February 2024

Scaling the Maturity Wall: The Near-Term Refinancing Opportunity

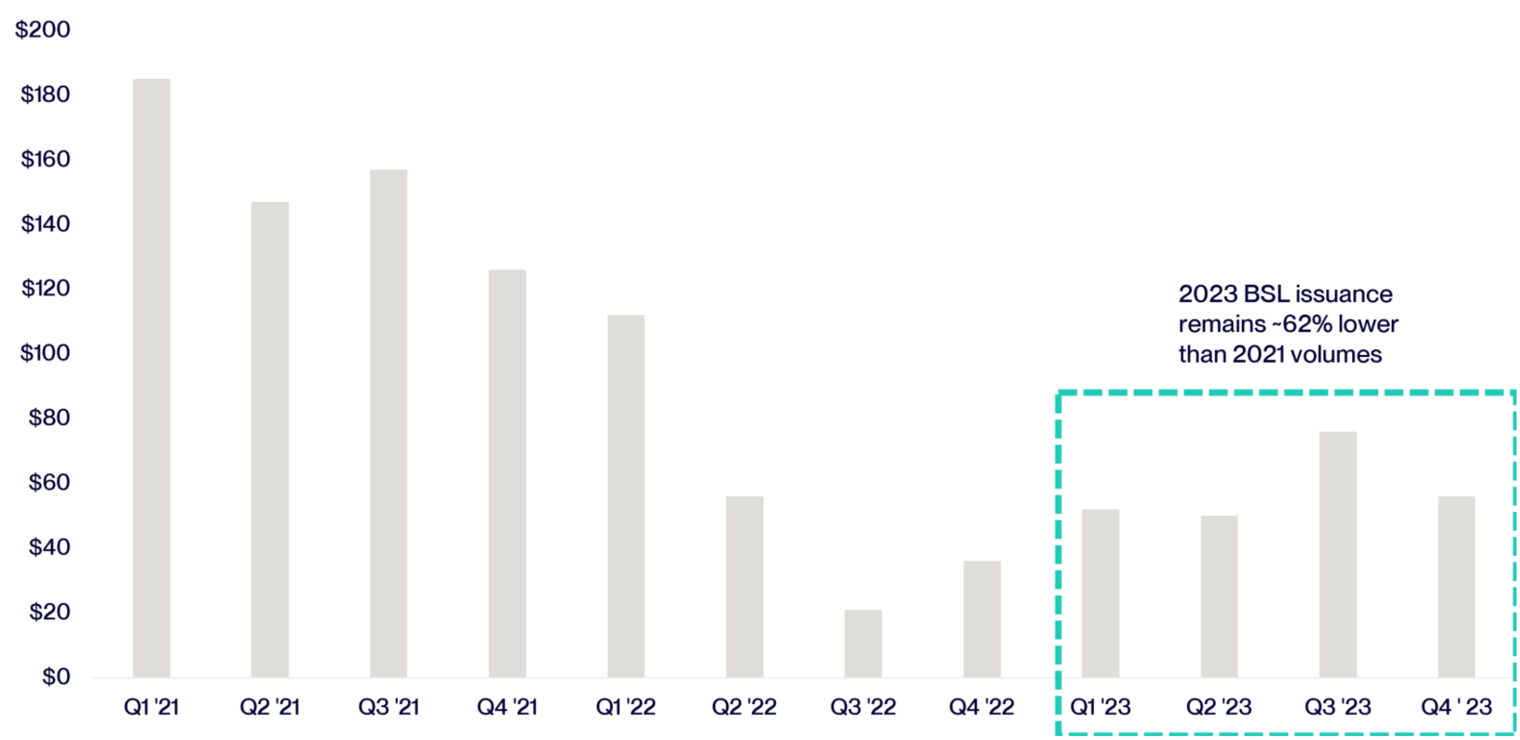
We believe refinancing opportunities will drive a considerable portion of private credit investment activity through 2025, with many borrowers facing near-term maturities[1] and new issuance activity in public markets remaining on the lower end of historical levels[2]. We see an opportunity for direct lenders with scale to provide refinancing capital, with such lenders generally offering greater certainty of execution and the ability to structure a more customized solution than what has historically been available in public markets.

