PAUL HASTINGS

THOMSON REUTERS

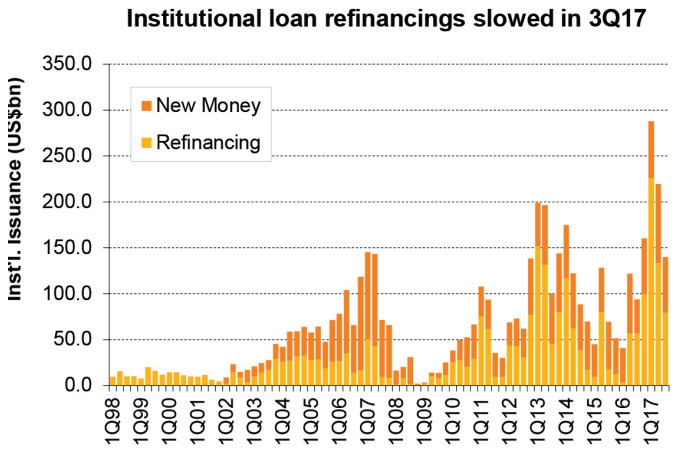
Market Intersection:

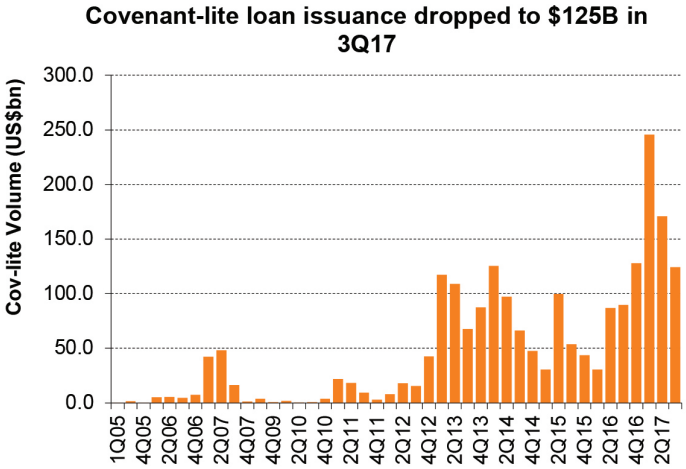
A Quarterly Look at the U.S. Credit Markets

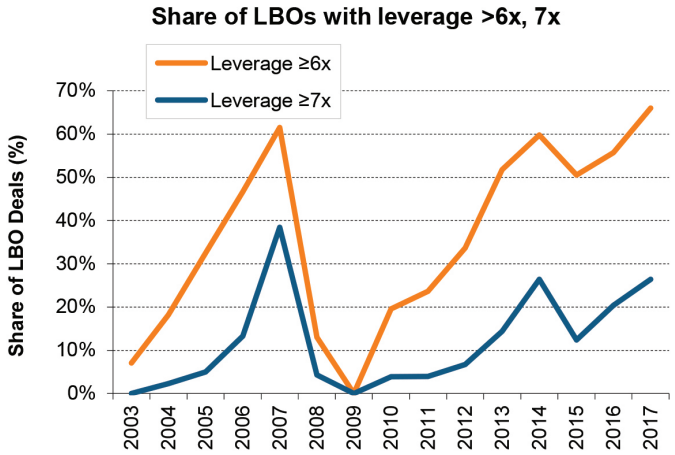
TR LPC Leveraged Market Recap: Changing structures dominate as U.S. lending reaches US$474bn in 3Q17

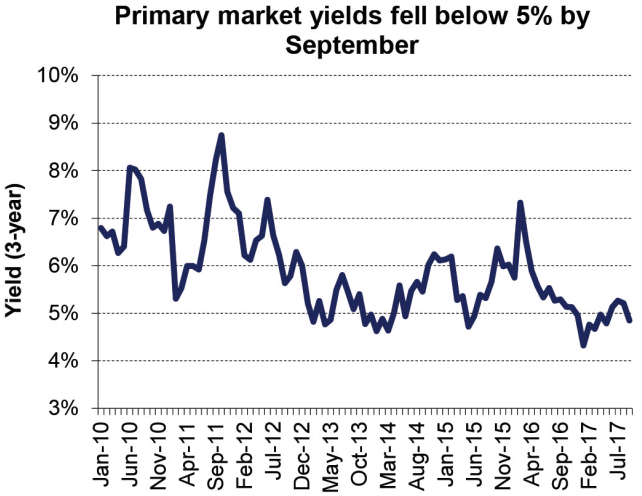
U.S. syndicated lending climbed to US$1.752trn in the first three quarters of this year and is less than US$400bn away from reaching an all-time annual record. This seems likely given that lending in the third quarter alone was US$474bn, following 2Q17's quarterly record of US$677bn. The deal mix shifted in both markets with M&A financings making up a greater share of a smaller pie as refinancings declined. Leveraged M&A loan issuance was US$77.9bn in the third quarter or more than one third of issuance, also up from 25% of the prior quarter's issuance."Earlier in the year people were holding back on what they were going to do from a financing perspective," said one arranger. "Issuers seem to be slowly coming to the conclusion that not much will change and financing rates are so attractive right now. If they wait any longer, I'm not sure what will change in Washington to make it worth the wait."

