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# Market Intersection:

## A Quarterly Look at the U.S. Credit Markets

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## LPC Leveraged Market Recap: 3Q18 Leveraged lending showed a pick up in new supply

Demand from separate managed accounts coupled with nearly US$100bn in new-issue CLOs and positive and steady retail loan fund inflows continued to outpace slowing supply of new loans in the third quarter. “The market was softer at the end of July,” said one portfolio manager. “We knew of big deals coming that the market was concerned about being able to process and absorb that much paper. But, after Labor Day, they were not only absorbed, they cleared at tighter levels.” Leveraged loan refinancings shrank to US$73.75bn in the third quarter, from US$286.36bn in the second quarter and US$159.14bn in 3Q17. Meanwhile, new money dropped to US$102.82bn in the third quarter, from US$125.19bn in the second quarter and US$132.94bn in 3Q17. “There was a fair amount of hand wringing around those large deals this summer because the market was in a different place,” said another lender. “The biggest surprise was how everything got absorbed, got soaked up very readily. Now there is not a lot of pipeline to backfill. Given the continued, unabated technicals that have been good all year, we have already started to see more repricings again, it was inevitably going to happen.” Besides tracking supply/demand characteristics in the market, lenders are focused on the regulatory front with respect to the eventual Libor replacement and expecting that leverage will probably continue to move up.

“Given recent guidance it feels like there is less scrutiny on a deal by deal basis but it remains portfolio driven. The market will keep taking leverage up higher than it has been but we believe there is still some natural discipline in the market,” said one lender.

**Fig. 1: Institutional loan refinancings were negligible in 3Q18**

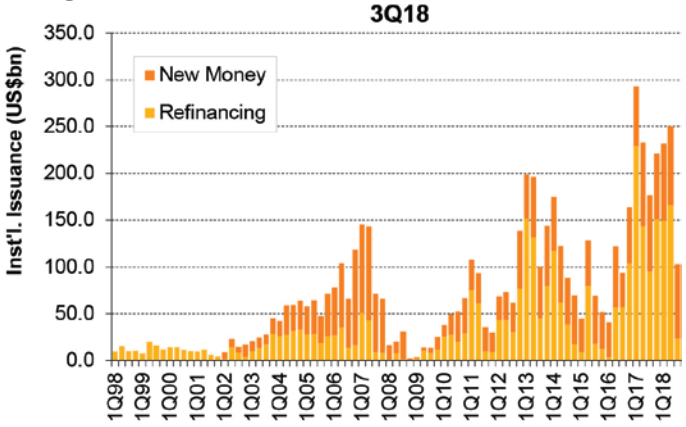
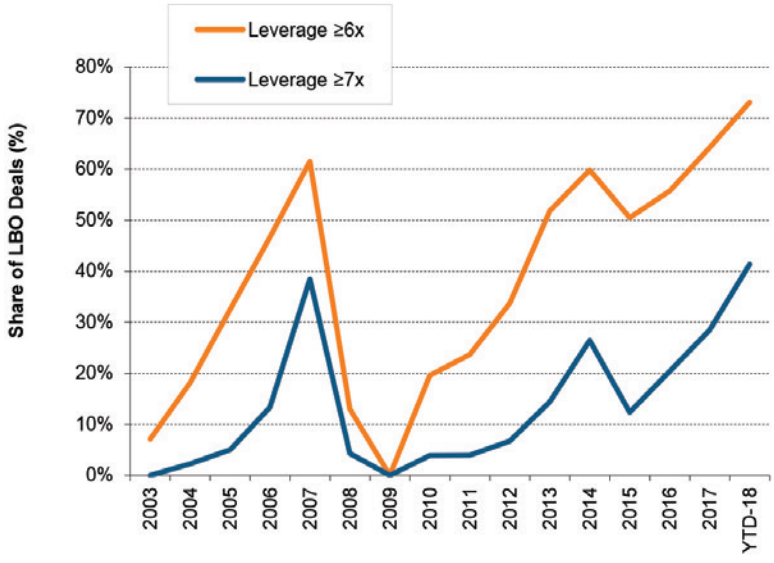



**Fig. 2: Share of LBOs with leverage >6x, 7x**




Source: LPC

## LPC Middle Market 3Q18 Recap: 2H18 activity shaping up to be below lenders' expectations

Middle market sponsored deals distributed in the syndicated market in 3Q18 were in short supply. After rising for seven consecutive quarters, momentum halted and volumes plummeted to only US$13.7bn amid a modest backup in pricing in the syndicated market (Fig. 3). Yields on first-lien middle market loans syndicated in the institutional market increased to 7.32% in 3Q18, up from 6.64% in 2Q18 which motivated sponsors to finance more middle market deals in the direct lending market. And since LPC estimates there are now at least 30 direct lending platforms with a US$100m-plus hold level, direct lenders are hoarding and self syndicating much of the LBO deal activity taking place in the middle market. Direct lending middle market volume, although also down modestly quarter-over-quarter, was much higher at US$26.2B. Pricing in the direct lending market actually tightened in 3Q18 across the capital stack despite a modest rise in Libor. Middle market second lien yields fell to 11.1% from 11.2%, mezzanine yields tightened to 12.27% from 12.33% and unitranche yields showed a drop-off for the second straight quarter to 8.78% from 8.85%. "We are losing deals like crazy to the unitranche," said a regional banker. LPC has tracked roughly US$8.8bn in unitranches closed in 3Q18, a new record high (Fig. 4).

