

# State of the Capital Markets:

## Fourth Quarter 2015 Review and First Quarter 2016 Outlook

Presentation to:

# Capital Markets Review – Fourth Quarter 2015

## Tale of two trends continues: volatility vs. constructive credit

- ◀ Fed move in December largely discounted; public markets remain impacted by China and commodities worries
- ◀ Challenged by outflows from HY funds last year (\$8B in December alone), bond volume softened to \$261.7B, from \$310.5B in 2014
- ◀ US leveraged loan issuance of \$420.7B was 20% off 2014's total of \$528.1B – worst performance since 2011
- ◀ Retail loan funds suffered net outflows of \$16.5B for 2015; first week of January marked 24<sup>th</sup> consecutive week of outflows
- ◀ 2015's new CLO formation of \$97.3B came up 22% short of the previous year record of \$124.1B amid risk retention headwinds

# Capital Markets Review – Fourth Quarter 2015

## What's the setting for debt and equity INVESTORS?

- ◀ GPs still deploying capital; add-ons easier than LBOs in this environment
- ◀ Middle market sponsor leveraged loan volume for 2015 was \$50.3B, off 27% from last year's \$69.5B level – lowest level of activity since 2009
- ◀ Private credit funds continue to invest opportunistically as regulated banks retreat from highly leveraged transactions
- ◀ Chase for yield now balanced with flight-to-safety impetus; institutional investors weighed more to cash, less large cap credit
- ◀ Junior capital (second lien and mezzanine) tougher to source with BDCs cash-constrained; unitranche more attractive risk/reward dynamic

# Capital Markets Review – Fourth Quarter 2015

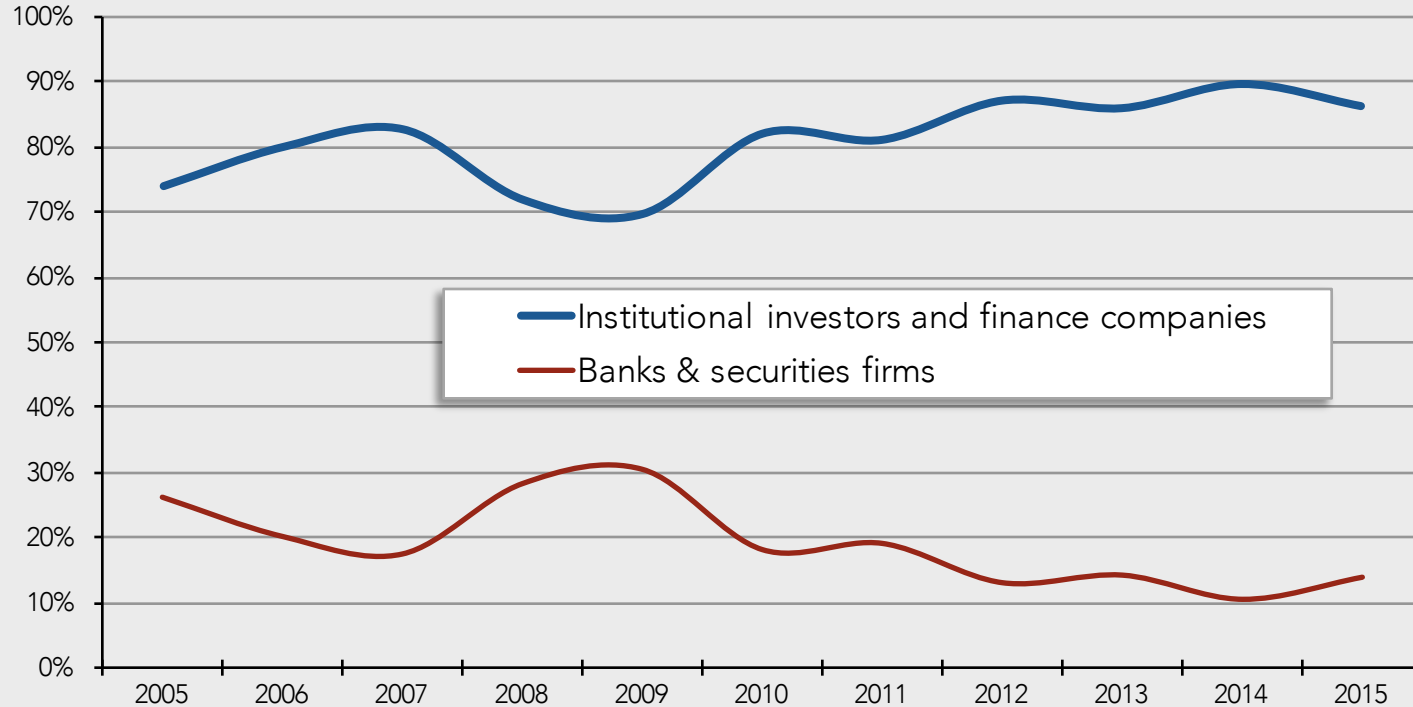
## How about debt and equity ISSUERS?

