THE Lead Left
Your Tour Guide to the Middle Market®

PDF | Research | Week of Nov 20, 2017

Quote of the Week

"The institutional loan market is cannibalizing some issuance on the high-yield bond side."
– Jeff Cohen, global head of leveraged finance capital markets, Credit Suisse.

State of the Loan Market (Last of a Series)

In what was the highest price ever paid for a painting, Leonardo da Vinci's "Salvator Mundi" sold last week for $450.3 million at a Christie's auction, beating by a wide margin the $179 million forked over two years ago for Picasso's "Les Femmes d'Alger."

The price tag also topped the entire building cost of New York's new Whitney Museum ($422 million). The satirical newspaper, *The Onion* , weighed in with a headline: "Buyer of $450 million Da Vinci Painting Sort of Assumed it Would Come with Frame."

Loan buyers in the leveraged market must have similar feelings of being short-changed this year. As yields have compressed and leverage crept up, investors are scouring the current pipeline for value. That search is complicated by loan structures weakening with a broad brush.

At the heart of this erosion is the definition of ebitda. As we've discussed at length in this space, sponsors are stretching cash flows to include various add-backs and pro forma adjustments to justify higher purchase price multiples. As our ***Chart of the Week*** highlights, those multiples are heading towards 11x on average for the overall market.

And it's not just affecting leverage covenants, to the extent that a maintenance test is even featured in the credit agreement. As an upcoming ***Lead Left Spotlight*** guest will point out, inflated ebitda is also distorting other covenants such as builder baskets, asset sales, debt incurrence, dividend allowances and excess cash flow sweeps.

Besides news from the art world, another surprise was the bipartisan support from the House Financial Services Committee for a bill that, among things, gives BDCs the ability to use up to 2:1 leverage to improve the yield of the assets in which they invest.

While some BDCs have already found ways around the 1:1 restriction, others might take advantage of the additional flexibility by buying lower yielding assets. With leverage, those loans could now meet the vehicles' higher return parameters.

Meanwhile the portrait of the bond market wasn't pretty. Cash poured out of retail high-yield funds to the tune of $4.4 billion, putting total outflows at about $13 billion for the year. That came in response to market jitters about the telecom sector, mostly centered around slowing growth and increased competition among wireless providers.

While no one thinks this marks the end of the bull credit market, it reminds us corrections are often triggered by emotions. Because bonds are unsecured and fixed rate, holders are more sensitive to rate or cycle worries. With the structural erosions being suffered by leverage loans in general, their value relative to bonds blurs.

This trend helps middle market loan buyers appreciate the benefits of that asset class. Traditional midcap agreements still have a leverage maintenance test. And the smaller the issuer, the more likely some form of junior debt will be found in the capital structure.

So while masterpieces are scarce in the loan world, experienced managers don't mind paint-by-numbers. As long as the numbers makes sense.

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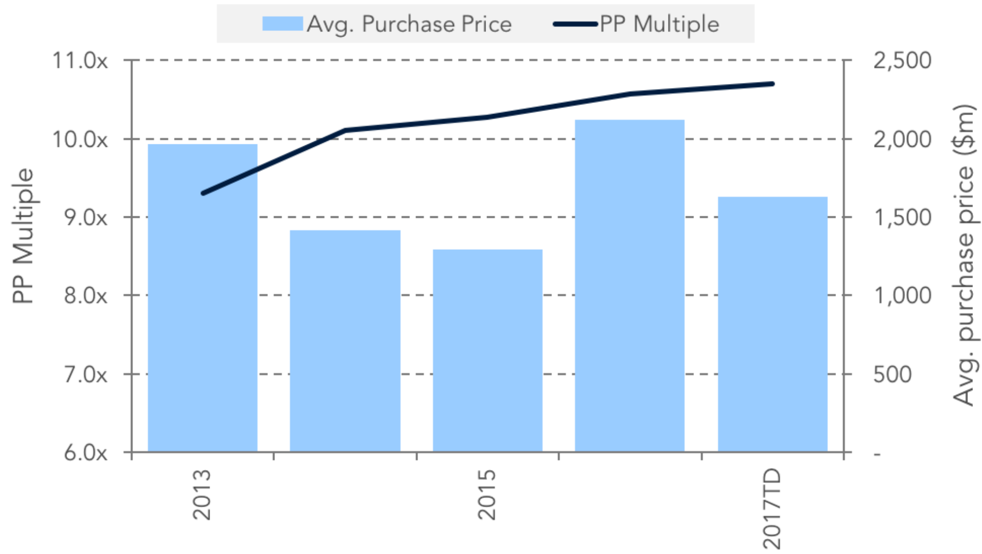
Special Report: How Big is the Middle Market?

