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Market Intersection:

A Quarterly Look at the U.S. Credit Markets

US leveraged lending was down 35% in 2019 to US$808bn

– Ioana Barza

"There is a slowness with respect to the willingness to both invest and pursue M&A. Every company I talk to is looking at smaller tuck-in acquisitions to complement the business," said one arranger. "In terms of doing anything more meaningful, their response is you need to feel comfortable with your base business in order to look out and try to expand your business." Leveraged buyout financings were down 19% to US$124bn, following a 28% drop in 2018 from 2017's US$211bn record. "Valuations are stubbornly high. At 11 times, you have less time to grow into your capital structure – meaning if you are a bit over levered at outset, even if you are performing well and generating good cash flow, as we are nearing a down cycle, there is a perceived risk, you don't have the runway to grow," said one underwriter. Some portfolio managers say their patience has run out and consider the idiosyncratic risks that have appeared across a wide range of industries as the end of the line for these credits. The severe reactions in the secondary are expected to continue and create a dead zone in some cases as bids drop precipitously. "There is all this stuff trading into the 80s and no one there to buy because distressed players do not want it until the 70s or lower," said one asset manager. Looking to 2020, these credits are creating a big investment opportunity, for those who have the flexibility and credit expertise to make the right picks. More than US$37bn has flowed out of retail loan funds while CLO managers are de-risking. Technicals that plagued the market in 2019 are expected to continue. "We see big moves in (loan) prices because no one is stepping in. The loan market is bigger and lower rated than we have ever seen but how can CLOs play offense with their existing vehicles?" asked a third asset manager. With the absence of retail, a less risk sensitive buyer, and an expanded ratings universe, ratings migration remains a big concern. As a result, the bifurcation among credits is expected to persist this year with investors wishing there will be more supply of higher-rated credits. "We expect to see even more caution on underwriting, wider caps, more flexibility because deals have been tough to get done," said a third leveraged underwriter.

Fig. 1 Institutional loan issuance was down 45% in 2019 to $400bn

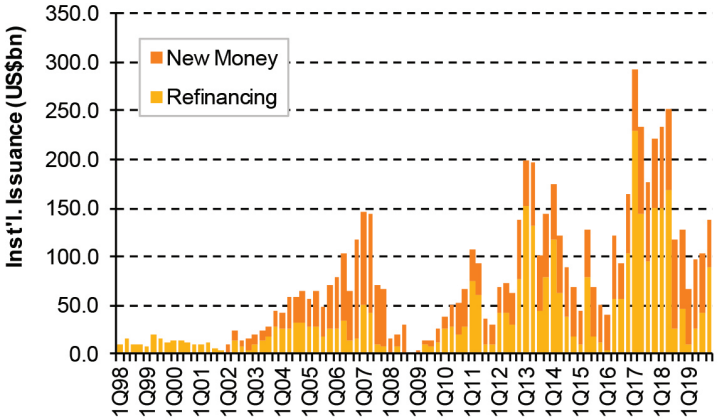
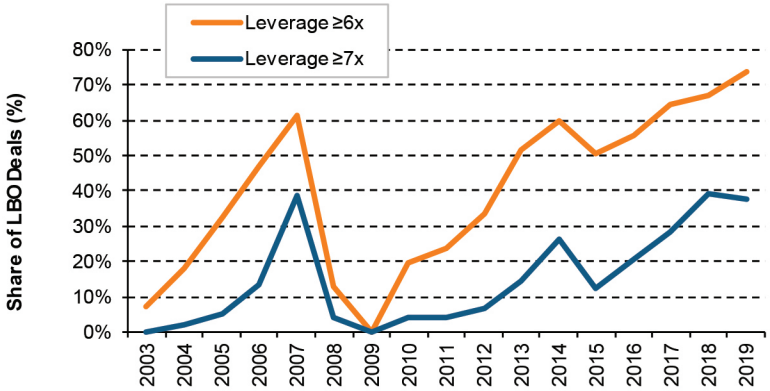


Fig. 2 Share of LBOs with leverage >6x, 7x



Source: Refinitiv LPC

Refinitiv LPC's Middle Market 4Q19 Recap: Direct lenders took sizable market share away from the syndicated loan market in 4Q19

