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Market Intersection:

A Quarterly Look at the U.S. Credit Markets

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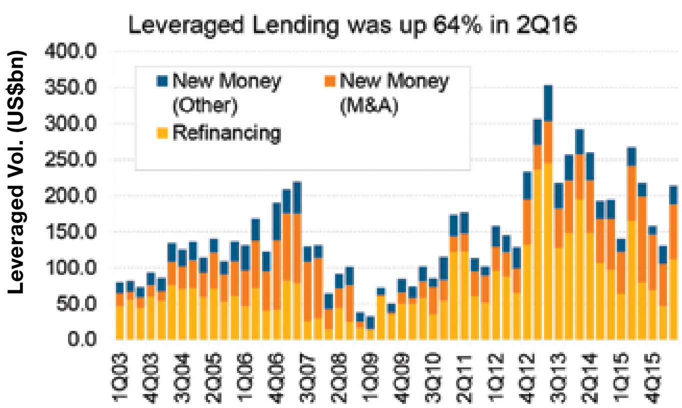
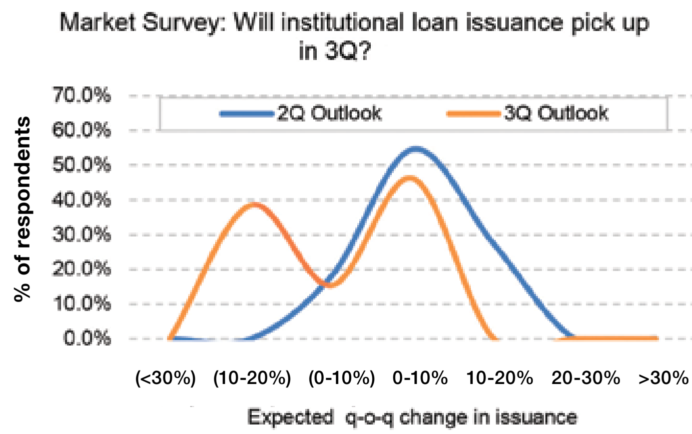
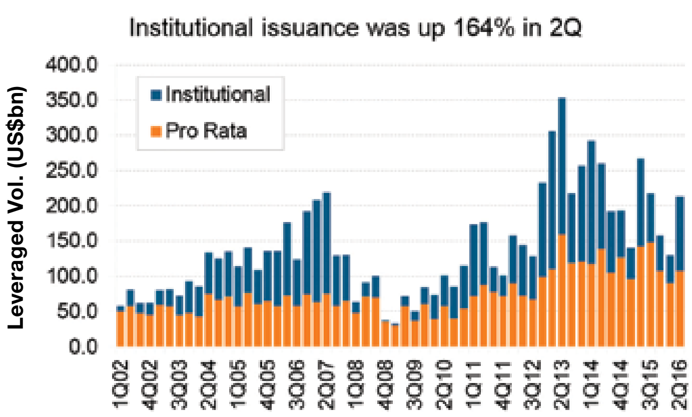
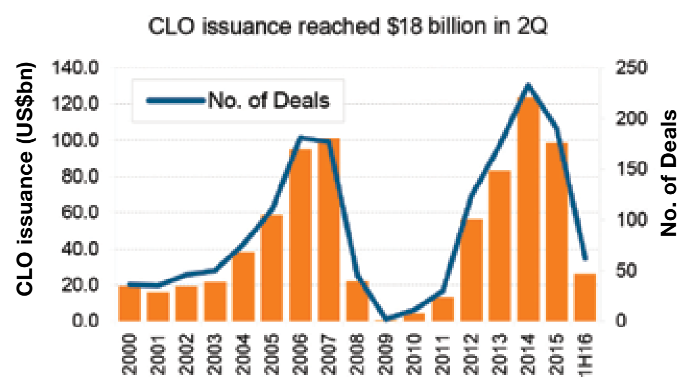
Leveraged Loan Market 2Q16 Recap

The spectacular turnaround in sentiment in the leveraged market resulted in a 137% jump in refinancing activity in the second quarter, reaching US$112B, up from US$47B in the first quarter and the highest since 2Q15's US$165B. With cash build-up from repayments, investors who had been sitting on the sidelines in the early part of the year amid broader market volatility and heightened risk aversion sought assets at a discount in the oversold secondary. In the primary, pent-up demand was met with an absence of new money supply, setting the stage for opportunistic repricings. Institutional refinancing activity jumped to US$52B in 2Q16, up from just US$3B in 1Q16 and US$18B and US$13B in 3Q15 and 4Q15, respectively. "The market turned around very hard from winter," said one lender. "Aside from commodities looking better, there wasn't a lot to hang your hat on so the rally is not fully explicable except there was a lot of cash and all it took was a little spark to get it in motion. We sprinted hard since then." However, as the quarter wound down and in the aftermath of the UK vote to leave the EU, momentum began to slow, repricings were postponed, and 54% of buyside and sellside sources surveyed by Thomson Reuters LPC expect issuance to drop in 3Q16, especially as markets digest Brexit.