- Introduction
- Middle market size by definition
- Middle market size by the numbers
- Conclusion

Download Report

Chart of the Week

Paying Up



The average buyout price in the overall market has shrunk by $500 million so far this quarter, though it's up as a multiple of ebitda.

Sources: *Thomson Reuters LPC*

Stat of the Week

	2017	2016	2011	2007
Americans' Christmas Spending Plans ($)	906	785	712	909

Source: GALLUP

Loan Stats at a Glance

S&P Global
Market
Intelligence

	This Week	Last Week	6MO Ago	YR Ago
New-Issue Clearing Yields				
$200M or less	4.85%	4.85%	5.88%	6.80%
$201M - $350M	6.14%	6.29%	6.19%	6.30%
$351M - $500M	5.38%	5.37%	5.54%	6.10%
$501M+	4.73%	4.77%	4.60%	4.88%
Middle market (≤ $50M)	5.95%	5.95%	6.39%	6.77%
Large corporate (> $50M)	4.97%	5.02%	4.85%	5.10%
Large corporate single-B (> $50M	5.40%	5.44%	5.20%	5.35%
Middle Market Credit Stats				
Sr/EBITDA	5.4	5.4	5.4	4.8
Debt/EBITDA	5.4	5.4	5.4	4.8
Middle Market Index Data				
Monthly Returns	0.07%	0.19%	0.50%	0.25%
Average Bid	97.31	97.40	97.41	95.54

Contact: Timothy Stubbs

Lead Left Spotlight

This week we continue our conversation with Daniel Winick, a partner in the banking and finance group of Clifford Chance US LLP, and Andrew Young, a senior associate in the same group. Their practice includes representing sponsors, corporates, lenders and participants in multijurisdictional leveraged and other finance transactions. Clifford Chance is a multinational law firm that is one of the ten largest globally. ***Second of two parts – View part one.***

The Lead Left: *From what we've seen, the issues surrounding incremental loans seem to be as much about MFN protections as anything else. What trends are you seeing in the market with respect to the MFN?*

Daniel Winick: Borrowers continue to negotiate creative ways to maximize financing flexibility and minimize incremental loan costs and constraints.

TLL: *Any other notable developments on exceptions to the MFN or other lender protections?*

DW: A growing list of borrowers have achieved flexibility in respect of the tenor of incremental loans. This includes (1) excepting from the MFN loans maturing outside a certain date (for example, two years after the existing loans) and (2) designating a certain amount of incremental debt to mature earlier than the existing loans. In the case of incurrences of such earlier-maturing debt, this presents a form of subordination that could impact the value of the existing loans.

The devil can also be in the details. For example, it's become common for borrowers to negotiate limits on the nature of incremental debt that will be subject to the MFN provision. Specifically, only incremental "senior secured term loans"

MFN exceptions that are growing in popularity include ones based on (1) the specific incremental basket utilized (for example, no MFN if only the fixed basket is drawn), (2) a designated amount expressly excepted, or (3) application of the incremental loan for a specific purpose (for example, an investment or acquisition).

Others exceptions have included broadening of classic ones, namely, yield buffers and sunsets. Traditionally, MFN clauses required an increase in pricing to remain within 50 basis points of any incremental loans. In 2017, sponsors and strong borrowers have pushed for 75 basis points. These higher spreads have been common in Europe, but not so much in the U.S. Somewhat surprisingly, in most cases lenders have successfully rejected higher MFN spreads, although at least some have cleared.

"The strong issuers' market over the last year has inspired innovative ways to facilitate more financing flexibility."

