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Market Intersection:

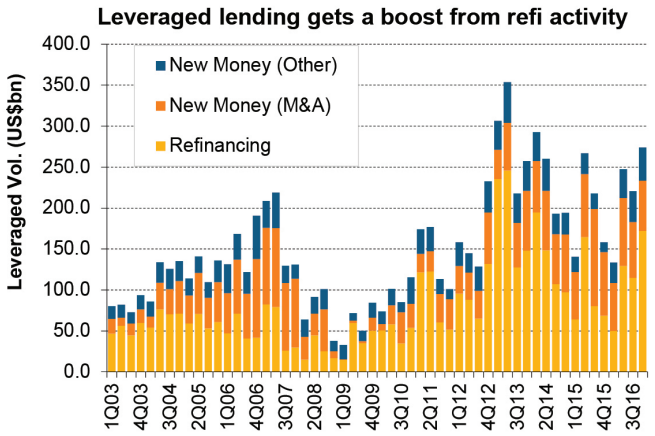
A Quarterly Look at the U.S. Credit Markets

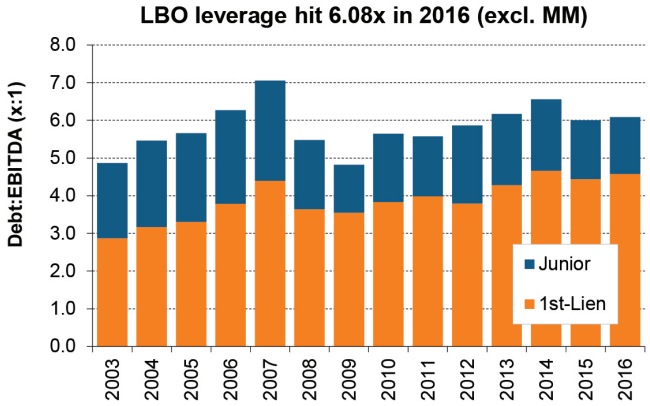
Leveraged lending jumped 12% to US$875B in 2016

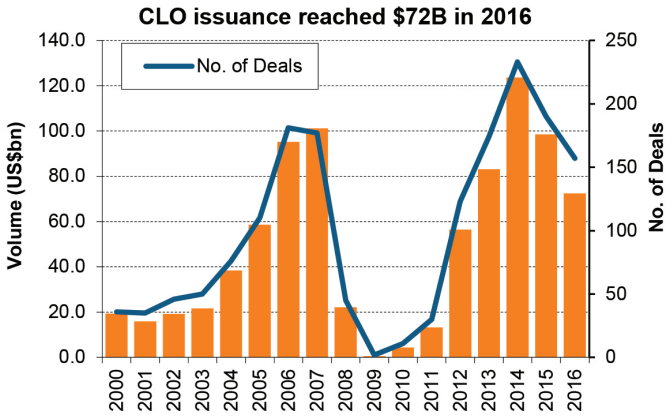
Characterized by shorter, steeper cycles, the U.S. leveraged loan market ended the year on a high note for secondary bid levels as investor demand for loans continued to outpace supply.

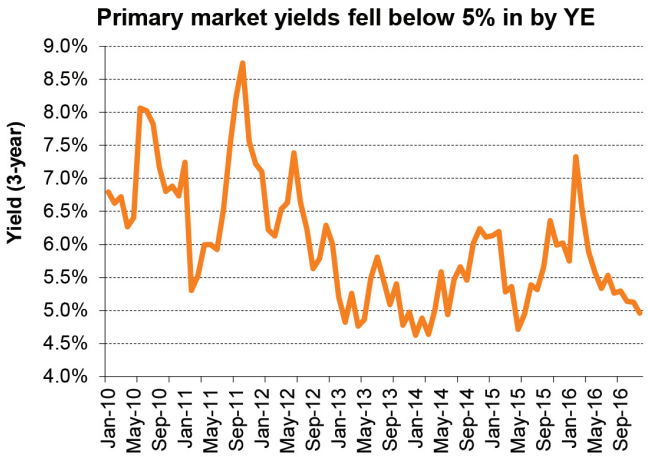
"The market is already way more volatile than it has ever been," said an arranger. "The market swings from 'nothing can get done' to 'let's reprice everything' multiple times a year, not every three years." Leveraged lending jumped 12% to US$875B in 2016, driven by an 86% increase in refinancing activity in the institutional loan market to the tune of US$216B. While institutional refinancing soared, leveraged pro rata refi activity was down 4% to US$250B in 2016.