- ⚡ Large cap issuers struggle with story deals, as broadly syndicated markets stick to better known plain-vanilla credits
- ⚡ Big banks wary of underwriting given uncertain buyer appetite; larger middle market arrangers filling the void
- ⚡ Regulatory pressures continue to curb overall bank appetite; non-banks providing one-stop shop solutions
- ⚡ Private credit arrangers employ “cargo pants” strategy to increase hold levels; unitranche financings provide certainty of execution
- ⚡ Borrowers and sponsors seeking flexibility at a price

# Capital Markets – Behind the Scenes

Nothing new about regulatory pressures favoring shadow banks

Primary market for highly leveraged loans (banks vs. non-banks)



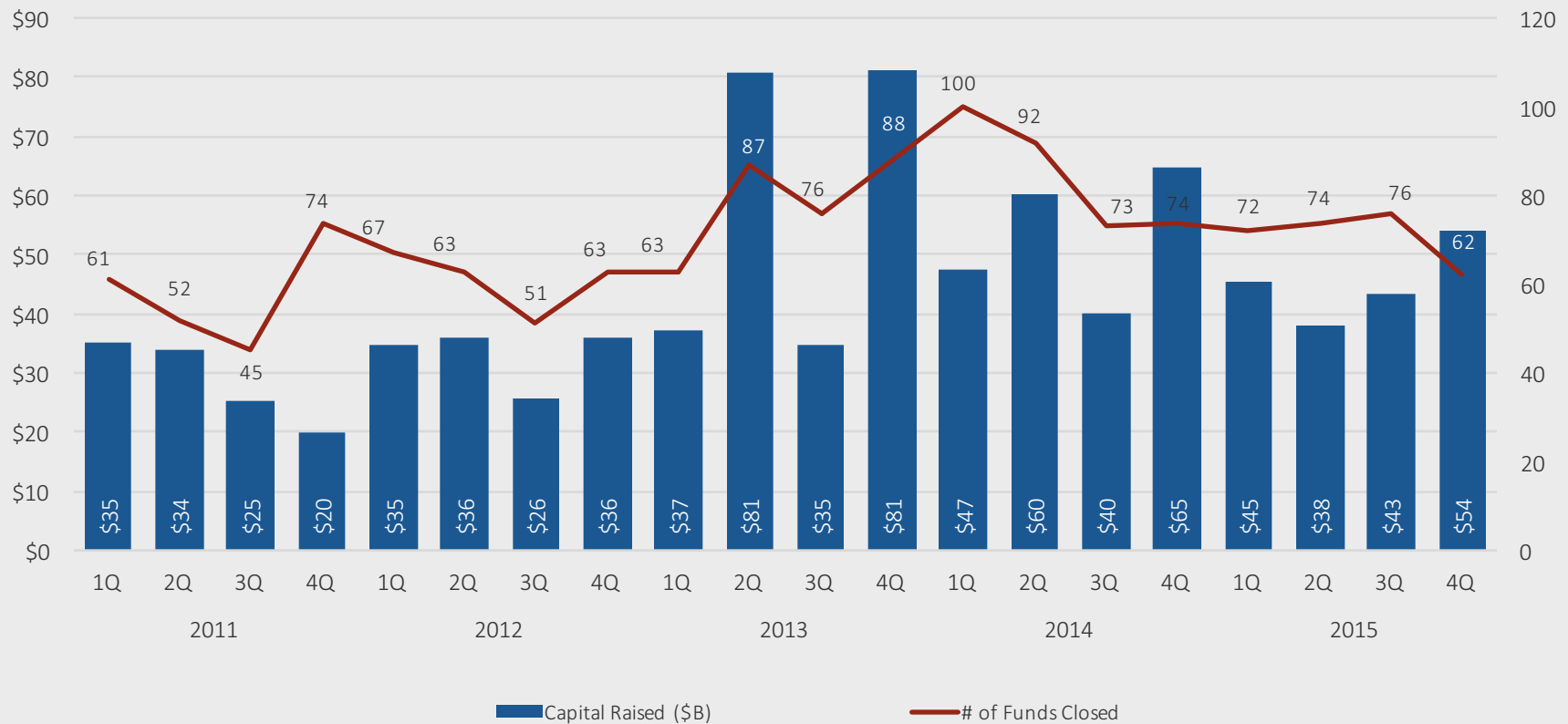
Institutional investor market share

Source: S&P LCD, Capital IQ



# Capital Markets – Behind the Scenes

North American PE fundraising ended the year on an upswing...

