DUFF & PHELPS

INDUSTRY INSIGHTS:

Capital Markets

Q3 2016 Review

Highlights

Middle-market issuers enjoyed a welcoming lending environment this quarter during which leverage providers took on increased levels of fundamental risk. This tolerance for increased risk reflected improving macroeconomic conditions on the one hand and appetite for yield on the other.

While aggregate issuance of high-yield bonds and leveraged loans declined modestly this quarter, we observed a migration of appetite toward those credit and hedge funds with higher risk/return parameters.

The return of leveraged recapitalizations largely offset a decline in middle market M&A related financing. Modestly positive fund inflows facilitated the successful absorbing of recap issuance.

Market analysts continued to closely follow monetary policy, even as major central banks largely stood pat for the quarter. To our surprise, geopolitical developments (other than a sharp, though brief, Brexit scare) and macroeconomic strengthening, had little lasting impact on market conditions.

Central banks remain accommodative, though signals from the Federal Reserve suggest a December rate hike.

In light of improving macroeconomic conditions, credit sources are taking on higher degrees of fundamental risk.

Lenders are focused on well-structured transactions; we noted increased appetite for growth-oriented financings (typically including unfunded acquisition lines).

Executive Summary

Middle-market issuers were greeted by strong demand this quarter from mainstream credit sources as well as those seeking higher degrees of risk and return. Commercial banks, while largely hewing to traditional leverage parameters, exhibited unusually high leverage tolerance for larger deals in noncyclical spaces. Business development companies returned to the market as their portfolio challenges began to abate. This mainstream demand was supplemented by increased activity among credit and hedge funds, as well as historically passive investors initiating direct credit programs. We observed increasingly aggressive credit parameters among these opportunistic participants, wherein borrowers were offered alternatives with higher leverage and structural characteristics.

Macroeconomic fundamentals continued to improve, though the focus remained on monetary policy. With an increasingly stark dichotomy of views at the Federal Reserve, volatility persisted in anticipation of clearer guidance on the pace and timing of rate hikes. Ultimately, central banks largely held pat in the third quarter, with the European Central Bank electing to continue its stimulus program, and the Fed left benchmark rates unchanged. The Bank of Japan, rather than cut into further negative territory, announced that it would maintain its easing program and focus on managing long-term yields.

Much of our activity this quarter involved transactions designed to facilitate organic and acquisition oriented growth, among other objectives. An improving macroeconomic backdrop, combined with the broadening of investment strategies among market participants, has allowed us to deliver increasingly holistic solutions to our clients. In particular, financings that incorporate unfunded acquisition lines alongside funded term loans have become increasingly widely available.

We anticipate that issuers will enjoy the benefits, in coming quarters, of a diverse universe of market participants offering an array of credit solutions. The market for ordinary course leverage should continue to be welcoming; this appetite will increasingly be complemented by solutions of a higher risk/higher reward, offering deeper leverage and more aggressive structures. Consequently, borrowers will enjoy an unusually broad menu of solutions from which to choose.

Indicative Middle-Market Credit Parameters

LEVERAGE MULTIPLES

	EBITDA OF $10MM - $20MM	EBITDA OF $20MM - $50MM
SENIOR	**2.50x - 3.50x**	**3.00x - 4.00x**
TOTAL DEBT	**3.50x - 4.50x**	**4.00x - 5.50x**