"Loan prices started to go up and have not stopped since the election and regulations are expected to become less onerous. Loans are at 101, it's the new par, but we are functioning on hope and anticipation because we know very little about (the incoming administration's) policies," said a third arranger. "These real time volatile reactions mean that it is no longer the case that in a good market your LBO will price at LIB+400 and in a bad market at LIB+375. Instead your LBO may price at LIB+500 in a tough market while a couple weeks later it is LIB+350, which is a huge swing based on nothing more than technicals and market sentiment."









Source: Thomson Reuters LPC

Rising rates coupled with a risk-on sentiment resulted in US$5.8B of inflows into retail loan funds following 2015's US$22B in outflows. Meanwhile, US$72B of new CLOs were issued in 2016 and separately managed account money from pension funds, sovereign wealth funds, endowments, and family offices continue to grow. With so much competition for limited assets, "we have run very hard to not even stand still and cannot even (find assets to) buy in secondary," said one investor.

The wave of opportunistic refinancings could slow if M&A financings took center stage. Leveraged M&A financings were down 18% to US$270B in 2016. Many arrangers believe that financing markets will support material M&A but valuations have to come down or equity sponsors need to develop greater confidence on prospects for growth. "One of those things has to happen to close the gap. I don't think financial markets have held M&A back in any way. Markets have been as good as they have ever been but valuations are high and optimism is low from the PE guys. They are running models based on outlook and not getting to the right place to justify paying up," added one arranger.

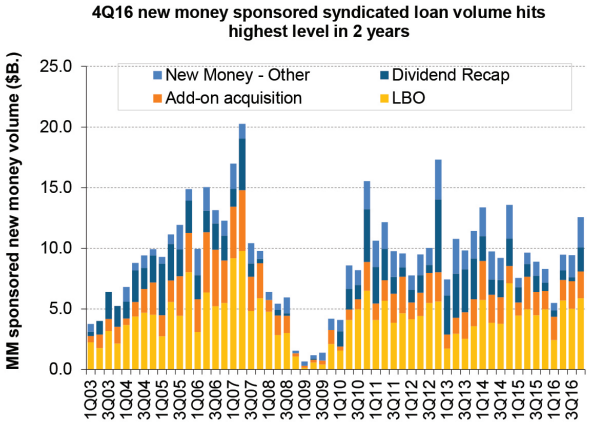
Thomson Reuters LPC: 4Q16 Middle Market Recap

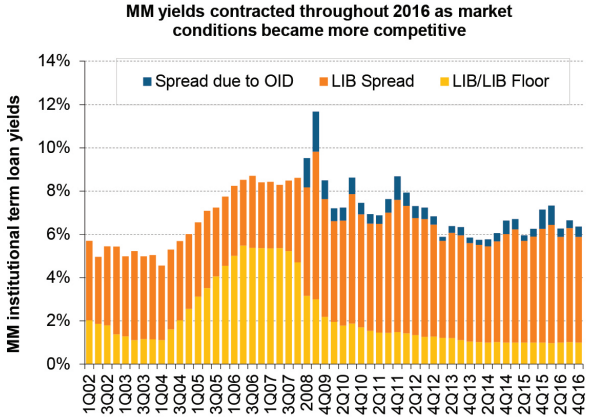
New money activity finally picked up in 4Q16 offering hope for improved dealflow in 2017

"There is optimism in our client base, they are thinking about growing." - middle market banker

Syndicated Sponsored Middle Market

Syndicated loan volume for middle market sponsored-backed deals finally experienced the pickup lenders have been waiting for all year. 4Q16 new money volume reached $12.6B, the highest level tracked in two years. This helped push syndicated LBO volume for full year 2016 to US$19.3B, surpassing 2015's US$18.9B. Many are hopeful we will see LBO volume grow further in 2017. However, lofty valuations and extreme competition from strategics continues to be a roadblock for sponsors. The syndicated middle market has gained back a bit of momentum it lost earlier in the year as middle market institutional loan volume skyrocketed in 4Q16 to US$10B, up 50% from both 3Q16 and 2Q16 levels. Declining yields, rising leverage levels, and loose documentation lured upper middle market companies back to the syndicated market late in the year. Looking to 2017, market conditions are expected to remain highly competitive as cash continues to pour in from both new CLO formation, retail loan mutual fund inflows, and back-door money such as managed accounts.