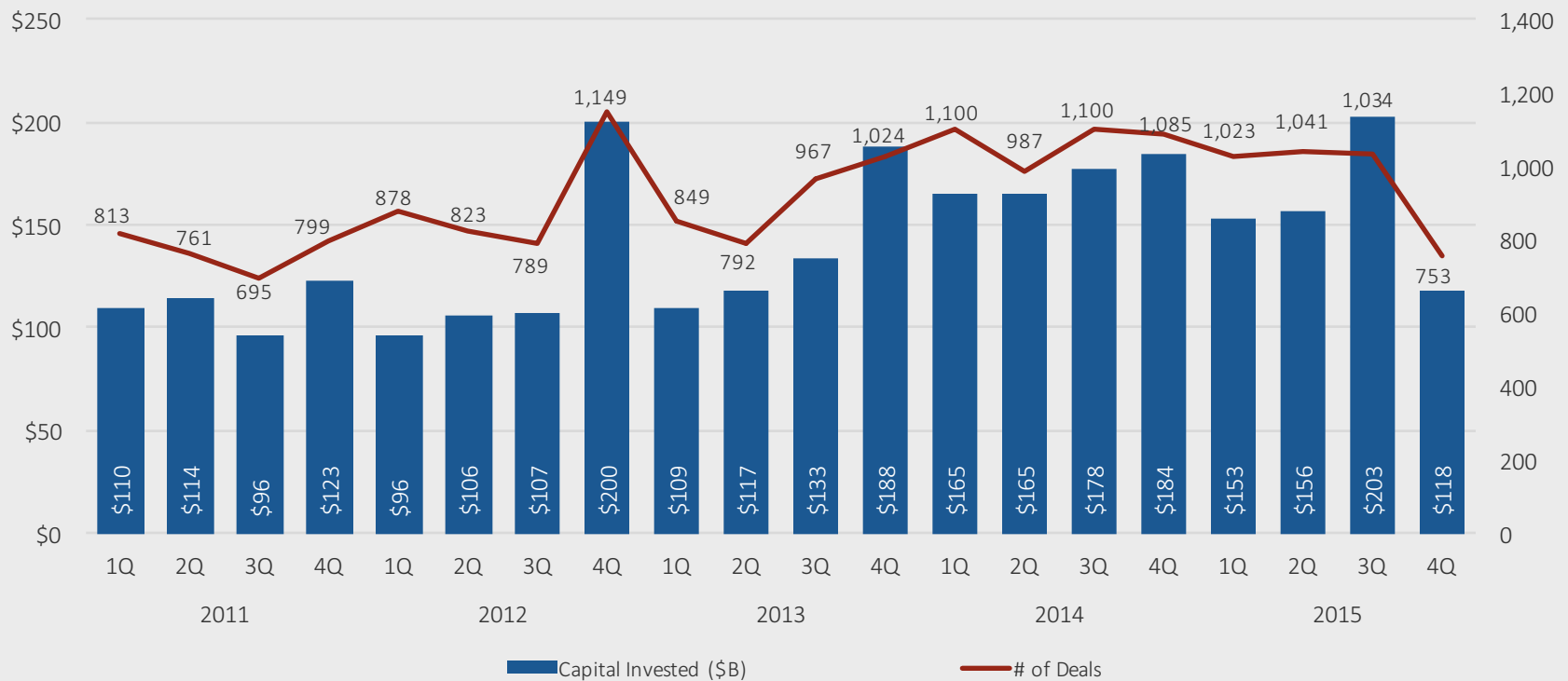


Source: PitchBook



# Capital Markets – Behind the Scenes

...while North American deal flow tapered off at year end

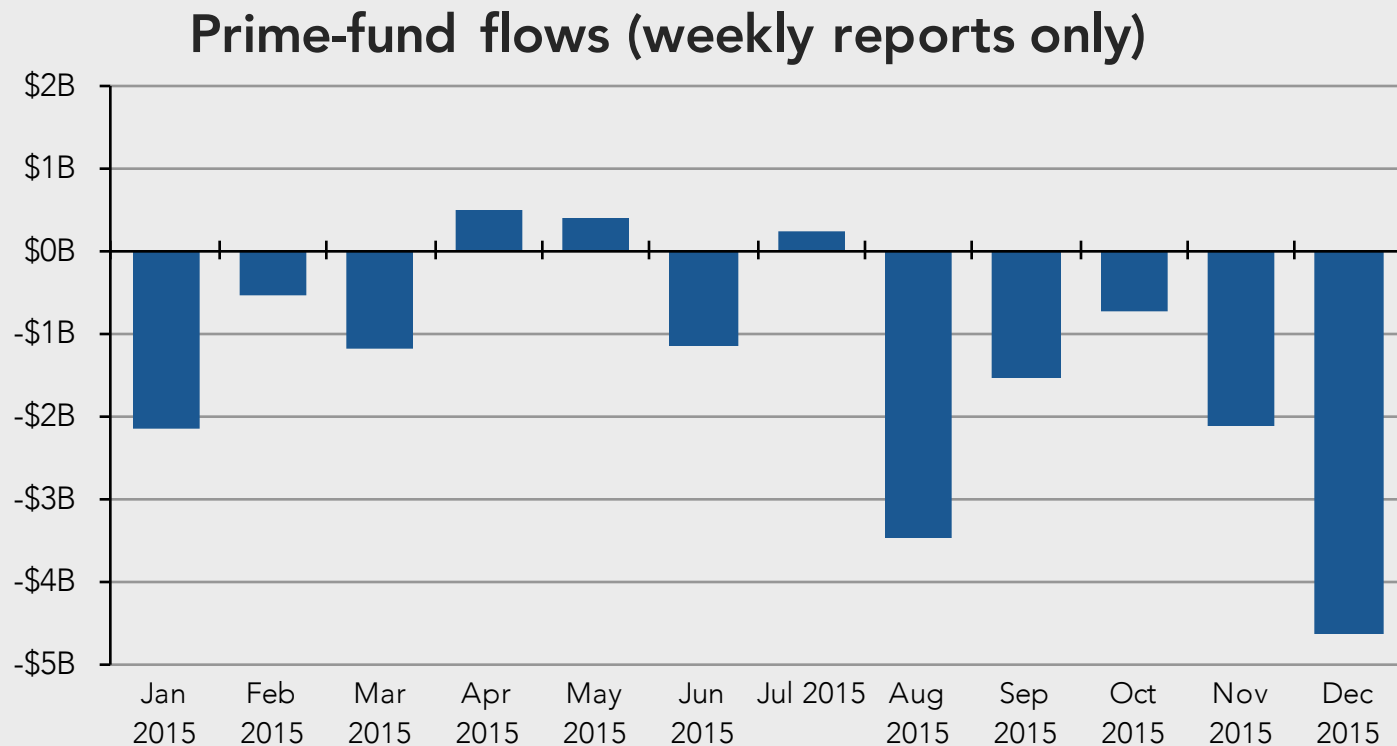


Source: PitchBook