"The abundance of liquidity available for the leveraged loan product has been sustained and continues to grow: that was the biggest story in the third quarter," said a second underwriter. "Some deals were even three times oversubscribed. Even more so, there are substantial pockets of liquidity at different rating levels and risk metrics, this is very impressive, it is not just strong BBs, it is strong across the board." New CLOs have been issued to the tune of US$80.3bn this year, a figure that has already surpassed 2016's full-year figure of US$73bn. "Sourcing enough paper is a big concern," said a CLO manager. "Risk retention seems to have taken a backseat but it is falling into haves/have nots. You are either sitting with capital or trying to figure out where to get it."









Source: Thomson Reuters LPC

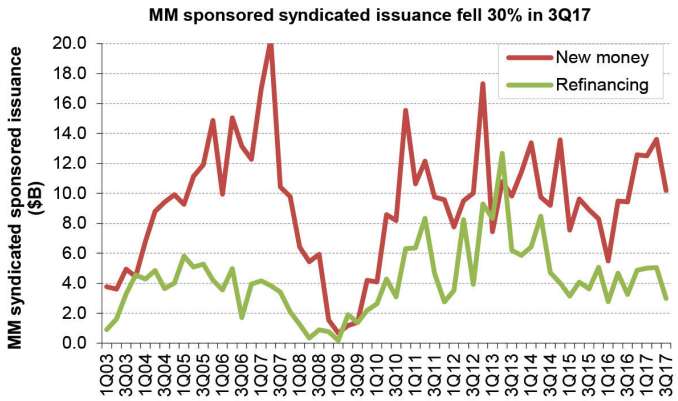
Total leverage on large corporate LBOs has reached 6.49 times total debt to EBITDA with senior debt to EBITDA reaching 4.9 times in the third quarter. Equity contributions fell slightly to an average of 38% in the third quarter from 41% in 2Q17 and 45% at this time last year. "We have been declining a lot of deals because of poor structure," said a second CLO manager. "It is painful when you're trying to grow your business. We would rather pay up in the secondary for a well structured credit. If it is a sleep at night credit you'll do it but if it's a credit you're ambivalent about, these days, we just can't do it. We've put up with a lot of sins, terms keep changing; it is a moving target." Despite the demand/supply imbalance, "we have been severing our ties with companies we have had in the portfolio for years," said a third CLO manager. "In one case a new sponsor came on board and was adding more than a turn of leverage and looking for a lower spread. It has been a bit trying for CLO managers to deal with the constraints we have for portfolio tests and we don't want to put anything in the portfolio that we'll regret putting in. Some deals have been pulled so thankfully we are seeing some pushback." Another added, "There is scope for pushback only on a name by name basis. A structure we found distasteful a few months ago becomes the norm." A third said, "We are on the path to really impact ultimate recoveries if we go into a bad cycle. No one thinks it will be the same cycle as last time but companies that do underperform, the jury is out as to how those loose agreements will get played out."

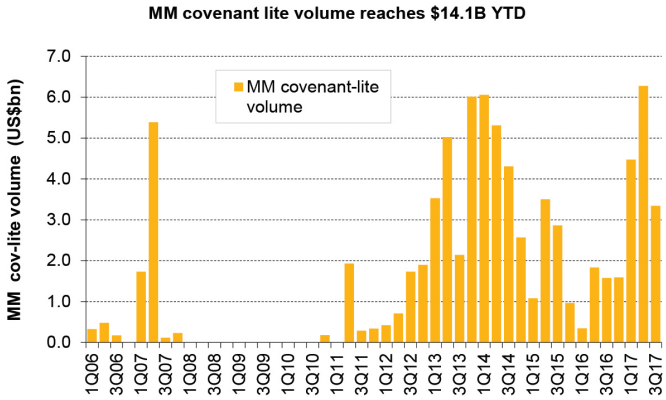
Thomson Reuters LPC: 3Q17 Middle Market Recap