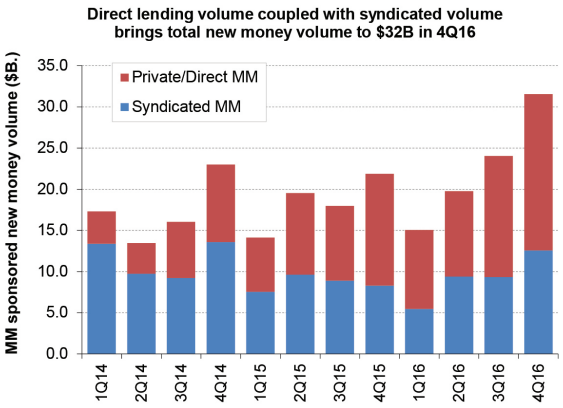


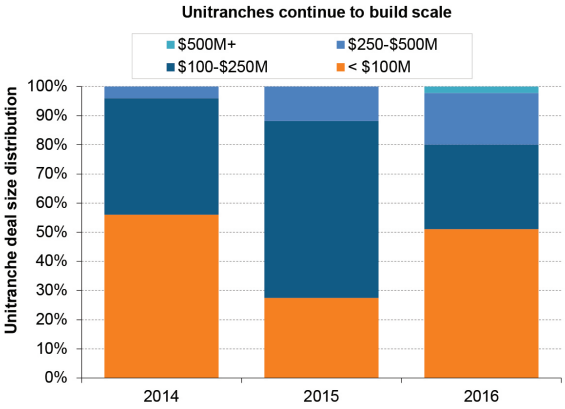


Direct Lending Middle Market

Alternative lenders raise unprecedented sums of money in 2016 with more to come in 2017

The direct lending market remains in vogue as middle market managers raised an impressive US$51B in capital in 2016. Lenders estimate the strong capital formation will continue in 2017 and another US$30-$40B in fundraising is possible. Similar to the syndicated market, direct lending volumes jumped in 4Q16 bringing total new money issuance (syndicated + direct lending) to US$32B in 4Q16 and US$90B for the full 2016 year. After a dismal first half of the year, second lien made a huge comeback in 2H16 and jumped by 88% bringing total volume to US$5.3B for the year. Second lien facilities showed the most pricing tightening, but senior lenders also felt the pressure to drop spreads on the margin to remain competitive and win deals. The unitranche continued to build momentum in 2016 as money poured into the market, direct lenders were able to grow their ability to offer larger unitranches. However, 50% of unitranches in 2016 continued to be on deals sized less than US$100M since there are many players that offer this product that do not have big enough holds yet to scale the product. Although morale and optimism is improved in 2017, many lenders are still trying to navigate the uncertain new policies coming down the pipe which may affect the healthcare sector, issuers that manufacture goods abroad, and how a change in the tax code impacts portfolio performance.





Source: Thomson Reuters LPC

The Legal Corner

Q4: A very active quarter, with an eye towards a busy 2017

The relatively abundant supply of refinancing debt issued during the fourth quarter of 2016 could be interpreted as issuers' attempts to safeguard against the potential downside of election-related volatility. Perhaps for similar reasons, dividend recapitalization transactions claimed a larger share of the market towards year-end than they had during the first three quarters of the year. However, these trends could also simply be the result of a desire to lock in attractive funding before the Federal Reserve raises interest rates further. The domestic and international political situation, while unpredictable, had little direct or apparent effect on syndicated leveraged debt terms. Financial sponsors found little difficulty obtaining commitments on aggressive terms to support their year-end acquisition objectives, though these deals generally originated from negotiated M&A transactions rather than competitive auctions. With the election now decided, some market participants anticipate that domestic political recalibrations will lead to deregulation of the financial sector and a rollback of leveraged lending guidelines that will allow syndicated debt arrangers to compete across a wider spectrum of the market and cap table.

Alternative lenders remained active in Q4 on the heels of a record-breaking year of fundraising. Unitranche and second lien facilities continue to be the most popular investments, both in the large cap space and the middle market. In the large cap space, "hybrid" second lien facilities consisting of a liquid syndicated first lien bank loan and a privately placed second lien loan continue to gain traction. In the middle market, sponsors continue their efforts to pull large cap terms "down market", such as grower baskets, ratio debt, less stringent limitations on restricted payments and investments, and others. These efforts have had mixed results depending on the competitive dynamic and credit strength of each particular deal. Market participants are closely following potential regulatory and tax changes that may be instituted by the new administration. Looking ahead, many alternative lenders are bullish on strong M&A activity in 2017 as they prepare to deploy the large sums of funds raised in 2016.

If you have any questions about the Q4 trends above, or any other market-related questions please feel free to contact any of the Paul Hastings attorneys on the following page.

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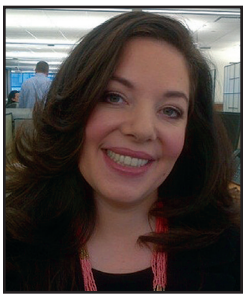

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