Huntington
COMMERCIAL BANK

Commercial Outlook

2025 Economic and Industry Overview

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Foreword

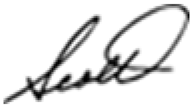
We're proud to present our inaugural Economic and Industry Outlook Report, designed to provide a forward-looking view of the most critical economic and industry factors expected to shape decisions in the coming year.

Heading into 2025, business leaders are facing countless unknowns. A changing political administration could reshape tax policy and the regulatory environment. Despite seeing the first interest rate adjustment in years, interest rate cuts may slow in the coming year based on shifting economic data.

Steady GDP growth and investments in manufacturing, infrastructure, and innovation suggest new opportunities for organizations positioned to act. With this report, we hope to bring what lies ahead into clearer focus with in-depth analyses of macroeconomic conditions, rate projections, M&A outlooks, and sector-specific trends.

Our priority is to connect you with insights that matter and serve as a trusted partner in your success by delivering our national capabilities locally. By sharing key research and actionable strategies from experts across the Commercial Bank, we aim to empower you to make informed decisions that align with your organization's risk management and growth goals.

At Huntington Commercial Bank, we look out for people and help you make connections. I hope this report provides the valuable insights needed to navigate upcoming volatility and opportunity.



Scott Kleinman
President
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MACROECONOMIC OUTLOOK

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Huntington COMMERCIAL BANK

Macroeconomic Outlook

THE MORE THINGS CHANGE…

Ian Wyatt
Director of Economics
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As we enter 2025, the Commercial Economics team brings you good news of continued economic growth. In 2025, we are forecasting solid economic and job gains driven by both strong household balance sheets and healthy job and income growth. Inflation is forecast to remain a bit above the Fed's target due to tight labor market conditions, which we forecast will lead to only a few Fed rate cuts. **We expect that the economy will grow about 2.5% in 2025 and jobs gains for the full year of 1.5-2.0 million or around 150,000 per month.**

The American consumer is set to remain the core driver of economic growth thanks to strong balance sheets and solid job and wage growth in 2025.

On the debt side of the household balance sheet, the average consumer is spending near record-low levels on servicing their debts, which gives them both more cash to spend and the ability to borrow more for larger purchases. On the assets side of the balance sheet, consumers have enjoyed a couple of very strong years in the equity markets that have left their investment account balances in very good shape. Tax cuts are another factor that could modestly boost spending but given the time it takes to pass tax changes the impact of any cuts will be felt more in 2026. Another policy change that could slow consumer spending is reinstating student loan forgiveness. Similar to tax changes, the legal complications around student loans mean the impact would be felt more in 2026 than 2025.

A core question is how will consumers spend their gains? We may look back on 2024 as the "year of the experience." It was easily the biggest year ever for air travel and a strong year for concerts, sporting events, and other experiences. Will 2025 be a reversion to more normal spending patterns with consumers shifting back towards durable goods like autos? A shift back would alter demand not just for autos, but also warehousing and transportation. There have been early signs of the shift back in consumer spending over the last couple of months with air travel gains slowing and auto sales accelerating, but this remains an open question. Higher interest rates caused consumers to delay purchasing products on credit like autos. We may be seeing a shift in this dynamic as consumers start accepting current interest rates and are sick of waiting for lower rates that may not come—we see this acceptance as more applicable to autos, RVs, and boats rather than housing.

On the business investment side of the economy, we expect solid growth in equipment, but there will be headwinds on the structures/real estate side of business investment. Multifamily investment will likely decline in market-rate buildings as existing projects are completed and an oversupply of apartments and high rates make it tough to justify starting new projects. The oversupply of new apartments will likely clear relatively quickly. Rent growth could rebound in 2026 as affordability issues limit tenants' ability to shift to home ownership and new

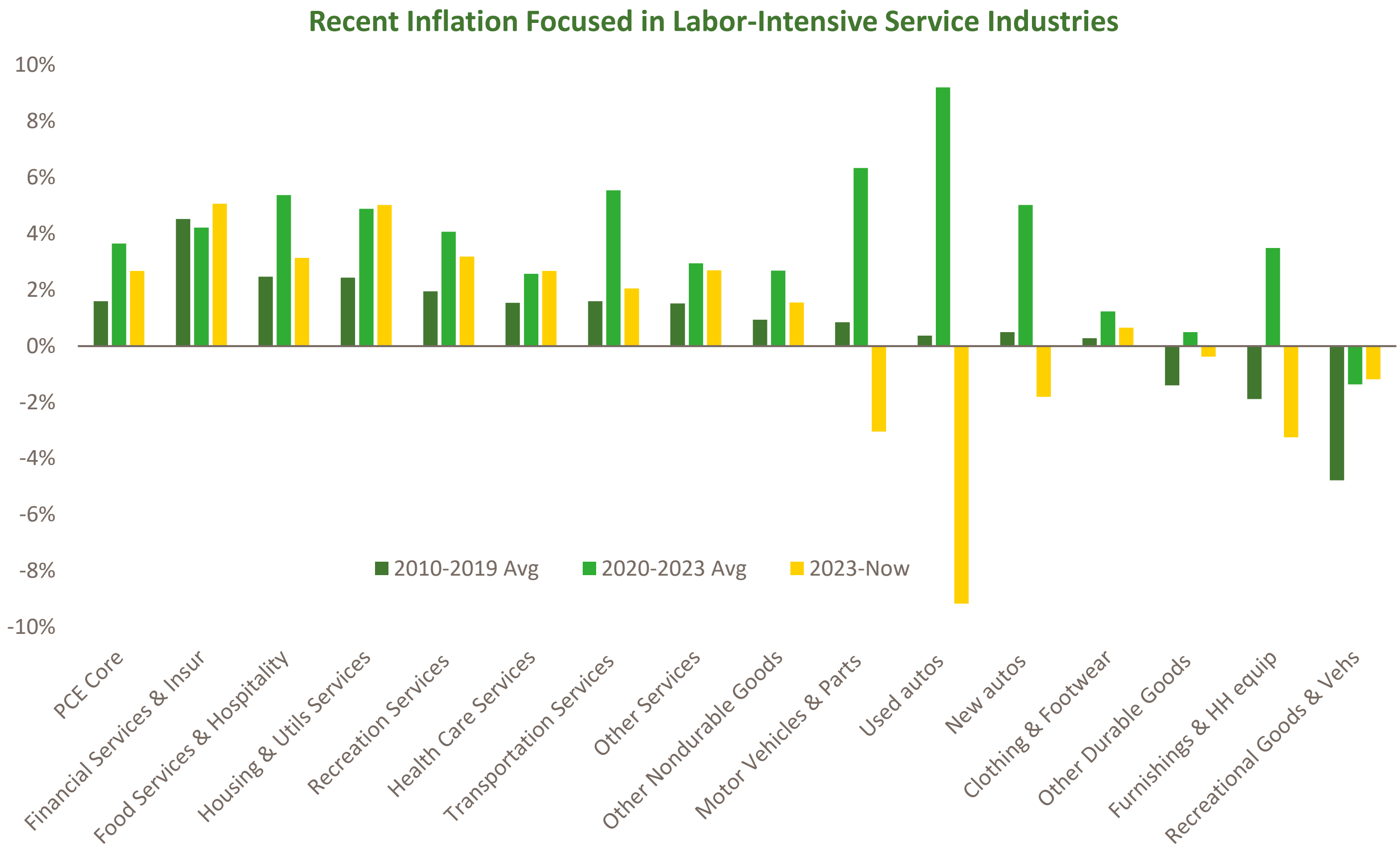

Fig. 1 – Source: Bureau of Economic Analysis (BEA). Accessed December 3, 2024.

supply dries up. Large warehouse space will likely remain oversupplied in 2025, and dynamics in warehouses are like the multifamily market and are limiting new construction activity. With soft support from multifamily and warehouses, the construction industry will need to lean into stronger categories like oil & gas, factories, data centers, utilities, and infrastructure.

Inflation stays a modest challenge. We expect inflation to be around 2.5% in 2025, putting it slightly above the Fed's 2.0% target. Our view is based on several factors:

- Tight lower-end labor market (see key themes discussion) keeps up wage pressure in many everyday spending categories.
- After falling in 2024 and lowering the overall rate of inflation, we expect pricing to stabilize in many infrequent/one-off spending categories such as autos, home furnishings, and recreational goods.
- Trade tensions push companies to seek alternative suppliers, sometimes at higher prices.
- Oil prices remaining near current levels as the shift to electric vehicles and plug-in hybrids reduces oil demand from key countries, including China, which is the second largest consumer of oil, only trailing the U.S.

How Would the Fed Respond?

Given our outlook for economic growth, the labor market, and inflation, how would the Fed respond? **First, it is important to remember that we have a closely divided Fed.** Back in Dec. 2023 when Powell spoke about cutting rates, other Fed governors pushed back, and the first rate cut wasn't for another 10 months. Following the -50 bps cut in September, both the meeting minutes and the Fed Governors' forecasts suggested a closely divided Fed. Just a slight, dovish majority wanted a -50 bps cut while a large, more hawkish minority wanted just a -25 bps cut. Subsequent economic data in October and November, including upward revisions to historical GDP, income, and savings data, paint the picture of an economy less in need of stimulus while concerns about inflation remaining sticky rise. It would only take a couple of governors adjusting their views to shift the board majority to a more hawkish stance. Recent comments from Powell and other governors suggest a pause in rate cuts is coming soon, and the board dynamic is reminiscent of January 2024 when the board delayed cuts. At the September 2024 meeting, most Fed Governors' forecasts for the end of 2025 put the Fed Funds Rate at either 3.375% (5 more -25 bps cuts through the end of 2025) or 3.125% (6 cuts). **Given recent data and our outlook for the economy, we expect that 5-6 cuts are unlikely. 3-4 cuts is a more likely scenario, leaving the Fed Funds Rate around 3.75% at the end of 2025.** However, it is important to remember the considerable uncertainty in any interest rate forecast and companies should plan for a wide range of scenarios next year. When developing interest rate scenarios for floating rates in 2025, companies do benefit from the asymmetric rates outlook: **It is very unlikely that the Fed Funds Rate increases next year, but a relatively flat Fed Funds Rate is not out of the question.**

Long-term rates. Since the Fed started cutting the short-term Fed Funds Rate back in September, long-term interest rates have increased substantially, shifting from an inverted yield curve (higher short-term than long-term rates) to a relatively flat yield curve with similar rates across durations. The 10-year Treasury yield rose from 3.62% on Sept. 16 to 4.17% on Nov. 29. Higher long-term rates are presenting a challenge for the housing market as buyers avoid moving and home ownership affordability is near record-low levels. Given the importance of long-term rates to the housing and auto markets, there is a possibility the Fed intervenes in longer duration rates markets.

Key Themes We Expect in 2025

1. Two-speed labor market will make inflation hard to fully tame.

Companies will struggle filling both lower skill service and transportation jobs and high-skill manufacturing jobs. We expect the new administration's policies will shape the labor market in a few ways. First, we expect continued support for subsidies and increased tariffs which will encourage the reshoring of manufacturing. Filling these growing skilled manufacturing jobs will remain a challenge as baby boomers leave the labor force and there is a lack of sufficient new manufacturing workers backfilling their roles.

Second, in transportation, warehousing, and service jobs, a lower rate of immigration, in part due to stricter immigration policies, will limit growth in the pool of workers while solid spending growth by consumers keeps demand for these roles high. Wage pressures in labor-intensive service jobs will make it tough to bring down inflation to the Fed's target.

In contrast, the labor market will remain softer for office workers in finance, insurance, real estate, and information technology. We expect that the soft labor market will allow employers to push more workers back into the office and that the Federal Government will join the shift with more pressure on workers to return to office. Job and wage growth will be positive, but slower in these white-collar roles than in service, manufacturing, and transportation roles.

2. China trade wars caused by the second "China Shock."

Over the last few years, China sought to offset its real estate bubble bursting by massively expanding manufacturing capacity across industries with a particular focus on green energy and electric vehicles. As that capacity comes online, it massively exceeds domestic Chinese demand. Exports are sharply rising for many types of products and factories are being run with a goal of maximizing employment and gaining market share rather than short-term profits. This is considered the second China shock, with the first being when China initially entered the world trading system and quickly displaced lower-skilled manufacturing jobs in many countries. Over the past year, the Commercial Economics Team has spoken with numerous manufacturers across the country in a wide range of industries. In almost every industry, companies tell us that rising Chinese exports is a significant challenge. Within the U.S. market there are existing protectionist policies, and these will likely increase along with unique aspects of the U.S. market that will serve to limit Chinese competition. Companies tell us the biggest challenge is in export markets, such as Latin America where there is no domestic industry to protect, so governments will gladly allow cheaper imports.

We are already seeing the impact over the last few weeks. Germany's export-oriented auto sector has announced massive layoffs largely due to losing market share in China and around the world as Chinese manufacturers gain ground. American/European Stellantis announced its CEO resigned. Japan's Nissan just fired their CFO, and their CEO cut his pay in half as the company struggles to adapt to a rapidly changing industry landscape. Though the auto industry garners headlines as an important and high-profile industry facing strong Chinese competition, the same story is true in plastics petrochemical manufacturing, golf carts, and everything in between.

In response, tariffs and other restraints on trade will become increasingly common not just in the U.S. and the European Union, but also in Latin America and Southeast Asia as they seek to protect domestic industries.
Export-oriented manufacturers will struggle with tougher competition and potentially more trade barriers in many countries.

