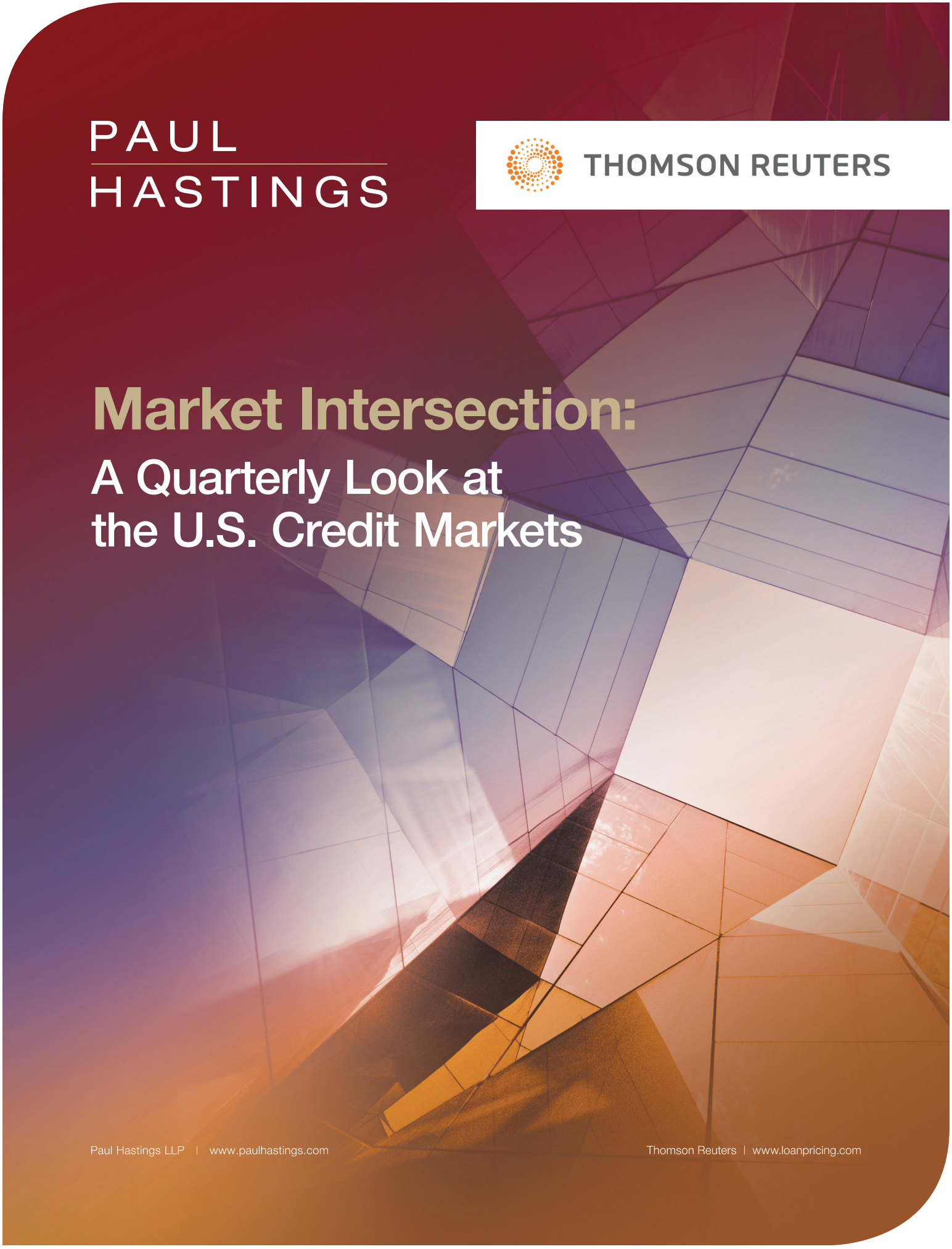
PAUL HASTINGS

THOMSON REUTERS

Market Intersection:

A Quarterly Look at the U.S. Credit Markets



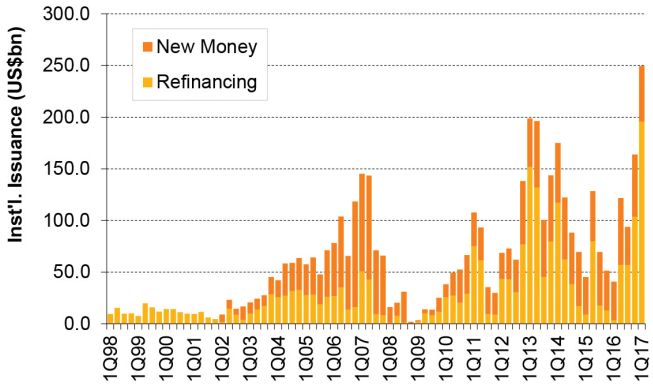
TR LPC Leveraged Market Recap: Opportunistic refinancings drove U.S. lending to US$535B in 1Q17

Record refinancing activity in the institutional market drove U.S. syndicated lending up 50% year over year. At US$535B, lending in the first quarter was down 8% from the prior quarter but refinancing activity was up 7% to US$409B. “The typical things that you want for the asset class are all there: low default rates, high historical returns over the last 12-24 months, and increasing interest rates,” said one arranger. “Those three things do not happen at the same time that often and could mean a huge boom in issuance. But, the product is just not there.”

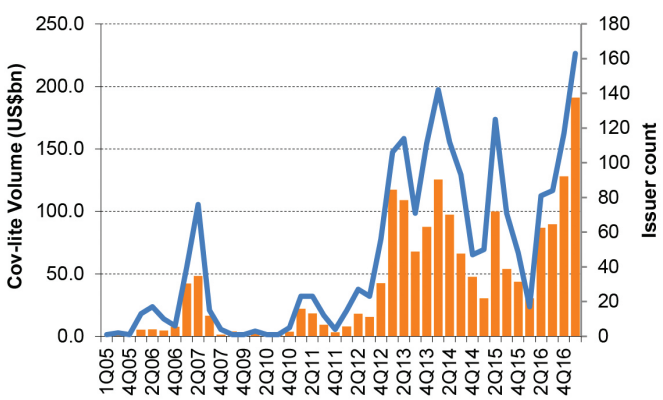
In the absence of sufficient new money supply, refinancings took center stage and were met with strong investor demand. In a rising rate environment, inflows into loan retail funds have been positive for over 22 weeks while roughly US$25B in new CLOs have been issued so far this year. Pension funds, sovereign wealth funds, insurance companies, endowments, and family offices have been allocating to the asset class through various avenues including Separately Managed Accounts. Some are first time investors while others are growing their current exposure to the floating rate, cash coupon, steady return asset.

As a result, issuers pursued opportunistic refinancings to the tune of US$261B in the leveraged market, surpassing 2Q13’s prior record of US$246B. Pro rata refinancings reached US$66B.

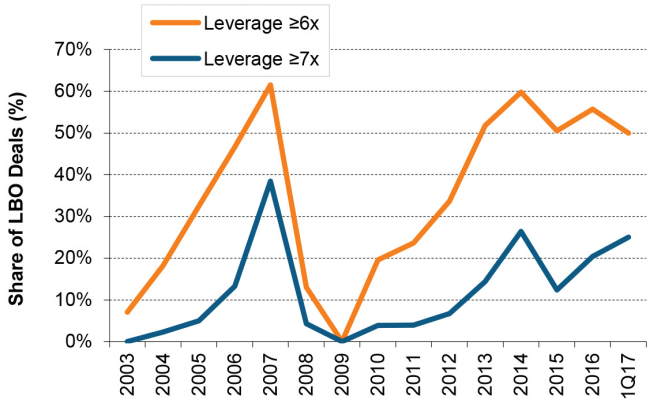
Institutional loan refinancings reached all time record in 1Q17



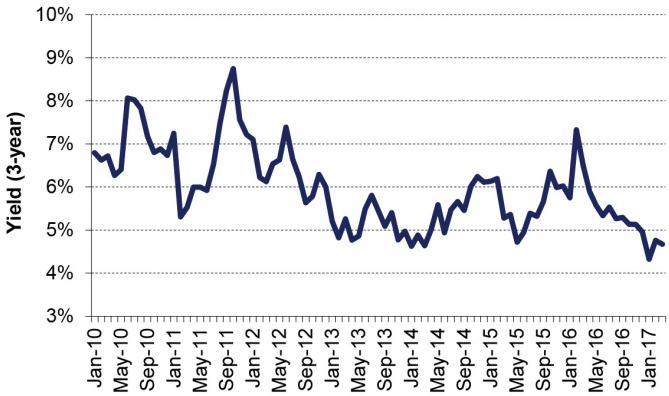
Covenant-lite loan issuance reached record in 1Q17