Andrew Young: Just as a point of information, the credit research team at Covenant Review reported that 19 deals have cleared market with MFNs of 75bps so far in 2017.

In terms of sunsets, virtually all new debt issuances propose an expiration on MFN protection, typically anywhere from 6 to 18 months following the closing date. Here, again lenders have been fairly successful in rejecting MFN sunsets. Covenant Review's data showed that 113 deals (about 20%) have cleared with MFN sunsets so far this year.

that are "syndicated" may trigger the MFN. Other examples include where first lien debt capacity is permitted via the debt covenant but there is no related MFN trigger, or where the MFN applies only to the initial incremental term loan incurrences.

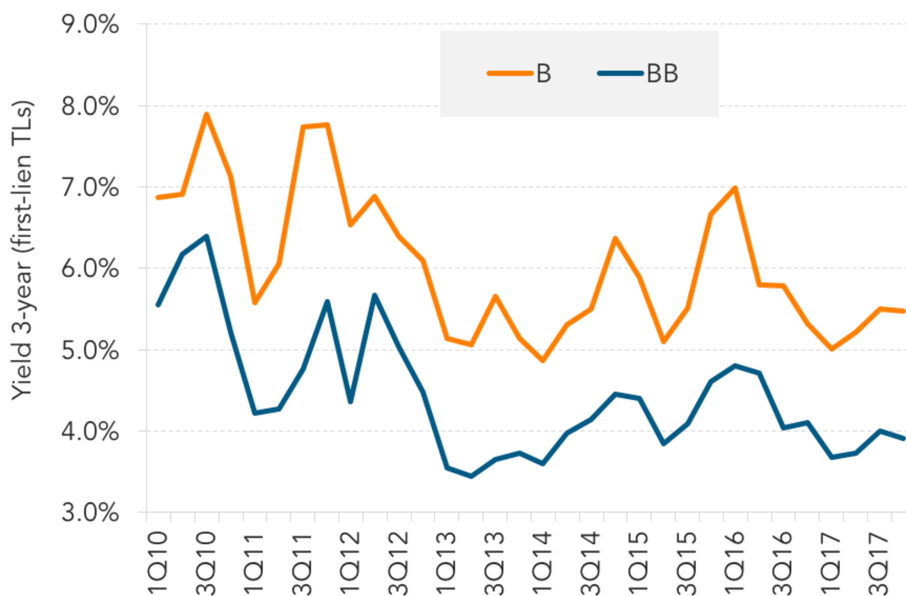
***TLL:** Very helpful. Any closing thoughts on incremental loans and expectations in the future?*

AY: From the borrowers' perspective, incremental loans provide quick access to liquidity and borrowers should not be penalized when they seek to finance a potential value-enhancing transaction, hence the growing list of MFN exceptions. From the lenders' perspective, lenders are assuming the risks of incremental loans carrying higher pricing and devaluing their paper. Thus, the duration and scope of the MFN has remained a final battle frontier to preserve one of lenders' most important economic protections, particularly when interest rates are expected to rise in the future.

DW: In summary, the evolution of incremental loans and MFN protection has always been a product of loan market conditions. The strong issuers' market over the last year has inspired innovative ways to facilitate more financing flexibility. The incremental sizing trends and MFN exceptions noted are just some examples and there may be more to come before 2017 ends. At the same time, if and when the market turns, it will be interesting to see how these features are revisited.