Conditions in the syndicated loan market were not in sponsors' favor in 4Q19 for middle market deals. With CLOs shunning less liquid and lower rated credits, most sponsors opted to hit up the direct lending market which caused syndicated volumes to tumble in the fourth quarter. Middle market sponsored syndicated issuance only reached US$11.4bn in 4Q19 which was the weakest quarter of the year and the lowest fourth quarter level logged post credit crisis. Meanwhile, issuance in the direct lending market reached $27.8bn in 4Q19 which was direct lenders' best quarter of the year in terms of volume (Fig. 3). This implies sponsors funneled dealflow to direct lenders (rather than the syndicated market) in 4Q19 at a ratio of 2.5x-to-1.0x, the highest on record. Banks clearly struggled to compete with direct lenders in the second half of 2019 on sponsor-backed deals. Refinitiv LPC's 2019 league tables showed that unregulated direct lenders' grew their market share as bookrunners on syndicated middle market deals to 41%, up from 39% in 2018 and up from only 14% back in 2013 when Leverage Lending Guidance first gained material traction in the market. "A ton of money is coming into the direct lending space and a 2% hold used to mean $100M, now it means $200M – direct lenders will continue to step in to fill the gap between higher quality and lower quality credits and I don't see that trend letting up anytime soon," said a capital markets head. And the structure of the year award goes to the unitranche which hit an all-time record high in 2019 at US$47.3bn, up 70% from the prior record in 2018 of US$27bn (Fig. 4). Direct lenders' long term, stable and locked up capital allowed them the ability to offer sponsors very favorable terms including no flex risk, certainty of execution and a reliable and affordable source of funding in 2H19. In fact, blended unitranches spreads fell to historically low levels in 4Q19 at only 578bps, down from 593bps in 3Q19 and 606bps in 2Q19. This is shocking considering Libor fell throughout the year and the institutional loan market showed wider spreads in the back half of 2019. Refinitiv LPC also tracked 20 mega-tranches closed in 2019 which are large corporate unitranches over US$500m in deal size. Looking to 2020, most lenders believe loan supply should be decent and resemble 2019 levels. "Supply is always hard to forecast, but you have to look at the number of companies that are sitting in portfolios that are three or four years old purchased between 10-15 times multiples. These credits are going to have to either do dividend recaps or add-on acquisitions near term to boost returns so that should keep a steady flow of activity in 2020," said a direct lender. "I just don't see much changing this year – big holds, lots of cash, folks keeping everything for themselves, it will stay competitive," said a finance company lender.

Fig. 3: Choppy syndicated markets drove MM sponsored dealflow to direct lenders in 4Q19

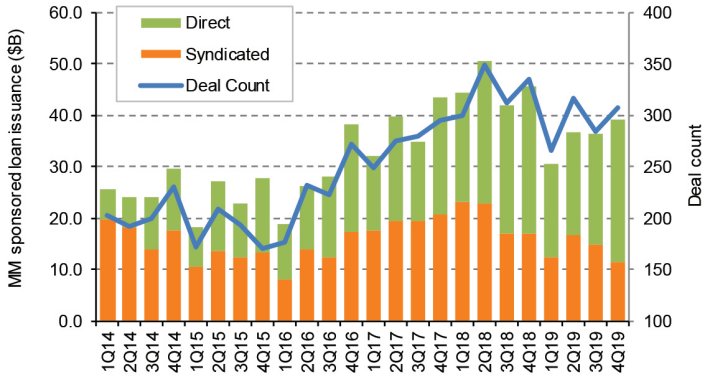
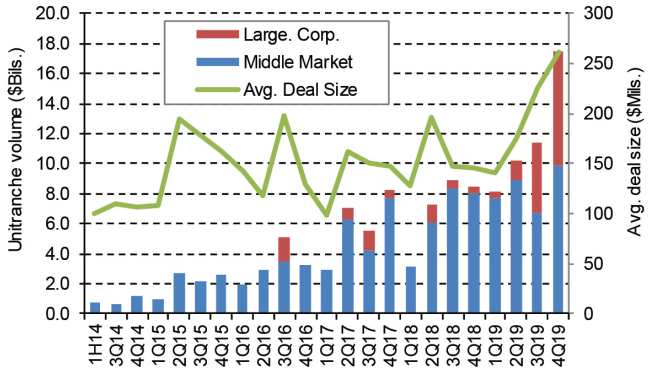


Fig. 4: Unitranche volume hits new record high in 4Q19 at $17.5bn



Source: Refinitiv LPC

The Legal Corner

Although direct lending as an asset class continued to expand throughout 2019 and competition for loan supply remained tight, lenders generally experienced increased success with limiting *J-Crew*-type risks as well as some progress mitigating *Chewy*-type risks. Overall, lenders also continued to push back with varying degrees of success on aggressive EBITDA adjustments and add-backs.

While some lenders experienced increased success with limiting the ability of borrowers to transfer material intellectual property assets outside of the collateral structure, lenders continued to struggle with limiting risk exposure under covenant baskets that allow for transfers and the potential leakage of other types of collateral. The percentage of leveraged loans trading at less than face value rose during 2019, which many attribute to a higher prevalence of "covenant-lite" loans and aggressive EBITDA adjustments and add-backs inflating EBITDA resulting in an understating of actual leverage. Overly aggressive EBITDA adjustments and add-backs also continued to present credit risk in the form of increased borrower flexibility to consummate certain transactions such as the making of restricted payments or the incurrence of additional debt outside the credit documentation pursuant to permitted debt baskets tied to leverage.

Lenders will continue to monitor the anticipated events of 2020 such as the November election and the ongoing trade negotiations with China and their effect on the availability of capital for direct lending and the supply of viable borrowers.

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About Refinitiv LPC

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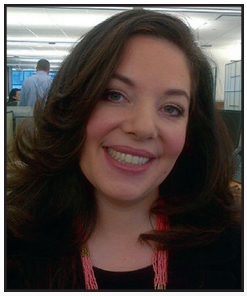

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