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Market Intersection:

A Quarterly Look at the U.S. Credit Markets

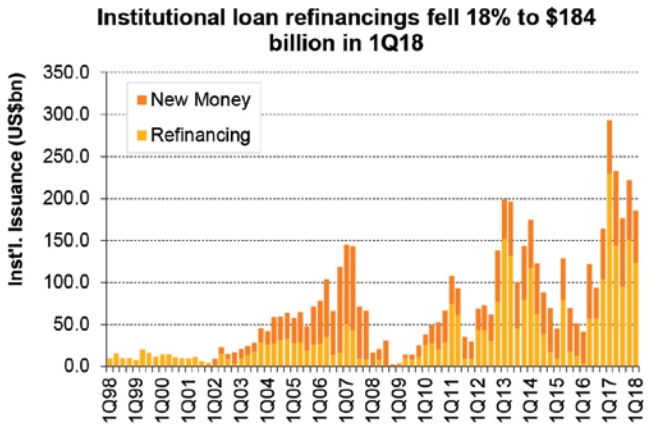
TR LPC Leveraged Market Recap: U.S. Leveraged Lending fell 33% yoy to $270 billion

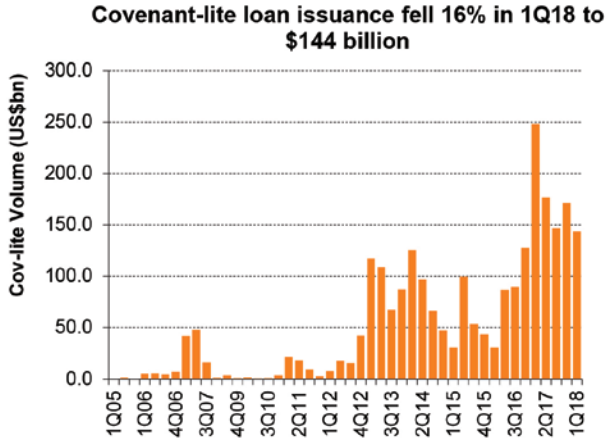
Leveraged institutional spreads fell below pre-crisis levels for the first time this past quarter as demand continued to outpace supply. However, the rise in Libor helped offset some of the declines leaving yields somewhat steady depending on the market segment.

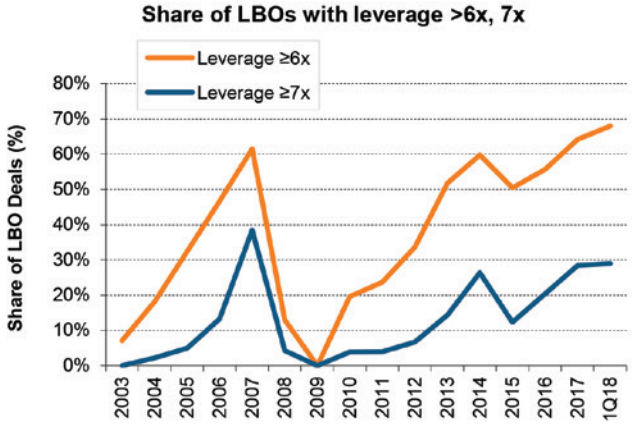
To investors' chagrin, refinancings, at US$182bn drove the bulk of leveraged lending although new money made up over one third of issuance, compared to one quarter at this time last year. All told, at US$270bn, leveraged syndicated issuance was down 33% year over year. But topline figures hardly speak to key shifts observed in the first quarter from the rise in Libor to the possibly final fall of risk retention for CLOs and the ongoing shifts around Leveraged Lending Guidance.

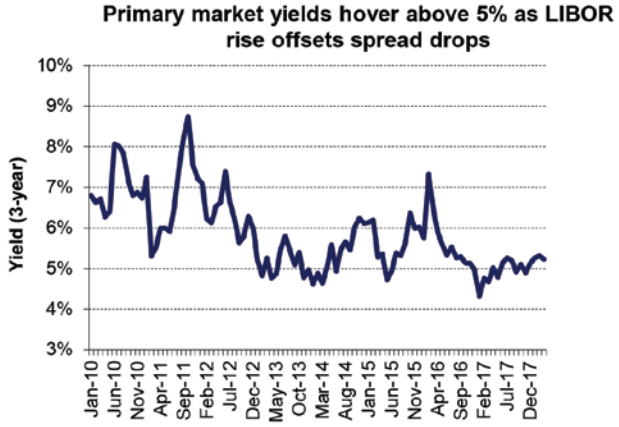
"The progression of Libor is material and has an impact on a lot of things, especially the cost of servicing leveraged capital structures, so it has some bearing on this asset class and possible flows into it, so we are keeping an eye on it," said one investor. An underwriter added that, "early in the year, we felt good about M&A and had a lot of things in our pipeline, but over time, some went to different bidders, deals fell apart, so the pipeline is a challenge, and we don't have so many deals we don't know what to do with them."