Contact:
Daniel Winick, Andrew J. Young

Primary leveraged yields tighten slightly so far in 4Q17

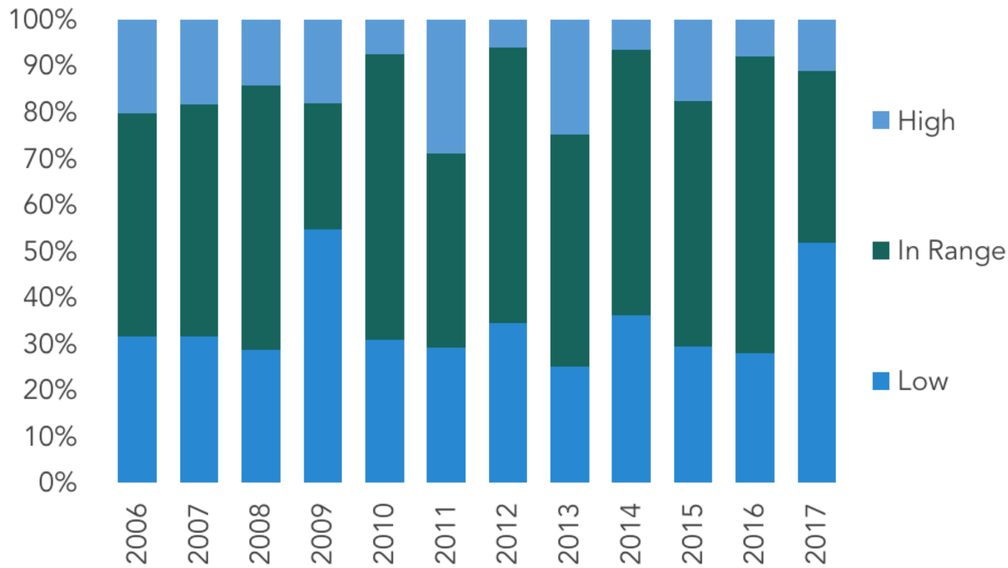


Yields have declined slightly in 4Q17 despite an increase in the Libor component. The average yield, assuming a three-year term to repayment is at 5.07% so far in 4Q17; slightly below the 5.16% recorded in 3Q17. Holding up the yields is the increase in the 3-month Libor, which is currently at 1.45%. Average Libor spreads have actually declined by 14bp from their 3Q17 levels and are currently at an average of 3.56%. Higher rated issuers have seen a slightly higher decline in yields. Average yields on first-lien institutional term loans for BB-rated issuers are currently at 3.91%; down from 4% in 3Q17. For B-rated issuers, yields are almost flat at 5.47% so far this quarter. Low yields continue to entice issuers to cut their costs, with many rushing to the market with repricings before the Thanksgiving break. While the market has been receptive and issuers have been able to cut their costs, investors are not giving in all the way and some signs of pushback have emerged. This week Weight Watchers increased pricing, among other investor-friendly changes, on its upsized US$1.59bn term loan, which refinances existing debt.

Contact: Diana Diquez / loanpricing.com

The Pulse of Private Equity

PE-backed IPOs: A hairy 2017



It's no secret that PE sellers have preferred outright sales over IPOs recently. There are big advantages to staying private, and many of the best-performing assets on sale since 2016 have been bought outright by financial or corporate buyers. Why test the temperamental public markets when acquisitions can bring in consistently high multiples? The PE-backed companies that have gone public this year almost confirm that perception. Through 3Q, almost half of 2017 IPO listings priced below their initial price ranges, a ratio not seen since 2009.

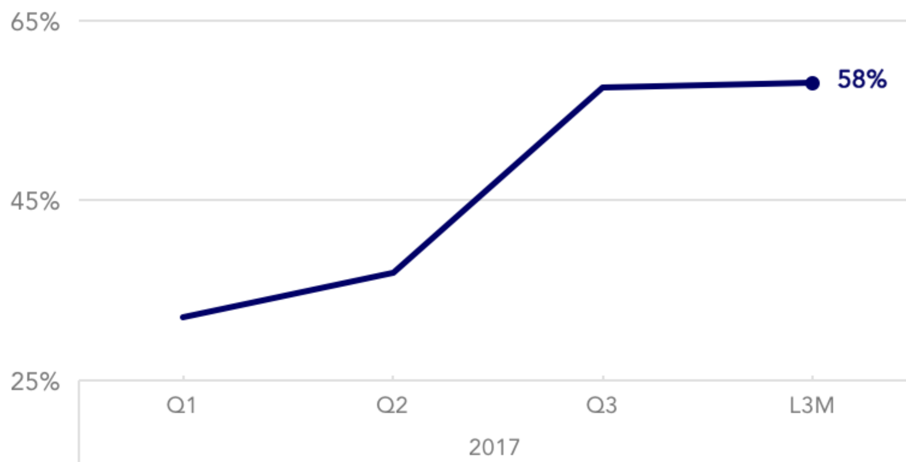
Times are different today, and PE's IPO woes are multi-faceted. Questions around profitability and leverage ratios were cited several times this year, as were questions around the current retail model, energy prices, tax changes, healthcare regulations and the sustainability of the recent tech surge. Among the PE-backed IPOs to underwhelm this year, several were tied directly or indirectly to the struggling retail sector or the still-questionable energy market. Perhaps the biggest difference between today's numbers and 2009's is the housing sector; among the better IPOs this year, three have direct ties to an improving housing market, including Floor & Décor (up 88% since listing), Jeld-Wen (which considered an outright sale around $3 billion, while its stock has surged 71% to a $4.1 billion market cap), and Invitation Homes, Blackstone's massive holding in the rental-home market, which is up 17% since going public in January.