3. Concerns about the Federal deficit.

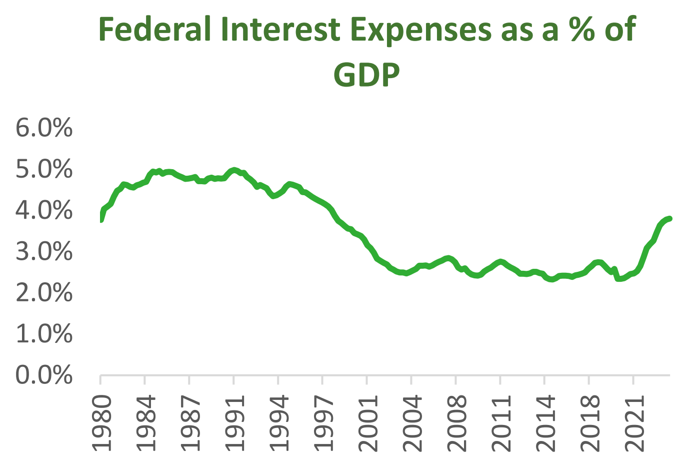

Fig. 2 – Source: FRED, Interest as Percent of Gross Domestic Product. Accessed December 2024.

The deficit in 2024 was 6.4% of GDP, one of the largest deficits we have experienced outside of recessions and wars. The combination of rising Federal debt and higher interest rates has pushed interest expenses as a

While we expect tax cuts are likely, interest expenses and bond market pressures will make this issue harder for policymakers to ignore in 2025. Heavy Treasuries issuance could also result in continued elevated Treasury market volatility. The recent rise in yields on longer-dated Treasuries suggests that the market is becoming more concerned about the sustainability of the debt.

Risks to the Outlook

While we expect solid growth in 2025, there are potential downside risks that concern us:

- Elevated long-term interest rates slow some segments of the economy, including residential construction and limit auto sales.
- Trade conflicts and the second China shock raise inflation and trigger major layoffs in manufacturing. The Fed faces a challenging stagflation scenario.
- Weakness in the white-collar labor market becomes more widespread and service-sector job growth slows.

FOREIGN EXCHANGE OUTLOOK

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Foreign Exchange Outlook

KING DOLLAR UNLIKELY TO BE DETHRONED IN 2025

Michael Stockdale
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Highlights

- The U.S. dollar has accompanied the increase in Treasury yields, reaching two-year highs.
- Growth dynamics favor the U.S. in comparison to other major markets, such as Europe and Japan.
- China's economy has disappointed investors, and it is unclear if recent stimulus plans will help.
- Protectionist trade policies will create additional headwinds for emerging markets.
- Volatility is anticipated to intensify across the FX market as global monetary policies diverge.

Dollar Dominance

The U.S. dollar is gaining momentum into year-end, surging to its strongest levels since 2022 against a basket of currencies. Monetary policy divergence, trade protectionism, and the broader macroeconomic outlook are all aligning to support dollar strength in the new year as well.

Several key factors influence the valuation of foreign exchange rates. Both trade flows and capital flows underscore a currency's external demand. Investors tend to seek out higher growth, higher yielding assets. For this reason, the dollar follows the direction of Treasury yields, particularly as differentials have widened against major peers. Broader risk themes also impact investor appetite for volatility. Negative events like liquidity crises, stock market crashes, and commodity shocks can spike demand for "safe havens." Fortunately for the dollar, it is backed by a highly rated and deeply liquid bond market, making it one of the most reliable haven currencies.

What is noteworthy about the current financial environment is that most of these key factors favor U.S. dollar appreciation. The recent trend away from globalization has encouraged protectionist policy for industry and trade. The new U.S. administration is expected to utilize measures like tariffs as a cornerstone of its economic agenda, perhaps even applying a broad 10%-20% tax on all imported goods. Consequently, a narrower trade deficit is expected to alleviate fundamental dollar selling.

What's more, the United States economy is projected to outpace the performance of other major countries. Domestic tax cuts and measures aimed at promoting American manufacturing should help contribute to above-trend growth. Interest rates will remain higher in the U.S. in comparison to major peers, too. As such, dollar-denominated assets have become more attractive from a pure return perspective, and particularly so when indexed for risk.

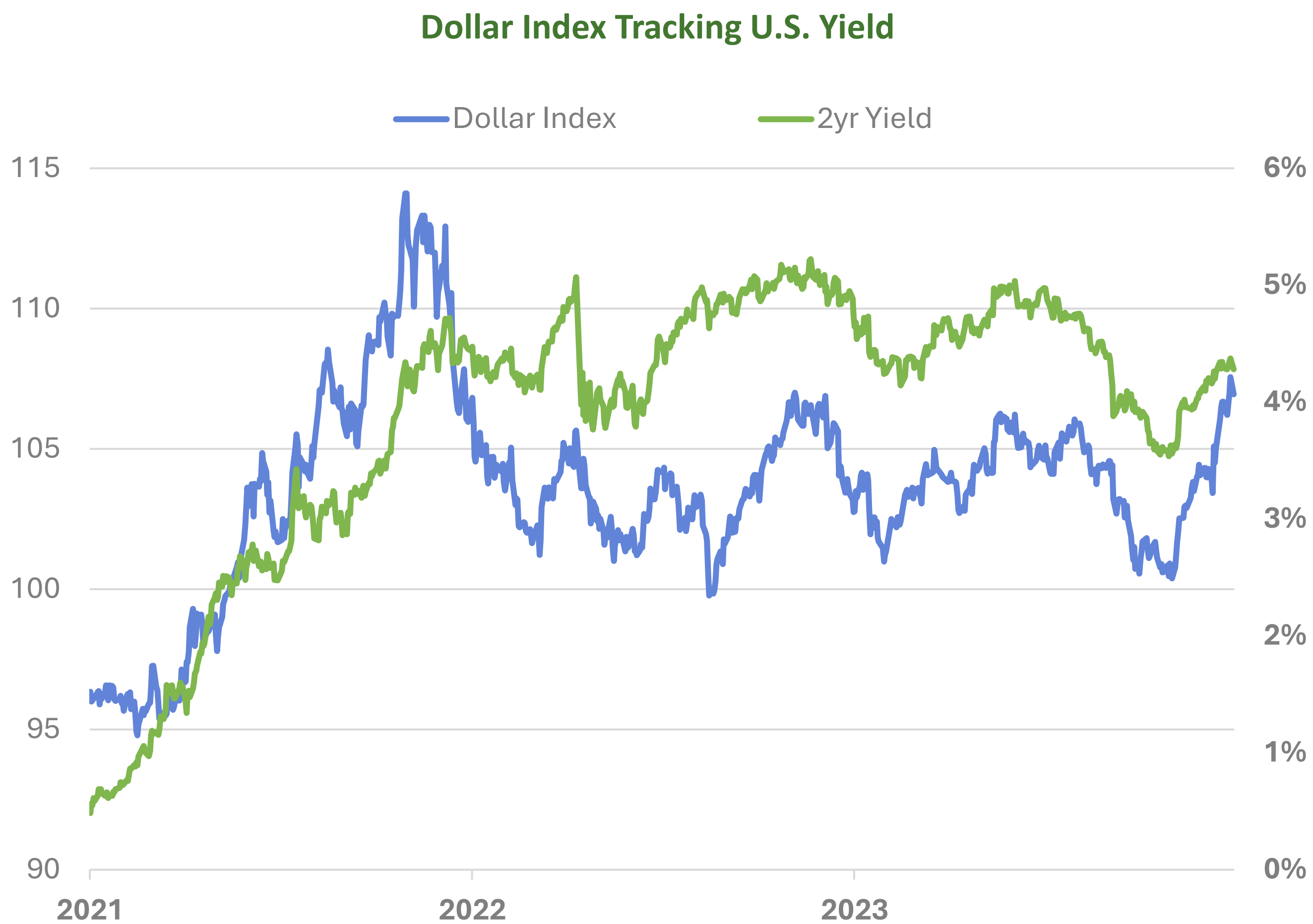

Fig. 3 – Source: Bloomberg, Dollar Index Tracking U.S. Yield. Accessed November 27, 2024.

Global Growth Concerns

The U.S. has remained incredibly resilient in the face of tighter financial conditions over the past two years. The same cannot be said of the broader global backdrop, though. In fact, higher interest rates have contributed to slower grow dynamics across Europe. Gross domestic product in the region expanded just 0.4% in the third quarter, as household consumption barely grew. In comparison, the U.S. economy advanced at a 2.8% annualized quarterly pace. Euro business surveys slumped to a ten-month low in November, marking an unexpected contraction in activity. So, while the Federal Reserve has the luxury of staying patient to combat inflation, the European Central Bank has pivoted its focus toward stimulus. Futures are now pricing a possibility the ECB eases 50 bps at its next decision.

In China, economic growth has slipped below the government's official 5% target with consumer demand not yet fully recovered from COVID-era lockdowns. Year-to-date, GDP has risen just 4.8%, and business activity surveys suggest the world's second largest economy slowed into the fourth quarter as well.

In response, China policymakers are pursuing their largest stimulus efforts since the pandemic. This move entails interest rate cuts, lower bank reserve requirements, deficit spending, and direct support for local state debt. And with the threat of U.S. tariffs up to 60%, Beijing may consider additional measures to offset any decline in external demand.

Business Activity Surveys (PMI's)

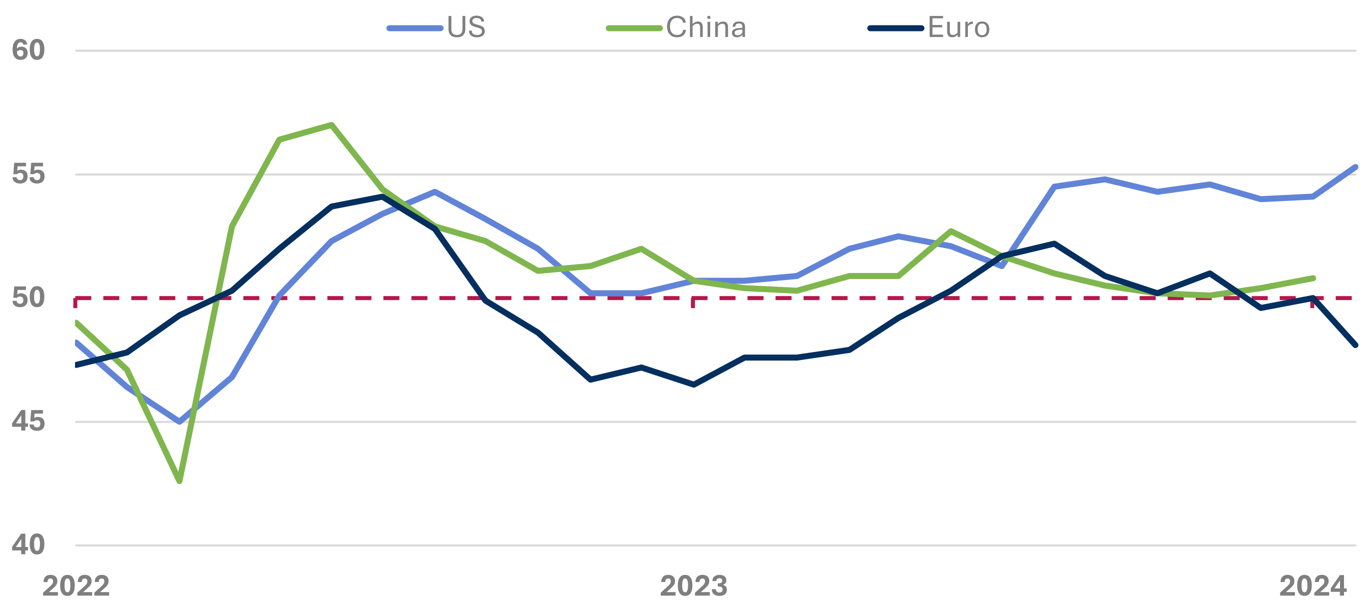

Fig. 4 – Source: Bloomberg. Business Activity Surveys by PMI – EU, China, Euro. Accessed December 2024.

Risks Emerge

Emerging markets find themselves in a precarious situation as we head into 2025. Softer demand from Europe and China have outweighed U.S. resilience. Trade partners and commodity suppliers have suffered from the slower regional growth. The recent rise in U.S. yields has also diminished the appeal of higher-risk emerging market bonds. Accordingly, there has been a massive flight from local currency bonds on back of narrowed spreads. Meanwhile, many emerging markets have been slashing interest rates on expectations for lower inflation.

Government policies could quickly escalate into a trade war if other countries react to the United States' proposed measures. Tariffs would surely reduce demand for many Latin American currencies, which are already on a backfoot against the dollar.