Although new money supply picked up, "there continues to be more demand than there is paper," said another underwriter. "It is a nice thing to see some new issue, and M&A, but there could be more paper out there, because everyone is still battling for paper."









Source: Thomson Reuters LPC

US$3.5bn flowed into loan mutual funds while estimates for new issue CLO activity keep increasing as it approached US$30bn in the first quarter. Besides the outlook for volumes, resets and refinancings have been incredibly active while spreads on new AAA liabilities are expected to continue to drop even into the 80bp-90bp range in the near term.

"It was like trying to drink water from a fire hydrant. We've never been as busy and it keeps getting busier," said a manager.

But it's not just new issue, resets and refinancings. Portfolio managers are increasingly focused on credit quality given structural deterioration in recent years.

"We are taking a good look at names in our portfolio while levels are attractive to see if we want to punch out of certain names," said a portfolio manager. "Knowing rates will be going up, that may present some challenges for some borrowers that they did not have to worry about over last few years. This is on a credit by credit basis, we are looking at how have they been performing and what challenges they are facing, we are being a lot more aware these days."

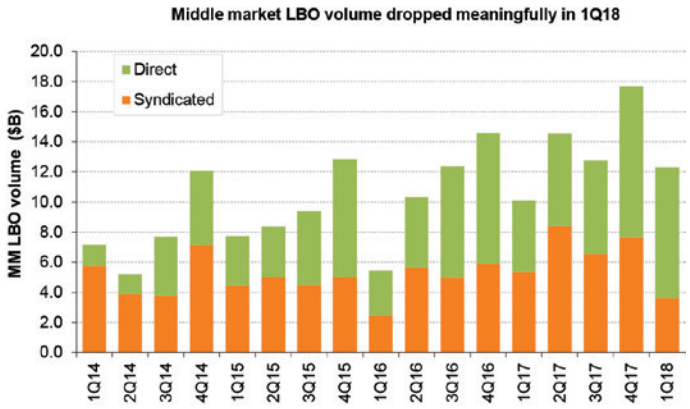
Another echoed, "We expect idiosyncratic problems and out of nowhere, so we are taking an eagle's eye view on every name to see where certain situations could mean a credit performs poorly. We are less focused on what's happening in industries broadly. Our focus has been on individual names."

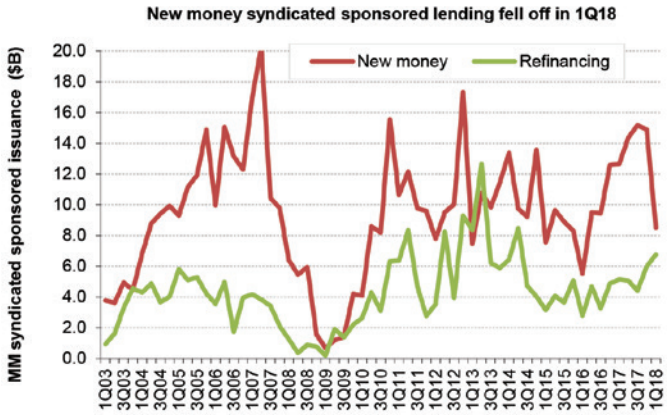
Thomson Reuters LPC: 1Q18 Middle Market Recap

M&A momentum of 2017 failed to carry over into 1Q18, however lenders are expecting a busier 2Q18

1Q18 new money lending dissapointed in the syndicated market

Lenders entered 2018 with high hopes that M&A volume would continue to climb from 4Q17's extremely robust levels. However, reality quickly set in that 2018 would remain a challenging M&A environment plagued by extremely tough market conditions, high valuation multiples and too much cash chasing too few deals. Middle market syndicated sponsored volume only reached $15.25 billion in 1Q18, down 27% from 4Q17's levels and down 14% from 1Q17's levels. "I have never seen so little syndicated volume and getting meaningful allocations was such a huge struggle this past quarter," said a middle market investor. Even more disappointing than volumes being down was the serious lack of "new money" deals hitting the market. The optimism driven by President Trump's tax plan and stronger economic growth has not yet translated into a meaningful pickup in buyout activity. Only US$3.6bn in middle market buyout deals were syndicated in 1Q18, down a whopping 53% from 4Q17's robust levels. "The cash flow forecasts for issuers only look marginally better following the lower tax rate, because so many issuers were not big tax payers to begin with," said a direct lender. "Purchase price multiples are still way too high and that remains the main deterrent to buyout activity." The average purchase price multiple for the few institutional middle market buyout deals tracked in the syndicated market this past quarter was extremely elevated at over 11.5 times . In the club/unrated middle market, the story is similar with purchase price multiples averaging 10.5 times, also quite elevated and near record highs. However buyout activity was somewhat more active in the club/direct lending market with an additional $8.7B in LBO volume clearing market.