Both syndicated and direct lending middle market volume was down in 3Q17, but direct lending held up better

Syndicated Sponsored Middle Market

Middle market sponsored syndicated activity was bit cooler than expected in 3Q17. After seeing volume climb for three consecutive quarters to a three year quarterly high of US$18.7B in 2Q17, issuance dropped 30% to US$13.2bn in 3Q17. Buyout activity followed a similar pattern with LBO volume down 52% to US$4.0bn in 3Q17 from a post credit crisis quarterly high of $7.2B set in 2Q17. When asked what the biggest themes were in 3Q17, lenders said too many dollars chasing too few deals, structures and terms continued to grind looser and pass rates remained high. Covenant-lite remains a hot button issue as this structure, which should only be reserved for liquid loans, continues to pop up on middle market issuers. In 3Q17, covenant-lite issuance comprised 21% of middle market sponsored syndicated volume compared to only 11% at this time last year. With 1 in every 5 sponsor-backed syndicated loans being covenant lite, those middle market lenders that promise investors they won't buy covenant-lite assets are further pressed to be even more aggressive on deals with covenants making the entire landscape more competitive. "The deals you have to watch out for are the $30-$40M EBITDA businesses where they are getting the terms of the $60-$75M EBITDA businesses", said a direct lender. "That is what we are seeing more and more of in this hot market and that is troubling," he added. "Everyone has a budget or has money they need to put to work, so everyone is trying to pick the best of the tough deals out there," said a regional banker.

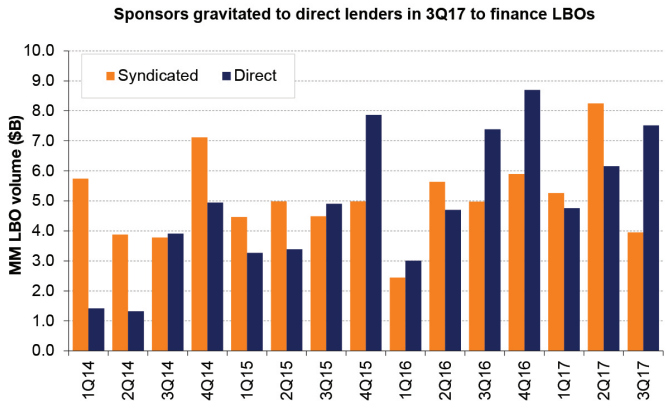


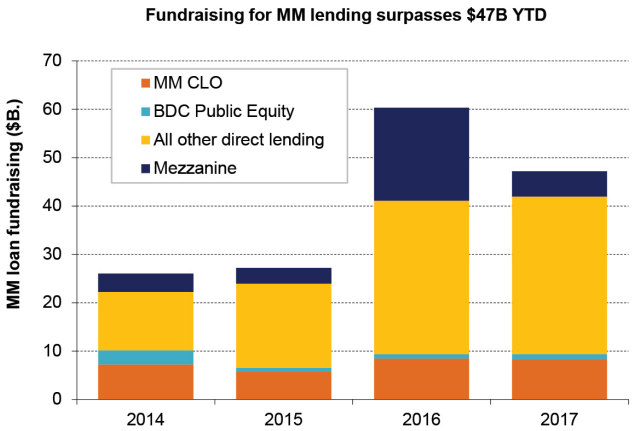


Direct Lending Middle Market

Sponsors favored the direct lending market for LBO financings over the syndicated market in 3Q17

Direct lending volume for sponsored deals tracked by LPC was also down in 3Q17, but only by 11% as opposed to syndicated volume which was down close to 30%. Furthermore, LBO activity for direct lending deals actually climbed in 3Q17 to $7.5B in 3Q17 from $6.2B in 2Q17. Sponsors felt more inclined to eliminate execution risk on M&A transactions in the third quarter rather than try to minimize pricing in the syndicated market but risk upward flex pressure. This is because sponsors paid lofty purchase price multiples on smaller deals in 3Q17 as the average PP mutliple on club/direct lending LBOs hit the highest level since LPC began tracking this market at 10.6 times. Because sponsors paid aggressive transaction multiples both leverage creeped up and equity checks averaged an elevated 55%. For lenders that play in the direct lending market, aggressive competition was also apparent. "You stretch yourself to the max and many times you still cannot win the deal – the competitiveness goes so far down the size spectrum that we even struggle to win the mandates on a $15M EBITDA business," said an alternative lender. Money continued to pour into the direct lending arena last quarter. LPC tracked about US$13.3bn in capital raised in 3Q17, on the heels of US$18.0bn and US$14.3bn raised in 2Q17 and 1Q17 respectively. "Everyone is trying to do the same thing – increase their hold size so they can stay relevant," said a lender. Until some volatility resurfaces, direct lenders continue to do their best to remain disciplined on pricing and terms. Lenders' fingers are crossed that M&A strengthens further in 4Q17 and helps alleviate some pressure.