Contact: Alex Lykken

Covenant Trends

Covenant
Review

Percentage of Loans with F&C Growers



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Contact: Steven Miller

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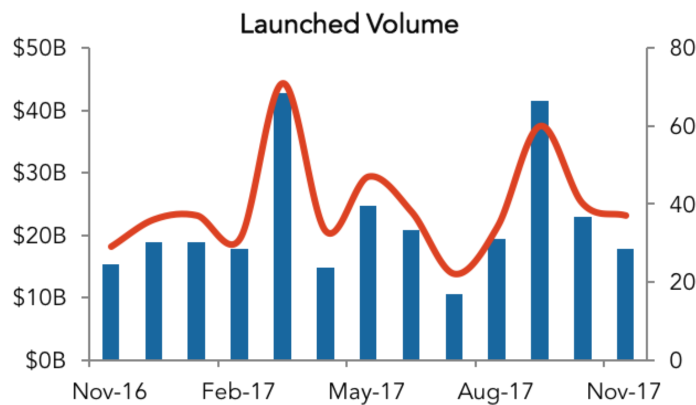

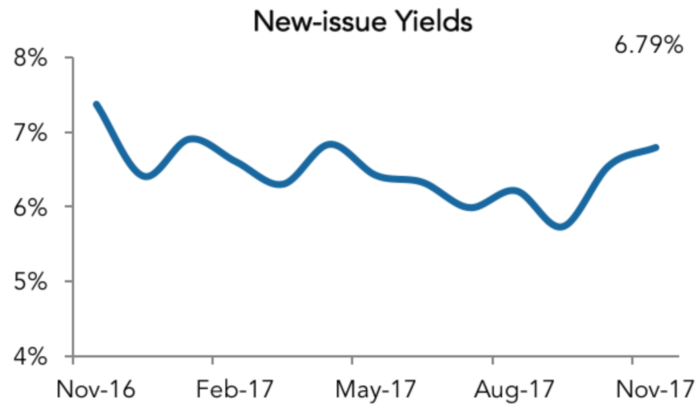

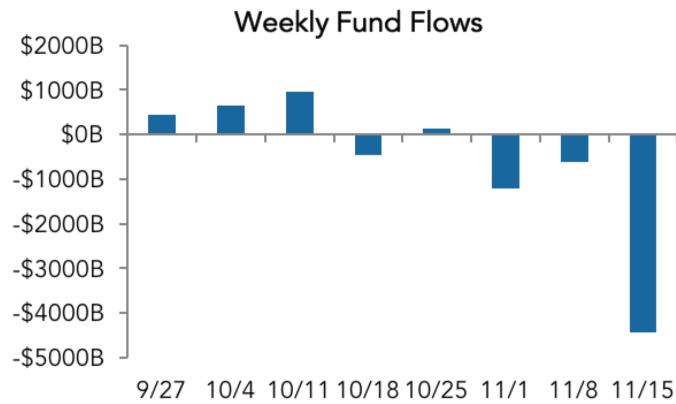

Weekly fund flows source: **Lipper**

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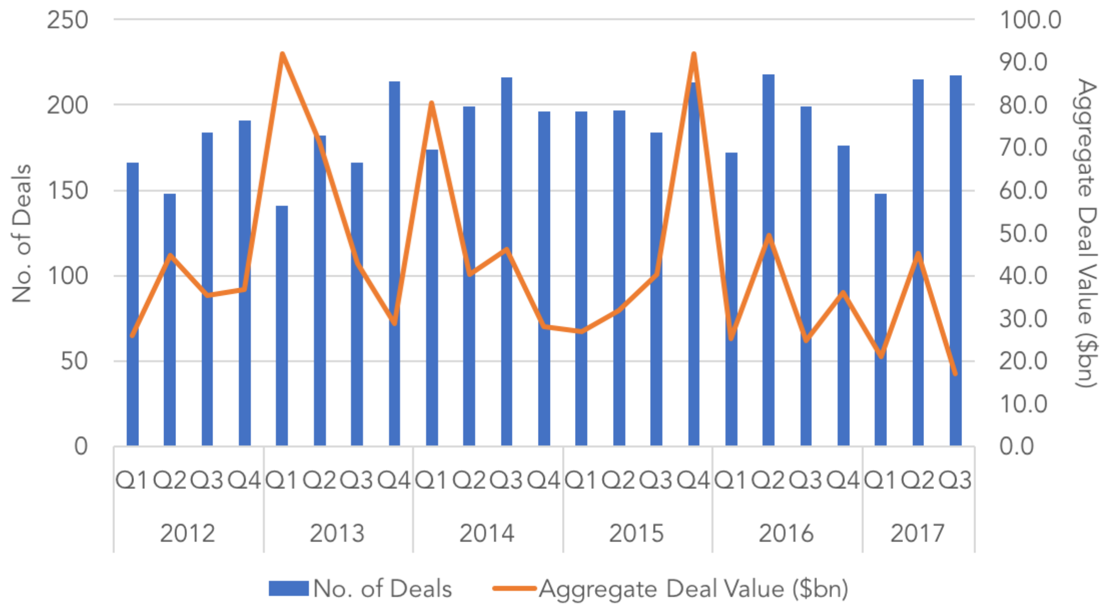
Contact: **Robert Polenberg**

Private Debt Intelligence

Private Debt Deals Completed in Q3 2017



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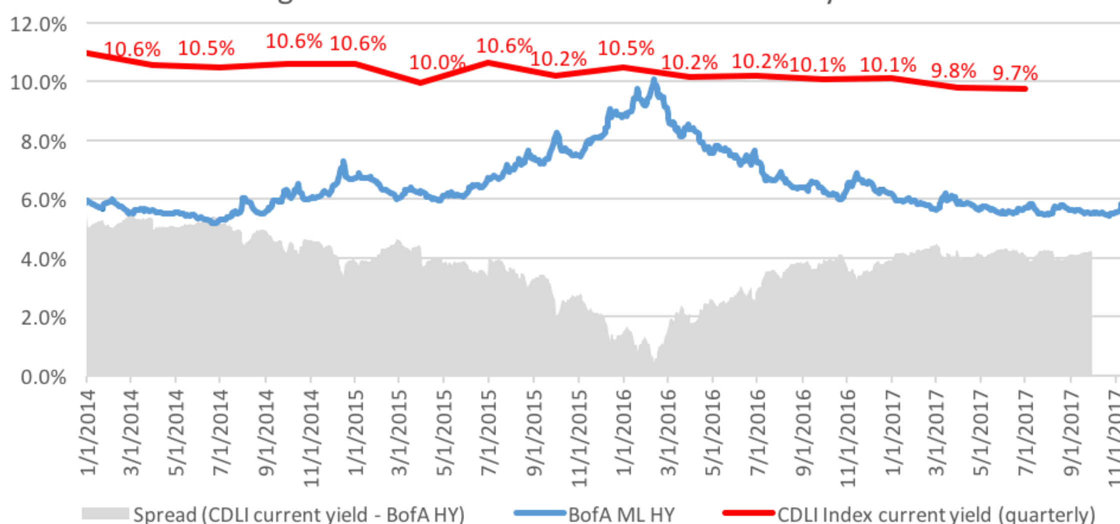
The private debt industry saw 217 deals recorded in Q3 2017, worth $16.9bn This brings Q1-Q3 2017 total private debt deal activity to 580 deals completed, worth an aggregate $83.2bn. In contrast to Q3, Q2 saw 215 private debt deals, which had an aggregate worth of $45.3n. While Q3 saw a similar number of deals as the previous quarter, recorded capital from deals fell by over $28bn. Previously, the lowest recorded capital from private debt deals over the past five years was in Q1 2017, which saw 148 deals worth $21.0bn. In fact, Q3 recorded the lowest amount of capital from deals since Q1 2010, which saw 85 deals completed, worth $15.0bn.

