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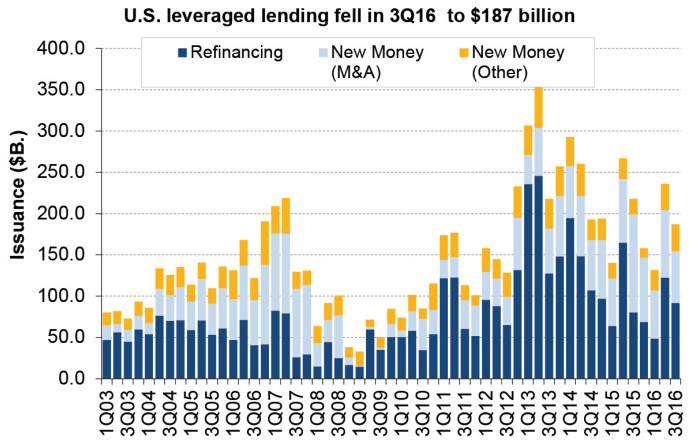
Market Intersection:

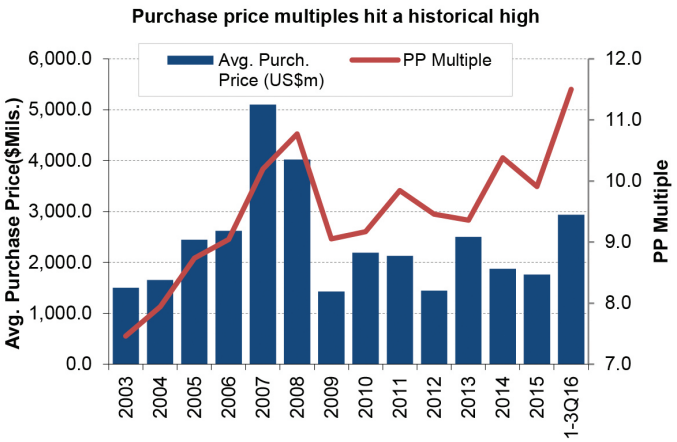
A Quarterly Look at the U.S. Credit Markets

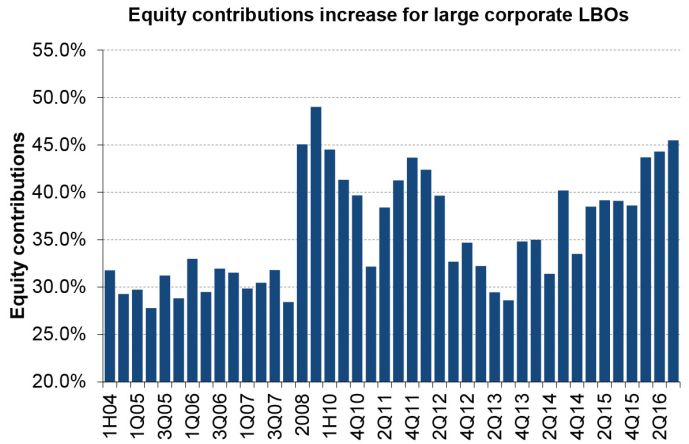
3Q16 Leveraged lending fell 21% to $187B compared to the prior quarter

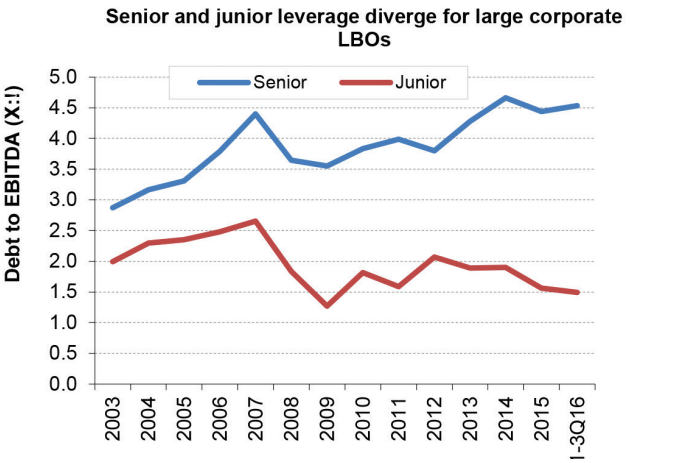
"The new supply is just not there and the secondary is highly bid as a result. It feels like we are running very hard to stand still, rather than meaningfully add to our balance sheet," said one lender at an institution that acts as an investor, buying up loans in the primary and secondary.

