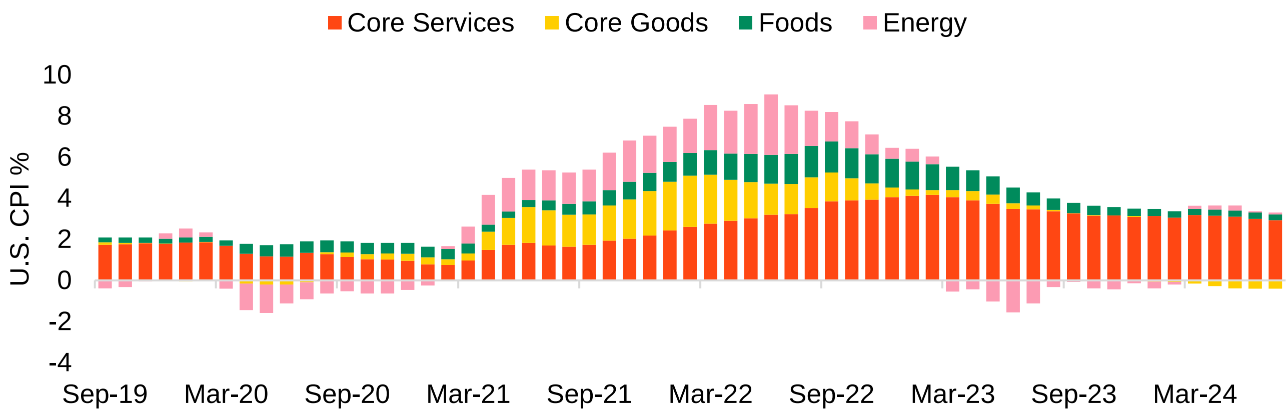
U.S. PPI final demand year-over-year growth, by category (not seasonally adjusted)



Source: Bureau of Labor Statistics, Bloomberg, BlackRock. As of July 2024 (most recent as of August 14, 2024).

Exhibit 3: A similar trend was evident in July CPI

U.S. CPI year-over-year growth, by category (not seasonally adjusted)



Source: BlackRock, Bureau of Labor Statistics, Bloomberg, BlackRock. As of July 2024 (most recent as of August 14, 2024).

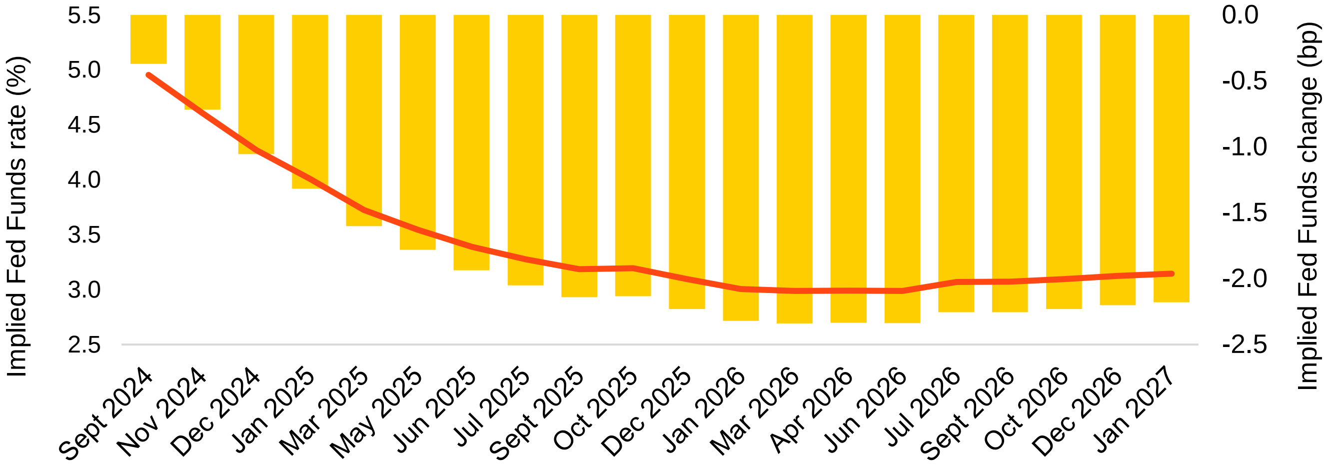
The *pace and magnitude* of cuts will be determined by the growth data

The growth data will also likely determine the *pace and magnitude* of future rate cuts, in our view. As shown in Exhibit 4, approximately 37bp of rate cuts are priced in for the September 2024 FOMC meeting as of August 14th. This compares to 49bp as of August 5th.

The decreased probability of a 50bp rate cut in September is consistent with lessened concerns of a near-term, material slowdown in economic growth following the jobless claims release last Thursday (August 8th). While historically a noisy data series, it was nonetheless very closely watched. It also coincides with the decrease in equity market volatility from the local peak of August 5th (Exhibit 5). Credit spreads have also retraced a large portion of their recent widening, with index-level spreads for the Bloomberg USD IG and USD HY Corporate indices closing at 100bp and 338bp, respectively, as of August 14th.