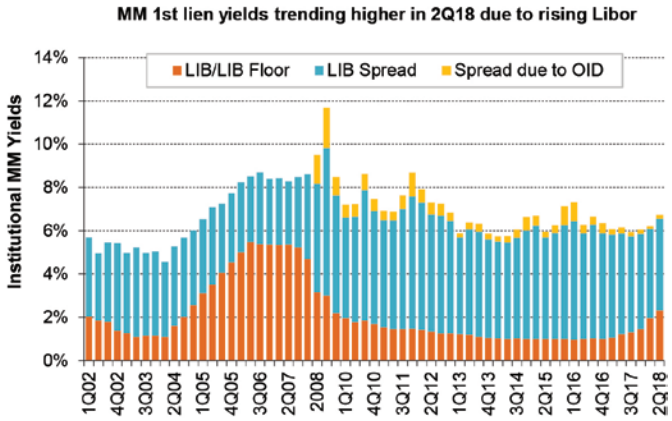


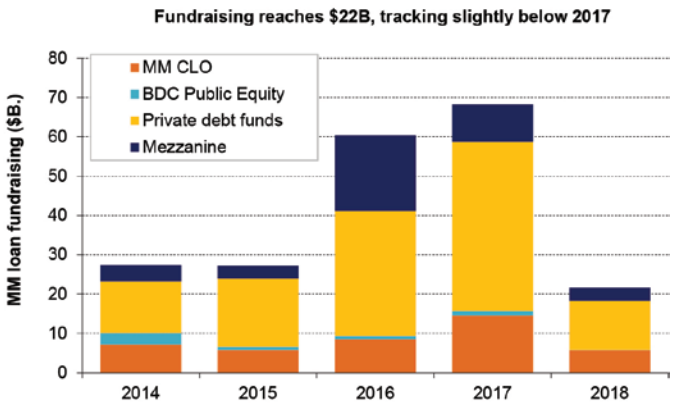


2Q18 Outlook

Despite a slower 1Q18, lenders' outlooks are more positive in 2Q18 with many saying we should see a pick-up in M&A and fewer repricings.

"It feels like spreads are very close to a bottom – everyone has a cost of capital so I can't see the market going much lower," said a direct lender. In fact, yields on institutional term loans in 2Q18 are already up to 6.74% from 6.21% last quarter driven by the rise in Libor and slightly wider spreads on new issue deals. However, lenders expect that overly aggressive lending conditions will likely remain. "Our forward looking pipeline is ok, things still feel competitive, quality feels marginal, higher quality stuff is still getting done very aggressively," said a direct lender.With many agreeing we are near the top of the cycle and interest rates are only moving higher, being more cautious on credit selection is a top concern for middle market players. "We are running more aggressive downside scenarios on our new deals, now is not the time to lever up lower middle market issuers," said a lower middle market lender. And many lenders are starting to assess their portfolio for sensitivity to interest rates and secular changes. "We have gone through and identified certain sectors we want to avoid at this late stage in the cycle," added a direct lender. Despite tough market conditions, investors continue to allocate money to direct lending. Year to date fundraising has already reached $22 billion. While inflows is tracking slightly behind 2017's $69 billion, lenders indicate investor interest remains strong in the asset class as direct lending remains appealing relative to alternatives.





Source: Thomson Reuters LPC

The Legal Corner

The $1.3 trillion US government-spending bill signed into law by President Donald Trump during the first quarter of 2018 included language that allows business development companies (BDCs) to increase their allowable leverage – from a 1:1 debt-to-equity ratio limit to 2:1. While BDCs' appetite for leverage may be tempered by any consequential effect on their credit ratings, this regulatory loosening could portend increased aggressiveness on the part of these non-bank lenders to wrest market share from bank lenders. With respect to documentation, middle market technology lenders have found much success during the first quarter in repairing the loophole uncovered by J. Crew, by restricting the transfer of material intellectual property from loan parties to non-loan parties (whether characterized as an asset sale or an in-kind investment). However, these restrictions are hotly negotiated (particularly around the question of what intellectual property should be considered "material") and are only beginning to "trickle up" to the large cap market with much resistance.

In the syndicated loan market, existing issuers continue to take advantage of investor demand for syndicated loan paper, resulting in sustained repricing activity through the first quarter of 2018. Market observers have been scrutinizing potential LIBOR replacements in advance of the impending demise of the benchmark at the end of 2021, even while participants have shied away from adopting any particular viewpoint and generally only insisted on LIBOR fallback language consistent with the shifting market standards. SOFR (the Secured Overnight Financing Rate) has emerged as an early frontrunner to replace LIBOR but is currently subject to significant limitations for its use in that capacity, chiefly among them that SOFR is an overnight rate whereas borrowers will require one, three and six month interest rate contracts (at least). Middle market lenders will likely ultimately follow whatever market convention is adopted by the large cap syndicated market and for those direct lenders who principally invest in fixed-rate second lien paper, the discussion is largely academic except insofar as those lenders set pricing based on the syndicated alternatives.

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