M&A financings fell 23% in the third quarter to US$63B, while registering only US$14B in LBO financings, down from US$21B in the second quarter. As sponsors compete fiercely for attractive targets, large corporate purchase price multiples year-to-date have reached an all-time high of 11.5 times. This is roughly a turn higher compared to the pre-crisis peak and up significantly from 2015's average of 9.9 times. In addition, one third of deals had an equity contribution of 50% or higher this year, up from 10% of deals last year and 5% or no deals in the three years prior. Roughly half of LBO financings were levered 6.0 times or higher, which is on par with last year, keeping average total leverage of large corporate buyouts steady at an average of 6.02 times this year to date, compared to 5.99 times last year.









Source: Thomson Reuters LPC

"Leverage may be okay, equity capitalization could be okay, pricing could be okay," said a second lender. "But where sponsors are driving non-money terms takes us into the realm of silliness, and it is the velocity of change too. It is not a slow-moving thing. They did a deal a month ago and come back today and the ask is that much greater, although the market hasn't moved that much in a month." "Banks can't compete as much on leverage anymore because you can only go so far before you are offsides, so this creates more competition on terms because it becomes the only differentiating factor," said a third lender.

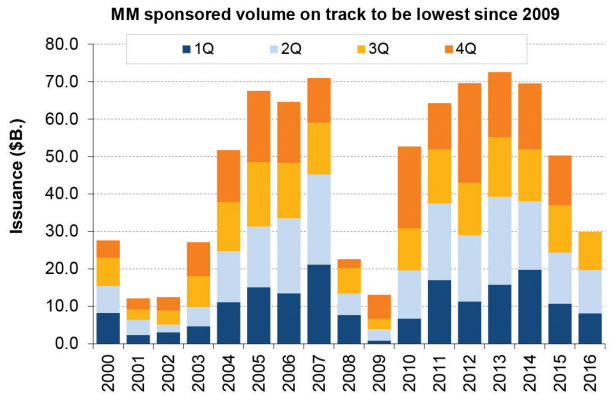
With strong demand facing off limited supply and competition on terms, sources say there could be further erosion in structures. "Because everyone is eager to make budget and we have had weak months and quarters, the level of aggressiveness has picked up," said one arranger. "People tend to look at what they have recently experienced rather than what has prevailed over a longer period of time. When you are in a strong market, there is a tendency to get ahead of yourself and commit to some bad product, and I worry that the market will do that."

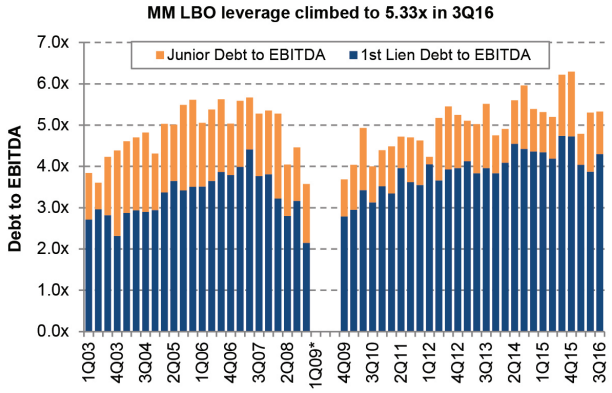
Supply demand imbalance persisted in 3Q16 in the middle market, quality was sub-par while terms deteriorated

"Everyone is underwriting off of peak EBITDA; they are aggressive on leverage and soft on covenants," said a middle market lender.

Syndicated Sponsored Middle Market

Syndicated loan volume for sponsored-backed deals was quite disappointing in the third quarter of 2016. Volume only reached $10.3B, down 12% from 2Q16 and down 19% from 3Q15. Banks and investors were hungry to put money to work but dealflow failed to materialize, resulting in highly competitive market conditions. Lenders saw covenant erosion, leverage loosening and silly behaviour return last quarter. Covenant lite volume on middle market credits rose 37% to $1.4B in 3Q16 while LBO leverage climbed for the third straight quarter to 5.33 times, up from 5.30 times and 4.79 times in 2Q16 and 1Q16, respectively. Lenders are hopeful for a pick up in activity in the fourth quarter, but they are expecting a meaningful share of that pick up to be driven by "opportunistic" transactions, such as dividend recaps or refinancings. While the fourth quarter is typically a heavy M&A quarter in the middle market, sponsors continue to struggle to buy assets, given inflated purchase price mulitples and extreme competition from strategics.

