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Market Intersection:

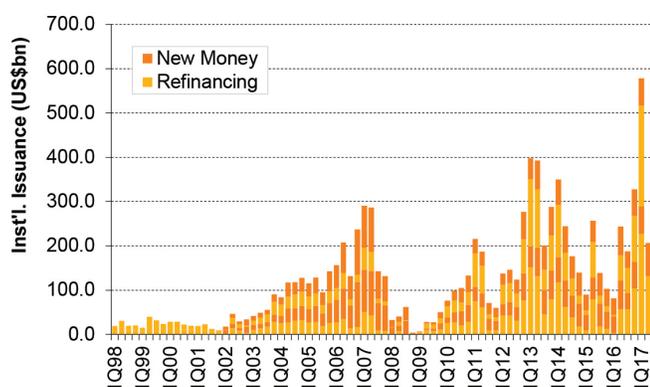
A Quarterly Look at
the U.S. Credit Markets

Market Intersection: A Quarterly Look at the U.S. Credit Markets

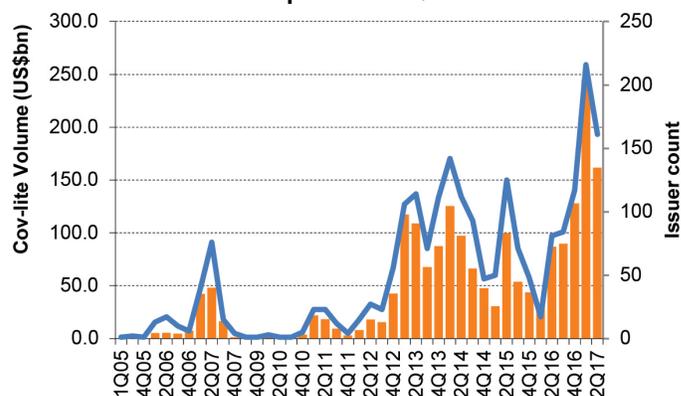
TR LPC Leveraged Market Recap: Opportunistic refinancings drove U.S. lending to US\$632bn record in 2Q17

At US\$623.8bn in the second quarter, U.S. syndicated lending activity was the highest on record, up two percent from the prior record set in the second quarter of last year. At US\$443bn, refinancings were the third highest on record after 2Q13's US\$459bn and 1Q17's US\$452bn. Meanwhile, new money lending was lackluster at US\$180bn, of which just US\$119bn was M&A-related. "M&A is slow and there is not a lot of visibility. We noted how slow the first quarter was and we saw an uptick this quarter and a relatively big number for Amazon," said one arranger. "The conversations are going on for sure, there is just so much uncertainty around policy here. It is pretty important for a lot of companies when they are thinking about major strategic transactions. Everything keeps getting pushed out." Although high valuations persist, LBO financings have reached US\$51bn in the first half of the year and if financings keep up this pace, they are poised to be the busiest post-crisis year with 2014 being the highest so far at US\$95bn. The average purchase price multiple on large corporate buyouts rose to 10.6 times in 2Q17, up from 9.9 times in 1Q17. Although equity checks have continued to average 40%, the average total leverage on large corporate LBO deals reached the highest level tracked since 4Q14 at 4.84 times first lien by 6.39 times total debt to Ebitda up from 4.65 times first lien by 5.98 times total debt to Ebitda in 1Q17. In fact, one third of large corporate buyouts were levered at seven times or greater in the first half of the year, up from 28% in 2016 and only 13% in 2015.

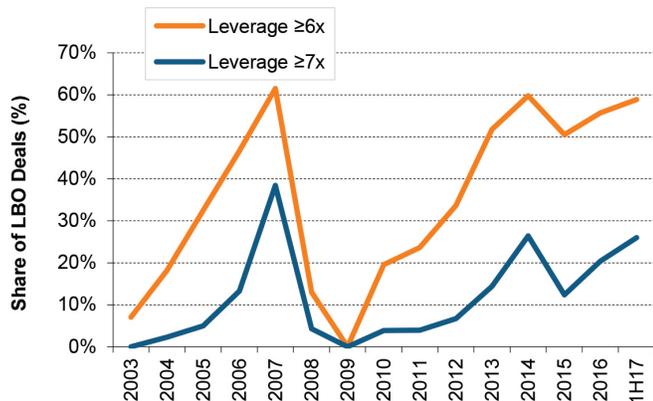
Institutional loan refinancings slowed in 2Q17



Covenant-lite loan issuance reached 2nd highest quarter in 2Q17



Share of LBOs with leverage >6x, 7x



Primary market yields inched past 5% for the first time since November 2016



Source: Thomson Reuters LPC

While banks continue to adhere to Leveraged Lending Guidance, sponsors are navigating that landscape. "With high valuations that are prevalent right now, it is more difficult for sponsors to pay enough or reach the required valuation but there are things (that can be done) around the edges like lowering the debt cost by pushing more of it into a lower cost secured capital structure and away from a second lien or bond structure, which can help that whole equation work out; it's helping M&A along, not defining it, at the edges," said one arranger. "The underwriting market is very competitive, I worry about the market getting ahead of itself," said another arranger. Arrangers are competing for deals and facing off against strong investor demand heading into the summer lull.