Higher Rates and Declining New Issuance in the Leveraged Loan Market

The rapid rise in interest rates that began in 2022 has resulted in significantly higher borrowing costs for issuers with outstanding floating rate debt. The average B/B+ issuer saw its borrowing cost more than double from ~4.9% in February 2022, just before the start of the Fed rate hikes, to a high of 10.5% in October 2023, and finishing the year at 10.1%[3].

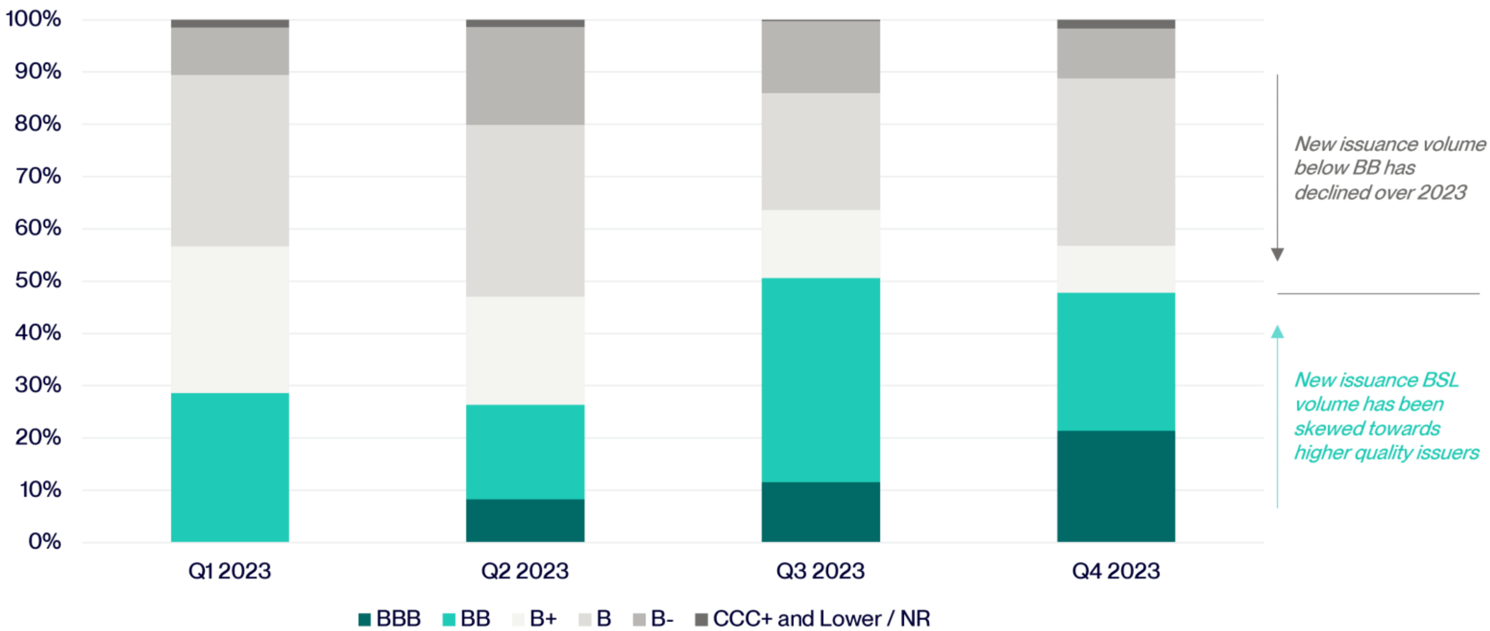
Capital availability from traditional sources declined during the same period as issuance across the syndicated loan market fell dramatically in 2022. While new issuance began to recover in 2023, it remains significantly lower than in recent years[2].

Broadly Syndicated Loan Issuance Volume ($B)[2]



Importantly, Broadly Syndicated Loan issuance that occurred in 2023 skewed toward higher rated borrowers by the later part of the year, with lower rated borrowers (rated BB or below), in the aggregate, making up a smaller percentage of the new issuance loan volume[4]. The significance of this ratings dynamic is discussed further below.