Indicative Middle-Market Credit Parameters

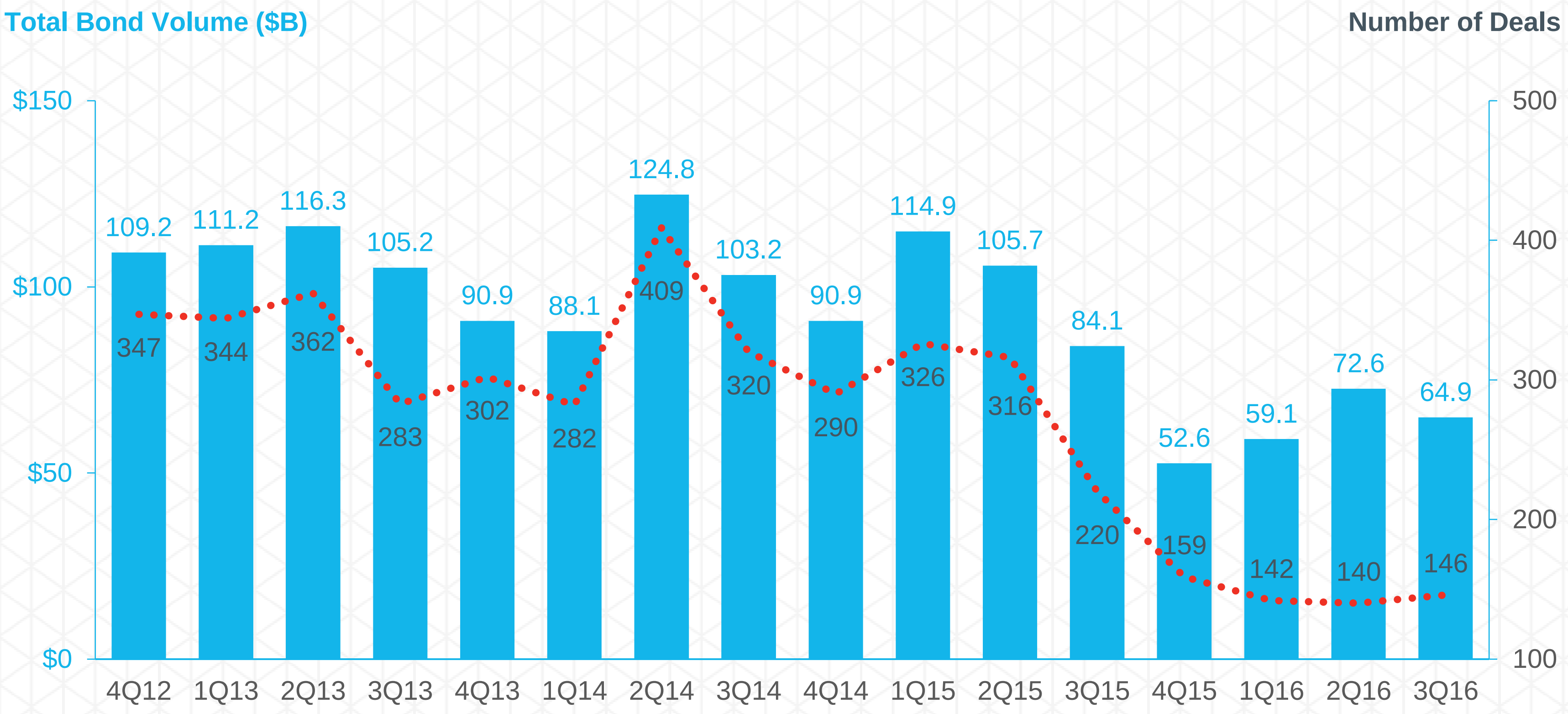
INFORMATION IN RED REPRESENTS PRIOR QUARTER VIEW

PRICING	EBITDA OF $10MM - $20MM	EBITDA OF $20MM - $50MM
FIRST LIEN	LIBOR + 3.00% - 4.00% (bank) LIBOR + 2.75% - 3.50% (bank) LIBOR + 4.50% - 6.50% (non-bank) LIBOR + 4.00% - 6.00% (non-bank)	LIBOR + 2.75% - 3.50% (bank) LIBOR + 2.50% - 3.25% (bank) LIBOR + 4.00% - 6.00% (non-bank)
SECOND LIEN	LIBOR + 7.00% - 10.00% LIBOR + 6.50% - 9.50%	LIBOR + 6.50% - 9.50% LIBOR + 6.00% - 9.00%
SUBORDINATED DEBT	11.00% - 13.00%	10.00% - 12.00%
UNITRANCHE	LIBOR + 7.00% - 9.50% LIBOR + 6.50% - 9.00%	LIBOR + 6.50% - 9.00% LIBOR + 6.00% - 8.50%

New Issuance

The number of high-yield issuances this quarter ticked up modestly, though dollar volume fell from the second quarter and remains below long-term averages. Given the largely benign near-term monetary policy outlook, relatively little discretionary bond financing occurred this quarter.