# Capital Markets – Behind the Scenes

Despite prospect of higher rates, loan fund outflows were \$16 billion



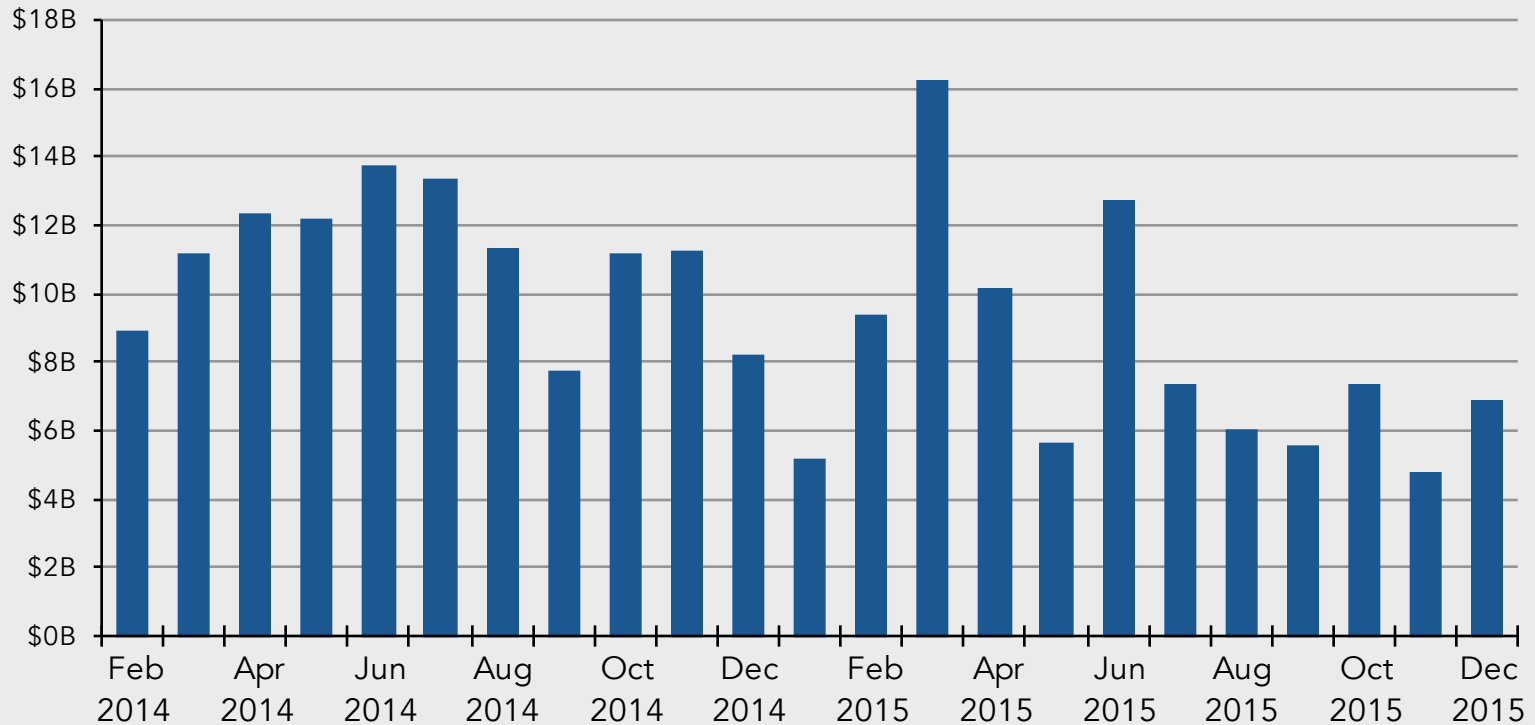
Source: S&P/LCD



# Capital Markets – Behind the Scenes

CLO formation slows as managers wrestle with risk retention