EM FX Performance (YTD)

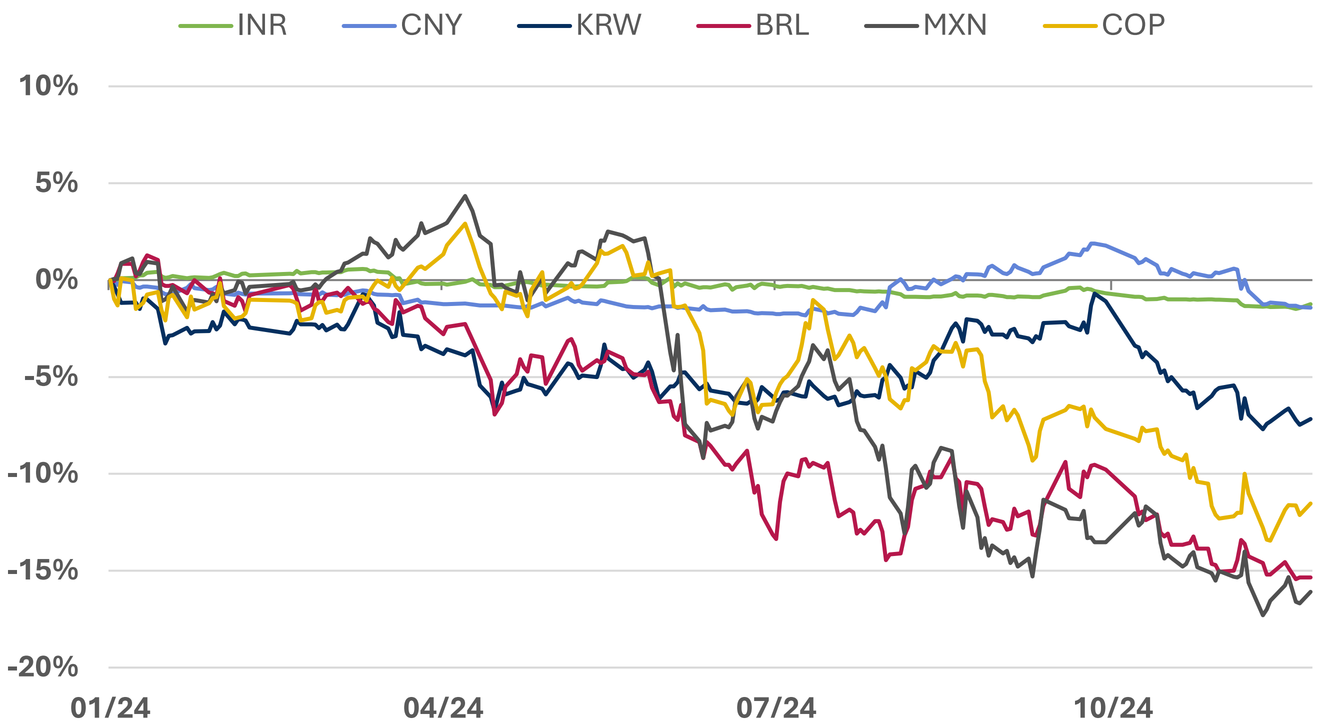

Fig. 5 – Bloomberg. EM FX Performance (YTD). Accessed December 2024.

Policy Volatility

The trajectory of global interest rate policy will also help shape the FX landscape in 2025. Whereas the Federal Reserve has become less dovish in recent weeks, central bankers in Europe and Canada have accelerated easing due to economic weakness and cooling inflation expectations. Conversely, Brazil has begun tightening again, and Japan has abandoned negative rates for the first time in years. **As policies and expectations continue to shift, anticipate an uptick in underlying volatility as currencies adjust too.** Utilize an options overlay strategy to mitigate more uncertain, longer-tenor risks.

Top Strategies to Consider

1. Run value-at-risk analytics to understand which exposures have the greatest impact.
2. Increase hedge ratios or extend hedge tenors to help protect from unexpected volatility.
3. Utilize an options overlay strategy to mitigate more uncertain, longer-tenor risks.

INTEREST RATE HEDGING

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Interest Rate Hedging

ONGOING RATE VOLATILITY REQUIRES STRONG HEDGING STRATEGY TO COMBAT UNCERTAINTIES

Scott McGrath
Managing Director – Interest Rate Derivatives
Huntington Capital Markets

Highlights

- Interest rate forecasts are often wrong, so rates strategies should assume a wider range of possible scenarios than market implied projections.
- If the Fed cuts rates as the market expects, fixed rates won't necessarily change unless longer term expectations shift.
- Leaders can expect rate volatility to continue into 2025 due to a number of economic and geopolitical factors.
- Mitigating these uncertainties requires a strong strategy that allows the business to pivot based on risk tolerance and changing outlooks.

Market Commentary

History has proven that predicting interest rate performance during a cycle is nearly impossible. If we look to as recently as the beginning of 2024, markets were pricing in six to seven quarter-point Fed cuts by end of 2024. By April, those expectations flipped to less than two quarter-point cuts by end of the year. Then by August/September, it was back to around five cuts by end of the year. Up to that point, the Fed had kept floating rates unchanged at the highest level seen since 2007.

Why did the outlook for cuts change so much and so often in 2024?

This volatility was due in large to the wide range of economic data released, varying Fed members' comments and changing opinions, and (mis)forecasting tough-to-predict near-term economic releases. The Fed's fight against inflation was making progress to bring inflation back down to an acceptable level, but then inflation became "sticky" and stopped moving lower. Employment figures initially showed a strong labor market, until suddenly the data was weak.

Throughout the year, Fed officials were dovish, then hawkish, then mixed.

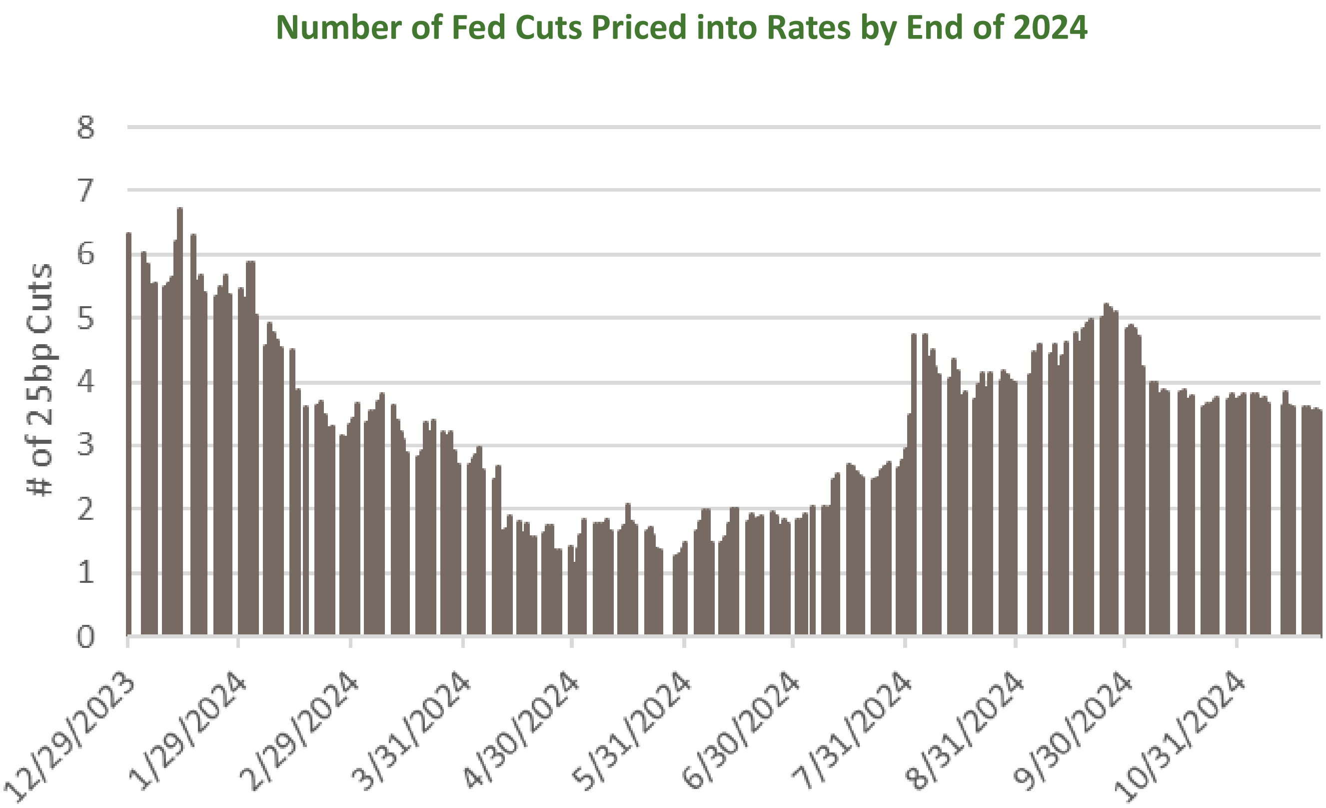

Fig. 6 - Source: Bloomberg. Accessed November 26, 2024.

Why The Fed's Short-Term Rate Cuts Led to Higher Fixed Rates

But wait, isn't the Fed cutting rates now? Yes, the Fed's first move to reduce overnight rates was on September 18, when they decided to reduce Fed Funds by 0.50%. At this meeting, Chair Powell signaled the Fed would begin to "normalize" rates on a meeting-by-meeting basis.

If the Fed continues to cut rates, remember that this does not imply long-term fixed rates will also decrease. We saw this in action following the September 2024 rate cut announcement, when we saw long-term rates moving higher. Yes, higher. The Fed controls short-term floating rates, so when they hike or cut rates, overnight rates and bank floating rates are affected immediately. When looking at longer term rates, they consider the market's average expected Fed policy over the respective longer period. So long-term rates move based on how long-term expectations change and are not solely based on an announced Fed cut or hike.

After the Fed cut in September, there were a series of good economic data released and optimism grew for future economic performance, which changed the market's longer-term expectations. This meant long-term rates moved higher even though the Fed had just cut rates significantly by 0.50%. Based on the new data, prospects for future rate cuts decreased.

Keep this in mind as 2025 unfolds. There are a series of expected Fed cuts already priced into long term rates. If the Fed delivers cuts as expected, long-term rates will not necessarily change unless longer term expectations change as well.

5 Year Treasury Yields (Fixed Rates) vs. 1mo SOFR (Floating Rates)

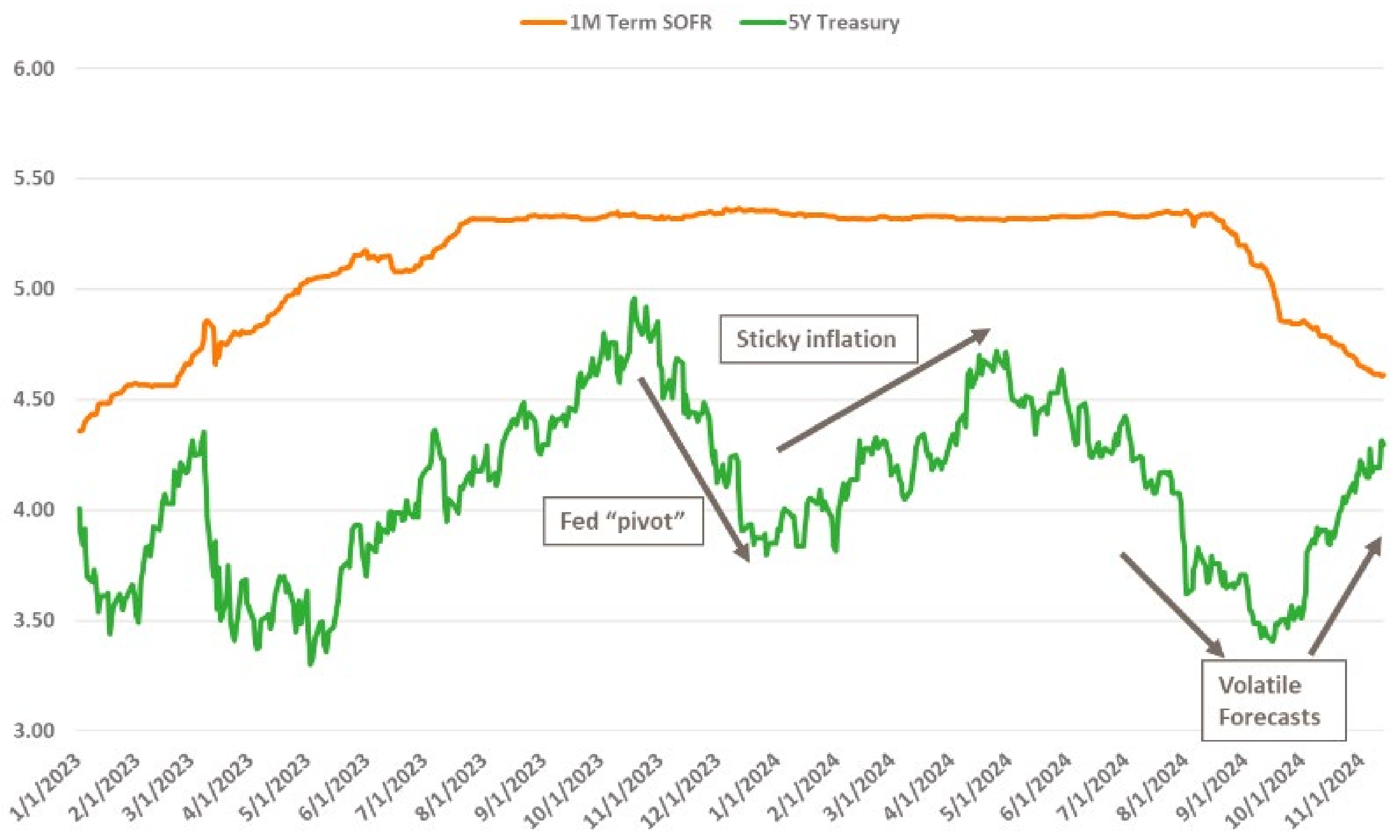

Fig. 7 – Source: Bloomberg. 5-Yr. Treasury Yields vs. 1-Mo. SOFR. Accessed November 26, 2024.

Expect Volatility to Continue in 2025

Volatility was evident in 2024. In 2025, expect more of the same. Many uncertainties on the horizon can change the forecast quickly, which means being completely exposed to floating rates can cause significant swings in a company's interest cost. Being caught off guard can impact cash flow, company performance, and create long or short moments of distress.

Uncertainties that Could Unfold in 2025

- **U.S. Deficit and Treasury Supply**: So far, so good, but many have asked whether the U.S. debt profile is sustainable. General bond economics infer that an increase in supply leads to a decrease in price, which increases yields. Will this be an issue in 2025?
- **Earnings and GDP growth:** Current forecasts for 2025 earnings growth for S&P 500 companies sits at around 13%. GDP has been growing at a solid pace, with most recent Q4 2024 data reading at 2.5% growth. This backdrop generally does not coincide with a Fed easing cycle. Can both exist in 2025?
- **Second Wave of Inflation:** Inflation can come in waves, generally within a few years after the last peak.
- **Deglobalization:** As the world moves to a more protectionist stance, onshoring manufacturing and/or taxing imports have been widely discussed. Over the last couple decades, sourcing goods and services from the cheapest locations in addition to global free trade approaches allowed for lower prices and inflation. How will this shift impact businesses?
- **Geopolitical Events:** Conflicts across the globe could add to risks of supply chain disruptions and commodity cost fluctuations.
- **A Data-Dependent Fed:** The FOMC meets every six to eight weeks and can quickly change their outlook and policies based on the economic environment. This dynamic makes it challenging to predict future Fed moves, which is a component of long-term fixed rates. As economic data comes in, this creates Fed policy forecasting volatility.

