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# Market Intersection:

A Quarterly Look at  
the U.S. Credit Markets



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### TR LPC Leveraged Market Recap: Annual U.S. syndicated lending surpassed US\$2.5trn in 2017 for the first time

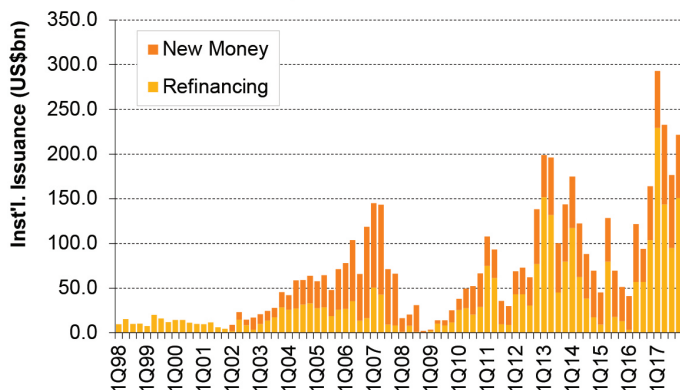
Leveraged lending was up 60% in 2017 to US\$1.4trn thanks to US\$933bn in leveraged refis, which doubled in 2017 and upped 2013's record by 23%. "2017 was a clear risk-on year," said one CLO manager. "Looking over the last 10 years, headlines could move markets, but looking at this past year, it seemed like everything was getting shrugged off. It was surprising and is one of the first years without real volatility at any point."

Few would argue that 2017 was the year of the CLO with US\$117bn in new issue in 2017, jumping 62% over the prior year. In addition, US\$164.8bn came in the form of refinancings and resets with US\$103.8bn in refinancings and US\$61bn in resets. With new issuers in the mix and a growing bid from Asian investors, deal activity was unprecedented.

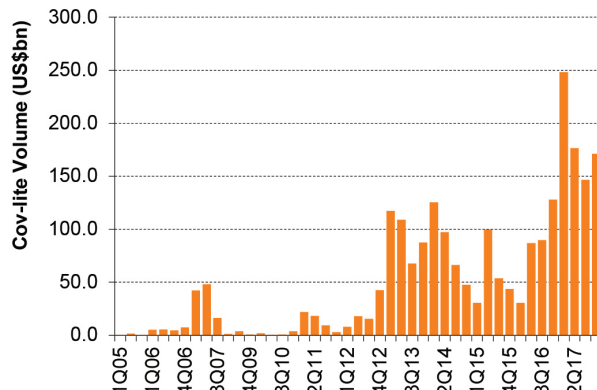
Although AAA spreads on new CLO liabilities reached tight in the low 100bp context for select managers, primary market loan spreads also tightened as issuers took advantage of favorable market conditions, to reprice their loans to cut borrowing costs.

"The economy is fine, we've got runway, but we are watching these secular changes which have been ongoing in retail or tech for example. We are cognizant of risks in individual companies and sub-sectors and trying to be smarter than the next guy in how we play it," said the portfolio manager.

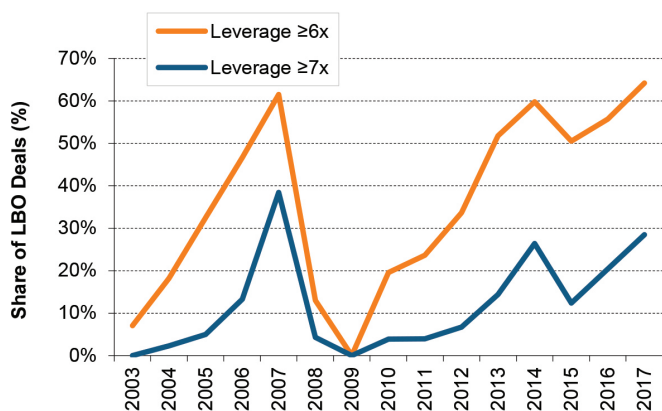
**Institutional loan refinancings reached record \$620 billion in 2017**