Share of LBOs with leverage >6x, 7x



Primary market yields fell to 2004 lows



Source: Thomson Reuters LPC

Meanwhile, the US$195B logged in the institutional market in 1Q17 beat out all prior full year refinancing activity in the institutional market and ranks only behind 2013, 2014, and 2016’s full year record levels of US$409B, US$235B, and US$221B respectively. All-in yields (including Libor or Libor floor and OID) averaged 4.61% in the first quarter, falling to lows not seen since 2004. Yields on single-B credits averaged 5% while yields on BBs fell to 3.67% on average.

Conversely, new money made up just one quarter of leveraged lending’s US$345B total in 1Q17 and M&A financings just 15%. Lenders and arrangers surveyed by Thomson Reuters LPC at quarter-end said that in the absence of a growing pipeline of new M&A financings, the refinancing wave could continue. Issuer optimism continues to be tempered by a lack of a timeframe or visibility on policies including corporate tax reform, deregulation, and infrastructure spending among others.

“It seems there could be a lot more downside than upside on the M&A front if you look at the leveraged market,” said another arranger. “New money deals mainly came from corporations selling divisions to sponsors. We are seeing pruning going on, spinning off from larger entities but not transformative transactions.”

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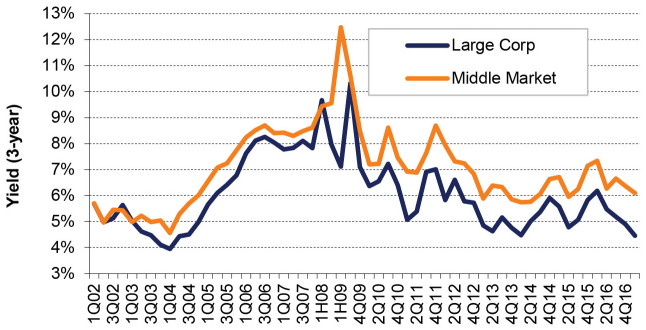
Thomson Reuters LPC: 1Q17 Middle Market Recap

A slow first quarter tempers middle market lenders' expectations

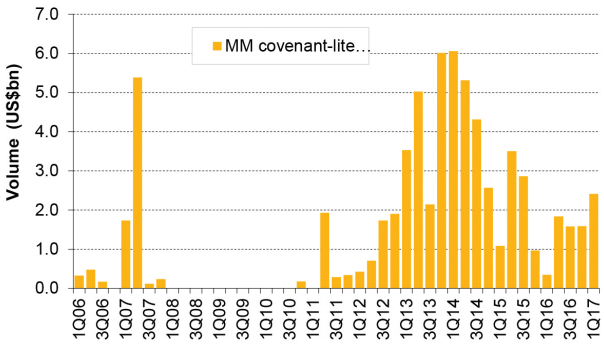
Syndicated Sponsored Middle Market

Lenders started 2017 with significant optimism that growth would pick up and M&A would stregthen, however 1Q17 failed to meet lenders' expectations. A supply demand imbalance plagued the sponsored market resulting in downward pressure on spreads, deteriorating documentation terms, increased leverage levels, and an intensely competitive environment. Middle market sponsored syndicated loan volume in 1Q17 reached US$14B, a meaningful improvement from the dire levels seen in 1Q16 of only US$8.3B. However, volume was 20% lower than 4Q16 levels with a significant share getting done in the institutional loan market. With large cap investors desperate to put money to work, many looked down market to rated middle market issuers. This has had a lot of negative consequences on dedicated middle market players. Yields on first-lien institutional term loans dropped to 6.10% in 1Q17, down from 6.36% in 4Q16 and the lowest level tracked since 2Q15. Not only were returns down, but risk was on the rise. Leverage levels continued to remain aggressive this past quarter and are higher versus 2016 levels. The average first lien and total leverage level on institutional middle market deals remained elevated at 4.66 by 5.14 times. And to make matters worse, middle market lenders' biggest pet peeve, covenant-lite, regained traction. Middle market covenant-lite volume in 1Q17 skyrocketed to US$2.4B, up from US$1.6B last quarter and the highest level tracked since 3Q15. "We are in the worst part of the cycle in terms of supply demand imbalance and the sponsors have all the power," said a middle market arranger.