Source: Thomson Reuters LPC

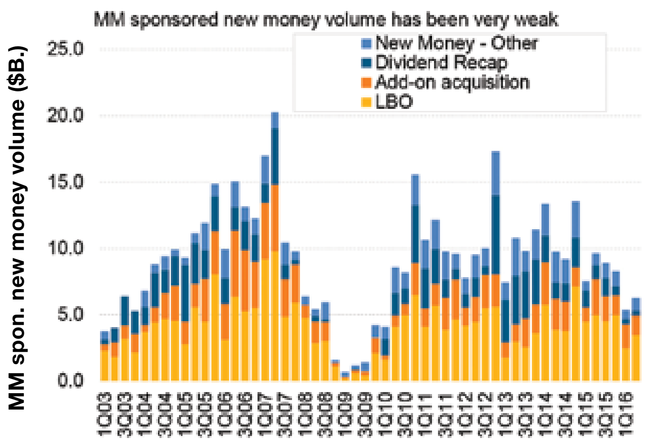
Lenders are hoping that the drop in valuations as markets digest the UK exit may encourage both corporates and sponsors to pull the trigger in the second half of the year. In the second quarter, US$76B in leveraged M&A financings crossed the finish line, up from US$58B in 1Q16. While total institutional issuance jumped 164% to US$106B on the back of the refinancing wave in 2Q16, leveraged pro rata was as usual more steady, up 20% in 2Q16, reaching US$108B, with US$47B in new money which was roughly on par with 1Q16. CLO issuance began to gain traction albeit with older deals finally pricing. Roughly US$8B priced in the first quarter and US$18B priced in the second quarter to date, while outflows from retail loan funds trended into positive territory before heading south in late June.

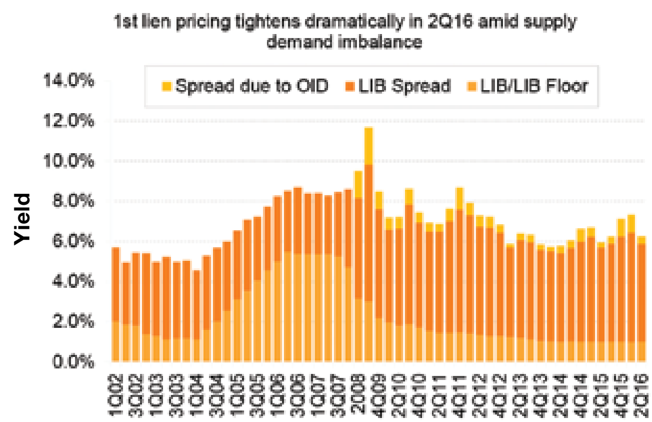
2Q16 MIDDLE MARKET RECAP: Activity improved, but was simply not sufficient to meet demand

"There are simply not enough loans to be made to keep up with the increasing number of debt providers," said a middle market investor.

Syndicated Sponsored Middle Market

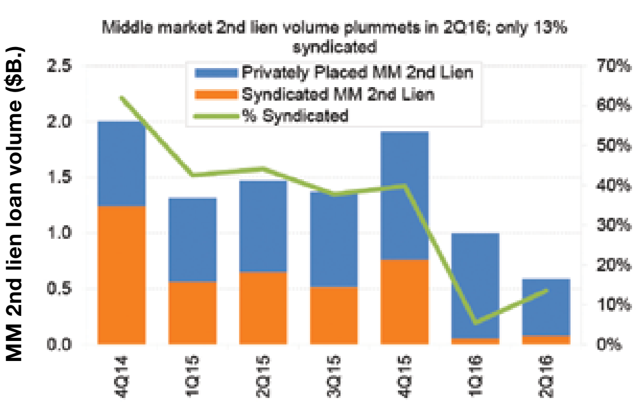
Syndicated loan volume for sponsor-backed deals showed a modest improvement over 1Q16's weak levels. Senior loan issuance reached $9.2B, a 16% increase over 1Q16 levels, but still 33% behind the levels tracked in the same quarter last year. Lead arrangers fought tooth and nail to win mandates while investors scoured the market for assets, hoping to squeeze their way into new and existing bank groups. The supply demand imbalance drove pricing on first lien institutional middle market term loans 100bps tighter to average 6.27% in 2Q16, down from 7.33% in 1Q16. The starting point for first lien pricing continues to be in that 475-500bps range as we enter the second half. Lenders do project that volume will improve in the second half of the year, but no one is overly bullish given many looming uncertainties such as global economic growth, interest rates, the U.S. presidential election in November and the ongoing impact of Brexit.