Lenders continue to characterize the middle market as hyper competitive with sponsors paying record high multiples for businesses at 10.7 times in 3Q18 and putting in a record high equity contribution of 56%. And it seems there are never enough new money deals to go around to make lenders happy. "We are seeing repricings and dividend recaps come back when we should be seeing a pick-up in M&A," said a middle market lender. "This will likely be an uneventful 4Q."

**Fig. 3: Both syndicated and direct middle market loan volume was down in 3Q18**

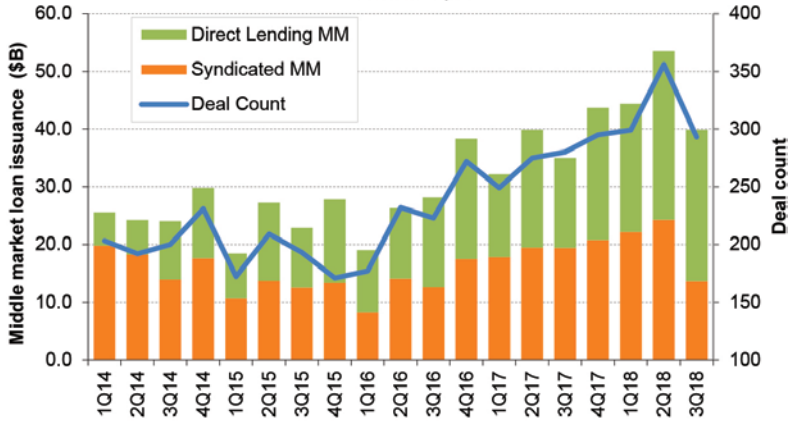
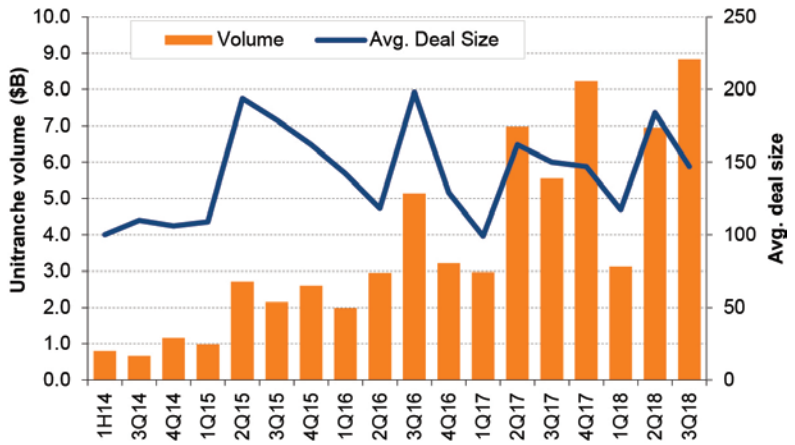



**Fig. 4: Unitranche volume hit new peak in 3Q18 at $8.8B**




Source: LPC

## The Legal Corner

At the time of this writing, many debt investors are considering whether recent high profile bankruptcies mark a durable shift in the fundamental factors underlying the frothy market for leveraged loans. However, these notable filings actually came just after the end of the third quarter. Thus, the summer closed out with lenders enjoying (albeit keeping a close eye on) low default rates even as supply for new loans also slowed to a trickle. At a recent industry conference, wary direct lenders spoke of focusing on protecting their downside in anticipation of the inevitable end to the current credit cycle, even while competing mightily for the dwindling supply of new loans. Many of these market participants were unnerved to see private equity sponsored borrowers in the syndicated loan market (e.g., Neiman Marcus) take advantage of the flexibility permitted under their debt documents to remove valuable assets from the credit group, in particular because many of these spinoff transactions took the form of unrestricted subsidiary designations and in-kind dividends rather than traditional asset sales, which would normally be subject to the covenant on affiliated transactions (among other protections). In response, middle market and direct lenders have expended considerable energy shoring up new paper to restrict this type of flexibility and, where middle market lenders have signaled that these protective measures were a priority they have largely prevailed in obtaining some safeguards. In contrast, the large cap syndicated market (where this flexibility is ubiquitous and largely unchallenged) has largely crossed its fingers and looked the other way. Indeed, with a significant share of syndicated loans being used in the third quarter for dividend recapitalizations, lenders in this market are more focused on finding opportunities to deploy capital rather than plugging holes in documentation. That being said, syndicated lenders did succeed in pushing back on some of the perennially negotiated incremental-related provisions, with MFN sunsets and carve-outs from MFN protections (such as dollar caps, later-maturing incremental tranches and M&A financings) being slightly less prevalent in the third quarter as compared to the second.

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**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

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**www.loanpricing.com**

## Key Contacts

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

**Frances Beyers**
Director of Market Analysis
T: +1.646.223.7423
frances.beyers@tr.com

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

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