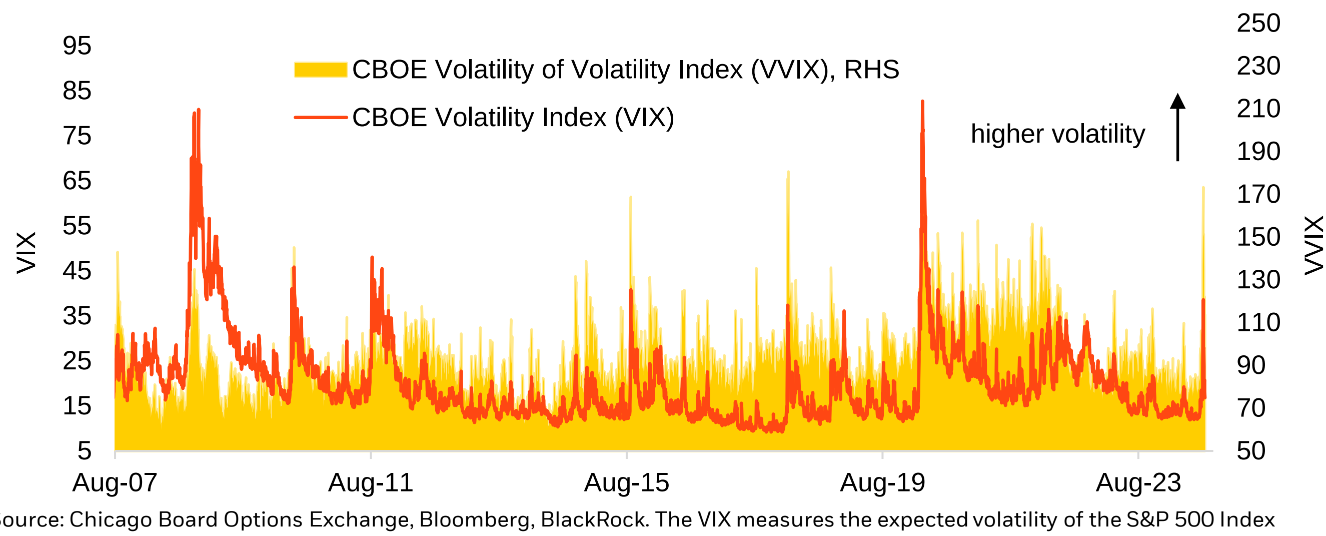
Upcoming events to watch ahead of the September FOMC meeting include Chair Powell's expected speech at the annual Jackson Hole Symposium (August 22nd – 24th), the July core PCE inflation reading (August 30th), and the August non-farm payrolls report (September 6th).

Exhibit 4: Market pricing implies 37bp of cuts at the Sept 2024 FOMC – lower vs. a week ago
Implied Federal Funds rate (%) and change (bp), based on Fed Funds Futures, through January 2027



Source: Bloomberg, BlackRock. As of August 14, 2024. **There is no guarantee any forecasts may come to pass.**

Exhibit 5: Volatility measures have moderated from the August 5th, 2024, local peak
Chicago Board Options Exchange (CBOE) Volatility Index (VIX) and Volatility of Volatility Index (VVIX)



Source: Chicago Board Options Exchange, Bloomberg, BlackRock. The VIX measures the expected volatility of the S&P 500 Index (SPX) and is calculated by using the midpoint of SPX option bid/ask quotes. The VVIX represents the expected volatility of the 30-day forward price of the VIX. As of August 14, 2024. **The figures shown relate to past performance. Past performance is not a reliable indicator of current or future results.** Index performance returns do not reflect any management fees, transaction costs, or expenses. Indices are unmanaged and one cannot invest directly in an index.

Pulse-check on private credit defaults, losses, and recoveries

Two and a half years after the Federal Reserve began its rate-hiking cycle – and on the lookout for the start of policy normalization – market participants are focused on how private debt is faring amid the higher interest rate environment. With that in mind, we take stock of key performance indicators - such as default rates, losses, and recoveries – which offer insight into borrowers' varying degrees of financial strength and ability to adapt to a higher cost of capital.

Understanding covenant default statistics requires a careful review

To frame the discussion, we first clarify some of the nuances of covenant default statistics, including: (1) the definition of a 'default' and (2) calculation methodology.

We start with the Lincoln International Valuation and Opinions Group Proprietary Private Market Database (Lincoln VOG database). For context, Lincoln is an independent valuation advisor specializing in illiquid alternative investments. As of 2Q2024, Lincoln's VOG database included approximately 5,500 U.S. operating companies, with a median EBITDA of $40-45 million, primarily owned by private equity sponsors.