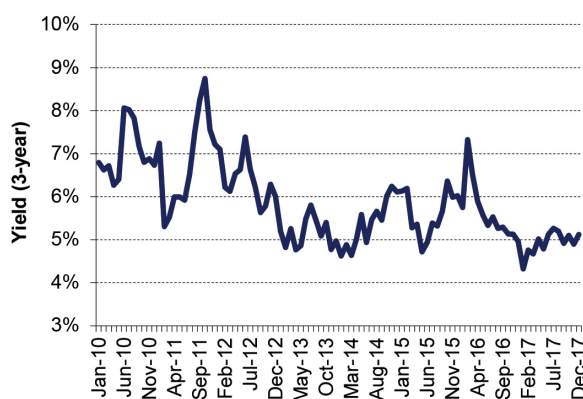
**Covenant-lite loan issuance more than doubled in 2017 to \$742 billion**



**Share of LBOs with leverage >6x, 7x**



**Primary market yields ended the year at 5.12%**



Source: Thomson Reuters LPC

Looking at 2018, "We haven't seen times where it (primary market spread on higher quality loans) gets much tighter," said a portfolio manager. "The market may prove me wrong on that score. I am not applying much judgment just looking at historically what has been the case. Typically when you get to these kind of levels, you see investors struggling for yield and weaker credits getting bid up heavily because people are stretching up the risk curve."

More is expected from equity sponsors who were increasingly active in pursuing LBO loans to the tune of US\$126bn in 2017, a 44% increase over 2016 and ranking second only to 2007's US\$210bn record.

In terms of underwriting, "people loosened up on their stringency to stay competitive (in 2017) but unlike in 2007, when underwriters ended up with billions of undistributed paper stacked up, there are controls across the street in how people run their business and how much risk they take on, there are limits and caps imposed and of course the pipeline is nowhere near the size it was back then."

Armed with new tools, "2017 stands out as a pretty good year for almost everybody in our business," said one leveraged loan arranger, "but it was not driven by very large transactions. We saw a lot of refinancings, small dollar item M&A, not a lot of splashy large cap M&A deals were in the mix. Three yards and a cloud of dust; we kept driving forward on a lot of refis, helping a little with P&L each time."

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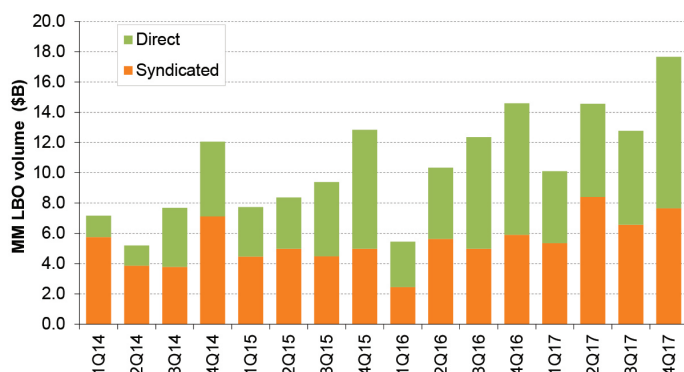
## Thomson Reuters LPC: 4Q17 Middle Market Recap

**M&A volume exploded in the middle market in 2017 driven by private equity shops feasting on smaller issuers**

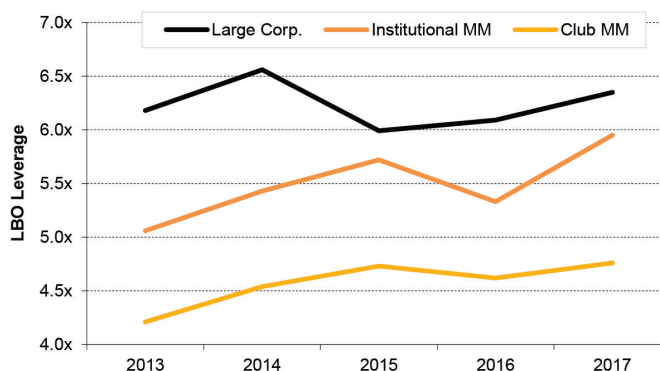
### 2018 will likely mirror 2017's robust levels