Total High-Yield Bond Issuance

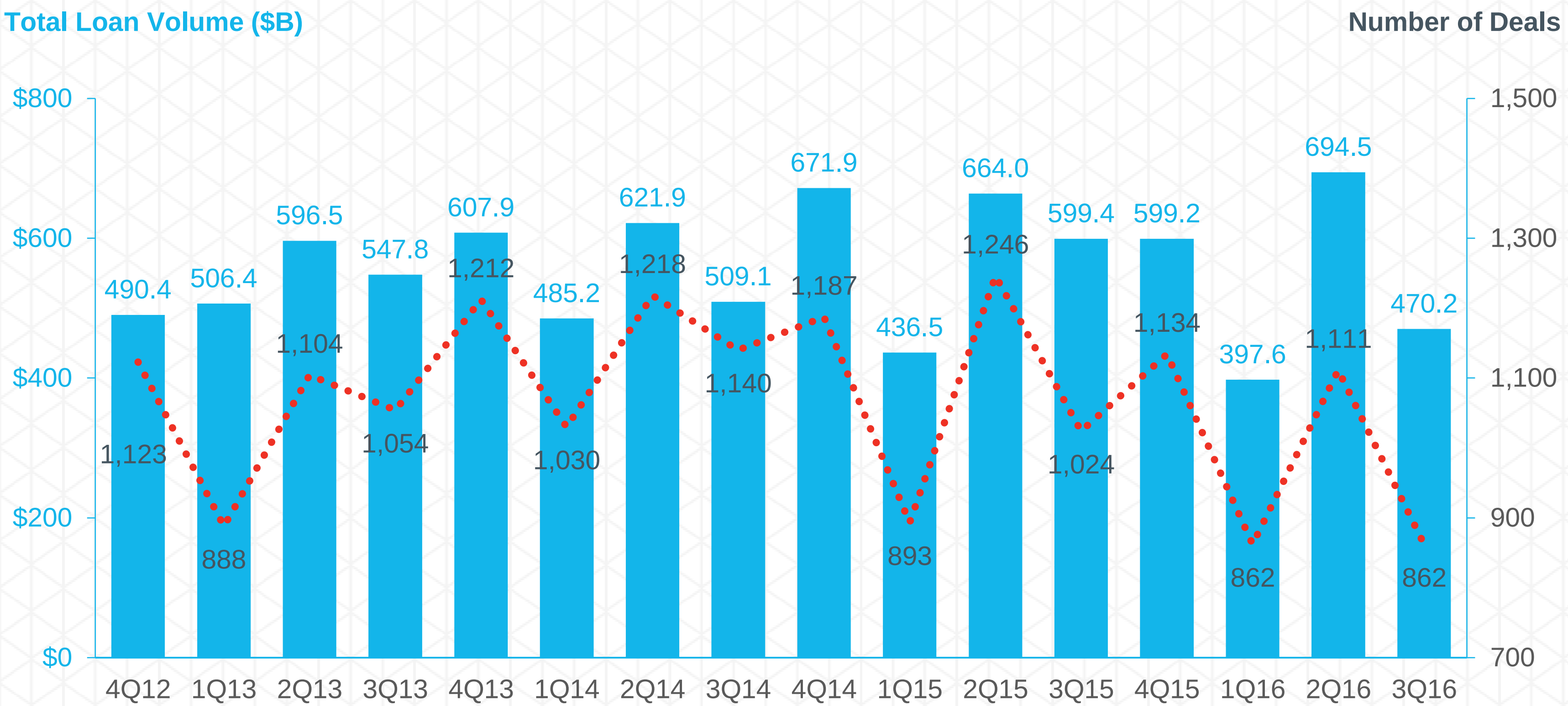


Source: SDC Platinum

New Issuance

The total dollar volume of new loan issuance declined, as did the number of transactions, in the third quarter. On a trailing two-month basis, aggregate dollar volume and, to a lesser extent, the number of transactions completed, moved toward historical means[(1)].

