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Market Intersection:

A Quarterly Look at the U.S. Credit Markets

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LPC Leveraged Market Recap: U.S. leveraged lending dropped 12% in 2018 to US$1.2trn, but pace slowed amidst volatility

Ongoing trade tensions and concerns of slowing economic and corporate earnings growth led to prolonged volatility in equities in the fourth quarter, a stalled high yield bond market, and also slowed issuance in the leveraged loan market. “We had this disconnect and the deals that suffer the most from it are the ones underwritten at the market peak but offered during a downdraft,” said one leveraged lender. “As volatility worsened and the year wound down, some of those deals got postponed.” A 21% drop in primary institutional loan issuance to US$726bn was offset by a 6% increase in leveraged pro rata lending, pushing it to a new record at US$514bn (Fig. 1). Underwriters said that when looking to 2019, volumes will be impacted. “We are looking at reduced leverage levels and higher pricing as the street works to lay out its pipeline,” said one leveraged underwriter. “Will this be another mini-cycle? My own personal view is that this downturn will last longer. What surprised me most was how rapid the decline was in the secondary,” said a second underwriter. According to LPC Collateral, only a handful of US Collateralized Loan Obligations (CLOs) had a weighted average bid of 99 or higher on their assets by early December, falling from a high of 55% of CLOs in September.

Conversely, “Anything truly bank held has not become available; there are lots of names I would like to find paper in but banks are not prepared to take a two-point hit,” said one pro rata lender. “At this stage credit is performing, there is no pressure to sell and that is what we want to buy, those better quality B loans that have just gotten a little cheaper.” In addition, one investor noted, “We do not view all of this as a preview to increasing default rates."

Fig. 1 Institutional loan refinancings were negligible in 4Q18

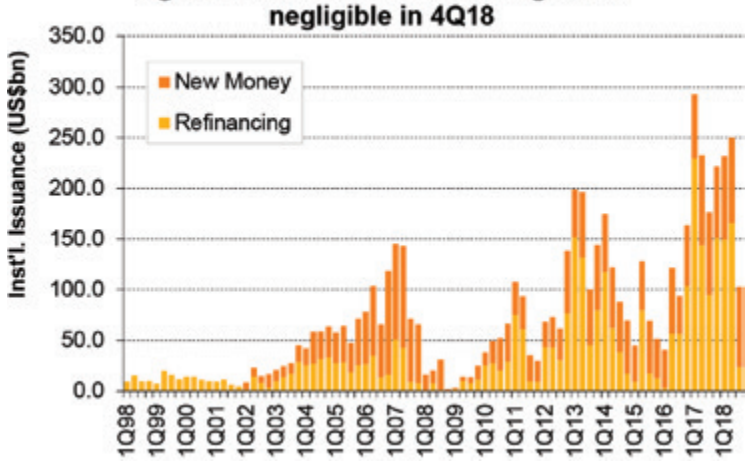
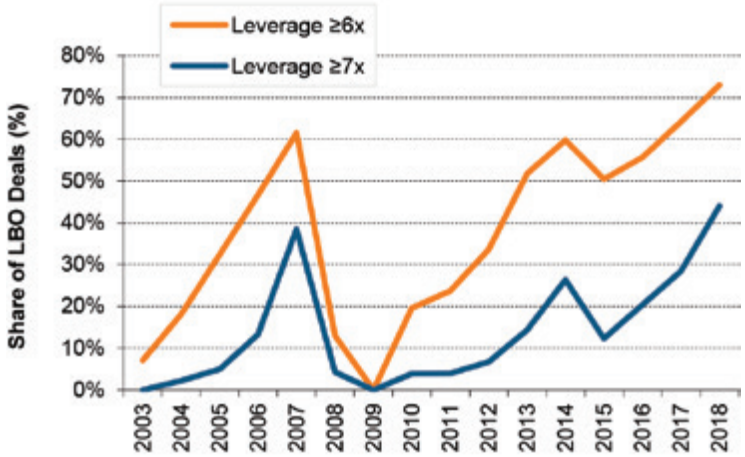


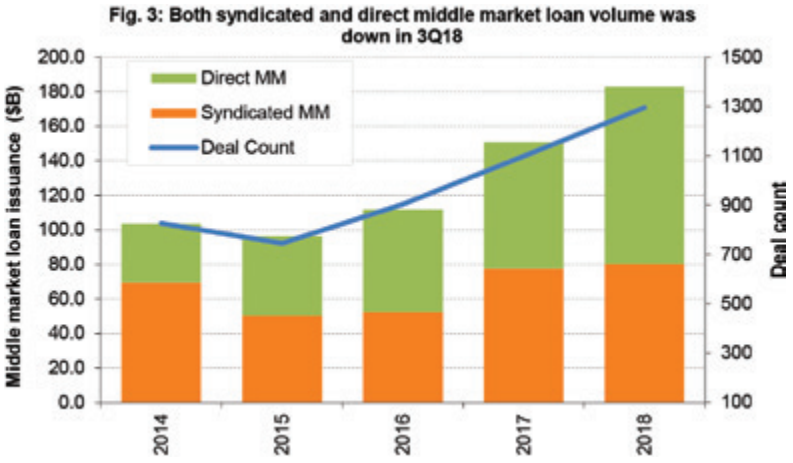
Fig. 2 Share of LBOs with leverage >6x, 7x