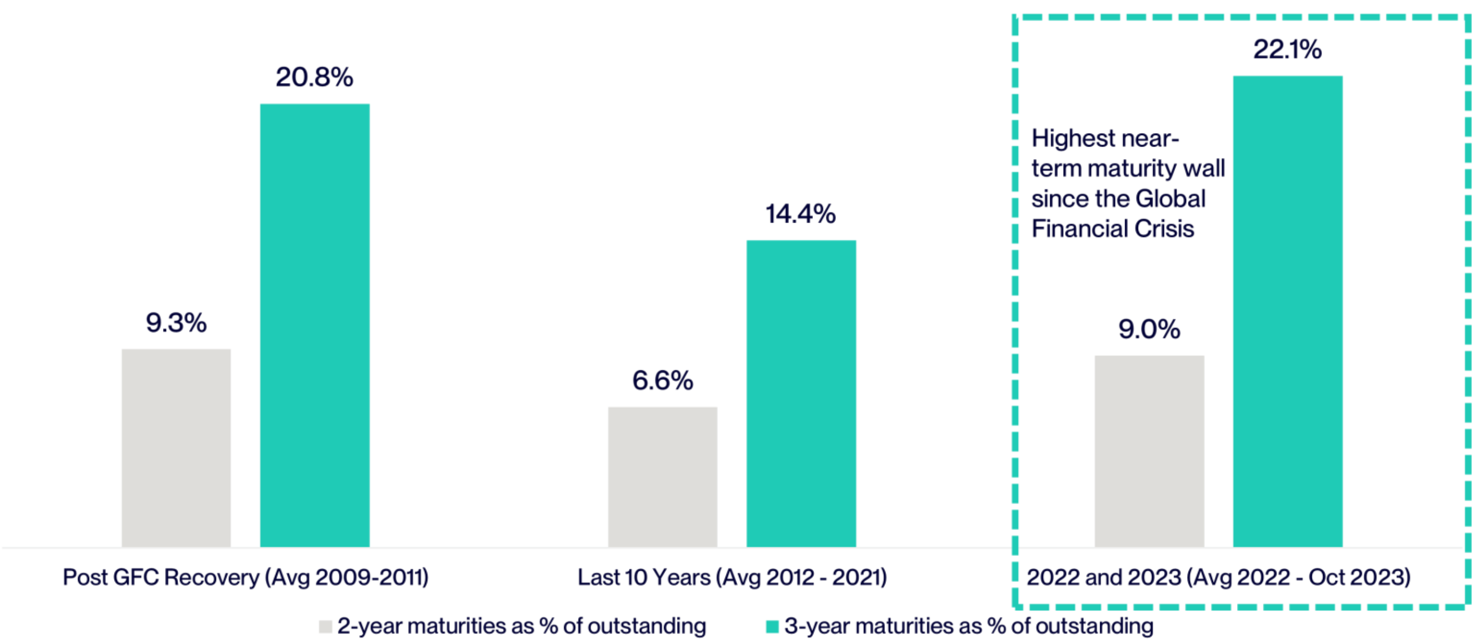
2023 Quarterly New Issuance Loan Volume by Rating[4]



A Backlog of Maturing Loans

We believe that a decline in new issuance activity in the public credit market, relative to historical trends, in combination with what we view as a "wait and see" approach from corporates, has resulted in a meaningful decline in refinancing activity. As a result, loans and bonds with near-term maturities (maturities in the next 2 and 3 years) make up the largest share of the outstanding high yield and leveraged loan markets since the period following the Global Financial Crisis[1].

Historical Volume of Near-Term High Yield and Leveraged Loan Maturities[1]