Source: Thomson Reuters LPC

The Legal Corner

As the balance shifted away from repricings and towards new M&A, the third quarter of 2017 saw falling margins begin to stabilize. A few opportunistic repricings stalled as lenders resisted capitulating to downward pricing pressure from private equity sponsors, particularly at the higher quality end of the ratings spectrum. Meanwhile, the covenant lite structure's share of the loan market surged to a new high and lender protective loan terms continued to deteriorate. For example, the syndicated market has recently allowed an expansion of the "Transformative Acquisition" exception to the ubiquitous first lien term loan soft call protection which would exempt from the premium a prepayment in connection with any acquisition where any debt (even permitted debt) is incurred. At the same time, lenders and arrangers scrambled to digest loan market developments such as the need for a replacement for the LIBOR benchmark and the new LSTA form of fronting letter.

As capital continues to flow towards the middle market asset class, sponsors who wish to minimize execution risk by eliminating flex (instead of simply obtaining the cheapest pricing available) are taking full advantage of the financing options available to them and are asking direct lenders to write larger and larger checks. At the same time as those sponsors ask their middle market debt providers to underwrite syndicated market provisions, they do not often miss an opportunity to chip away at those terms. Hard call, prevalent in middle market deals, is under attack as sponsors request carve-outs to that lender protection that approximate the exceptions to the soft call protection that they have obtained in syndicated deals for several years (e.g., changes of control and IPOs). Still, middle market and direct lenders have gotten some traction in their efforts to tighten call premium language in the wake of the Momentive decision - a drafting point that has not yet filtered through the syndicated market.

About Paul Hastings

A leading global law firm, Paul Hastings provides innovative legal solutions to many of the world's top financial institutions and Fortune 500 companies in markets across the United States, Europe, Asia, and Latin America. Our leading Finance practice supports clients with a deep global bench of legal experts to address various financing challenges with strategic thinking and flawless execution. We work with clients in every key financial center on an exceptional array of both domestic and international finance matters. Our lawyers represent financial institutions and servicers as lenders, and public and private companies as borrowers, in working capital and acquisition financings across a broad range of business sectors and industries. We also have particular experience in guiding clients through complex restructurings and turnarounds and are recognized market authorities on intercreditor arrangements across all lending structures.

www.paulhastings.com

Key Contacts

Michael Baker
Co-Chair of
Leveraged Finance Practice
T: +1.212.318.6855
michaelbaker@paulhastings.com

William Brady
Head of Alternative Lender
and Private Credit Practice
T: +1.212.318.6066
williambrady@paulhastings.com

John Cobb
Co-Chair of
Leveraged Finance Practice
T: +1.212.318.6959
johncobb@paulhastings.com

Christopher Ross
Of Counsel
Corporate Department
T: +1.212.318.6788
christopherross@paulhastings.com

Jennifer Yount
Chair of Finance and
Restructuring Practice
T: +1.212.318.6008
jenniferyount@paulhastings.com

About Thomson Reuters LPC

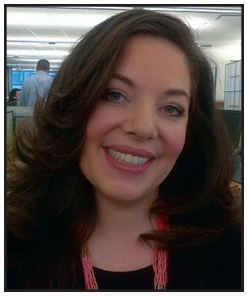
Thomson Reuters LPC is the premier global provider of information on the syndicated loan and high yield bond markets. Our first-to-the-market news, comprehensive real-time and historic data helps industry players stay informed about market trends and facilitate trading and investment decisions.

From offices in New York, London, Hong Kong, Sydney and Tokyo we are the one source for comprehensive coverage of the syndicated loan markets worldwide.

Our publications, online news, analysis, valuation services and interactive databases are used every day by banks, asset managers, law firms, regulators, corporations and others to drive valuation, syndication, trading, and research and portfolio management activities.

www.loanpricing.com

Key Contacts



Ioana Barza
Director of Analysis
T: +1.646.223.6822
ioana.barza@tr.com

Frances Beyers
Senior Market Analyst
T: +1.646.223.7423
frances.beyers@tr.com

David Puchowski
Senior Market Analyst
T: +1.646.223.6843
david.puchowski@tr.com