North America remains the most active region in the private debt industry, representing 66% of all private debt deals tracked in Q3.

Europe was the second most active region, and makes up 29% of private debt deal activity. Historically, these two regions account for the largest proportions of the private lending market largely due to their political structures, as well as because of their regulatory environment. Additionally, North America and Europe have seen a slowdown of traditional lending which has benefitted the development of the private debt market.

When broken down by industry, industrials represent the largest proportion of deal activity, and account for a fourth of private debt deals completed in Q3. Information technology and consumer discretionary account for 17% of deals, while healthcare represents 13%. Food and agriculture made up the smallest proportion of deals (5%).

Contact: Naomi Feliz



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Source:* *Cliffwater Direct Lending Index* *and* *BofA Merrill Lynch US High Yield Effective Yield

The red line in the chart is the *Cliffwater Direct Lending Index (CDLI) current yield, which is based on the investment income of the underlying assets held by public and private BDCs. BDCs invest in middle market companies, and the Index comprises of more than 6000 middle market loans – with 58% senior debt, 29% subordinate debt and 9% equity. The blue line displays the BofA Merrill Lynch US High Yield, which tracks the performance of USD denominated below investment grade corporate debt publically issued in the US. Increase in high yield depicts dislocations in market, pricing in higher risk. The spread of CDLI current yield minus BofA ML HY (shaded area in grey) shows the premium of middle-market loans over traditional High Yield, gauging attractiveness of the asset class. The higher premium for middle-market, to some extent, depicts the illiquidity for private loans and credit risk associated with smaller companies. Since early 2016, we have seen a steady surge in the spread, **increasing to 391 basis points as of 20 November 2017** , making middle market relatively more attractive.

** As of 30 June 2017, **the CDLI index** includes USD 89bn in assets, with more than 6000 loans – approximately 58% senior debt, 29% subordinate debt, 9% equity and 4% other. BDC eligibility to be included in the Index is at least 75% of total assets represented by direct loans as of the Index valuation date. All the yields are unlevered. CDLI Index yield is total interest income of all BDCs covered, divided by their total assets, reported quarterly (9.7% as of 30 June 2017). **CDLI** data is quarterly while **BofA Merrill Lynch HY Effective Yield** is daily.*