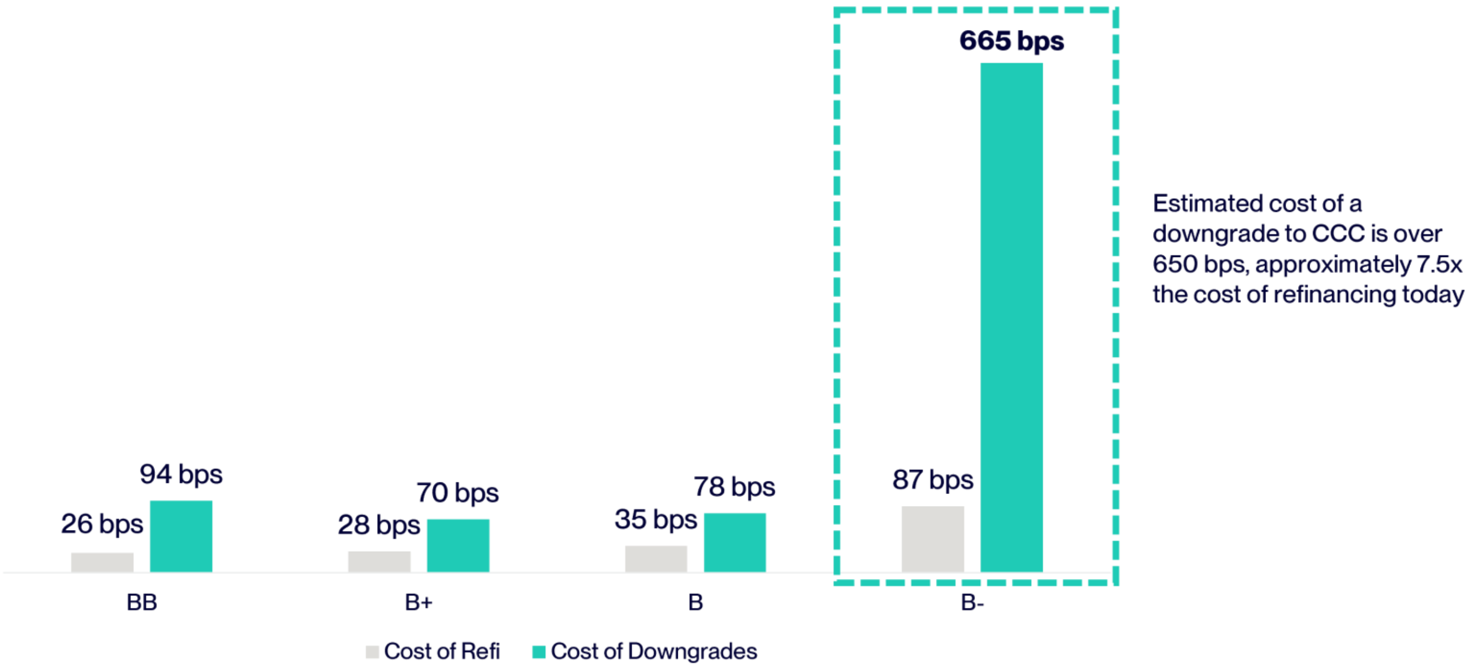


Potential Downgrade Risk Provides a Catalyst for Near-Term Activity

As a borrower's debt maturity date approaches, it generally faces increasing risk of downgrade from ratings agencies. This risk becomes most acute within 12 months of the maturity date, as the term debt is deemed to be a short-term liability for accounting purposes.

Downgrades can significantly increase the cost of borrowing for a business. The combination of a greater perceived credit risk, and regulatory and structural constraints that limit certain lenders' (such as CLOs and mutual funds) exposure to CCC loans, means that a downgrade from B- to CCC+ can be particularly costly as the potential lender pool narrows. Morgan Stanley estimates that such a ratings decline would add over 650 bps to the cost of a company's newly issued debt, approximately 7.5 times the incremental cost associated with a refinancing if a B- rating can be sustained[5].

Estimated Cost of Refinancing vs. Downgrade[5]