What This Means for Your Business

What can be done to mitigate these uncertainties? Customers can manage interest rate risk with interest rate derivatives. For borrowers, risk tolerance for spikes in interest costs need to be considered. Generally, longer term debt can have the most interest rate sensitivity. If long-term debt is hedged and short-term debt is left floating (such as with a working capital revolver), this inherently creates a fixed/floating mix that serves as a good starting point for a hedging strategy.

It's crucial to set and execute a strategy that allows you to be tactical based on risk tolerance and the changing outlook.

Top Strategies to Consider

1. Plain vanilla swaps, meaning you swap floating rate to fixed rate to achieve desired mix.
2. Hedge portion of long-term debt now, then hedge another portion in near term.
3. Varying hedge tenors based on the expected timing for debt.
4. Simple approaches are often the most effective, but a number of structures are available–Huntington's relationship team stands ready to provide a consultative approach to achieve the desired risk profile.

COMMODITIES MARKETS

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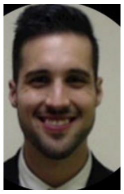
Commodities Markets

TARIFF AND TRADE POLICY ANTICIPATION DRIVES COMMODITY MARKET PRICING



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Highlights

- Domestic aluminum and hot rolled steel prices have rallied in lockstep with the U.S. election amid concerns about tariffs and tit-for-tat trade actions from China, both of which could impact U.S. metals consumers.
- Global metals prices have experienced large intraday swings as markets balance a strengthening U.S. dollar, Beijing's stimulus efforts, and new bans on critical metals trading and memory chips between the U.S. and China.
- U.S. companies should consider evaluating supply chain impacts and manage inventory risks in the face of pricing uncertainties in the coming year.

Market Commentary

As we look ahead to the coming year, commodities markets are telling dueling stories. In the U.S., markets are seeing price escalation in the wake of tariff and trade policy uncertainties, while globally, many metal markets are trending downward on dollar strength and weaker demand estimates from China and Europe. Heading into 2025, businesses can expect diverse pressures to continue impacting pricing both domestically and internationally.

Building supply chain resiliency and mitigating risk in the commodity markets will be crucial for businesses.

Tariffs, Trade Policy, and Prices

The incoming Trump administration's pledge to impose higher tariffs on China and new tariffs on products from Canada and Mexico has already made an impact across a range of commodity markets. Domestic prices, particularly on aluminum and steel, are rising in fear of how those tariffs might impact the U.S. Rising costs for these materials would strain domestic manufacturers and supply chains given the reliance on these countries for metals and mining.

Meanwhile, many global metals markets, specifically copper and tin have seen sharply declining prices due to a myriad of factors including the strength of the U.S. dollar, disappointing Chinese stimulus results and negative economic data out of Europe, in addition to concerns about the impact of future tariffs on import demand.

Midwest Premium Aluminum Index Spiking

The Midwest Premium Aluminum Index is highly susceptible to influence from tariff actions because it is closely tied to importing and transporting aluminum into the U.S. Recently, in the weeks following the U.S. election, we've seen a spike in this index with prices reaching $0.21/lb. in December compared to sub-$0.19/lb. the year prior.

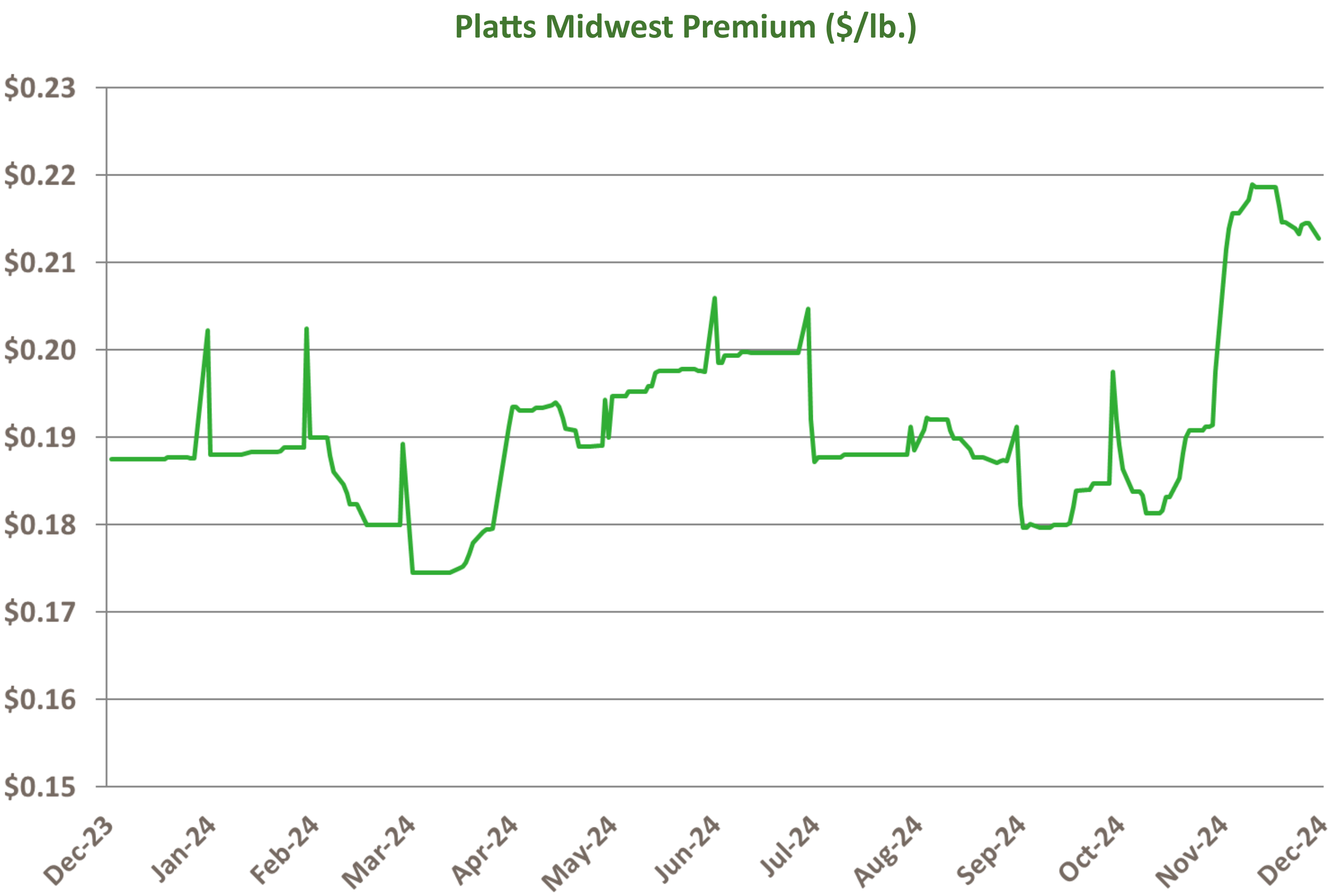

Fig. 8 – Source: S&P Global Commodity Insights, Platts Midwest Premium Pricing. Accessed November 27, 2024.

Understandably, this spike has caused concern among U.S. companies. Canada, China, and Mexico are the top three sources of U.S. metals and minerals, accounting for 41% of the value of U.S. imports of these materials in 2023[1]. **The proposed 10% tariff on goods from China and 25% tariff on imports from Canada and Mexico stand to dramatically impact pricing for manufacturers that rely heavily on aluminum, as well as copper and steel products.**

Hot-Rolled Coil Steel Futures Rise in Tariff Anticipation

Unlike aluminum's considerable rise in pricing right away, domestic steel future index has more or less maintained pricing per ton since the November election results. The impact of potential tariff and trade policy action, however, is clear when looking at forward curves in the coming year.

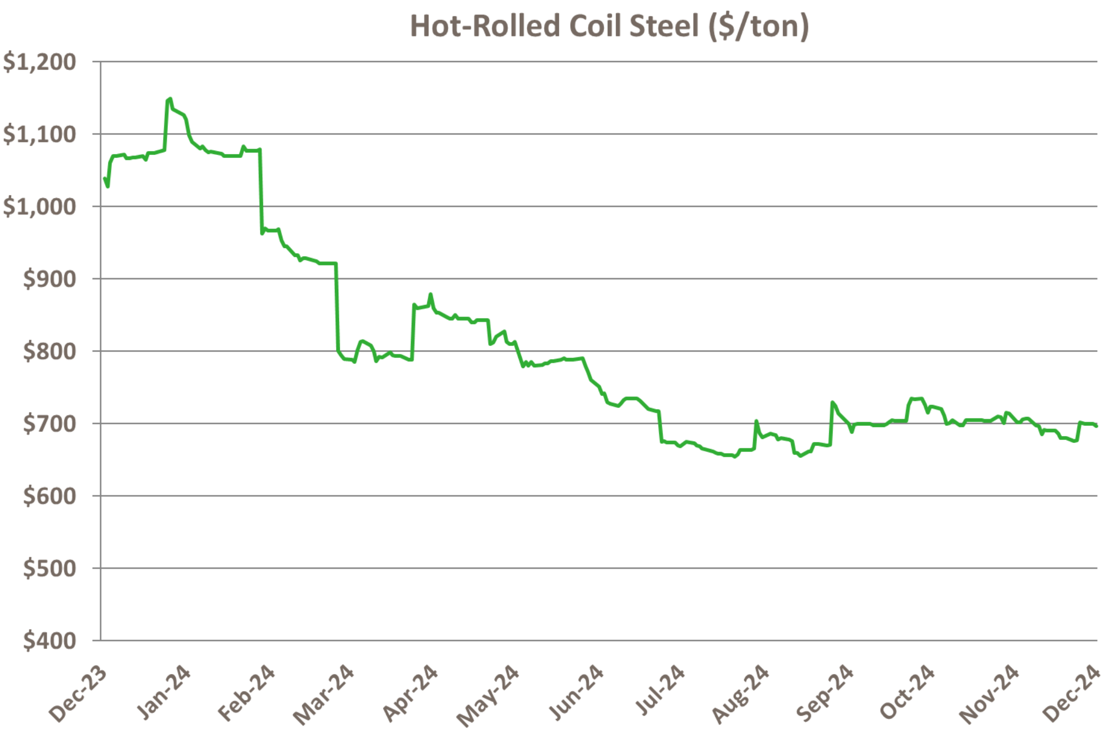

Fig. 9 – Source: S&P Global Commodity Insights. Hot-Rolled Coil Steel Pricing by Ton. Accessed November 27, 2024.

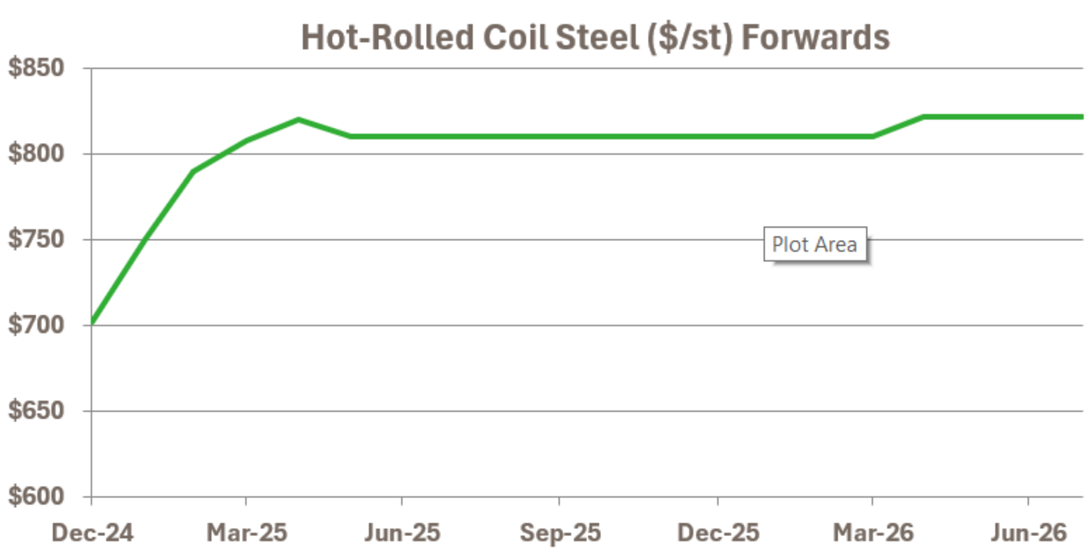

Fig. 10 – Source: S&P Global Commodity Insights. Hot-Rolled Coil Steel Pricing, Forwards. Accessed November 27, 2024.

Domestic hot-rolled steel prices are expected to rise starting in 2025 as the market makes assumptions about how tariff action could impact the value of steel on a go-forward basis.

The threat of a 25% tariff on all imports from Canada is the more important metric to watch as it will have an impact across many sectors including auto, energy, and construction.

Producing an accurate price forecast for the first half of 2025 will be difficult until more details about the tariffs materialize, but steel hedgers today will face a premium for purchasing futures six months out.

LME Copper Index Price Slump as USD Strengthens

Copper is the bellwether commodity for most global markets, given it follows the U.S. dollar and general economic news more than any other metal. We have witnessed this in action recently. The U.S. dollar jumped to a two-year high after the election and continued to rise through November – and following that, copper prices slumped for eight weeks straight.