Contact: Jonathan Berke

November Update: Middle Market Deal Terms at a Glance

SPP CAPITAL PARTNERS

Deal Component	November 2017	November 2016
Cash Flow Senior Debt (x EBITDA)	Micro Cap 1.75x-3.00x Small Cap 2.75x-4.00x Midcap 3.25x-4.75x	Micro Cap 1.50x-2.50x Small Cap 2.50x-3.50x Midcap 3.00x-4.00x
Total Debt Limit (x EBITDA)	Micro Cap 3.25x-4.50x Small Cap 3.50x-5.00x Midcap 4.50x-6.00x	Micro Cap 3.00x-4.50x Small Cap 3.00x 4.50x Midcap 4.00x-5.50x
Senior Cash Flow Pricing	Bank: L+3.00%-5.00% Non-Bank: <$10.0MM EBITDA L+5.50%-8.00% Non-Bank: >$15.0MM EBITDA L+4.50%-6.00% (potential for a 1.00% floor)	Bank: L+3.00%-4.50% Non-Bank: L+4.50%-8.00% (potential for a 0.50% - 1.00% floor)
Second Lien Pricing (Avg)	Micro Cap L+7.00%-11.00% floating (1.00% floor) Small Cap L+6.50%-8.50% floating (1.00% floor) Midcap L+6.00%-7.50% floating (1.00% floor) Fixed rate options range from 7.0%-11.0%.	Micro Cap L+8.00%-11.00% floating (0.50% - 1.00% floor) Small Cap L+6.50%-8.50% floating (0.50% - 1.00% floor) Midcap L+6.00%-7.50% floating (0.50% - 1.00% floor)
Subordinated Debt Pricing	Micro Cap 12.00%-14.00% Small Cap 10.00%-13.00% Midcap 10.00%-12.00% Warrants limited to distressed and special situations; Second lien may buy down to ~9.0%.	Micro Cap 11.00%-14.00% Small Cap 10.00%-13.00% Midcap 10.00%-12.00% Warrants limited to sub $5 million EBITDA and special situations; Second lien may buy down rate to ~9.00%. Equity co-invests readily available.
Unitranche Pricing	Micro Cap L+7.00%-11.00% (1.00% floor) Small Cap L+6.50%-8.50% (1.00% floor) Midcap L+6.00%-7.50% (1.00% floor) Fixed rate options range from 7.0%-11.0%. ABL revolver can be arranged outside of the Unitranche to arbitrage all-in pricing.	Micro Cap L+8.00%-11.00% (0.50% - 1.00% floor) Small Cap L+6.50%-8.50% (0.50% - 1.00% floor) Midcap L+6.00%-7.50% (0.50% - 1.00% floor) Fixed rate alternatives readily available. Most unitranche lenders allow a small ABL facility outside of the unitranche facility though pricing is likely to be impacted by size of revolver if external to unitranche.

*Micro Cap= <$5.0mm EBITDA(1)
*Small Cap= >$10mm EBITDA
*Midcap= >$20mm EBITDA
*Changes from last month are in red
(1) <$5.0mm for November 2017

Contact: Stefan Shaffer

Select Deals in the Market

Deal	Arranger	Sponsor	Industry	Facility*	Spread	LIB Flr	OID	Rating
Specialty Care (CL)(1L)(1)	Antares	Kohlberg & Co.	Healthcare	230	425	100	99.5	B-/B2
Specialty Care (2L)(4)	Antares	Kohlberg & Co.	Healthcare	65	825	100	99	B-/B2
Golden West Packaging	Citizens	Lindsay Goldberg	Forest Product	125	525	100	99	NR/NR
Eating Recovery Center (CL)(1)	Antares	CCMP Capital Advisors	Healthcare	190	450	100	99.5	B-/B3
US Lumber (CL)(2)	SunTrust	Madison Dearborn Partners	Forest Product	215	600	100	98.5	B/B2
Riverstone Utopia Member (1)	Barclays	Riverstone	Oil & Gas	225	425	100	99.5	NR/NR
Innovative Chemical (1)	Antares	Audax Group	Chemicals	205	400	100	99.5	B-/B3
Lyons Magnus (CL)(1)	RBC	Paine & Partners LLC	Food & Beverage	195	425	100	99.5	B-/B2
Big Ass Solutions (CL)(1)	CS	Lindsay Goldberg	Manufacturing & Mach	250	425	100	99.5	B/B2
SunSource	Barclays	Clayton, Dubilier & Rice	Building Materials	235	N/A	N/A	N/A	NR/NR
Walker & Dunlop (1)	Wells Fargo	Fortress Investment Group	Services & Leasing	166.5	300	100	100	BB-/Ba3
BayMark Health Services (1L)	Capital One	Webster Capital	Healthcare	29	475	100	99.5	NR/NR
BayMark Health Services (2L)	Capital One	Webster Capital	Healthcare	45	850-875	100	98.5	NR/NR
Averages				167	480	100	99	

* Senior only
** May be estimate based on leverage. Assumes unfunded revolver
NA Not Available
All dollar amounts in $MM
Corporate ratings unless otherwise noted

(1L) First Lien
(2L) Second Lien
(CL) Covenant Lite
(D) Dividend
(AO) Add-On

New Deal
Flex Up
Flex Down

Call Schedules
(1) 6 Month 101
(2) 101
(3) 104/103/101
(4) 102/101

Source: S&P/LCD, Thomson Reuters/LPC, market sources

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