PAUL HASTINGS

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Market Intersection:

A Quarterly Look at the U.S. Credit Markets

Refinitiv LPC's Leveraged Market Recap: 2Q19 Leveraged lending ticked up but remains low

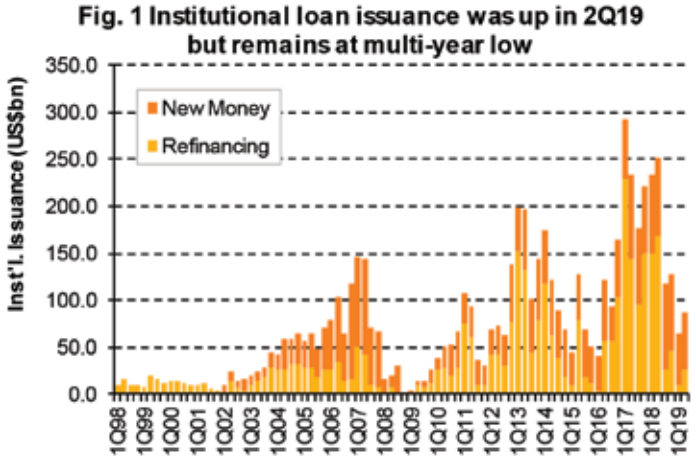
"There is a lot of uncertainty out there, so borrowing costs are low but you just don't know what is happening geopolitically, with the trade discussions, the latest tweet, so it doesn't feel like a steady state or the most conducive environment for M&A," said one investment grade underwriter. Leveraged lending ticked up 14% in the second quarter to US$189bn but it still remains the second slowest quarter after 1Q19 since 1Q16. Leveraged M&A financings were down slightly in the second quarter to US$56bn from US$62bn. Refinancings were up slightly to US$99bn from US$81bn in the first quarter.

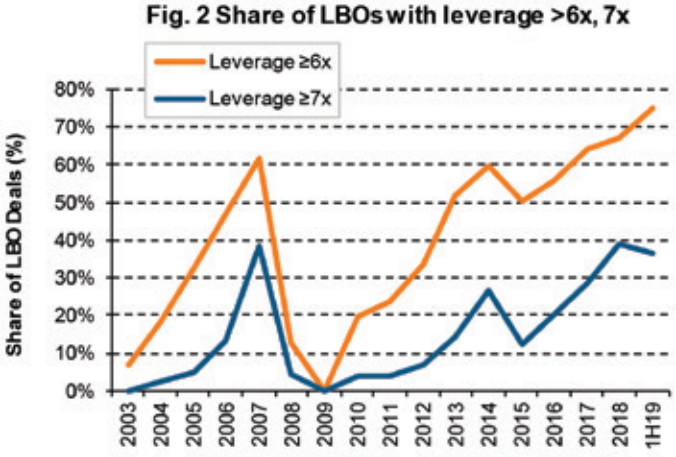
"M&A is down for any number of reasons: multiples are really high today, assets feel expensive. Plus the general feeling that we are edging towards the end of the credit cycle and there may be specific concerns depending upon industry tariffs, trade issues, what Trump could be doing," said one underwriter.

Leveraged pro rata lending was steady in the second quarter at US$103bn while institutional loan issuance was up 37% to US$85bn. Institutional loan refinancings rose to US$26bn in 2Q19 from just US$10bn in the first quarter and remain at multi-year low (Fig 1).

"The whole market shifted and investors expected to be rewarded for risk," said one leveraged underwriter. "It was surprising to see the speed with which this shift occurred." Although leverage levels remained high, investors pushed back agressive deals and structures (Fig. 2).

Another added, "The overlying expectation of a stable (leveraged) market has changed in the second quarter. It started from trade issues with Trump which sent minor shockwaves leading to credit analysis of companies that you wouldn't think might be affected by what might transpire if there's a trade war," said one leveraged bank lender. "We are focused on three things: will it happen? Will it slow our economy down? How will it affect individual companies that are overly levered?"