With the equity markets constantly hitting new all time record highs day after day in 2017, private equity shops with war chests of cash struggled to afford companies of scale last year. A solution was to execute on add-on acquisitions and snap up smaller, middle market issuers. As a result, middle market syndicated LBO volume jumped to US\$28.1 billion in 2017, the second highest level on record and only 5% behind 2007's all time record high of US\$29.7 billion. And when the direct lending deals that are reported to LPC are included, 2017 was no doubt a record year for middle market LBO financings to the tune of US\$55.1 billion. When looking to 2018, lenders expect middle market LBO activity to resemble 2017 levels at near record levels or greater. However, it is hard to imagine purchase price multiples and leverage levels going any higher on smaller credits than they were last year. Extremely competitive auctions drove the average purchase price multiple on institutional middle market credits to an unprecedented new record high at 11.3 times, surpassing the prior record set in 2015 of 10.7 times and over two turns greater than the 9.2 times tracked back in 2007 during the buyout boom. Even smaller unrated club deals logged record high purchase price multiples in 2017 of 10.0 times. Record leverage levels naturally followed suit given the prevalence of unregulated direct lenders who are not burdened by Leveraged Lending Guidance. Institutional middle market deals, which are typically rated and sold off to CLOs, exhibited average leverage of 4.83 times first lien by 5.95 times total debt to EBITDA in 2017. While unrated club deals, which are typically more conservatively structured, also reached lofty leverage levels near 5 times.