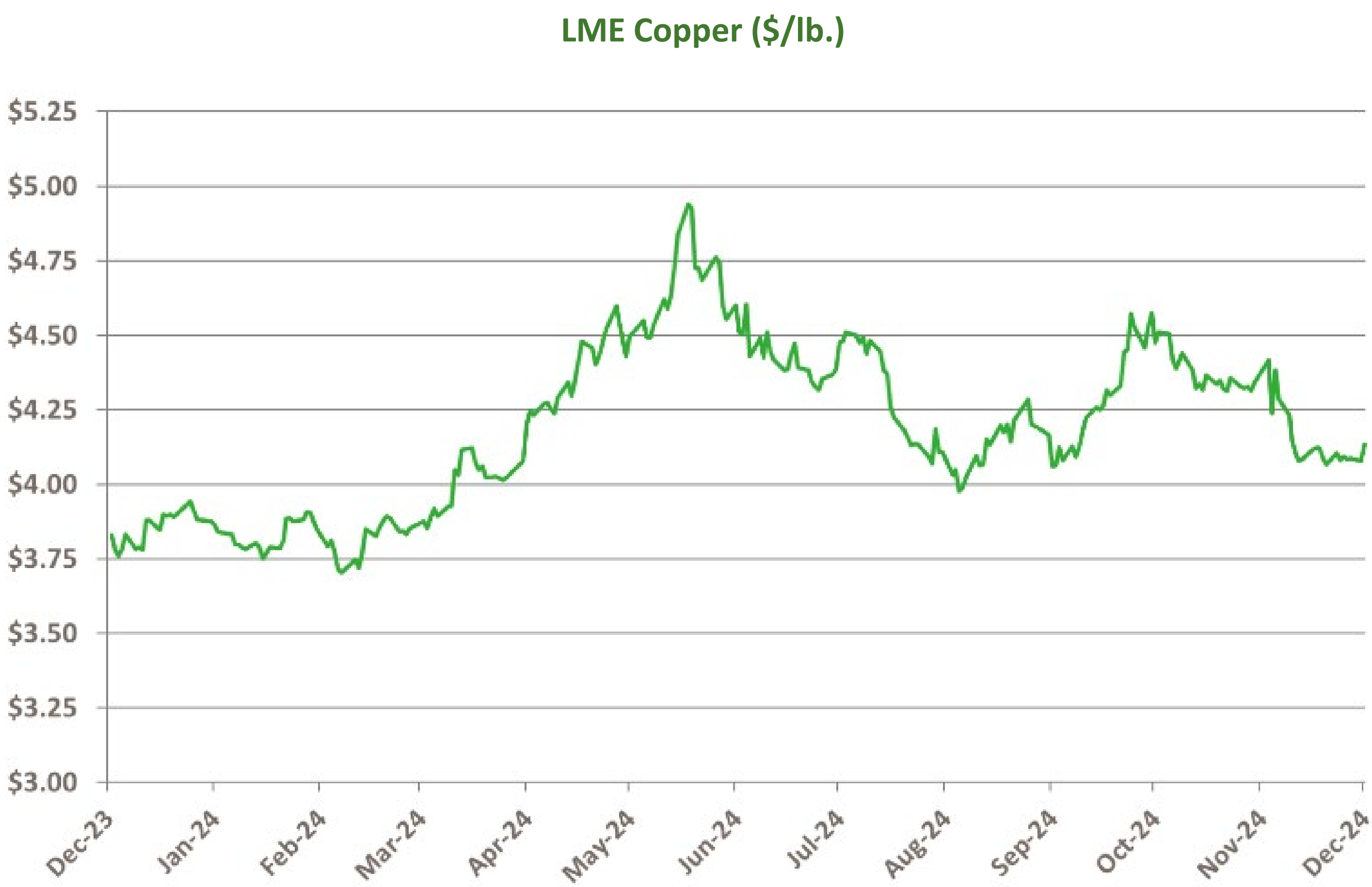

Fig. 11 – Source: Bloomberg, LME Copper Pricing by Pound, Moving Avg. Accessed November 27, 2024.

Declining copper prices due to USD strength and fears of tariffs could signal a slowdown in industrial activity and global markets. Recent economic data from China showed industrial output is slowing and industrial profits are falling, indicating economic challenges for Chinese businesses. China's producer prices and orders have dropped YoY through Q3 2024[2].

What this Means for Businesses

1. **Anticipate pricing shifts based on policy changes.** Domestic and international commodity metal indexes will experience diverse pricing pressures in the onset of tariffs or trade policies. Import tariffs typically increase domestic pricing as demand for U.S. produced metal rises to avoid paying tariffs. Tariffs globally have a bearish effect on overall commodities demand, especially given the significance of the U.S. and China on global consumption.

2. **Managing knowns amidst the unknowns will be key.** Developing a strategy focused on protecting inventory values and sales margin will be crucial in managing volatility throughout 2025.

3. **Prioritize supply chain impacts.** Incorporate supply chain resiliency into strategic plans ahead of trade policy changes to understand if product lines will be impacted by tariffs. Focusing on supply chain diversity in the event tariffs are introduced will be as important now as it was in 2018 when Section-232 tariffs and trade action against China were enacted.

M&A Outlook

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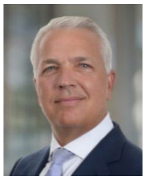
M&A Outlook

MIDDLE MARKET M&A POISED FOR STRONG COMEBACK IN 2025



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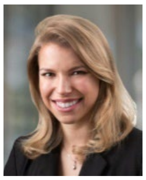

Sarah Doherty
Director of Market Intelligence
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Highlights

- An expected surge of M&A activity driving deal volume and value will make deal positioning important for sellers in 2025.
- Macroeconomic clarity is expected to mobilize owners to deploy growth and exit strategies, fueling inventory.
- Tailwinds from interest rate cuts, the Syndicated Loan market, and seller movement is expected to unleash private equity activity.

M&A Market Backlog and Drivers

The Merger and Acquisition (M&A) market is now in its third year of a downcycle, marking an abnormally long decline by historic standards and indicating that the market is overripe for the start of a bull run in 2025. Newton's Third Law of Motion, that for every action there is an equal and opposite reaction, largely holds true for M&A cycles.

The lackluster dealmaking environment that has settled in following the M&A boom of 2021—where volume subsequently dropped 15% year-over-year (YOY) in 2022, 22% in 2023, and another 9% as of Q3 2024—has created a backlog of transactions that will inevitably be spring loaded into the market.

Ultimately, there are three fundamental middle market M&A drivers that will uncork dealmaking activity:

1. **History:** Patterns in M&A cycles show that downturns last 12-24 months, making this market past due for an upswing.
2. **Biology:** Business owners who did not sell in the past three years are now even closer to retirement age.
3. **Capitalism:** Private equity (PE) is sitting on a war chest of capital that needs to be deployed to meet investor returns.

"We are now in our third down year—we are already beyond the normal correction period. This is the 'when' part of the equation. The other two fundamentals fall in the 'why' part of the equation—they are 'biology' and 'capitalism.' They are both absolutes. At least to my knowledge, people don't grow younger, and capital does not grow more patient."

John Ferrara, Capstone Partners Founder and President during Q4 interview on the M&A markets.

We are already seeing early signs of a recovery, with quarter-over-quarter (QoQ) volume growth in middle market deal activity for the first time since Q4 2021.

To that end, Capstone is bullish on the year ahead and expects a three-pronged surge in M&A activity from business owners coming to market, PE firms as both buyers and sellers, and strategics going on a feeding frenzy following the scarcity of deals since 2021.

This release of activity will drive deal volume and value amid an increasingly competitive marketplace, making preparedness and deal positioning of heightened importance for sellers.

Historic Middle Market M&A Cycles

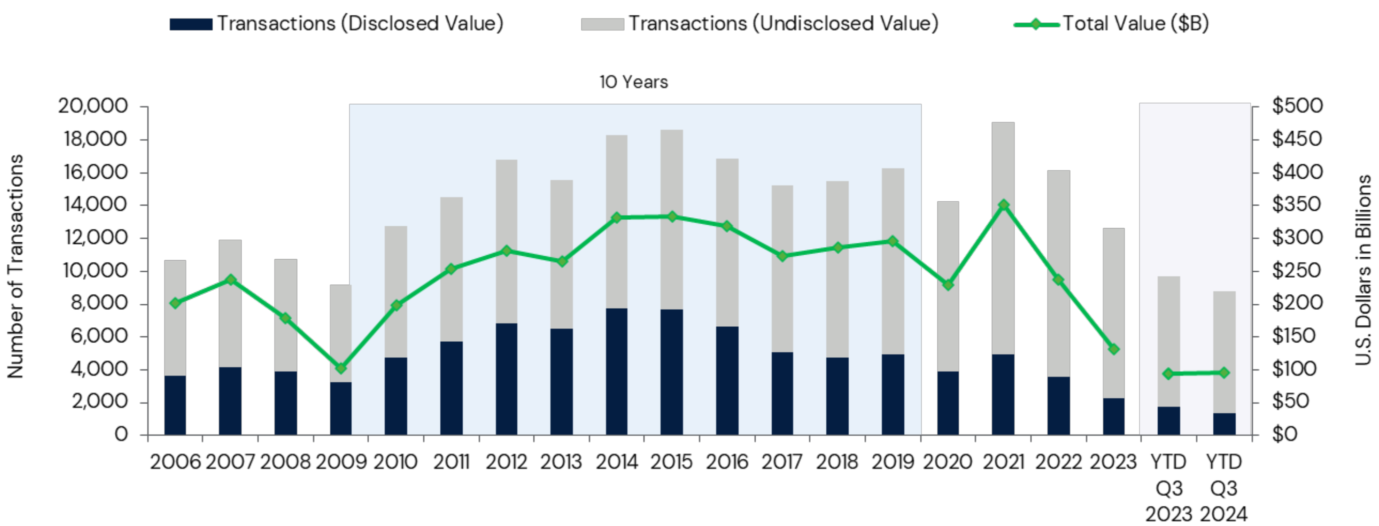


Fig. 12 – Note: Blue shaded areas indicate economic expansion; Enterprise Value < $500 million. Source: Capital IQ and Capstone Partners, December 2024.

Market Private Business Owners Gain Clarity, Confidence

Private business owners have weathered a challenging and reliably unpredictable environment since the COVID-19 pandemic and are eager for a modicum of macroeconomic clarity to transact with confidence. The landmine of challenges that business owners have navigated has been spotlighted in Capstone's Middle Market Business Owner Survey, which gauges the health of the middle market and sentiment of private business owners through analysis of around 400 survey responses.

Over the past three years, the most notable hurdles that private companies have faced according to these results have morphed from Supply Chain Disruptions in Q3 2021(47% of business owners surveyed) to Workforce Shortages (Q4 2021, 21%), to Economic Uncertainty (Q1 2022, 27%) and have since lingered around Inflation (59% in both 2023 and 2024). Business owners have reported lowering expenses, raising prices, and Topselling away assets to increase profitability and drive performance improvement in the higher-for longer interest rate environment.

The Federal Reserve's recent rate cuts are expected to be a key signal for business owners to shift priorities from operational optimization to business expansion or liquidity.

Furthermore, the result of the 2024 U.S. Presidential election is slated to have a significant impact on the private sector, including middle market businesses. Based on our survey findings, the lion's share (42.5%) of CEOs indicated that a party change in the White House (from Democrat to Republican) would have a positive impact on business operations. While a political party change was deemed positive across most business demographics, operators of larger companies (100+ employees) felt stronger about the positive impacts of a party change compared to smaller business owners.

Regardless of CEOs' political stance, the vast majority cited macroeconomic issues as the most important factor in the 2024 election.

The enhanced clarity on the heels of two consecutive interest rate cuts and the election is expected to mobilize private business owners to deploy growth and exit strategies, fueling M&A inventory.

Private Equity Firms Sitting on Capital, Portfolio Company Exits

Not only are private business owners coming back to the 2025 market, but so are PE firms with the dual-sided mandate to both *deploy* capital for investors through acquisitions and *return* capital to investors through exits—making them both buyers and sellers in the opening market.

Two key factors that PE firms noted would jumpstart their deployment activity were "an increased volume of assets coming to market" and "greater availability of debt financing," according to Ernst & Young's Q3 2024 PE Pulse survey conducted by AlphaSights[3].

This suggests that the tailwinds from the interest rate cuts, the opening of the Syndicated Loan market, and the movement from sellers are the catalysts needed to unleash PE activity in 2025.

PE firms are currently sitting on more than $1.6 trillion in idle dry powder that must be put to work. Sponsors have become important drivers of middle market deal volume over the past decade, climbing from 30% of buyers in 2014 to 43% through Q3 2024. That said, PE volume through Q3 2024 is down 35% from its 2021 peak and firms have shifted from pursing platform acquisitions to deploying hold-and-build strategies.

While add-on transactions as a percent of buyouts have remained firmly above 57% since 2021, the scale finally shows signs of rebalancing. In each quarter of 2024, add-on acquisitions as a percent of sponsor activity dropped—from 69% in Q1 to 64% in Q2, to 60% in Q3. Hand-in-hand, PE platform acquisitions rose 18.9% QoQ in Q3, representing the first back-to-back QoQ increase in platform deal volume since Q4 2021 and marking a much-needed revival in sponsor platform dealmaking.

On the other side of the PE mandate, exit activity has shown signs of improvement and will further enable fund managers to pursue scalable platform opportunities.

The median PE holding time for portfolio companies reached a record high of seven years in 2023, putting increasing pressure on firms to exit their investments and deliver returns to their limited partners (LPs). While exit activity has remained depressed on a YOY basis (falling 22.9% through Q3), activity increased 15.5% QoQ in Q3, again representing the first double-digit QoQ growth since Q4 2021.

PE-backed company inventory levels have reached a record high. Platforms established between 2019 and 2022 have comprised the majority (52.5%) of the inventory backlog, denoting a significant number of private equity-backed companies ripe for exits.