Total Loan Issuance



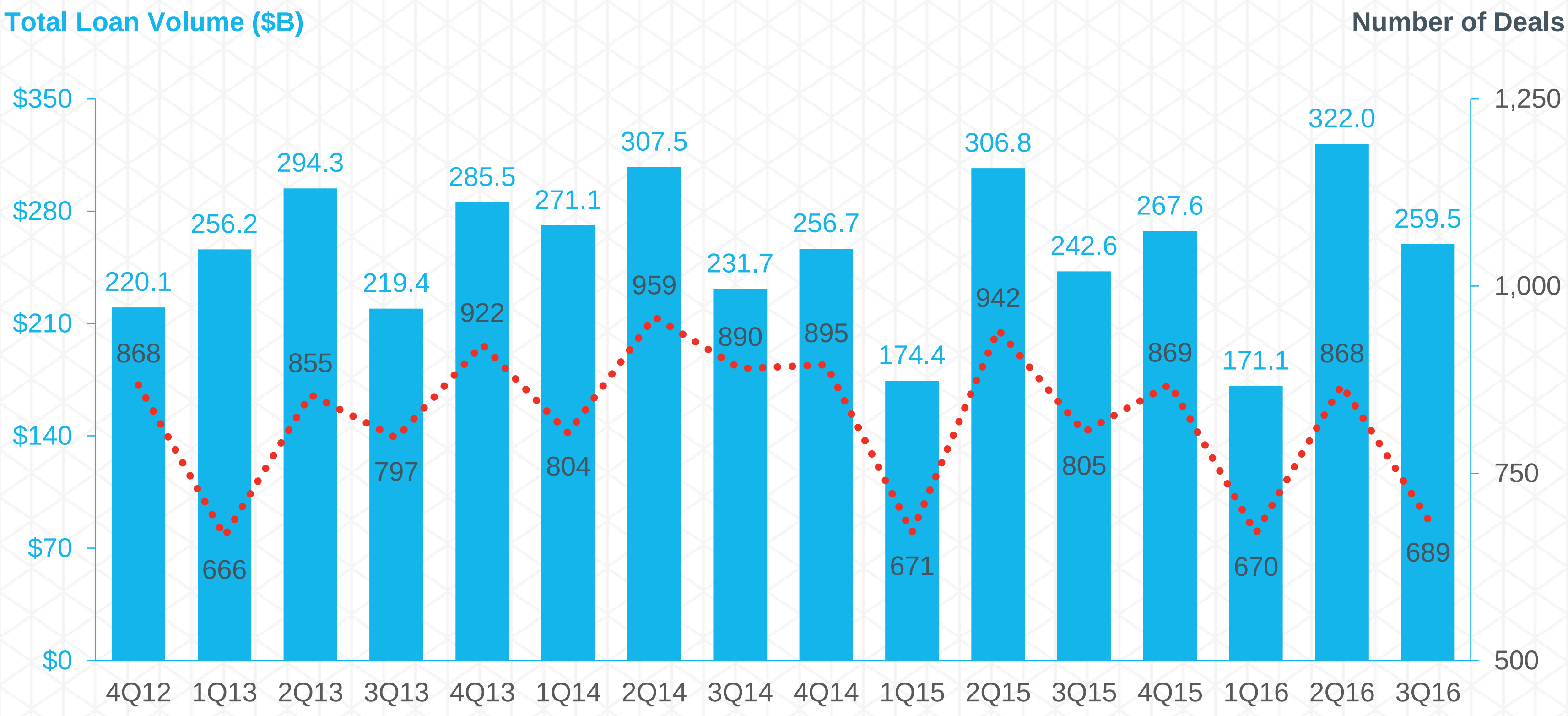
(1) We attribute the spike in Q2 activity to the deferring of planned Q1 issuance, in light of volatile market conditions early in the year.

Source: SDC Platinum

New Issuance

Consistent with our observations on total loan issuance, third quarter dollar volume and the number of transactions declined, though less so in the middle-market. We note that middle-market issuance on a trailing two-quarter basis continued to be strong, as we observed a migration of appetite toward those credit and hedge funds with higher risk/return parameters.