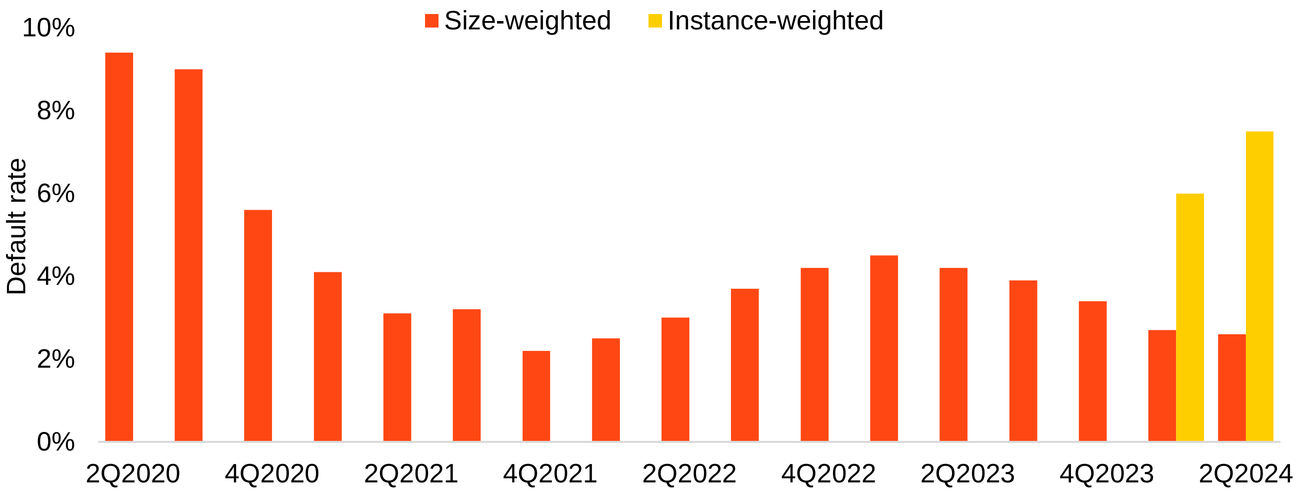
Lincoln International defines a 'default' as a covenant default, not necessarily a monetary one. This means a borrower default may not lead to lender losses but instead may give lenders time and a legal position to address issues *before* a payment default occurs. Lincoln's primary default rate calculation is size-weighted, and this measure has signaled resilience in the private debt asset class with *declining* covenant default rates.

Indeed, Lincoln's size-weighted default rate fell in 2Q2024 to 2.6%, marking the fifth consecutive quarterly decline. While this decline in default activity is partially due to the collaborative relationship between borrowers and lenders (i.e., both parties working together to amend existing covenants, as needed and as appropriate), the size-weighted nature of the statistic also influences the default rate, in our view. For example, the instance-weighted default rate (which we view as akin to an issuer-weighted statistic) for the Lincoln VOG database *increased* from 6.0% in 1Q2024 to 7.5% in 2Q2024.

Exhibit 6 illustrates the material difference in (1) the nominal level (i.e., 2.6% for size-weighted vs. 7.5% for instance-weighted) and (2) the quarter-over-quarter change (i.e., size-weighted declined, while instance-weighted increased) between the two metrics.

Exhibit 6: Differences between size-weighted and instance-weighted default metrics indicate a nuanced topic

Aggregate covenant default rate, including size-weighted and instance-weighted, for the U.S. portfolio companies included in the Lincoln International VOG Proprietary Private Market Database



Source: Lincoln International Valuations & Opinions Group Proprietary Private Market Database, BlackRock. As of 2Q2024. A default is defined by Lincoln as a covenant default (not necessarily a monetary default). The size-weighted calculation considered the total net debt balance for each of the portfolio companies that had a defaulting security in the respective quarter. The instance-weighted calculation is only available for 1Q2024 and 2Q2024.

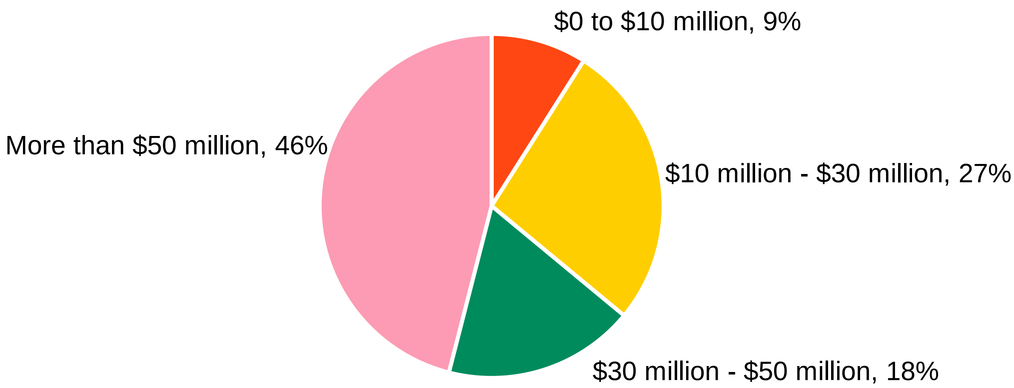
The difference between the two metrics, in our view, can largely be attributed to weighting methodology, with the instance-weighted default rate affected more by activity from smaller borrowers, which tend to have higher covenant default rates (as outlined later). Such differences in default methodology (i.e., par-weighted vs. issuer-weighted) are also frequently encountered in the public (liquid) corporate credit universe.

Private debt: Not a "one size fits all" asset class

As we outlined in February 2024, the risk-return profiles vary substantially across the different private debt strategies, portfolios, and vintages (see: *Private Debt: Exploring the Nuances* for more). This underscores the importance of manager selection, credit selection, and portfolio diversification within private debt, in our view.