Yields tightened meaningfully in 1Q17



MM covenant lite volume hits highest level since 3Q15

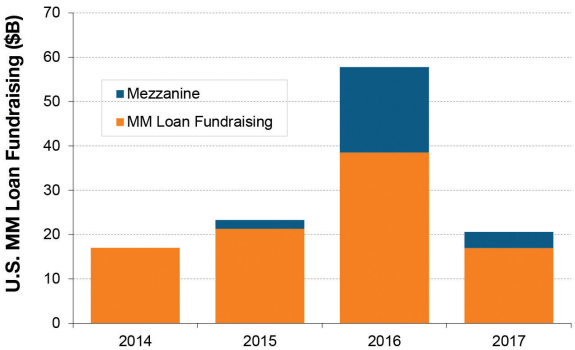


Direct Lending Middle Market

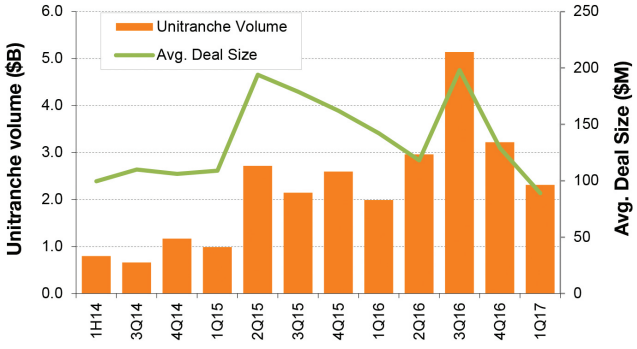
Alternative lenders struggled to compete with the favorable terms in the syndicated market

Money continues to flood the direct lending space with almost US$19B in capital already raised through April. If this pace continues, fundraisng could match 2016's unprecendented levels of US$58B. However, new money loan supply is not keeping pace and direct lenders are facing an intensely competitive environment. Club lenders are facing the same deterioration in terms as lenders are experiencing on larger deals. "I think it is the issuers with Ebitda in the US$30-US$40M range which are most concerning because they are true club deals but they are being bought by large cap sponsors that are bringing big boy terms down on to deals where they just don't belong," said a middle market arranger. For those middle market direct lenders that refuse to give up their credit morals, they need to bid adieu to some of their favorite assets that can simply shave pricing and obtain looser structures in the institutional loan market. The unitranche product has certainly struggled in 1Q17 as issuers have gravitated to cheaper alternatives. LPC tracked unitranche volume of US$2.3B, down 28% from 4Q16 levels. It was mostly smaller issuers that took advantage of the structure this past quarter. Over 70% of the unitranche transactions tracked by LPC in 1Q17 had a deal size of under US$100M while in 2016 only about 50% of the deals had a deal size under US$100M. The average blended yield on unis in 1Q17 was 8.55%, this is roughly 100bps more than the weighted average cost of capital on the first-lien /second lien structure. Sponsors gravitated towards second lien facilities this past quarter as pricing has been tightening given strong demand. After peaking in 2Q16 at 12.0%, the average yield has fallen for three consecutive quarters down to 10.67% in 1Q17.

Middle market loan fundraising surpasses $20.6B YTD



Unitranche Volume falls 28% q-o-q to $2.3B



Source: Thomson Reuters LPC

The Legal Corner

CLOs and other investors, many of whom ramped up new issuance in late 2016 ahead of the effective date of risk retention rules implemented under the Dodd-Frank Act, sought opportunities to deploy capital during the first quarter of 2017. With M&A-driven financings occupying a smaller share of the leveraged loan market, borrowers sought to take advantage of the high demand environment and strong market technical factors by refinancing or repricing existing debt. Though this activity kept market participants busy during the quarter and resulted in tighter spreads, changes to other debt terms were generally modest. Nevertheless, many expect M&A activity during the year to remain robust, which will provide private equity sponsors the opportunity to continue to push aggressive terms on provisions such as EBITDA adjustments, incremental facilities and other debt baskets.

If you have any questions about the Q1 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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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.

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About Thomson Reuters LPC

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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.

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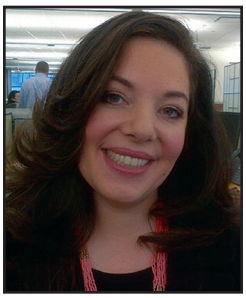

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