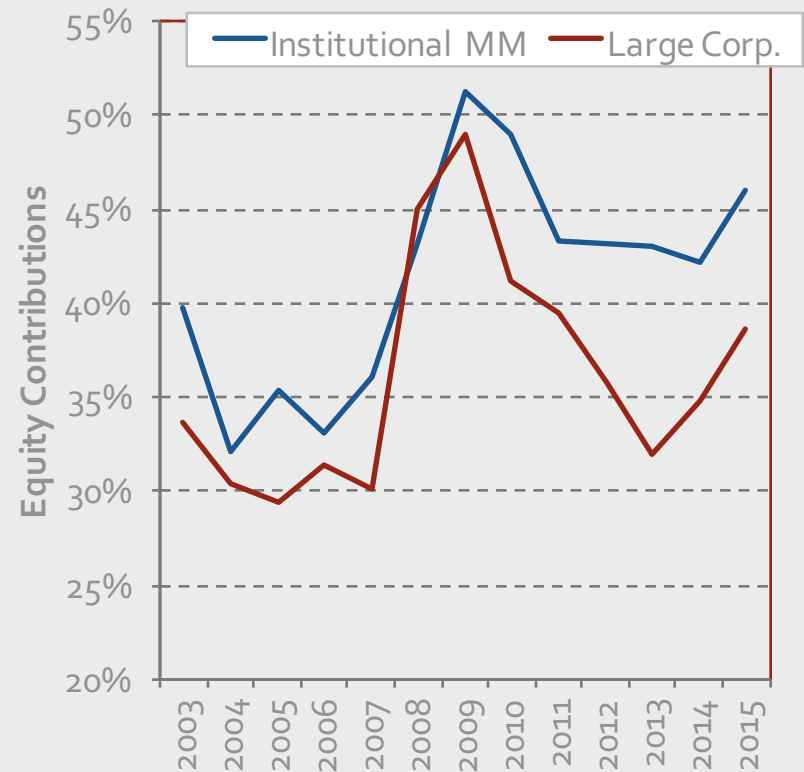
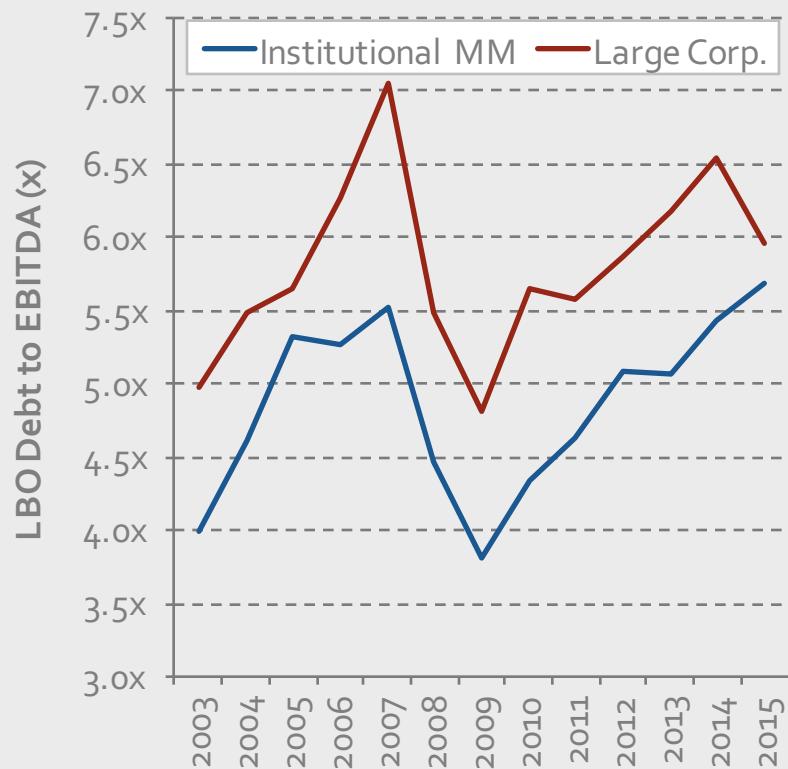
## Monthly CLO volume



Source: S&P/LCD

# Capital Markets Metrics – Leverage

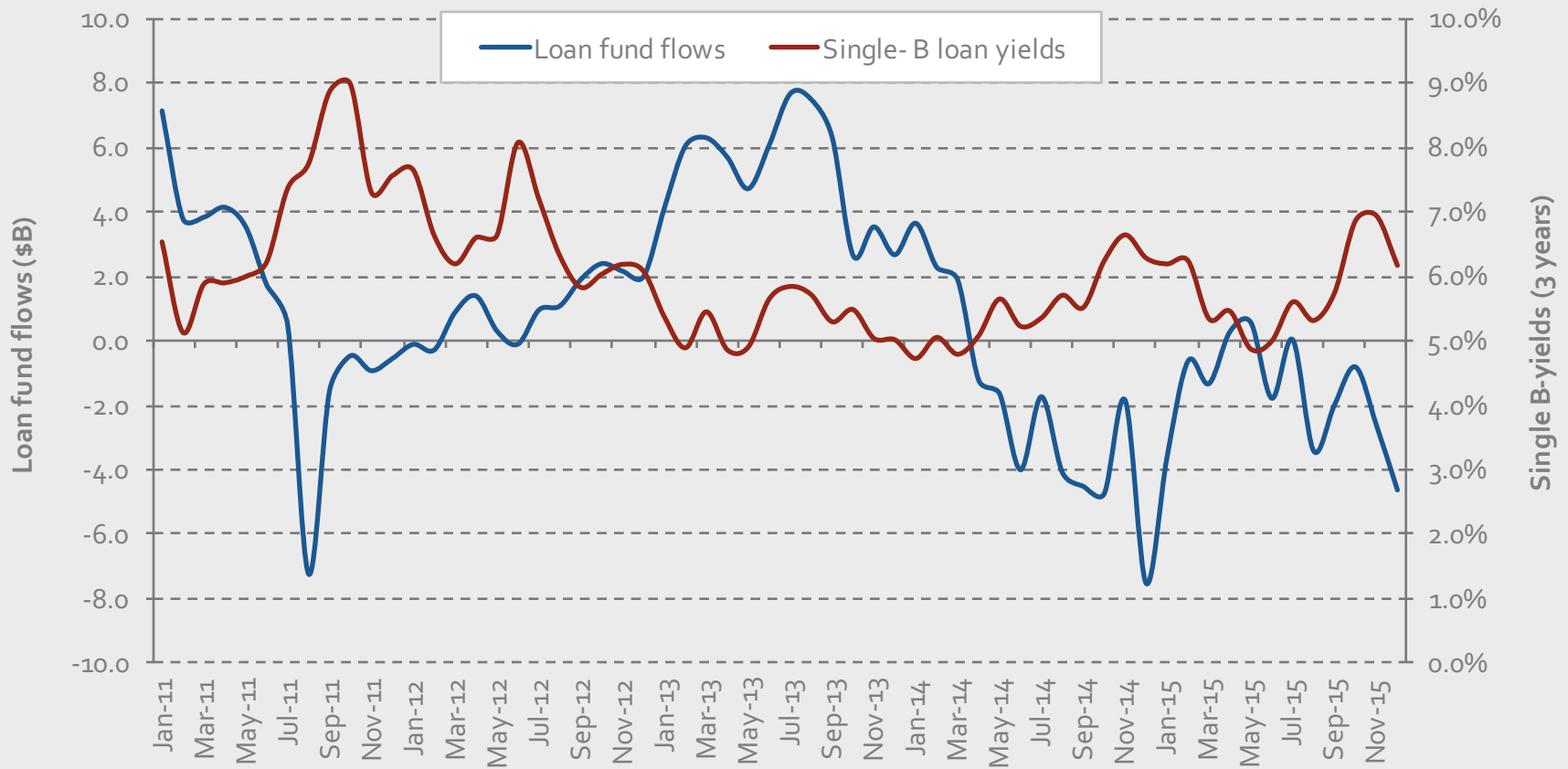
## Leveraged Lending Guidance impacting leverage levels