"The world doesn't have enough risk assets right now. The amount of calls the buy-side gets from very large pension funds and insurance companies in the US and Asia and elsewhere has been overwhelming. They want and need yield. They want some returns and equities seem fully valued so non-investment grade credit is where you can get some yield. That trend of money coming to US credit markets, it'll take something significant to slow it down." Looking to the third quarter, she added, "The supply/demand imbalance has been fairly pronounced all year and dismaying a lot of loan investors. We'll see more equilibrium if there is an uptick in volume and the underwriting pipeline. We will see demand more satiated if there is a higher level of supply. We'll still see repricings even though the majority of market has repriced."

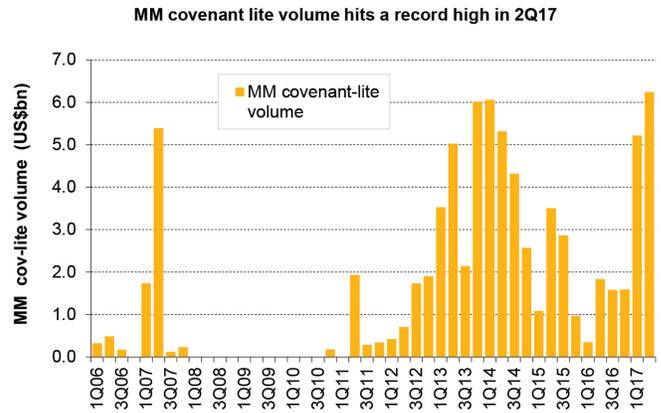
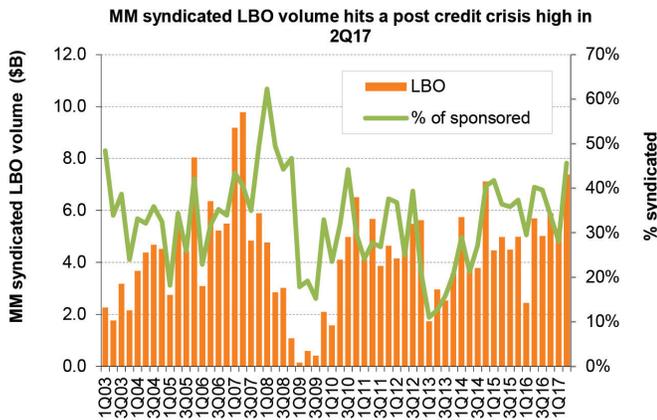
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Thomson Reuters LPC: 2Q17 Middle Market Recap

Institutional market cramped middle market lenders' style in 2Q17

Syndicated Sponsored Middle Market

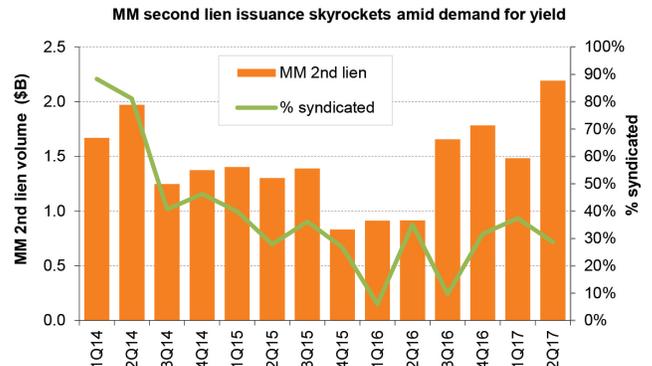
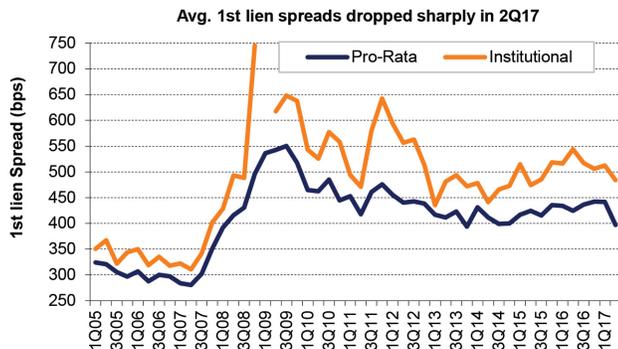
Since the new administration took office in 4Q16, new money syndicated loan volume for PE-backed deals has been trending higher. New money issuance of \$11.8 billion in 2Q17, while not overly robust, is much improved from the dire levels tracked in 2015-2016. In fact, LBO syndicated loan volume hit a post credit crisis high this past quarter at US\$7.4bn. While the volume trends seem to be heading in the right direction, middle market lenders are having a hard time getting allocations and committing to this flow. With large cap investors exhibiting stronger demand for less liquid assets this year driven by the need for yield, many large middle market issuers/sponsors have bailed on the direct lending market and turned to the institutional market to structure their deals. The result has been a complete degradation of terms on middle market loans. After hitting a new record in 1Q17 at US\$5.2bn, middle market covenant-lite issuance spiked 20% to an even bigger record high in 2Q17 of US\$6.24bn. Not only did covenants loosen in 2Q17, but sources say overall credit documentation was destroyed as arrangers, desperate to win deals, caved to large cap sponsors' every wish. "Unfortunately as middle market players continue to grow in size, they are forced to provide these loose terms to sponsors in order to win deals and put money to work," said an investor. Leverage levels also loosened to very concerning levels. First lien and total debt to EBITDA on institutional middle market deals increased in 2Q17 to 4.72 times by 5.43 times, up from 4.66 times by 5.14 times last quarter.