Total Loan Issuance (EBITDA < $50MM)

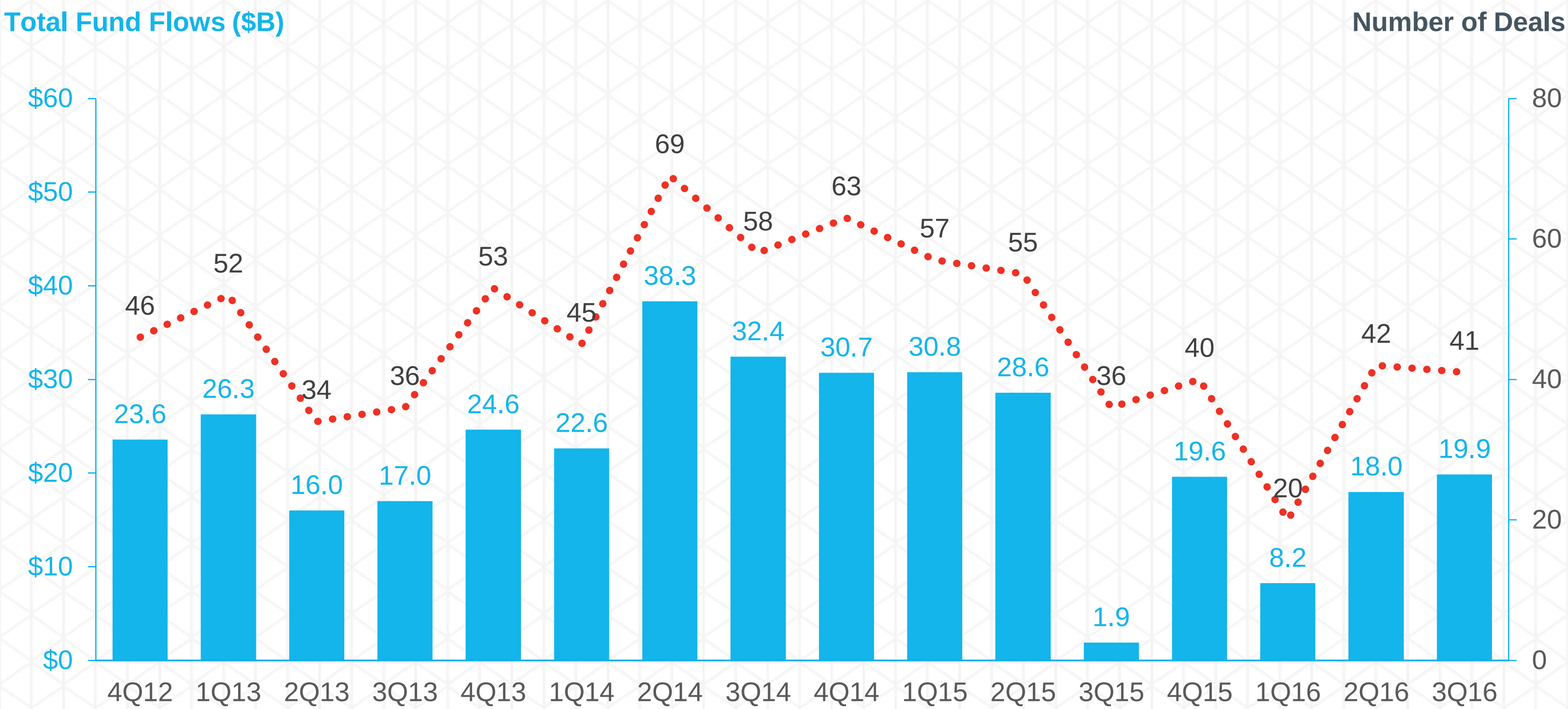


Source: SDC Platinum

Fund Flows

Issuance of collateralized loan obligations (CLOs) increased modestly this quarter. The relative importance of CLOs in the middle-market diminished somewhat as credit funds, hedge funds and BDCs exhibited increased risk appetite.