Source: Thomson Reuters LPC

# Capital Markets Metrics – Pricing

Sentiment shifts in 4Q15 away from the issuer



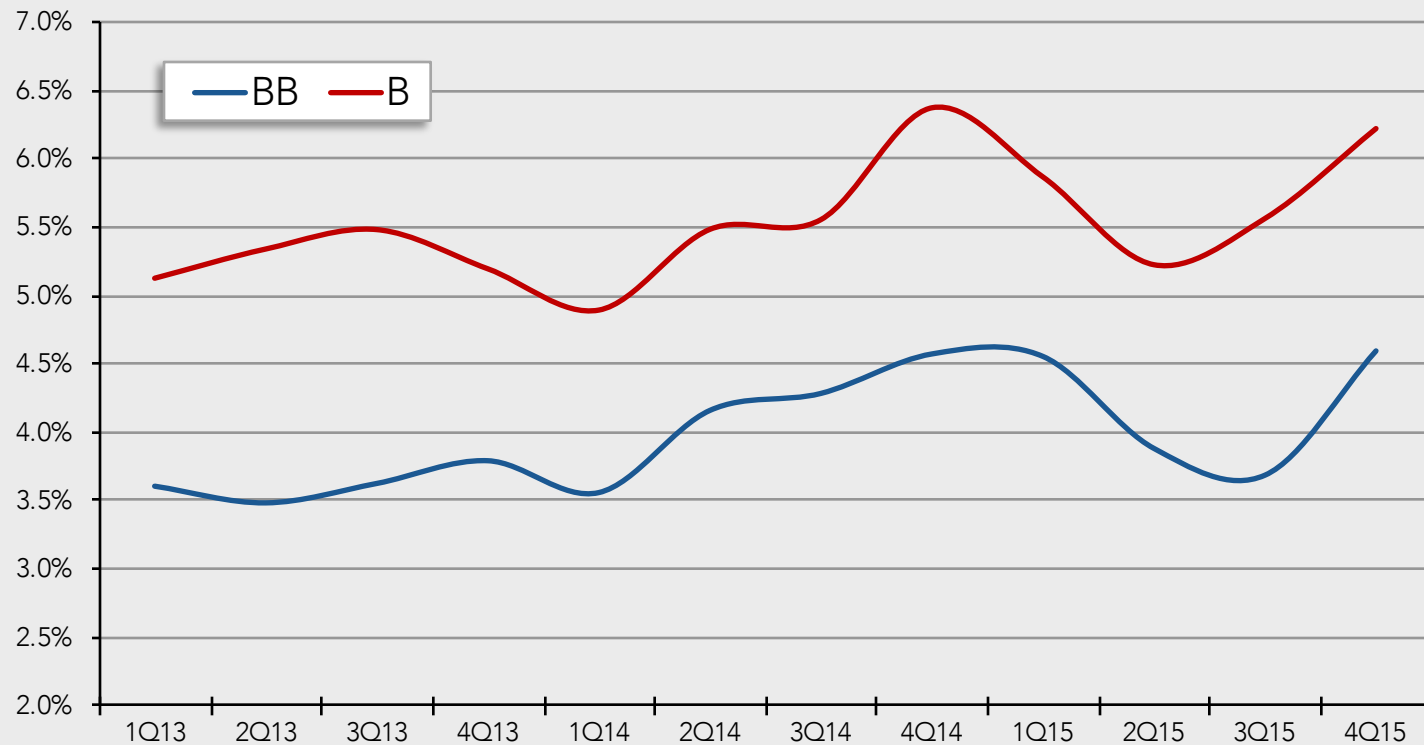
Source: Thomson Reuters LPC



# Capital Markets Metrics – Pricing

Both “good” and “better” credits remain range-bound

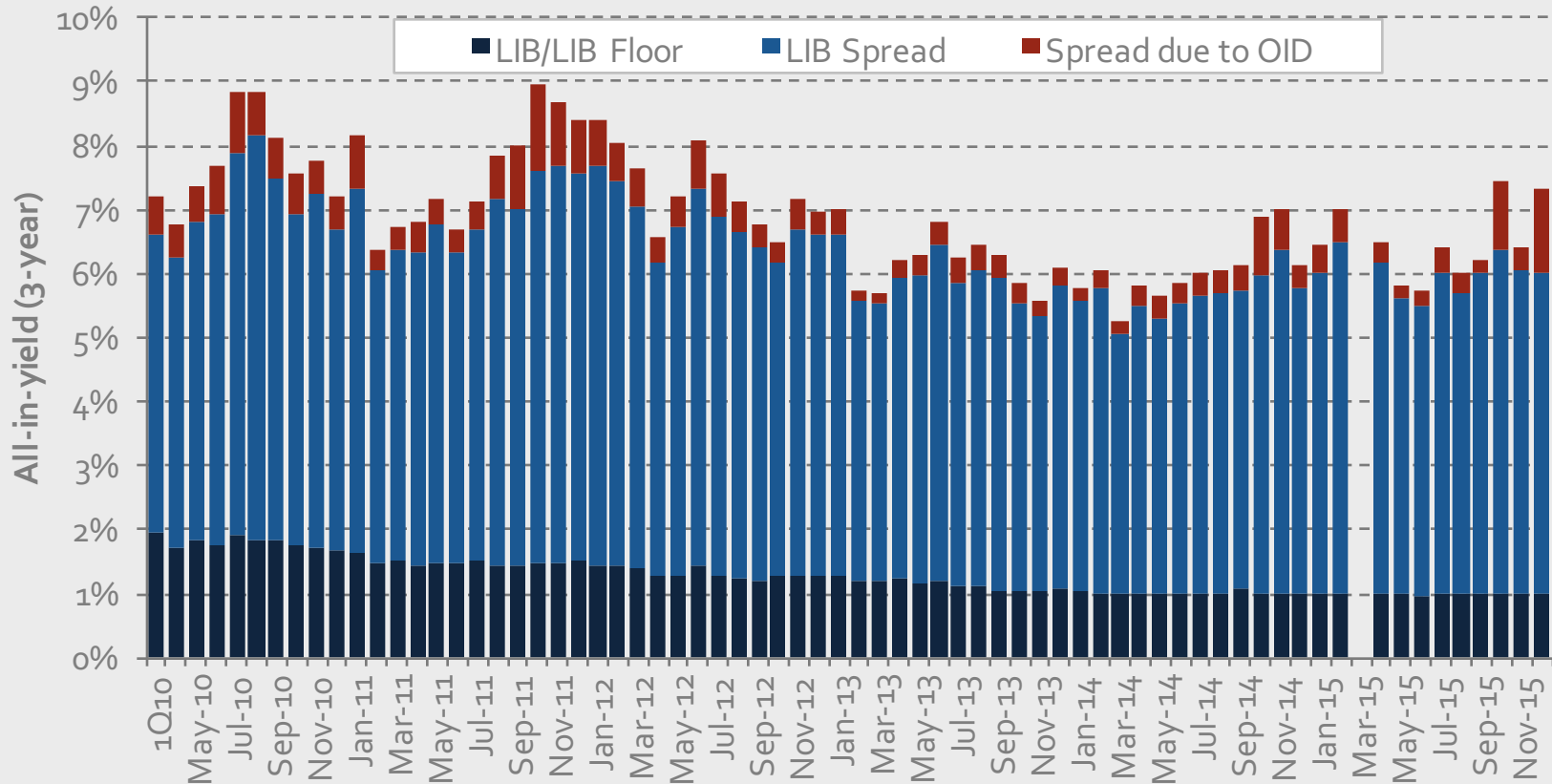
## New-issue yield to maturity for leveraged loans



Source: S&P LCD

# Capital Markets Metrics – Pricing

## Yields on leveraged middle market loans tick up in 4Q15



Middle market institutional yields (3 year)