**Middle market LBO volume accelerated in 2017**



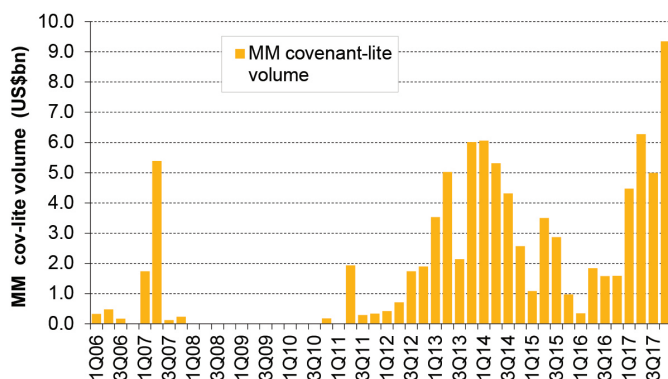
**Leverage peaked on MM LBOs in 2017**



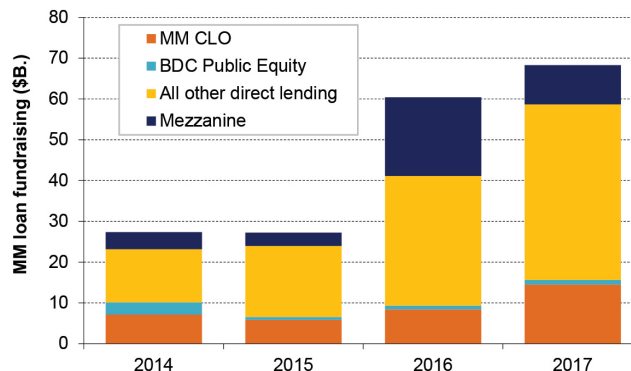
### Lender concerns for 2018

Despite very strong M&A volumes, few lenders would say they were awash in dealflow opportunities in 2017. Many middle market lenders struggled to find enough high quality transactions and many expect this challenge to remain in 2018. "2018 is going to be more of the same, a tricky year, we are just trying to stay up in terms of quality," said a direct lender. Weak documents and covenant lite moving down market is the top hot button for middle market lenders this year. Covenant lite volume for middle market issuers hit a brand new record high in 2017 of 25.1 billion, up 37% from the prior record set in 2014 of \$18.3 billion. Based on TRLPC's 1Q18 MM Survey, lenders predict covenant-lite volume will remain near record levels or move even higher in 2018. "Right now the terms are terrible, you cannot hang your hat on terms - all you can do is pick the credits you think are the most resilient," added another lender. Further adding to market pressures is all the money being raised by direct lenders. In 2017, fundraising reached a record high at \$68 billion, surpassing 2016's \$60 billion. And this influx of money is not expected to slow down in 2018. With three rate rises expected in 2018, lenders anticipate money to flood into middle market direct lending this year. "The money coming in is just way too much - you just know that uneasy feeling when the market is somewhere near the top of the cycle, similar to how we felt in 2007," said a lender. "But the big difference between today and 2007 is we used to have covenants and tighter documents to protect us," added the lender.

**MM covenant lite volume surged in 4Q17 to over \$9.0B**



**Fundraising for MM lending reached \$68B in 2017**





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### The Legal Corner

In October of 2017, even before the US presidential election concluded with a result that market participants hoped would lead to pro-business reforms, the Government Accountability Office (GAO) rendered an opinion that the leveraged lending guidance (LLG) jointly issued in 2013 by the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation and the Office of the Comptroller of the Currency was a “rule” that must be submitted to Congress for approval. The effects of the GAO’s opinion are still developing as the legislative branch works its way through its processes (and simultaneously undertakes to address other significant policy areas such as tax reform, immigration and government funding). Though the likelihood of the various potential outcomes are difficult to handicap, two plausible consequences are the curtailment or even abandonment of the LLGs altogether. Bank regulators would still retain broad authority under statutory “safety and soundness” provisions to take enforcement action against banks that participate in the leveraged loan market, however, if the LLGs were largely rendered ineffective those regulators could not criticize a transaction for its failure to comply with the LLGs (including, potentially, the 6x leverage guideline embedded therein). Some market observers believe that the LLGs have caused banks to reduce their exposure to highly levered loans, which void created an opportunity for non-bank lenders to increase their market share. Congress’ disapproval of the LLGs could spur banks to re-engage with riskier credits and act as a governor on the non-bank lenders’ sizeable and growing participation in the large cap leveraged loan market.

Non-bank lenders (principally investment banks and large asset managers) have an especially strong presence in the middle and upper middle markets where they have demonstrated a capacity and willingness to write the entire debt check (in particular, with respect to second lien paper). Indeed, these market participants have seen their share of the leveraged loan market climbing steadily and, in some cases (notably, debt financing for LBOs) double year over year. While their immunity to the LLGs permit them to underwrite more highly levered transactions, a reduction in the leverage profile of M&A-related loans in the fourth quarter as compared to the third quarter, coupled with the potential demise of the LLGs altogether, could present some headwinds to the non-bank lenders’ growing market share. Nonetheless, during 2017 non-bank lenders often wielded the bargaining power that comes with providing financial sponsors with simultaneous deal certainty and pricing certainty in order to protect those key terms such lenders hold dear, like caps on EBITDA addbacks and affiliated lender provisions. These market participants’ solid and growing stature as an arranger of middle market LBO financings acted as one of the few remaining bulwarks against the markets’ general surrender of lender protective terms in the name of yield, which was only exacerbated by the glut of refinancing paper issued in 2017 (of which the vast majority was arranged by banks rather than non-bank lenders).



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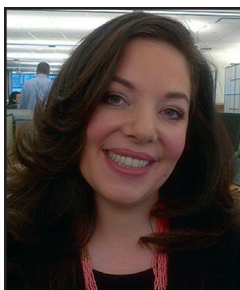
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