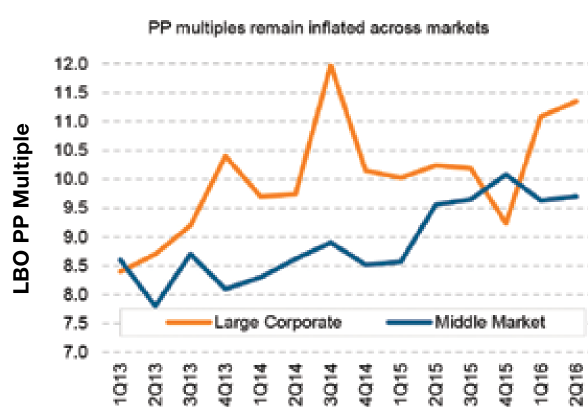




Direct Lending Middle Market

The direct lending market continues to steal market share away from the syndicated market. LPC tracked $19.5B in senior loan volume in the unrated/club middle market in 2Q16. As direct lenders continue to raise massive amounts of dollars behind the scenes, it has allowed them to increase their hold levels and swallow entire small deals on their own or club up larger deals among just a few players. Unitranche and mezzanine displaced second lien facilities in this market in 2Q16. LPC tracked $1.1B in mezzanine volume in 2Q16, up from just $750M in 1Q16. At the same time, second lien volume plummeted to just $510M, down from $1.0B in 1Q16. Arrangers continue to privately place middle market second liens with direct lenders. Only 13% of the second lien facilities were syndicated while 87% were privately placed in 2Q16 according to TR LPC data. As such, pricing on second lien facilities widened to 12% in 2Q16 from 10.8% in 1Q16. Unitranche facilities continue to gain traction in the middle market and blended pricing averaged around 8.54% in 2Q16. LPC tracked a nice pick up in LBO activity in this market as LBO loan volume jumped to $7.8B from just $3.7B in 1Q16. Extreme competition among sponsors has resulted in very inflated purchase price multiples at around 9.7x in 2Q16.





Source: Thomson Reuters LPC

The Legal Corner

Q2: Aggressive Terms and Some Convergence Between Large Cap and Middle Markets

Perhaps owing to a mismatch between supply and demand, aggressive terms found acceptance in the large cap leveraged loan market during the second quarter of 2016. Borrowers had continued success pushing for permissive EBITDA definitions (including look-forward periods as long as 18-24 months and caps on add-backs as wide as 30% or, in some cases, absent completely), narrow call protection triggers and the ability to reclassify items between dollar capped baskets and unlimited leverage-based baskets. Limited Condition Acquisition provisions are now fairly entrenched in the large cap space as borrowers, particularly private equity-backed portfolio companies, seek certainty of funding for tack-on acquisitions. Mindful of leveraged lending guidance promulgated by the Fed and the OCC, some traditional lenders have pulled back from the most highly levered transactions, providing an opportunity for alternative lenders to pitch unitranche facilities, “bought” second liens and other bespoke structures.

In the middle market, sponsors continued their efforts, with mixed results, to "pull down" a number of terms that have traditionally been limited to the large cap space, including builder baskets, permitted dividends and investments with the proceeds of retained ECF and equity issuances, permitted sponsor and borrower buybacks, and flexibility in the form of uncapped investments and permitted acquisitions, both governed instead by a leverage ratio. Conversely, the migration of intercreditor terms flowed up market in some transactions. Specifically, there were a number of large cap transactions viewed as "hybrid" in the sense that they were financed with syndicated, liquid first lien paper held by banks, and private, illiquid second lien paper held by one alternative lender or a small club of alternative lenders. These "hybrid" transactions provided the opportunity for some alternative lenders to "pull up" a number of second-lien friendly intercreditor terms that have historically been limited to private middle market transactions.

If you have any questions about the Q2 trends above, or any other market-related questions 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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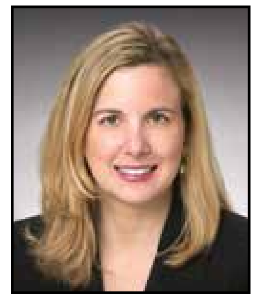

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About Thomson Reuters LPC

Thomson Reuters LPC is the premier global provider of information on the syndicated loan and high yield bond markets. Our first-to-the-market news, comprehensive real-time and historic data helps industry players stay informed about market trends and facilitate trading and investment decisions.

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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