A robust backlog of sponsor-held companies, pressure to distribute returns to LPs, and a normalizing valuation environment have supported a bullish outlook for exit activity into 2025.

Growing Inventory of Private Equity Portfolio Companies Ready for Exit

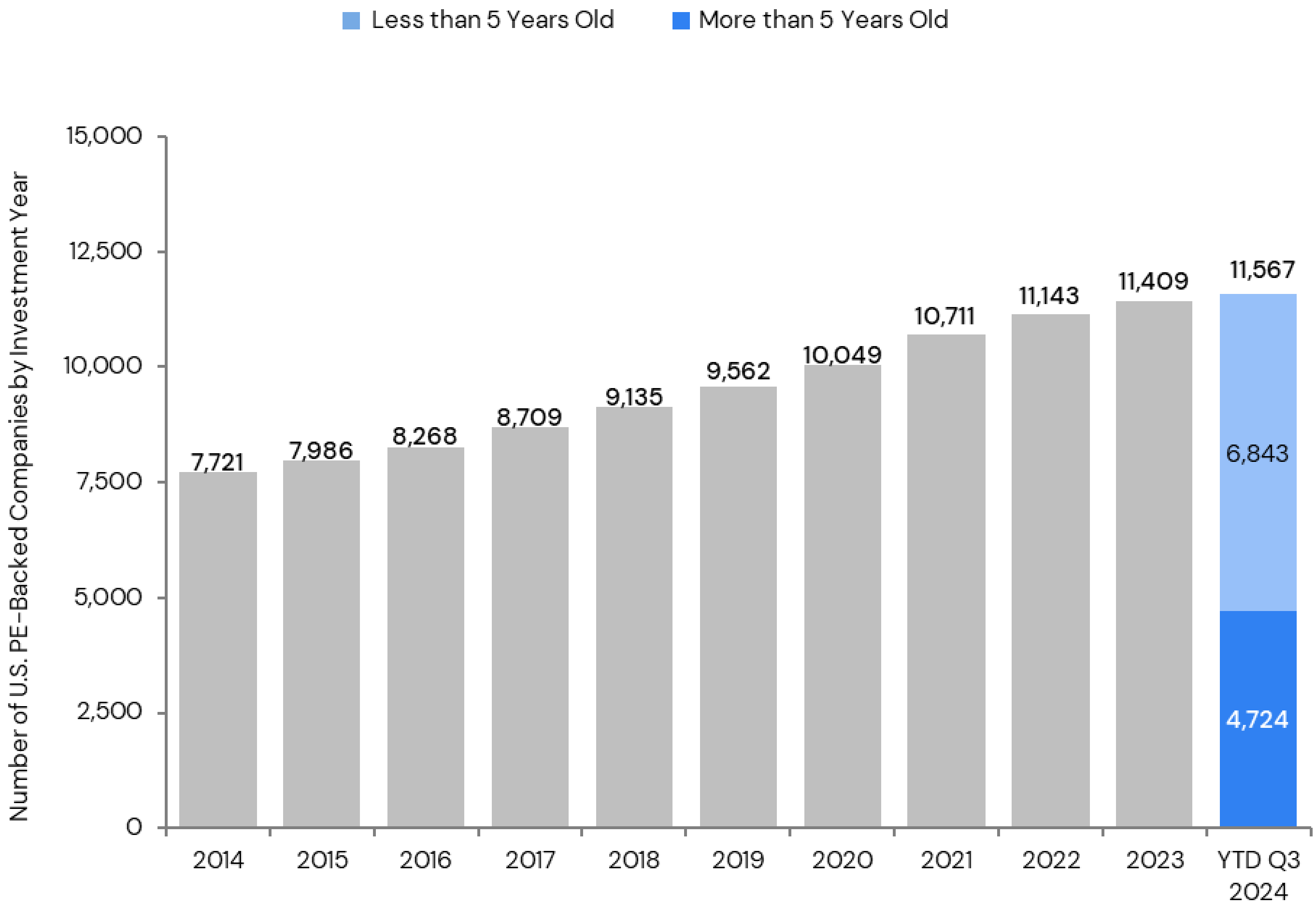


Fig. 13 – Source: Pitchbook and Capstone Partners, Number of U.S. PE-Backed Companies by Investment Year. December 2024.

Strategics Hungry for Acquisition Opportunities

The final group of players to mention are the strategic buyers. This pool has continued to be the mainstay of middle market M&A activity, with private (43% of buyers through Q3) and public (14%) companies driving more than half of closed deal activity.

The main element demurring strategic acquisition volume has been the lack of companies available to buy. Quality assets have been highly sought after and achieved premium valuations. This is evidenced by private strategics' paying an average multiple of 10.9x EV/EBITDA through Q3, the highest multiple for this buyer pool since (you guessed it) Q4 2021 and two turns higher than the middle market average of 8.6x EV/EBITDA. Additionally, many public companies have benefited from the strength of the Equity markets and are eager for expansionary opportunities through M&A. **When more deals come to market, strategics will be competitive bidders eager for growth opportunities.**

What this Means for Middle Market M&A and Business Owners

The 2021 M&A boomerang of activity was largely driven by owners rushing to market ahead of potential changes in the long-term capital gains tax rate—deal volume reached a brief and brilliant high before fizzingly out. The coming market return will look very different due to basic supply and demand. Today, demand is in abundance: Sponsors are armed with a record level of dry powder that must be deployed to meet promised investor returns.

1. **Strategics, many flush with cash from the strong Equity market run, are hunting for growth opportunities.** Supply is what has been lacking and its return will activate the market.
2. **Improving market sentiment will boost CEO confidence and shift mindsets from defense to offense, causing many to engage in M&A.** Like private business owners, many PE firms have prioritized managing liquidity and reducing costs in portfolio companies over the past several years. The clearer macroeconomic outlook and more accommodating financing backdrop will prompt general partners (GPs) to prioritize exiting assets that have extended holding times, further buoying deal supply.
3. **The level of dealmaking activity in the queue will require a much longer tail to digest than the white-hot boom of 2021.** This pending M&A market run will be more akin to a gradual multi-year climb, beginning as early as Q1 2025. With dealmaking already showing sign of gaining momentum as of Q3, middle market volume could increase as much as 20% next year as it begins normalizing towards historic annual deal volumes.

The middle market is poised to become increasingly competitive over the next few years and the question that should be top of mind for business owners is "how will you stand out?" PE firms will be bringing highly professionalized companies to market. Many fellow private owners will also have businesses that have gone through several years of performance improvement and financial stability initiatives. Among the CEOs surveyed by Capstone in 2024, 62% have started to plan a business exit, demonstrating the prevalence of succession planning in the middle market.

M&A readiness can enhance the probability, valuation, and speed of a sell-side transaction, with preparation and planning marking the first of six phases in a typical M&A process.

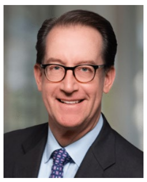
Maximizing growth strategies, building a strong leadership team, and determining financial needs have been the top three steps taken by business owners eyeing an exit opportunity. While these three steps are crucial, building a professional advisory team comprised of investment bankers, financial advisors, and lawyers can alleviate exit planning pressure, particularly when completing a business valuation and preparing historical financials for a quality of earnings review.

EQUITY CAPITAL

Chris Hastings
Head of Equity Capital Markets
Capstone Partners

Equity Capital

SOFTENING VALUATION ENVIRONMENT DRIVES DEMAND FOR GROWTH EQUITY SOLUTIONS



Chris Hastings
Head of Equity Capital Markets
Capstone Partners

Highlights

- Overall choppy middle market M&A valuations have spurred a flurry of growth equity deals.
- Growth equity investment strategies have become a key value creation tool for many sponsors, especially in the current exit environment.
- Structured equity is expected to continue to be a major part of the overall equity financing market in 2025.
- Nontraditional investors are taking a closer look at their portfolios to assess whether it's time to shift to new areas of opportunity or continue participating in traditional growth equity investments.

Market Commentary

While merger and acquisition (M&A) valuations are heavily dependent on a company's financial profile and operating sector, the overall middle market M&A valuation environment has remained soft compared to historical levels. The average middle market purchase multiple was 8.6x EV/EBITDA in Q3 2024, according to Capstone Partners' Q3 2024 Capital Markets Update[4]. Though this average was consistent on a year-over-year (YoY) basis, it remained muted compared to full-year 2021 (10.1x EV/EBITDA)—the most recent peak of middle market M&A activity.

A slow M&A market has spurred a flurry of growth equity deals as many business owners have looked to secure partial liquidity and defer a full sales process until a more favorable valuation can be reached.

One of the solutions we often see is selling a minority stake of a company. If a business owner is ready to exit and it just happens to be a tough market for that sector regarding valuation, rather than sell the full company today, they sell a minority stake to a growth equity investor. By doing so, the business owner can still create liquidity in a situation where they are not the happiest with the valuation—often referred to as taking two bites of the apple. The owner gets to take a portion of the proceeds with this transaction and can then capture the balance of the proceeds when the growth equity firm is ready to exit.

The other common valuation in selling a minority stake of a business is to put performance metrics in place. If a business owner believes that their company is going to grow significantly in the next couple of years, they can negotiate a future valuation with the investor if the company hits those metrics. This is a win-win. As the company performs, the investor can make a better return, and the owner can benefit from an increased valuation.

Growth Equity Activity Rises as Sponsors Limit Debt Exposure

PE firms have increasingly deployed growth equity investments to generate returns rather than full buyouts/majority stake deals. Growth equity investments typically target late-stage, rapidly expanding businesses in order to bolster growth through operational leverage initiatives rather than financial leverage.

This strategy has become a key value creation tool for many sponsors, especially as the exit environment has continued to favor profitable businesses with strong EBITDA margins and limited debt exposure.

Of note, the number of growth equity investments through Q3 2024 rose 15.1% YoY to 1,145 deals, according to PitchBook's Q3 2024 U.S. PE Breakdown report[5]. Total growth capital deployed by PE firms reached $75.8 billion during the same period, marking an increase of 4.9% YoY.

Fundraising challenges have afflicted both buyout and growth equity funds through Q3, with total growth equity fundraising volume and value falling 22.5% and 30.3% YoY, respectively. However, growth equity funds have continued to comprise a meaningful share of total PE funds raised. Growth equity funds accounted for 14.1% of total sponsor funds through Q3 2024, mirroring the prior year period of 15.5%.

Sponsors' ability to successfully exit growth equity holdings and distribute LP returns will likely spur elevated fundraising activity in the long-term.

Growth Equity Transaction Activity Rebounds Year to Date
(Number of Closed Transactions)

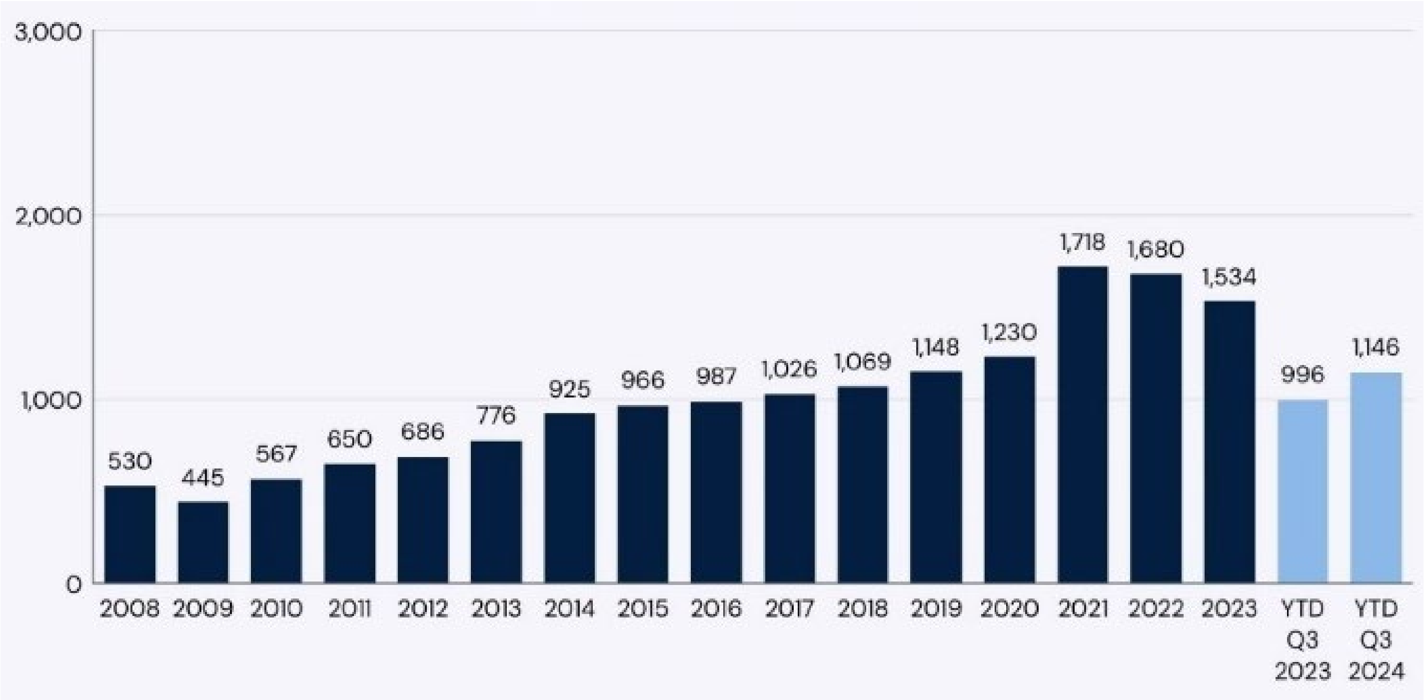


Fig. 14 – Year to date (YTD) ended September 30. Source: Pitchbook Q3 2024 U.S. PE Breakdown Report, Capstone Partners Q3 2024 Capital Markets Update.