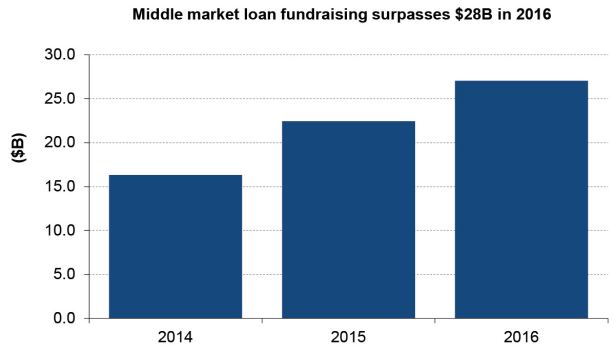


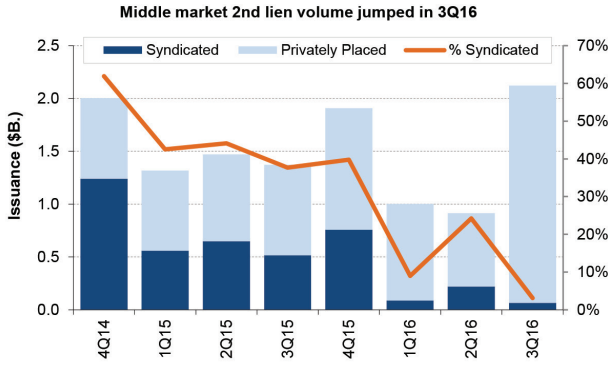


Direct Lending Middle Market

"There is no price a bank can offer a sponsor that is cheap enough to warrant them putting in more equity," said a regional banker

The direct lending market continues to flourish as money pours in from yield-hungry investors. Thomson Reuters LPC tracked over $28B in middle market loan fundraising year to date, already surpassing the $22B and $16B raised in 2015 and 2014, respectively. Thomson Reuters LPC tracked $25B in middle market private/unrated loan issuance in 3Q16, up 26% from 2Q16. Banks' share of unrated/private deals dropped to just 30% in 3Q16 from closer to 40% in 2Q16. Second liens made a major comeback this quarter as volume jumped to $2.1B in 3Q16, up from $916M and $1.0B in 2Q16 and 1Q16, respectively. But 97% of second lien facilities were privately placed rather than syndicated, as sponsors prefer to minimize execution risk on smaller deals. Middle market M&A volume was much more robust in the direct lending market compared to the syndicated market as LPC tracked 93 unrated/private LBO deals, which is roughly $11.2B in loan volume. Both purchase price multiples and equity checks on smaller deals continue to be at record levels both up and down the EBITDA size spectrum. Spread tightening was apparent in this market across the entire capital stack, with second liens showing the biggest drop in pricing.





Source: Thomson Reuters LPC

The Legal Corner

Q3: More of the same, but with a few stark changes

A lighter flow of M&A activity in the syndicated large cap market during the third quarter allowed Borrowers to take advantage of a market hungry for leveraged loans, even after accounting for a surge of opportunistic re-pricings. Where financial sponsors were able to identify worthwhile LBO targets they continued to push aggressive terms with the banks, and arrangers generally conceded to these asks simply to maintain a toehold during this slow period while relying on flex rights to rein in the most aggressive requests. Some private equity firms focused on international targets as a way to keep their capital productive, and these cross-border acquisitions continue to drive convergence between domestic capital markets and European-style lender protections.

The large cap market continued to provide opportunities for alternative lenders to invest capital in transactions viewed as "hybrid" in the sense that they were financed with syndicated, liquid first lien paper held by banks, and private, illiquid second-lien paper held by one alternative lender or a small club of alternative lenders. Piggybacking off the progress made in the “hybrid” transactions that closed in the second quarter, and based on the nature of the second-lien investments as a “buy and hold” or “private” second-lien as opposed to a “syndicated” or “liquid” piece of paper, many alternative lenders gained further traction in the third quarter in their efforts to "pull up" a number of second-lien intercreditor protections that have historically been limited to private middle market transactions.

As compared to the syndicated leveraged lending market, middle market M&A activity for direct lenders was more robust. Borrowers pushed aggressive terms, but with mixed results. Alternative Lenders responded in one of two ways: (1) They conceded to highly selective Sponsor’s “asks”, but held firm on more aggressive requests. Or, (2) they opted out and made loans to non-sponsor owned businesses, to borrowers in alternative industries, and/or made loans for alternative non-acquisition purposes, such as working capital, capital expenditure investments, or investor payments.

If you have any questions about the Q3 trends above, or any other market related questions feel free to contact any of the Paul Hastings attorneys listed below.

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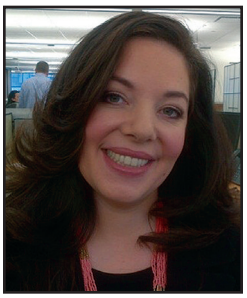

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