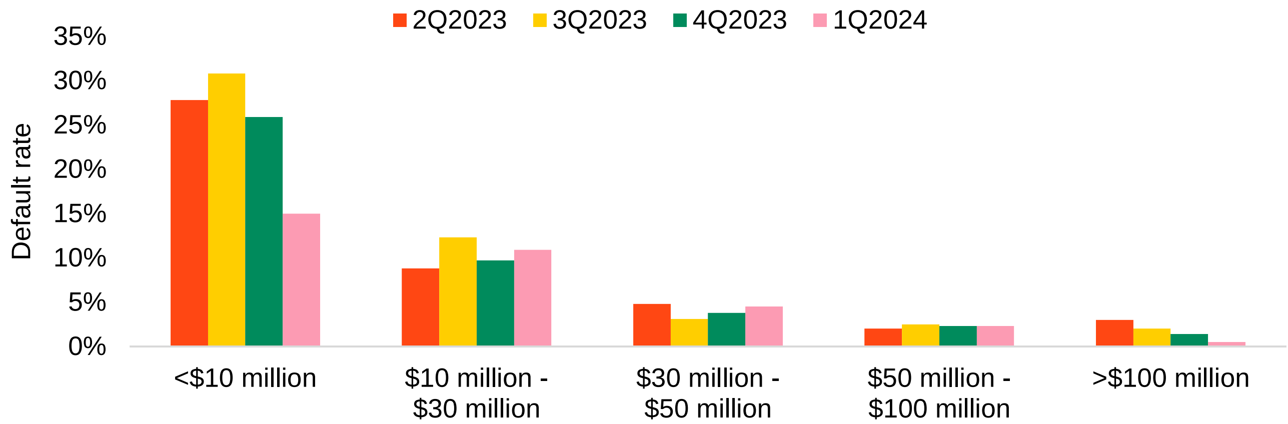
Businesses with less than $10 million and between $10 million - $30 million in annual EBITDA collectively represent more than one-third of companies in the Lincoln VOG database (Exhibit 7). Further, smaller borrowers have generally experienced higher covenant default rates compared to larger ones in the database (Exhibit 8), in part due to more restrictive covenants in the lower middle market. Without understanding such nuances, the instance-weighted default rate may overstate (at first glance) the frequency and severity of covenant defaults in the aggregate Lincoln VOG universe, and by extension, the broader asset class of private debt.

Exhibit 7: Lincoln International's dataset is diversified across borrower size
Share of portfolio companies in the Lincoln International VOG Proprietary Private Market Database by LTM EBITDA



Source: Lincoln International Valuations & Opinions Group Proprietary Private Market Database, BlackRock. As of 1Q2024.

Exhibit 8: Covenant default rates vary by borrower size
Covenant default rates (size-weighted, by annual EBITDA) for companies in the Lincoln International VOG Proprietary Private Market Database



Source: Lincoln International Valuations & Opinions Group Proprietary Private Market Database, BlackRock. As of 1Q2024. A default is defined by Lincoln as a covenant default (not necessarily a monetary default). The size-weighted calculation considered the total net debt balance for each of the portfolio companies that had a defaulting security in the respective quarter.

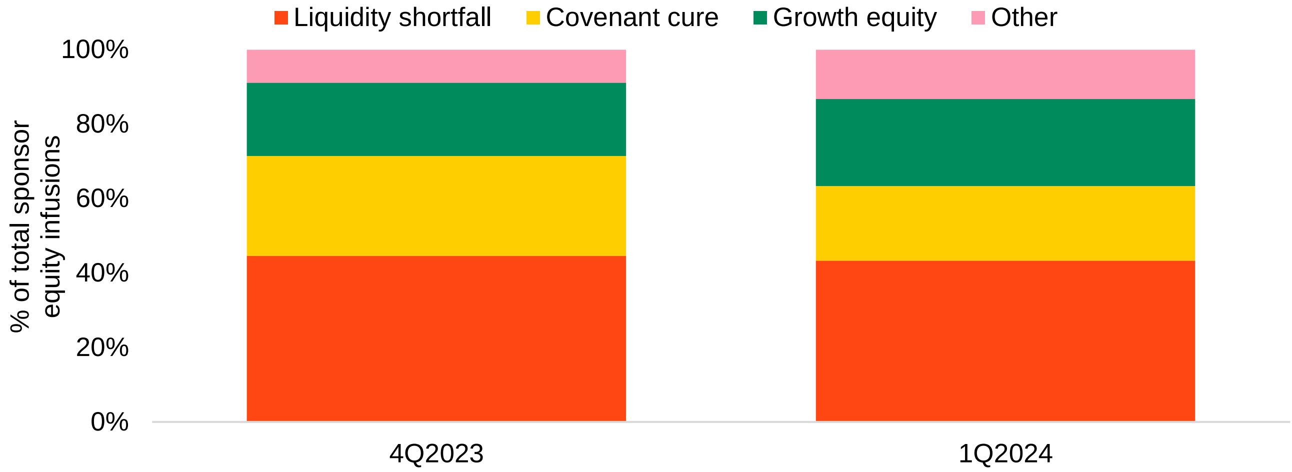
Sponsor ownership can influence direct lending borrower defaults

Beyond company size, the type of ownership can also impact a borrower's propensity to default. For example, ownership by a private equity sponsor (i.e., "sponsor ownership") can benefit both borrowers and lenders, as sponsors have a financial incentive to keep borrowers current (i.e., the capital they've already invested) and can provide liquidity support, as such sponsors also tend to be large, investment grade rated firms. According to the Lincoln VOG database (aforementioned), 34% of all amendments observed in 1Q2024 (most recent available) were sponsor capital infusions. Of those sponsor infusion amendments in 1Q2024, 43% addressed a liquidity shortfall and 20% cured a covenant (Exhibit 9), illustrating how sponsor support can provide an additional cushion for borrowers, if necessary.