Increase in Structured Equity

In times of market volatility, structured equity can be an effective tool for companies to raise capital that is less dilutive than traditional equity. We expect structured equity to continue to be a major part of the overall private equity financing market in 2025. The approach blends aspects of debt and equity to provide business owners with a flexible capital solution that does not require them to give up control of their company.

There are two different types of structured equity deals, and in each case, the profile of the company and the type of investor are very different.

Traditional Structured Equity

The first type of deal, traditional structured equity, is a hybrid security in which the investor accepts a lower return threshold in exchange for downside protection. It is a lower cost of capital alternative to traditional growth equity and is for companies with strong positive cash flow.

For companies with strong positive cash flow (double-digit EBITDA) that are considering raising equity capital, structured equity can be a good alternative to traditional equity given it is much less dilutive. Furthermore, structured equity can be a means of preserving valuation and gives companies more time before conducting their next priced round. The most common structure is a redeemable preferred security with warrant coverage that is typically two-thirds less dilutive than a traditional equity deal. The return threshold for these types of structured deals is typically in the mid-teens on an internal rate of return (IRR) basis. The investor base for structured equity deals consists of special situation funds and credit funds.

Many larger asset managers, hedge funds, and PE firms also have separate funds dedicated to structured equity investing. Capstone has intimate knowledge of the structured equity investor universe due to its extensive experience in the space.

Structured Equity for Growth Investors

The second type of structured equity is used by growth investors to mitigate near-term investment uncertainty, in which the return hurdle for the equity investor is the same as for any growth equity investor (25%+). In these cases, traditional growth investors may add stricter terms to convertible preferred investments as a means of protecting downside risk.

Structure can be included in a convertible preferred investment in multiple ways so that the growth investor can achieve the return hurdle of 25%+ IRR while protecting downside risk:

Participating Preferred Feature: Rather than using a traditional convertible security, investors may ask for participating preferred stock, which allows the investor to receive the face amount of investment at exit in addition to proceeds based on equity ownership. This double dip feature contrasts with a traditional convertible security in which an investor is entitled to receive either the face value investment amount or their equity ownership at exit.

- **Increase in Liquidation Preference:** Typically, convertible preferred investors are entitled to 1.0x their capital at exit if not converted to common stock. For further downside protection, investors may increase this to 1.5x, 2.0x, etc.
- **Additional Capital Tranche**: This enables an investor to deploy more capital if certain financial milestones are achieved.
- **Valuation Ratchet Feature:** Investors can adjust valuation of investment if certain performance milestones are not met.

Capstone's Equity Capital Markets Advisory Group is now seeing nontraditional investors take a closer look at their current portfolios and assess whether now is the time to shift to new areas of opportunity or continue to participate in traditional growth equity investments.

Regardless of strategy, investors are seeking more favorable terms to protect against downside.

In terms of use of proceeds, some investors are more interested in seeing that proceeds from their capital are used for working capital rather than providing liquidity for existing stockholders. Although, for companies with proven scale and profitability, there remains an option for shareholder liquidity to accompany a primary component.

DEBT CAPITAL

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Debt Capital

MIDDLE MARKET CREDIT COMMENTARY

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Highlights

- The debt market is firmly in borrower-friendly territory, leading to reductions in borrowing rates and improved loan terms across the credit landscape.
- Two leading indicators are pointing toward an improved M&A market in 2025.
- Borrowers should consider exploring a refinance now to avoid a crowded environment once the M&A market fully recovers.
- Dividend recaps soared in 2024. Should M&A acquisition activity return in 2025 as anticipated, lender appetite for these deals will likely decline.

Favorable Tone in Middle Market Credit

The debt market is firmly in borrower-friendly territory marked by institutional lenders competing heavily to win new loan mandates. Lackluster M&A activity, improving corporate performance, and ample "dry powder" have resulted in heightened pressure amongst lenders to stem repayment of outstanding loans (via refinancings) and to deploy their growing capital funds into new opportunities.

The net result for middle market borrowers has been a meaningful reduction in borrowing rates and improved loan terms across the credit landscape.

M&A Loan Activity Rising

While the M&A market has been depressed for roughly two and a half years since the Federal Reserve rate hike cycle began, the leveraged finance market has adopted a more upbeat tone in recent weeks. Uncertainty is the enemy of M&A, but with the U.S. presidential election now behind us, better visibility on interest rates, lower inflation, and healthy financial results by middle market private companies, M&A activity is now gaining momentum. For the first time in nearly two years, refinancing and repricing loan activity is taking a back seat to leveraged buyout and acquisition financings.

A growing chorus of market participants believe that the long-stalled M&A market is now awakening with deal flow picking up in Q4 2024 and expected to continue into next year[6].

At Capstone, the pace of client NDA signings in Q3 2024 was up +24% YOY and, since the election, our near-term M&A calendar for post-holiday launches has improved, two leading indicators that suggest a rosier M&A market in 2025.

Middle Market Borrowers Remain Strong

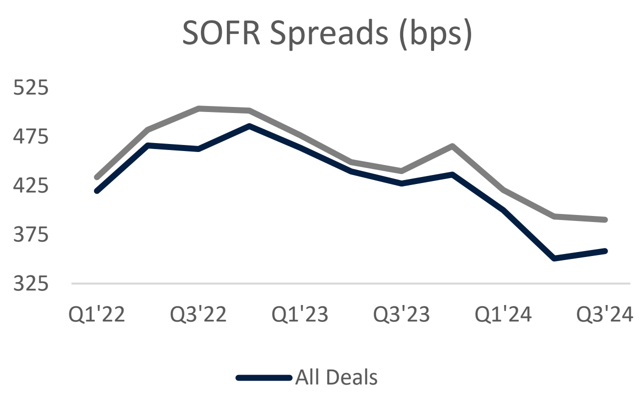
Favorable financial results by borrowers have supported these trends. According to Golub Capital, middle market private companies have continued to perform well with a 5.1% YoY revenue growth and 7.9% earnings growth as of Q3 2024, the eighth quarter in a row of solid performance. While their index reflects consistent margin expansion being driven by cost discipline and pricing power over the last five quarters, Golub highlighted that dispersion of operating results is increasing with many companies adapting well to the macro environment while low performers are falling further behind[7].

Rates Trending Down

Borrowing rates on senior and unitranche loans continue to decline based on the tandem impact of SOFR reductions and spread compression. Following two rate cuts by the Fed this year (and a third possible in December), the SOFR has meaningfully dropped from its peak of 5.3% to around 4.6% today. Currently, the market anticipates further Fed rate cuts well into 2025 and for the SOFR to ultimately bottom out near 3.8% a year from now[8].

After peaking in Q2 2022, SOFR spreads have compressed for most borrowers by 75-125 bps over the last five quarters, although market participants believe spread levels may now be approaching the bottom. Pricing on private credit deals has stabilized, at least for now, at the SOFR +4.5%-4.75% level for sponsored upper middle market deals and 50-75 bps higher for core middle market credits. Pitchbook LCD recently noted that about 80% of private credit deals in the last six months were priced below SOFR +6% while about 80% of loans in the second half of 2023 were priced above SOFR +6%[9]. Based on our recent experience, smaller and "story" credits are finding pricing in the SOFR +6.5%-7.5% range today.

SOFR Spreads Over Time



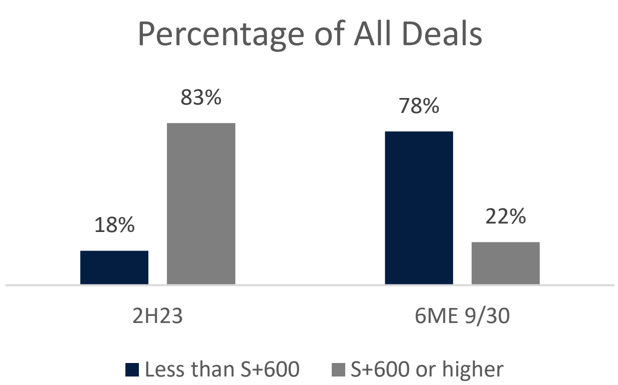


Fig. 15 – Source: Pitchbook LCD U.S. Credit Markets Quarterly Wrap, Q3 2024.

Debt Capacity Inching Upwards

As lower-rated deals continue to take a larger slice of the market this year, average leverage ratios have risen from their 2023 dip. This year, upmarket leverage loans (companies with $50M+ in EBITDA) have had an average debt/EBITDA ratio of 4.7x, up from 4.5x last year but well below the 5.3x levels seen in 2022-23[9]. Smaller businesses are typically limited to more conservative levels (by 1x-1.5x) depending on size, sponsorship, sector and other factors.

Debt/EBITDA Ratio Levels

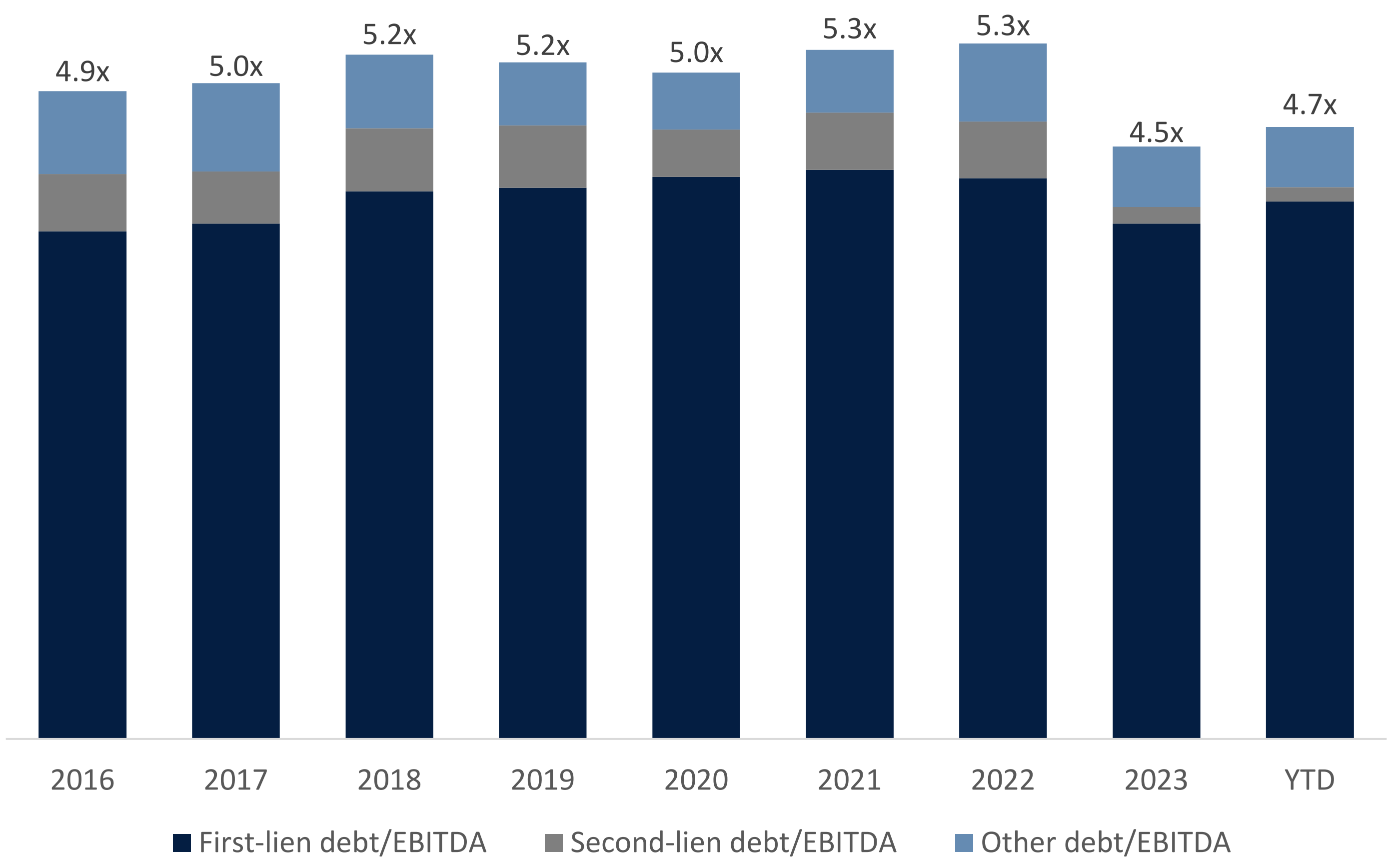


Fig. 16 – Source: Pitchbook LCD U.S. Private Credit & Middle Market Weekly Wrap, November 2024.

Nevertheless, given today's still-elevated rate levels, debt capacity is often range-bound by projected interest coverage ratios, not EBITDA per se. For all deals (LBOs, refi, etc.), the average EBITDA/interest ratio has fallen to only 3.1x this year, well below the 4+ levels experienced in 2020-22.

Further, lenders continue to require healthy equity cushions – most new loans today bear loan-to-value ratios (debt/enterprise value) below 55%, averaging 52% for leveraged buyouts in Q3 2024[10].