Total CLO Issuance



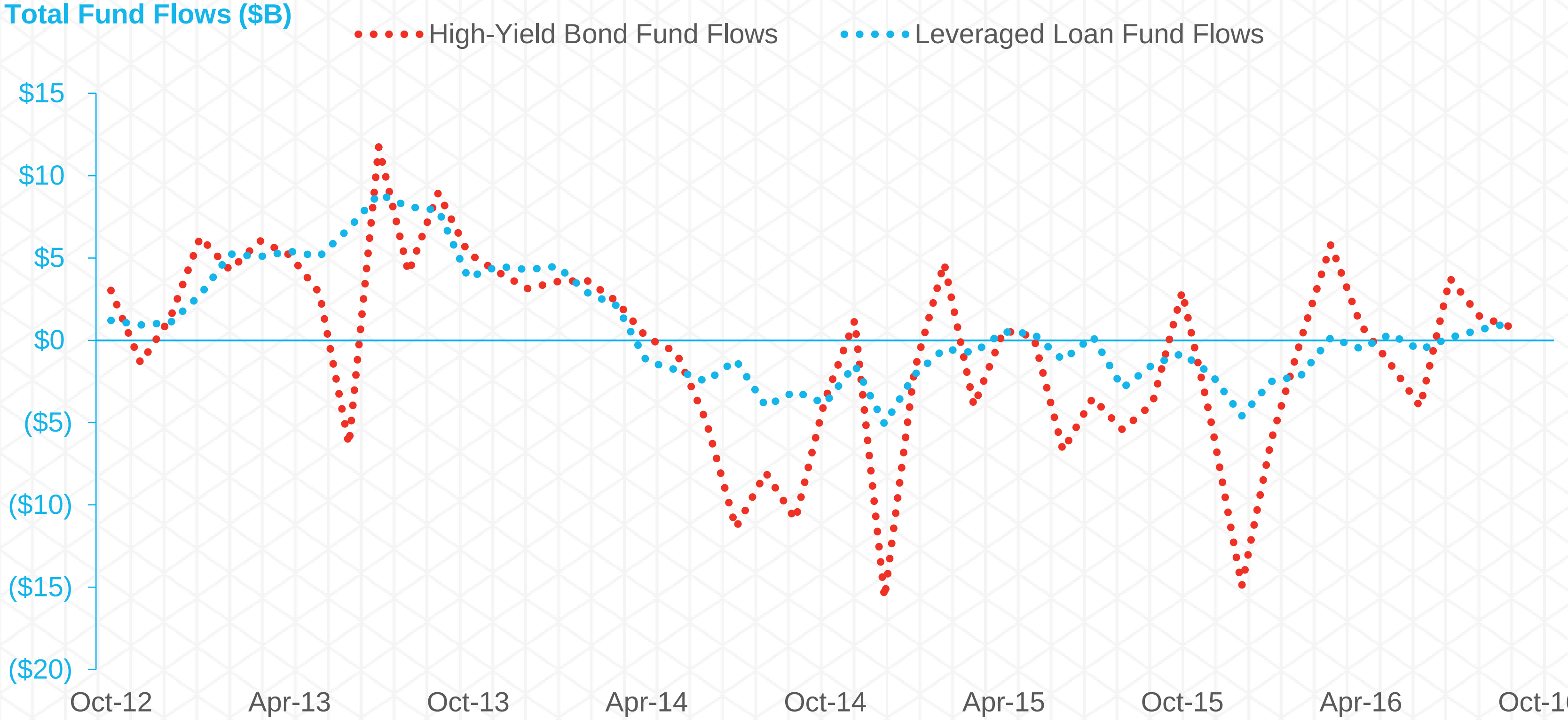
Source: SDC Platinum

Fund Flows

Leveraged loan fund inflows grew in each month of the third quarter. It appears that mutual fund investors are positioning themselves for a rising yield environment.