Data from KBRA DLD – another third-party data provider that tracks direct lending defaults – also highlights the "sponsor vs. non-sponsor" differential. The KBRA DLD Direct Lending Index included about 2,400 borrowers as of August 6th, 2024. KBRA DLD default metrics are instance-weighted (not size-weighted), and a "default" is defined as a bankruptcy, payment default, or distressed exchange. As of August 2024, KBRA DLD's direct lending universe experienced a 1.9% trailing twelve-month (TTM) default rate, comprised of a 1.5% default rate for sponsored issuers and a 3.3% default rate for non-sponsored issuers (Exhibit 10).

Exhibit 9: Sponsors can provide an extra layer of financial support to borrowers

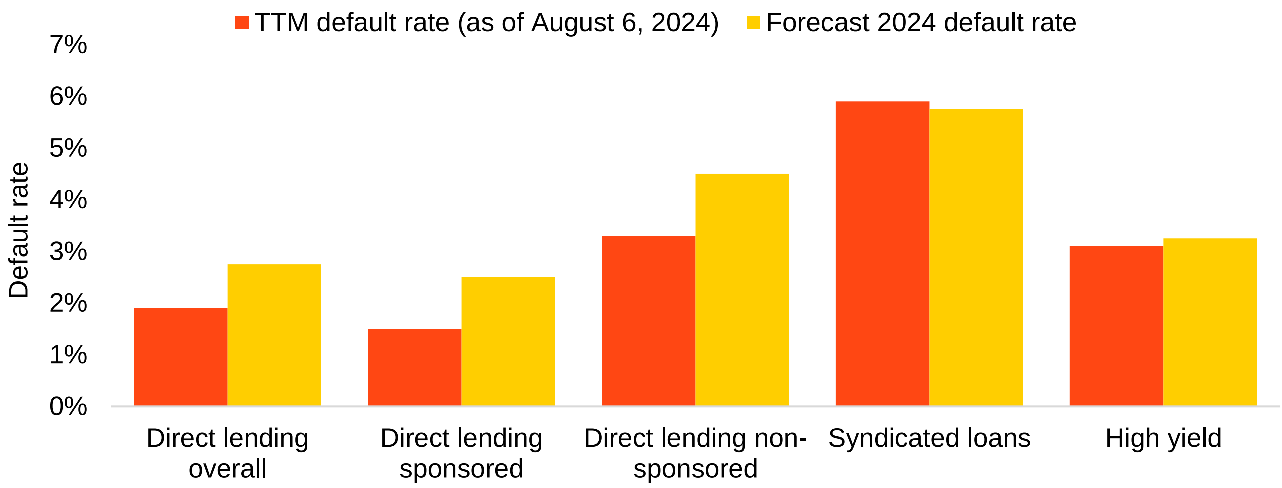
Share of sponsor equity infusions based on the purpose for infusion, by count



Source: Lincoln International Valuation & Opinions Group Proprietary Private Market Database, BlackRock. As of 1Q2024. "Other" reflects any earmarked uses of the sponsor equity infusion not reflected in the remaining categories. © 2023 Lincoln Partners Advisors LLC. All rights reserved. Used with permission. Third party use is at user's own risk.

Exhibit 10: Direct lending default rates remain below KBRA DLD's forecasts

Trailing 12-month (TTM) default rate and 2024 forecast default rate, by issuer count



Source: KBRA DLD, BlackRock. As of August 6, 2024. Defaults include bankruptcies, missed payments, distressed debt exchanges, and/or restructurings. Forecasts are KBRA's. **There is no guarantee any forecasts may come to pass.**