Direct Lending Middle Market

Big repayments left direct lenders scrambling for assets and yield

Money continues to flood into the middle market searching for enhanced yields with loan fundraising surpassing \$33B through mid July. The surge of money into first and second lien middle market assets coupled with large cap investors coming down market resulted in a meaningful tightening in pricing in 2Q17. This drove many issuers that had executed deals in 2015-2016 with primarily a middle market investor base to tap the institutional market in 2Q17 to shave pricing. This left many direct lenders playing defense and forced to decide how low they were willing to go on price to keep an asset. This includes many juicy unitranche facilities which also were redone with an institutional execution in 2Q17. Considering first lien pricing caved so dramatically in 1H17, demand for second lien has skyrocketed this year. "It is like the revenge of the second lien, last year no one would underwrite any second lien and this year there has been a major shift with players desperate for yield," said an arranger. Almost US\$2.2 billion in middle market second liens were tracked in 2Q17, up from US\$1.4 billion in 1Q17 and US\$916 million in 2Q16. Very few market participants expect the trend of strong lender/investor demand coupled with insufficient dealflow to abate in the second half. "While it is certainly more likely we will see price widening rather than further tightening, market conditions should remain pretty competitive," said a source. Dealflow and the quality of credits in market is the number one concern for the majority of lenders.



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The Legal Corner

Refinancings, rather than new M&A, continued to drive supply in the large cap leveraged loan market during the second quarter of 2017 and resulted in a good deal of movement around economic terms. Heading towards the summer, it was not uncommon for borrowers to obtain reverse flex on pricing after initially entering the market with a more conservative offering. Even the 1% LIBOR floor began to crack as several deals passed through the market without this feature, which had become a standard term of syndicated leveraged loans in the wake of the global financial crisis. Perhaps the demise of the LIBOR floor is inevitable, given the global economy's rebound from the depths of the crisis and the ensuing curtailment of the Federal Reserve's easy money policies. However, this type of degradation of lender protections seems driven principally by loan investors' search for yield in the context of a chronic mismatch between supply and demand for leveraged loans, rather than a long term economic outlook, given that it does not quite square with the cautious approach that M&A participants adopted in light of persistent uncertainty regarding major areas of public policy, such as healthcare and tax reform. Interestingly, a relatively large number of the new money loans made during the quarter to fund M&A involved sales of assets among private equity sponsors, rather than public-to-private deals.

Alternative lenders remain active in both the large cap space and middle market in an increasingly competitive environment. Competition has been steep not only for lenders, but for private equity sponsors who are seeing an auction process that includes many suitors. In the large cap space, the "hybrid" second lien facilities consisting of a liquid syndicated first lien bank loan and a privately placed second lien loan have continued to make their mark on the market, approaching borrower EBITDA levels north of \$400 million. In the middle market, bifurcated unitranche has made a sudden comeback in what, for a few quarters, had appeared to be a primarily first-lien/second-lien driven market. Creativity in structuring is also on the rise with a number of transactions involving multiple layers of debt, such as a first-lien/second-lien structure that also includes a split collateral ABL as well as a holdco loan and/or a mezzanine loan. Notwithstanding uncertainty in Washington on issues such as repeal/replacement of the ACA as well as tax reform, many alternative lenders are optimistic that strong M&A activity will persist through the remainder of 2017.

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