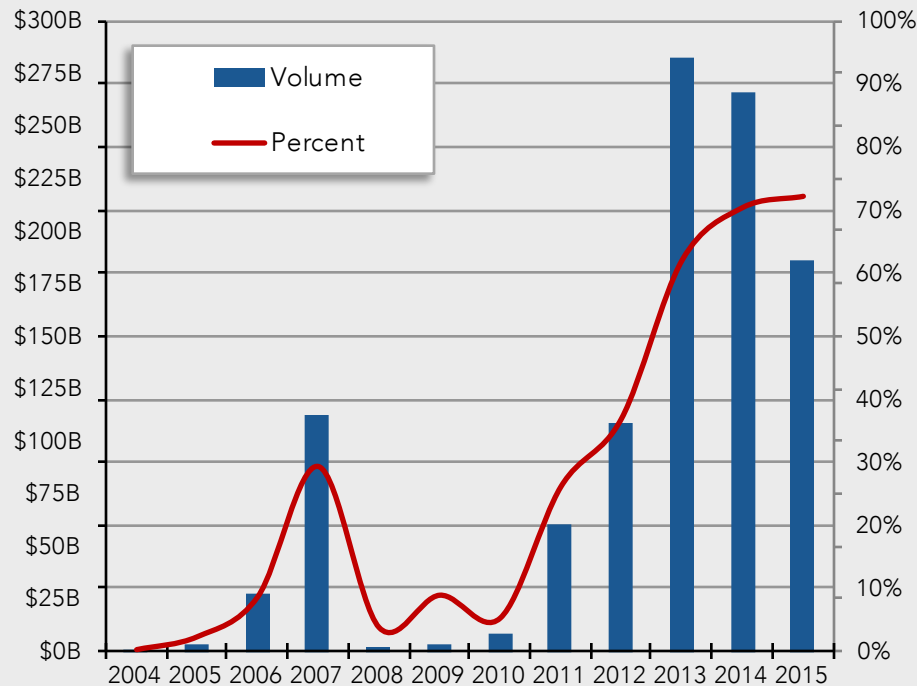
Source: Thomson Reuters LPC



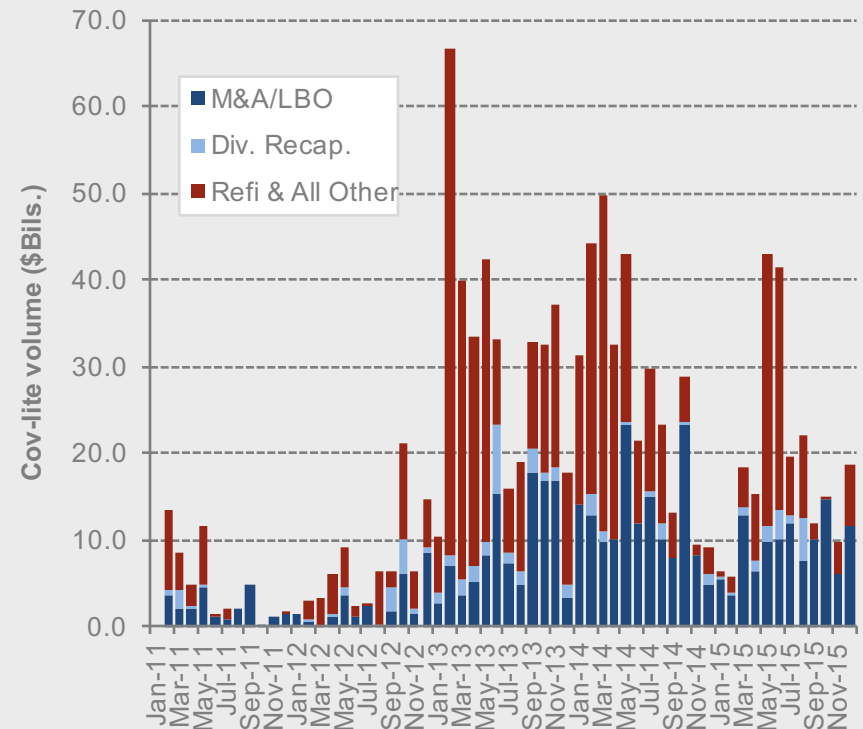
# Capital Markets Metrics – Covenants

## Covenant-lite issuance cools in 4Q15 in the face of volatility

### US Covenant-Lite Loans



### US Covenant-Lite Loans (by purpose)

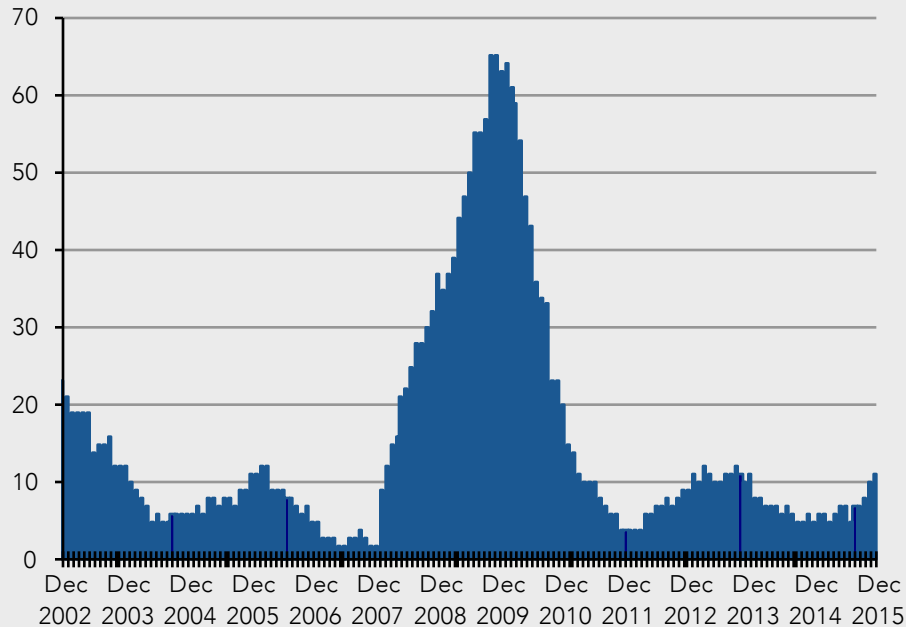


Source: S&P LCD & Thomson Reuters LPC

# Capital Markets Review – Credit Quality

While energy sector is focus of concern, overall defaults remain low

Lagging 12-month default number of issuers



Lagging 12-month leveraged loan default rate by number



Source: S&P LCD

# Capital Markets – First Quarter 2016 Outlook

## Advantage swings to the buy-side as volatility widen spreads

- ⚡ Non-bank direct lenders stepping into void left by skittish public markets and regulated lenders under leveraged lending constraints
- ⚡ Continued retail loan outflows and modest CLO formation will temper new deal issuance in broadly syndicated market
- ⚡ Middle market origination will be driven by one-stop credit solution providers partnering with key sponsor lender relationships
- ⚡ Additional direct lending capacity coming from new firms and smaller managers merging or bulking up with JV's and partnerships
- ⚡ All-in first-lien loan yields widen to 6% for BSL's; mid caps to 7% ; unitranche still in 7-9% all-in range
- ⚡ Expect leverage of 3.5x senior/4.5x total for traditional middle market; 4.0x senior/5.5x total for larger mid caps; 4.5-5.0x senior/6.0x total for BSL



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**Now Where Were We?**  
We've all noticed the market conditions two years ago when the Dow had closed at 12,839. Today it stands at 18,450, a 27% improvement. Credit spreads back in April 2012 easily peaked at 100bps. Last week's Treasury Credit Spread Index was seven times underwritten and priced at 50. After the first seven games of the 2012 season, the NY Mets advance record was 6-8. The price tag was \$5.

**Quote of the Week:**  
"It's in an environment where the discerning eye of real credit investors has given us to the area discerning generic yield grade."  
— Stuart Lippman, portfolio manager, TEG Subscribers LLC

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Show highest activity, deleveraged existing loans, and the yield curve has started moving the year in the leveraged loan market.

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- Detailed information on deals in the market
- Plus our popular Charts and Quotes of the Week

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