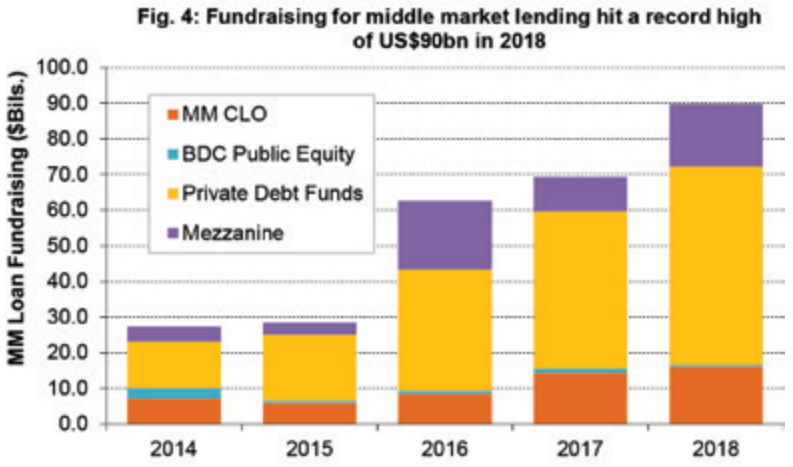


Source: LPC

LPC Middle Market 2018 Recap: 2018 was a record year for middle market sponsored lending

Despite broad market volatility in 4Q18 in the equities, leveraged loans and the HY bond markets, middle market sponsored lending remained competitive and insulated from investor pushback. Record inflows came into the middle market private debt world and lenders put it to work just as fast - making 2018 the highest year on record for both syndicated and direct middle market sponsored debt issuance. Syndicated middle market sponsored loan issuance reached US$80.3bn in 2018, 3.4% higher than the previous record set in 2017 and 13.3% higher than 2007's pre-credit crisis peak. Meanwhile, the direct lending market also saw record loan volumes to the tune of $102.5bn, which means the direct lending market financed 56% of total middle market sponsored backed loans tracked by LPC in 2018 (Fig. 3). These strong volume figures were driven by record fundraising for middle market private debt at $90bn in 2018, up 29% from 2017 levels (Fig. 4). Market conditions remained competitive all year long and as a result, LPC tracked record leverage levels in 2018 on both institutional middle market loans (5.2x 1st lien by 5.8x total debt to EBITDA in 2018) as well as direct lending loans (4.5x 1st ien by 5.0x total at 4Q18). Yields on institutional middle market first lien loans did rise to 7.72% in 4Q18, up from 7.32% in 3Q18. This was the highest average level tracked in almost seven years. However, rising Libor and slightly wider OIDs were really the biggest drivers to rising yields, spreads were only modestly higher in 4Q18. In 2019, lenders' outlook is slightly more pessemistic than it was heading into 2018. With many uncertainties on the horizon, lenders generally feel loan volumes will be down, fundraising will be tougher and credit quality will be more of a focus and concern this year. "While it is always hard to predict where we are in the cycle, we all know we are much closer to the end than we are to the beginning," said a lender.





Source: LPC

The Legal Corner

The fourth quarter of 2018 continued to see the increasing popularity of unitranche lending in the middle market, and many experts expect this trend to continue in 2019 and to continue to move more and more upmarket. For those unfamiliar, unitranche facilities are an alternative to first lien and second lien loan structures. In a unitranche deal, senior and subordinated debt tranches are made under a single set of loan documents, administered by a single agent, with a blended cost. The lenders then enter into an "agreement among lenders" to negotiate their rights in an event of default or bankruptcy. In the past, unitranche facilities were reserved for stable cash-flow businesses, but at the request of more and more private equity sponsors, unitranche facilities are now being offered to a broader market of businesses. For instance, Bain Capital Specialty Finance has recently devoted over 19% of its portfolio to a joint venture with Antares Capital, focused on unitanche lending. This joint venture had over $1.5 billion in unitranche commitments in 2018. Other business development companies are also using joint ventures as part of their unitranche lending structure - include a joint venture between Ares Capital and Varagon, and another with Solar Capital and PIMCO. Part of the popularity for unitranche facilities is that currently borrowers are often obtaining better pricing under a unitranche deal under the blended pricing structure, than under a first lien-second lien financing package. It is also often more economical for borrowers to pay back a unitranche facility – instead of paying off a cheaper first lien loan while the more expensive second lien loan accrues interest, there is only one loan to pay off and so the borrower is able to keep its payments targeted.

There are questions, however, about how an "agreement among lenders" will play out in a down cycle. As the market is growing increasing wary about a downturn in the current credit cycle some time during 2019, there are questions about how a bankruptcy court will treat lender rights in a unitranche facility as there is not a significant body of case law to rely upon. Which lenders will be entitled to a debtor-in-possession financing, or to post-petition interest? While this is well-tested in a traditional first lien-second lien scenario, it remains to be seen how bankruptcy courts will treat unitranche facilities.

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