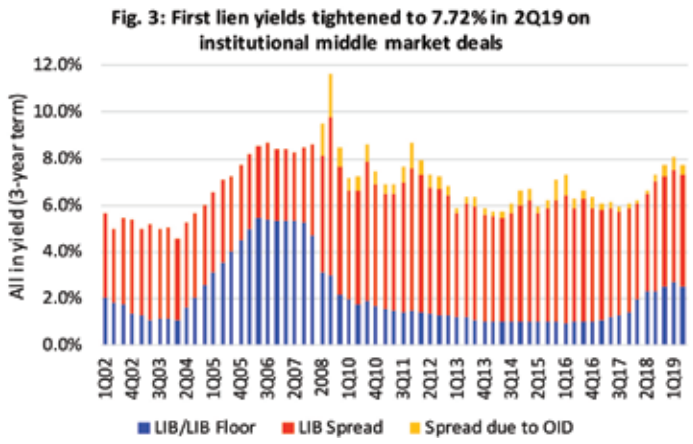


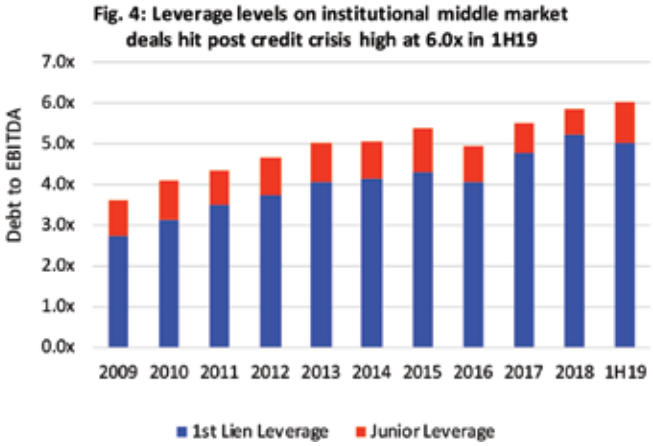


Source: Refinitiv LPC

Refinitiv LPC's Middle Market 2Q19 Recap: MM sponsored lending picked up in 2Q19 in both the syndicated and direct lending market

Syndicated middle market sponsored lending showed a modest pick-up in activity in 2Q19 after a very dire 1Q19. Total syndicated PE-backed middle market issuance reached US$13.6bn in 2Q19, up 10% quarter over quarter but still 40% lower than 2Q18 levels. After peaking in 1Q19, yields on institutional middle market loans tightened to 7.72% in 2Q19 from a lofty 8.06% in 1Q19, howerver the drop was largely due to a decline in Libor while spreads remained somewhat elevated (Fig. 3). Given a dearth of large-scale transformative LBOs in the broadly syndicated loan market last quarter, CLOs and other institutional investors were forced to pay attention to smaller deals. Middle market syndicated LBO issuance reached US$6.3bn in 2Q19, the highest quarterly level tracked since 4Q17. With investment banks very behind on hitting budgets following 1Q19's volatility, they were particularly aggressive calling on sponsors in 2Q19 trying to lead upper middle market buyout financings. Many of the buyouts led by investment banks and syndicated to institutional investors had particularly aggressive leverage levels and structures. On an annual basis, leverage levels on institutional middle market deals hit a new record high in 1H19 at 5.04x/6.02x, up from 5.22x/5.87x in 2018 (Fig. 4). Meanwhile, in the direct lending market in 2Q19, volume showed a similar trend to the syndicated market, growing 10% quarter over quarter to $19.8bn, but still 29% behind 2Q18 levels. Direct lenders continued to characterize the dealflow environment as lackluster, overly aggressive and highly competitive. Unitranche and all senior capital structures continued to dominate the direct lending market as both mezzanine issuance and second lien volumes were down pretty meaningfully this past quarter. Unitranche volume hit a brand new quarterly high at $9.2bn in 2Q19 while both mezzanine issuance and middle market second lien volumes in the first half of 2019 are tracking to be the lowest annual levels since before 2013. Leverage metrics on direct lending deals in 2Q19 looked similar to 1Q19, however things appear slightly more aggressive on the margins. Average leverage for direct lending deals was 4.5x / 4.9x in 2Q19 while bank-led deals exhibited a moderately lower average leverage of 4.0x / 4.5x. Close to 20% of deals were levered more than 6.0x in 2Q19, the highest level tracked, while also roughly one in four deals had "first lien" leverage levels greater than 5.0x. Sponsors continue to pay lofty prices for assets, with purchase price multiples on middle market LBO deals averaging over 11.0x for the second quarter in a row.