Recovery and loss metrics inform how defaults impact lenders

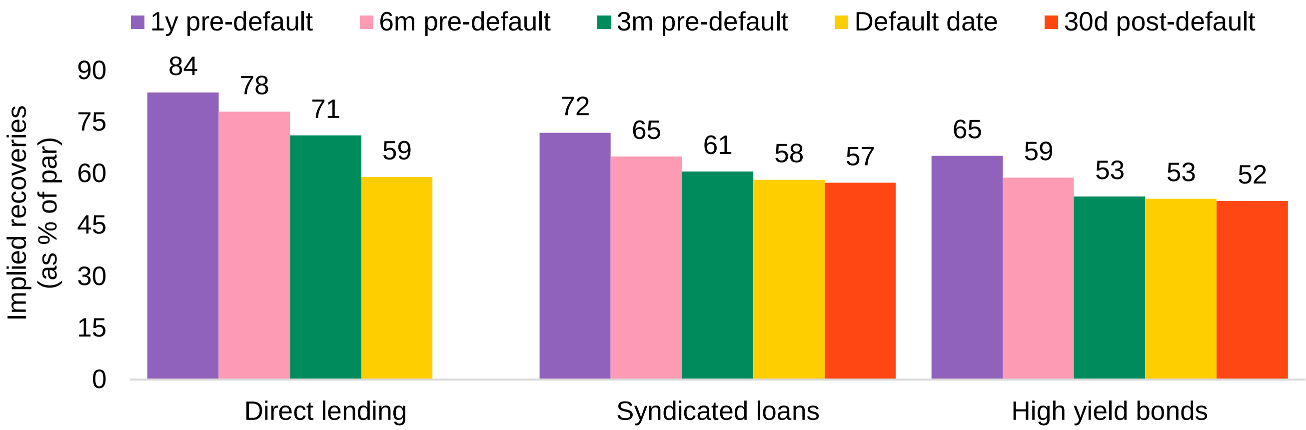
Beyond the *frequency* of defaults, the *severity* of such actions also has important implications for investors and lenders. To track this, we turn to recovery and loss rates.

According to data compiled by KBRA DLD, potential credit impairment is priced into syndicated loans and high yield bonds *earlier*, and more meaningfully, than in direct lending (Exhibit 11). For example, whereas syndicated loans and high yield bonds experienced the most material pricing decline between "1 year pre-default" and "6 months pre-default", private debt experienced the most material repricing much closer to the default itself (between the "3 months pre-default" and the "default date").

From the beginning of the sequence (i.e., "1 year pre-default") to the "default date", private debt prices declined nearly 30%, versus 19% for syndicated loans and high yield bonds, using the implied recovery rates captured by KBRA DLD. Importantly, however, the *ultimate implied recovery rates for direct lending were inline (or slightly better than)* syndicated leveraged loans and high yield bonds. (Note that other factors, such as market/issuer liquidity, earnings results, rating agency actions, and the broader macroeconomic environment, among others, may also influence the "starting price" of syndicated debt).

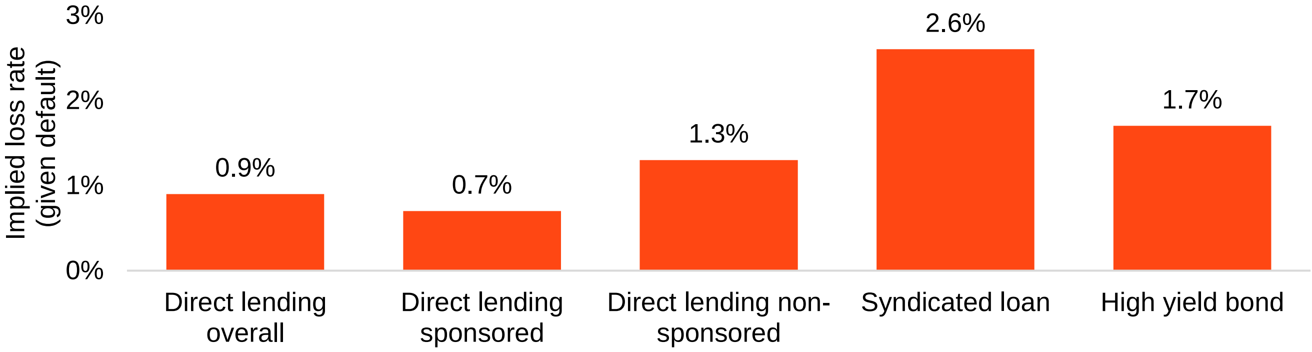
KBRA DLD also details implied losses (given default) – a metric that provides insight into how much capital the lender potentially lost. Notably, direct lending experienced the lowest losses (Exhibit 12), at 0.9%. By contrast, implied loss rates for syndicated loans and high yield bonds are higher (again, Exhibit 12). Two key factors, in our view, contributing to lower loss rates in private debt are (1) more frequent use of covenants, which allow lenders to address issues before a payment default and incorporate structural protections, and (2) a (typically) smaller group of lenders, more capable of quickly collaborating with the borrower to find a solution, which has the potential to reduce some of the "friction" costs associated with a more traditional restructuring or bankruptcy.

Exhibit 11: "Default date" implied recoveries converge for direct lending & syndicated loans
Average trailing 12-month (TTM) implied recoveries, unweighted



Source: KBRA DLD, Solve, BlackRock. Sample includes 25 direct lending loans, 65 syndicated loans, and 27 high yield bonds. Chart uses KBRA analysis completed in July 2024 and August 2024. **There can be no guarantee any forecasts will come to pass.**

Exhibit 12: Direct lending has the lowest implied loss rates (given default)
Trailing 12-month (TTM) implied loss rate (given default)



Source: KBRA DLD, Solve, BlackRock. Loss rate given default = default rate * (1 – implied recovery rate). Chart uses KBRA analysis completed in July 2024 and August 2024. **There can be no guarantee any forecasts will come to pass.**