Interest Coverage Ratio Levels

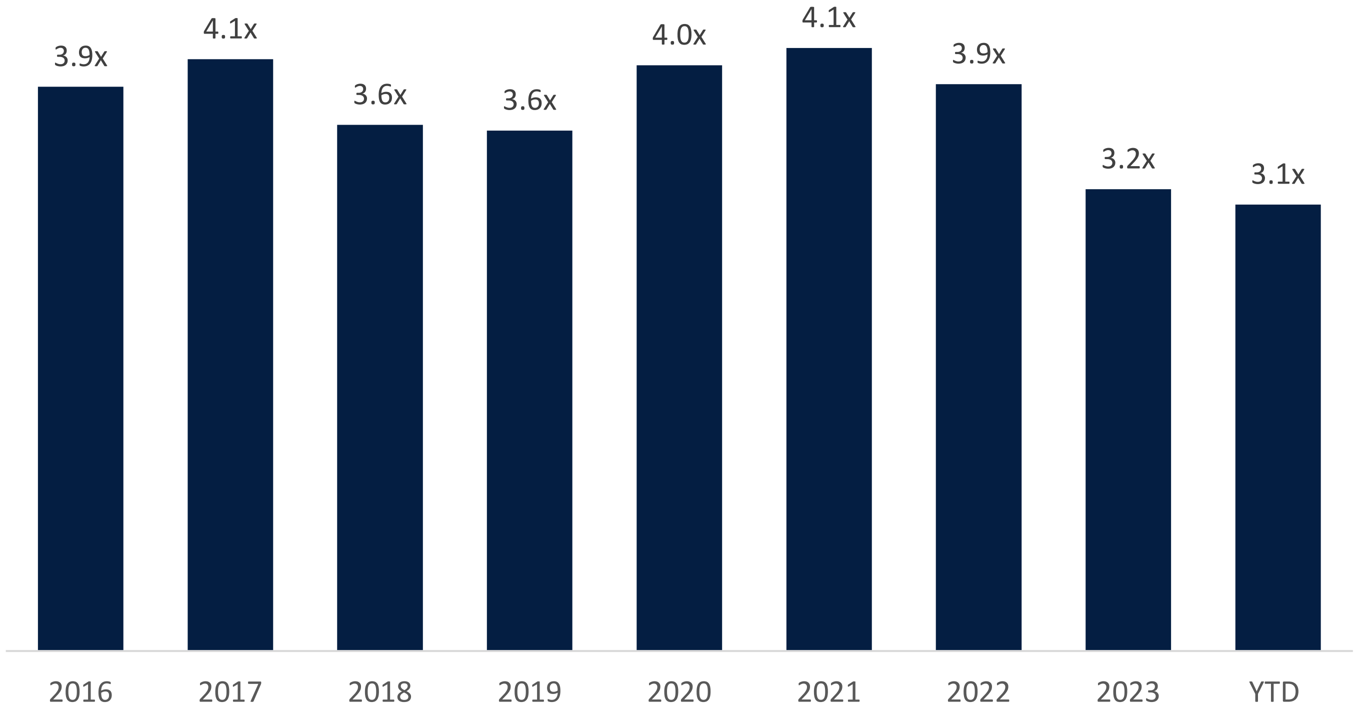


Fig. 17 – Source: Pitchbook LCD Reawakened LBO Market Shifts, October 2024.

Refinancings and Repricings Playing Out

Predictably, the reduction in rates spurred a wave of refinancings in the first half of 2024 across the credit landscape, especially refinancings in the broadly syndicated loan (BSL) market of private credit term loans issued in 2022-23 by sponsored upper middle market borrowers with an EBITDA of more than $50 million.

The rapid pace in Q1 of private credit loans being refinanced in the BSL market has slowed if not reversed over the last six months due to competitive pressure. Historically, private credit lenders (non-banks) have been paid 100-150 bps more than banks in exchange for certain structural advantages they can offer: speed, certainty, no ratings, DDTLs, PIK options, etc[11]. However, this rate premium compressed during the first half of 2024 as direct lenders lowered spreads, especially in the upper middle market, to better compete against banks. At Capstone, we have noticed some larger lenders pivoting towards non-sponsored and/or core middle market credits to help preserve pricing spread on new loans.

U.S. Institutional Loan Volume ($B) By Use of Proceeds

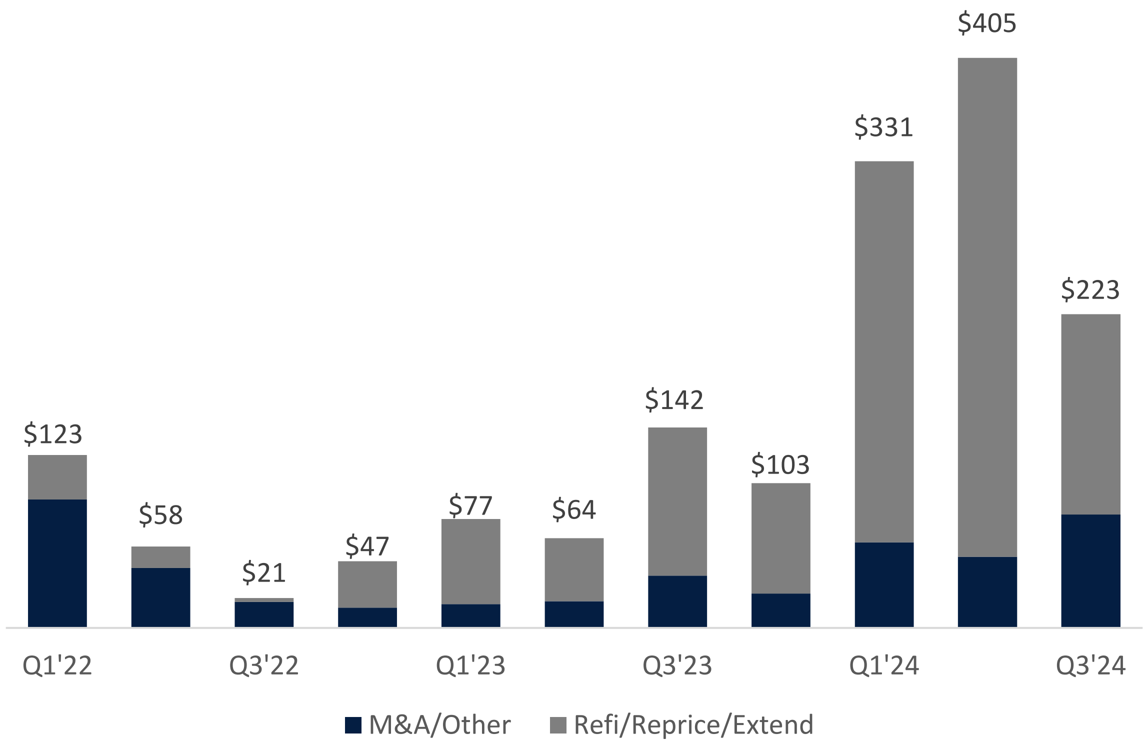


Fig. 18 – Source: Pitchbook LCD U.S. Credit Markets Quarterly Wrap, Q3 2024.

U.S. Institutional Loan Volume (% of Total $) By Use of Proceeds

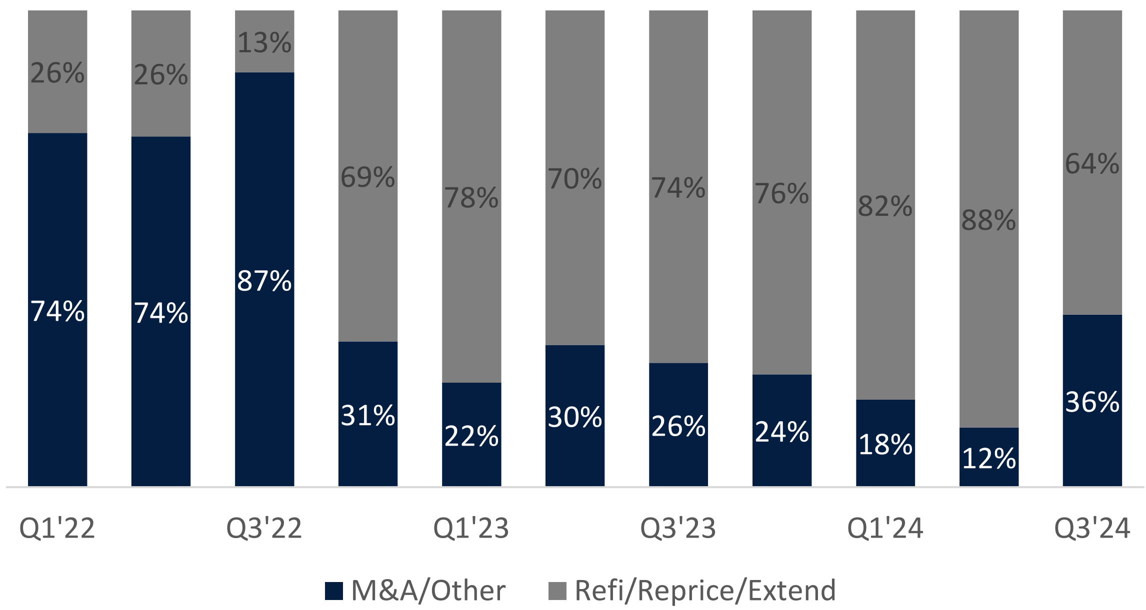


Fig. 19 – Source: Pitchbook LCD U.S. Credit Markets Quarterly Wrap, Q3 2024.

Pitchbook LCD reported that through Q3 2024, more than 60% of all leveraged loans outstanding at the start of the year have been repaid, repriced, and/or extended, an all-time record[9].

While refinancings have now largely played-out, lender attention has pivoted to other uses, such as dividends and M&A. Unless already considered, borrowers are encouraged to explore a refinance to avoid a crowed environment once M&A fully recovers.

Dividend Recaps Back on the Scene

This year, sponsors have increasingly turned to loan-funded dividends to return capital to their LPs given the difficulties of exiting portfolio investments through traditional sale and IPO routes. The resurgence of the M&A market cannot come quick enough for them. The median age of PE portfolio companies in the U.S. last year was 4.1 years (a 10-year high), while the median hold period for exited companies was 7.1 years, an all-time high[9].

After minimal activity in the second half of 2022, dividend recaps have soared this year, particularly during Q3 2024. In September alone, more than $19 billion in dividend loans were issued, by far the most for any single month in the U.S[9]. While typically reserved for sponsored companies with strong business models and balance sheets, lenders have been willing at times to widen the aperture for lesser credits as well, especially when the dividend is combined with an accretive use of proceeds, such as through M&A or growth initiatives.

Most lenders (especially banks) have a natural bias against dividend recaps, but many will consider such deals for existing borrowers and/or new clients showing particularly strong financial performance. Should M&A platform acquisitions activity return, lender appetite for dividend recaps will likely decline.

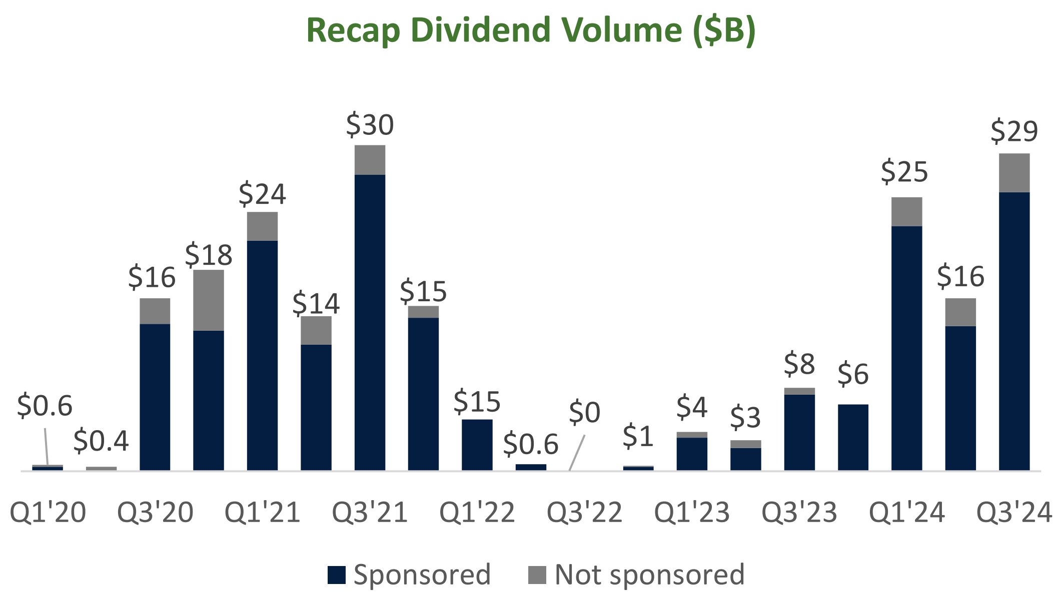


Fig 20 – Source: Pitchbook LCD U.S. Private Credit & Middle Market Weekly Wrap, November 2024.

Loan Defaults Are Running Below Expectations and Improving

Market predictions last year of a coming recession and a resulting uptick in loan defaults during 2024 were not realized as the corporate credit market proved surprisingly resilient. While lower quality borrowers continued to face headwinds due to elevated interest rates hurting their ability to service debt, lenders have been quick to provide support through amendments that allow covenant relief, maturity extensions, and liberal use of payment-in-kind (PIK) interest. PIK interest essentially allows borrowers to pay interest with more debt. Moody's Ratings estimates that PIK has risen to approximately 6.7% of income amongst private credit funds today[12].

Lower interest rates, accommodative lenders, and equity support from private equity sponsors have positively impacted loan default rates this year. The Proskauer private credit default index for senior and unitranche loans in Q3 was 1.95%, a healthy decline from 2.71% in the prior quarter[13].

The improvement suggests that sponsors, borrowers and lenders are proactively finding ways to avoid true defaults by addressing potential credit issues before they become acute.

Of note, the default rate for private credit was lower than levels experienced in the syndicated loan market due largely to the structural differences of private credit: more rigorous underwriting, constant monitoring, greater access to information/management, a small group of lenders, and financial maintenance covenants.

For loans that do default, recovery rates tend to be higher in the private credit market (75%+) versus the bank/BSL market (40%-60%) owing to tighter covenants, better lender protections, and tighter relationships with borrowers/sponsors[14]. Private credit lenders also tend to rely more heavily on out-of-court restructurings in lieu of value-eroding bankruptcy proceedings.

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