Source: Refinitiv LPC

The Legal Corner

U.S. loan markets remained cautious and the second quarter saw a brief reversal from loosening covenants due to uncertainty surrounding the trade war with China, dovish commentary out of the Fed and an increasing sentiment that the end of the credit cycle is near. While large sponsors continued to push the envelope, they faced significant resistance from institutional investors. Covenant flex was instrumental in retaining more reasonable terms in sponsor-backed credits clearing the market. For example, after a brief uptick in April, aggressive MFN protection included in deals at launch was largely brought back into check during syndication, lowering 75 basis point-spreads to 50 basis points or lengthening or eliminating the sunset. Asset sale sweep step-downs and uncapped adjustments to EBITDA followed a similar trend.

Following the announcement by the Financial Conduct Authority ("FCA") that LIBOR would soon be discontinued, lenders and issuers scrambled to document the future transition to an unknown rate. The consensus in the syndicated loan market landed on expressly providing for amendment procedures, most often permitting the agent and borrower to agree on the then-prevailing rate. The syndicate would then have a short period of time to object to the proposed replacement rate. In late April, the Fed's Alternative Reference Rates Committee ("ARRC") released final recommendations for LIBOR fallback provisions which includes input and feedback from a host of market participants. While not mandatory, the ARRC recommendations provide much anticipated guidance on the appropriate provisions and procedures to include in both new issuances and amendments with maturities falling after the anticipated LIBOR discontinuation.

For syndicated loans, the ARRC recommends either the "amendment" approach that has percolated throughout the market since the FCA announcement or a "hardwired" approach, the latter of which aims to provide certainty at execution. Both approaches offer specifically identifiable "triggers" that begin the transition away from LIBOR to the alternative rate, identified by the ARRC as the Secured Overnight Funding Rate ("SOFR"). As the name suggests, SOFR is an overnight rate, which stands in stark contrast to the month(s)-long interest rate contracts borrowers currently have and will continue to require. To account for the fundamental difference, adjustments to the interest rate margins will be necessary. Spread adjustments follow a "waterfall" in the hardwired approach, looking to spreads selected (i) first, by the ARRC, (ii) second, by the International Swaps and Derivatives Association ("ISDA"), and (iii) third, if neither the ARRC nor ISDA have endorsed an applicable spread adjustment, by the agent and borrower giving due consideration to prevailing adjustments. Participants on both sides of the market await further clarity on SOFR (which the New York Fed began publishing in April 2018) before we expect to see a larger buy-in to the hardwired approach. In the interim, the amendment approach provides a general framework with the benefit of additional flexibility as the market continues to digest information and proposals about SOFR. Once the market has an opportunity to test the waters with SOFR and coalesce around replacement provisions, the hardwired approach should take hold as it dispenses with the need to undertake the amendment process for thousands of existing loan agreements.

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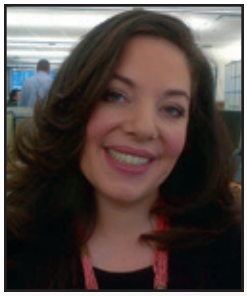

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