Corporates move forward with debt issuance, M&A

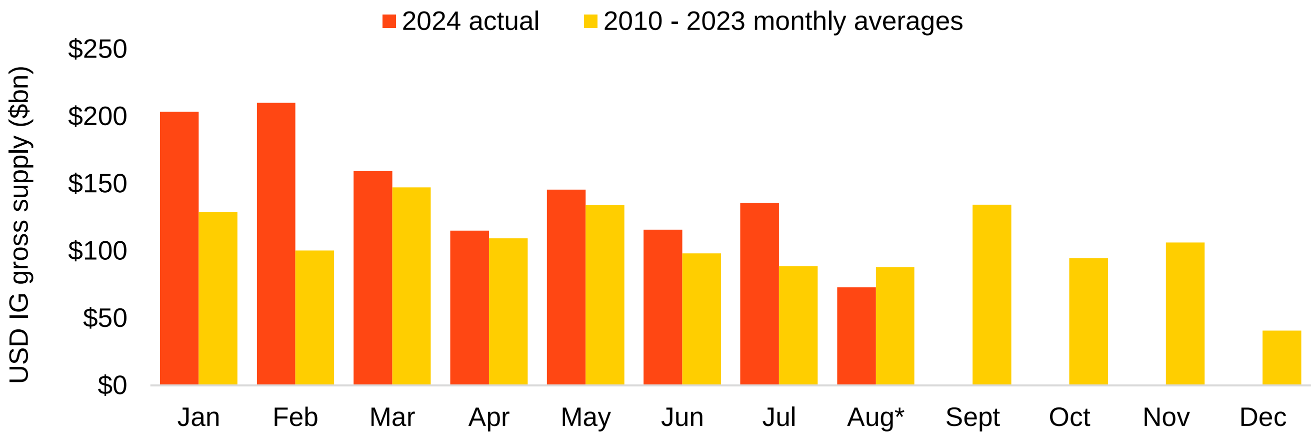
Debt issuance across the corporate credit landscape – including USD investment grade (IG), high yield (HY) and leveraged loans – has been running at a robust pace so far this year. Despite elevated U.S. Treasury yields (relative to the post-financial crisis era), tight credit spread levels, and a strong tailwind of yield-based investor demand have paved the way for corporate borrowers to move ahead with their funding plans.

As we outlined a few weeks ago, we believe some of the elevated activity – especially the stronger than typical summer volumes (Exhibits 13 and 14) – represent a "pull forward" of activity from later in the year.

The use of proceeds in IG has mainly been driven by "general corporate purposes", and to a lesser extent, M&A and debt refinancing. Meanwhile, the use of proceeds in the leveraged finance market (including HY bonds and leveraged loans) has been more focused on debt repayment and refinancing, as management teams build resilience and liquidity cushions into their balance sheets.

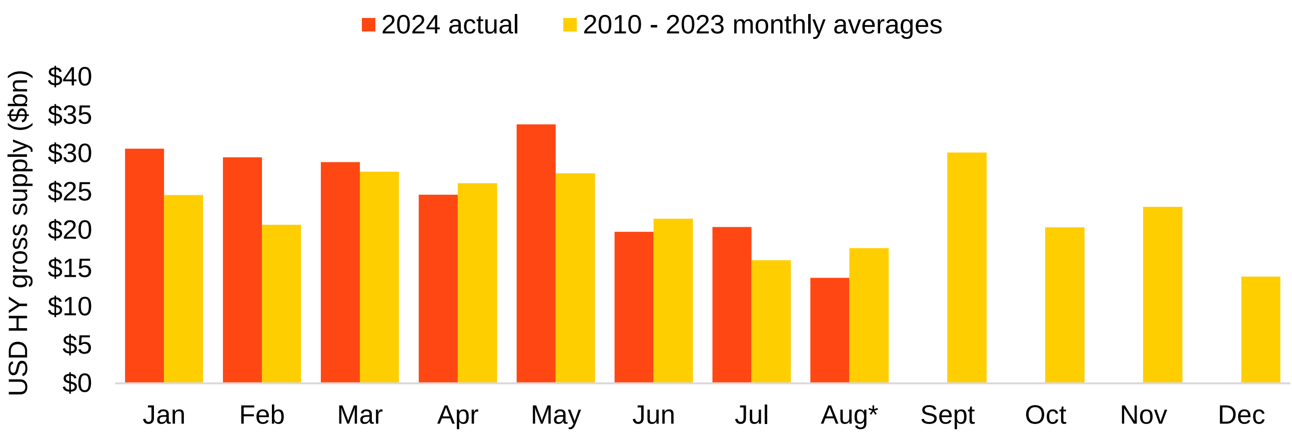
Year-to-date through August 14th, more than $1.16 trillion of new USD IG gross debt has been priced, according to transactions compiled by Dealogic. For context, this compares to the Bloomberg USD IG Corporate Index notional value outstanding of $7.2 trillion. And in the USD HY universe, $201 billion of gross debt has been issued through August 14th. This compares to $1.37 trillion outstanding for the Bloomberg USD HY Corporate Index.

Exhibit 13: 2024 USD IG supply has been consistently tracking above the monthly average
USD investment grade gross supply ($bn), by month



Source: Dealogic (ION Analytics), BlackRock. As of August 14, 2024. *August actual figure is as of August 14, 2024. The full monthly August average is shown for 2010-2023.