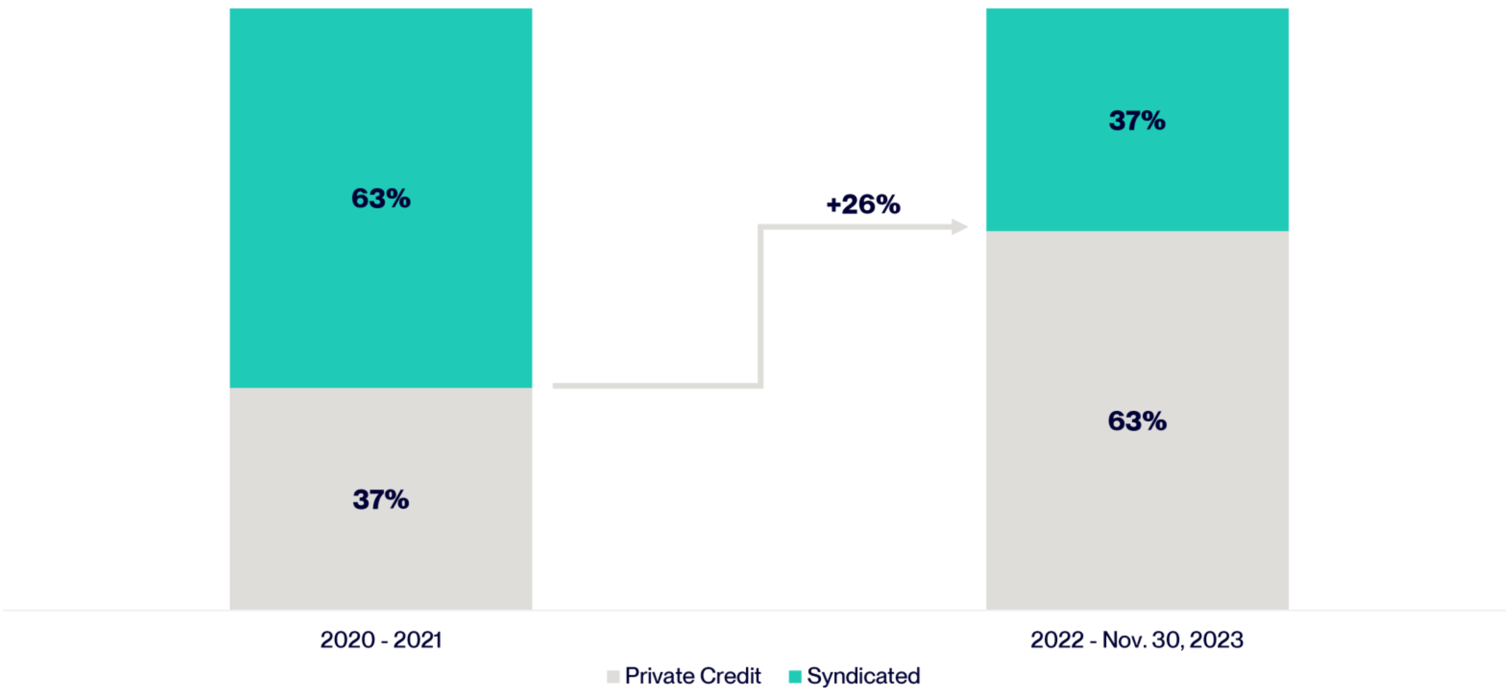


Over half of the loans maturing by the end of 2025 are obligations of issuers rated B- or lower[5]. We believe that lower-rated issuers with upcoming maturities will have to weigh the choice between refinancing in the near-term in a higher spread environment, versus waiting for a more favorable borrowing environment but risk a potentially costly ratings downgrade due to an approaching maturity.

Implications for Private Credit

In our view, the combination of reduced activity in the public credit market and the maturity wall has, and will continue to, generate opportunities for private credit. For instance, these factors likely contributed to more non-LBO transactions being financed through private credit than through the syndicated market in each quarter since the start of 2022[6].

US Non-LBOs Financed by Private Credit vs. Syndicated (Deal Count) [6]



Given the size of the pending maturity wall and the rating composition of the borrowers facing it, we expect to continue to see meaningful refinancing opportunities in private credit through 2025. In our experience, companies looking to refinance debt maturing in the near-term benefit from greater certainty of execution and the ability to structure a customized solution specific to their financing needs. Both are advantages of the private credit market relative to the syndicated market[7].

End Notes

[1] Source: US High Yield and Leveraged Loan Strategy; Data through October 2023.

[2] Source: PitchBook LCD; Data through December 31, 2023.

[3] Source: PitchBook LCD Loan Stats Weekly, as of January 4, 2024.

[4] Source: LevFin Insights / CreditSights, Data through December 31, 2023. Commentary represents HPS's subjective opinions and views as of the date hereof and is subject to change depending on market environment.

[5] Source: Morgan Stanley Global Credit Strategy Research, January 31, 2024. Commentary represents HPS's subjective opinions and views as of the date hereof and is subject to change depending on market environment.

[6] Source: PitchBook LCD, Data through November 30, 2023. Private credit count is based on transactions covered by LCD News.

[7] Source: PitchBook | LCD 2Q 2023 Quarterly Wrap. Survey Data as of June 23, 2023. Reflects expected drivers of private credit activity over broadly syndicated activity in the coming 12 months.

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