Exhibit 14: USD HY issuance has also been above average for many months this year
USD high yield gross supply ($bn), by month



Source: Dealogic (ION Analytics), BlackRock. As of August 14, 2024. *August actual figure is as of August 14, 2024. The full monthly August average is shown for 2010-2023.

As Exhibits 13 and 14 illustrate, September is a seasonally active period for issuance in the USD IG and HY markets. Given the pace of issuance so far this year, as well as some event risks slated for 3Q (September FOMC) and 4Q (U.S. election), we see scope for supply to potentially underwhelm the typical September pace. That said, this will be largely determined by the broader macro economic backdrop and investor risk sentiment.

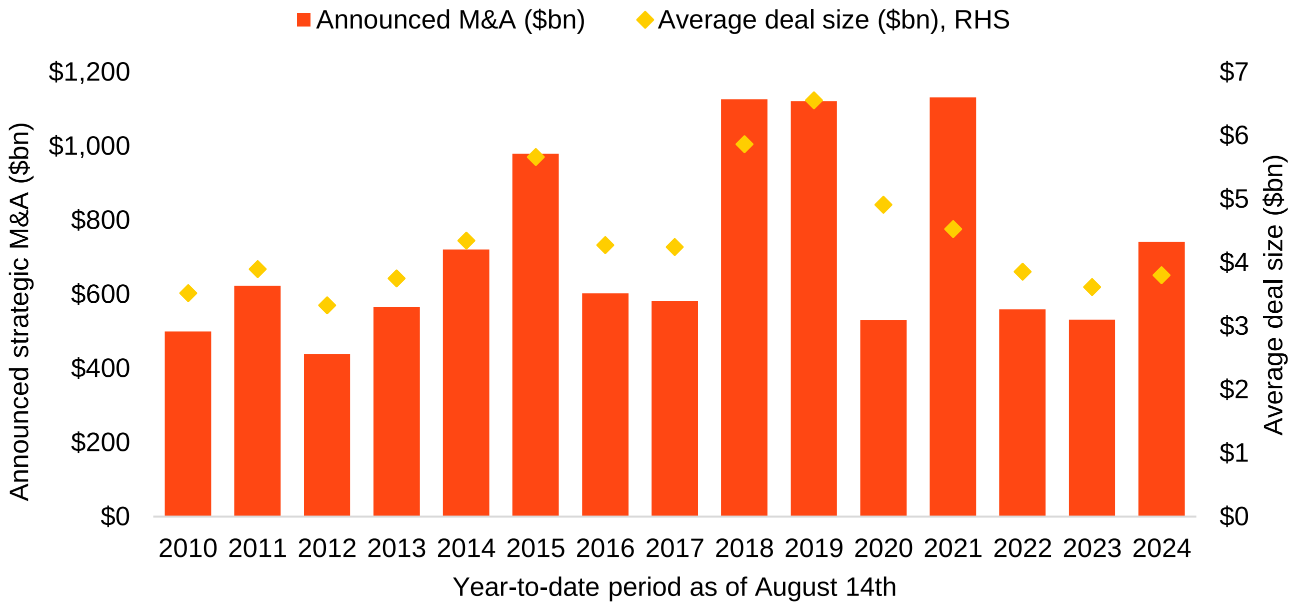
Somewhat related to debt issuance plans has been corporate management teams' approach toward acquisition activity. So called "strategic" M&A – which means a private equity sponsor is not involved on either side of the transaction (as buyer or seller) – has been tracking well above the 2022 and 2023 pace, as highlighted by Exhibit 15. And with $742 billion of deals announced through August 14th, this year's pace is tracking only 6% below the average of the past 10 years (2014 – 2023).

As we have outlined previously, cash-rich and highly-rated IG firms are likely to have an advantage (relative to their lower-rated and more levered peers) in competing for assets in the current financing environment. This is likely to be yet another driver of dispersion in corporate credit – albeit more of a longer-term differentiator, as the benefits of technological developments become clearer.

For bondholders, the funding mix of such activity is important to monitor, as deals slated to be funded with cash can meaningfully reduce existing liquidity cushions, and deals requiring additional debt typically result in new bond offerings at a spread "concession" to existing debt in the secondary market. (Note: Even in the example of "cash funded" M&A transactions, often the cash utilized for deal-making ultimately gets "replaced" with a new debt issue, based on anecdotal experiences over a longer-term history).

Approximately 35% of the year-to-date strategic M&A transactions have been funded entirely with stock according to data from Dealogic (Exhibit 1). This is slightly above the 30% average of the prior ten years and is a bright spot for bondholders. That said, "cash only" deals have featured rather prominently, at 52% of deals (by value), which is above the 10-year average of 45%. This suggests to us that higher interest rates have not deterred management teams from pursuing cash / debt funded M&A.

Exhibit 15: Year-to-date strategic M&A is tracking well above the 2022 and 2023 pace
Announced strategic M&A volumes ($bn), by year-to-date period, and average deal size ($bn), RHS. Captures deals announced by North American and European acquirers, valued at $1 billion or more at announcement. Excludes cancelled and withdrawn deals.



Source: Dealogic (ION Analytics), BlackRock. As of August 14, 2024.

Unless otherwise stated, all reference to $ are in USD.

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