Mutual Fund Flows

Total Fund Flows ($B)



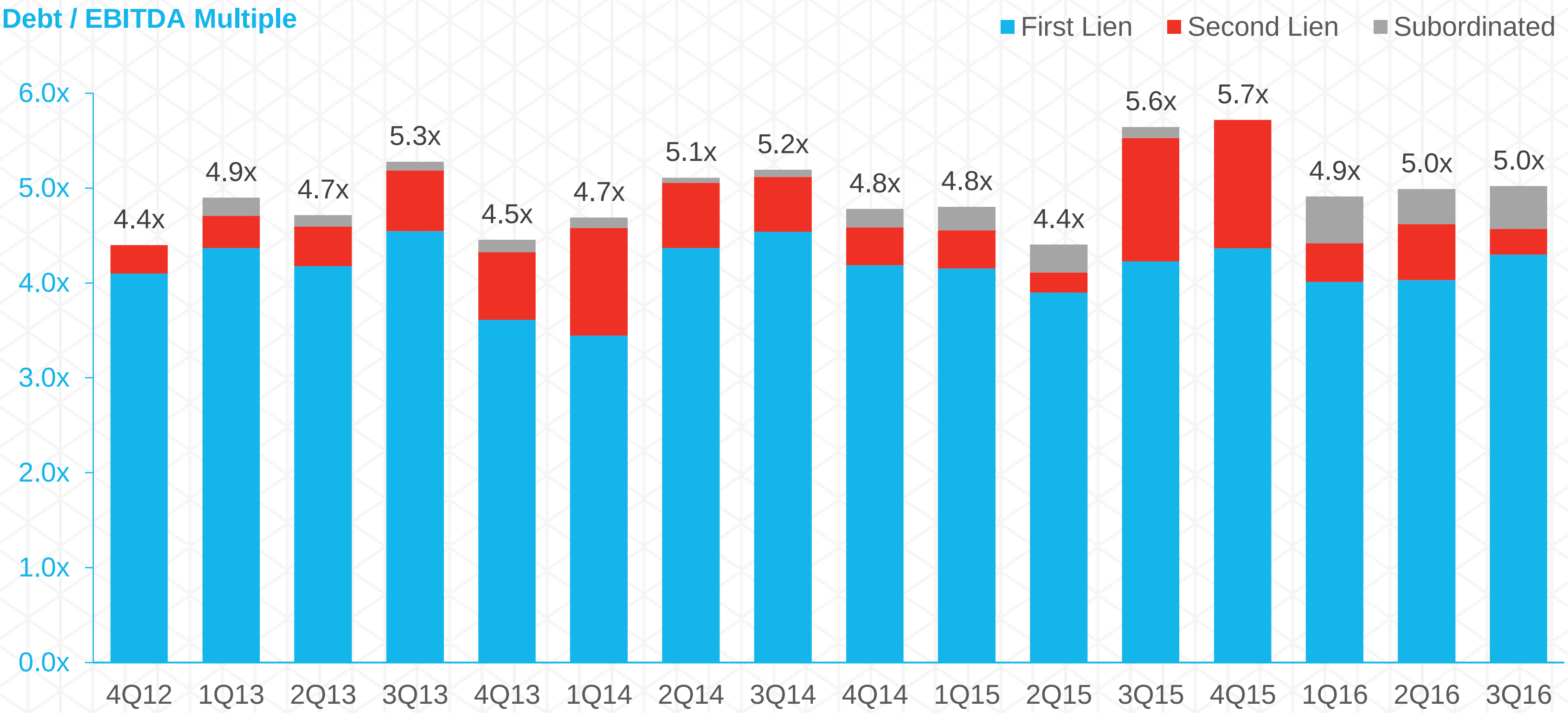
Source: Investment Company Institute; Lipper FMI

Leverage

Mean total leverage multiples for middle-market financings remained at ~5.0x this quarter. The amount of first lien debt, however, increased by approximately 0.3x, reflecting a rotation of lender appetite to single source unitranche structures and away from bifurcated senior/junior structures. While commercial banks continue to demonstrate modest risk appetite, credit funds and BDCs, among others, filled the void with unitranche solutions.

Leverage Multiple (EBITDA < $50MM)

Debt / EBITDA Multiple

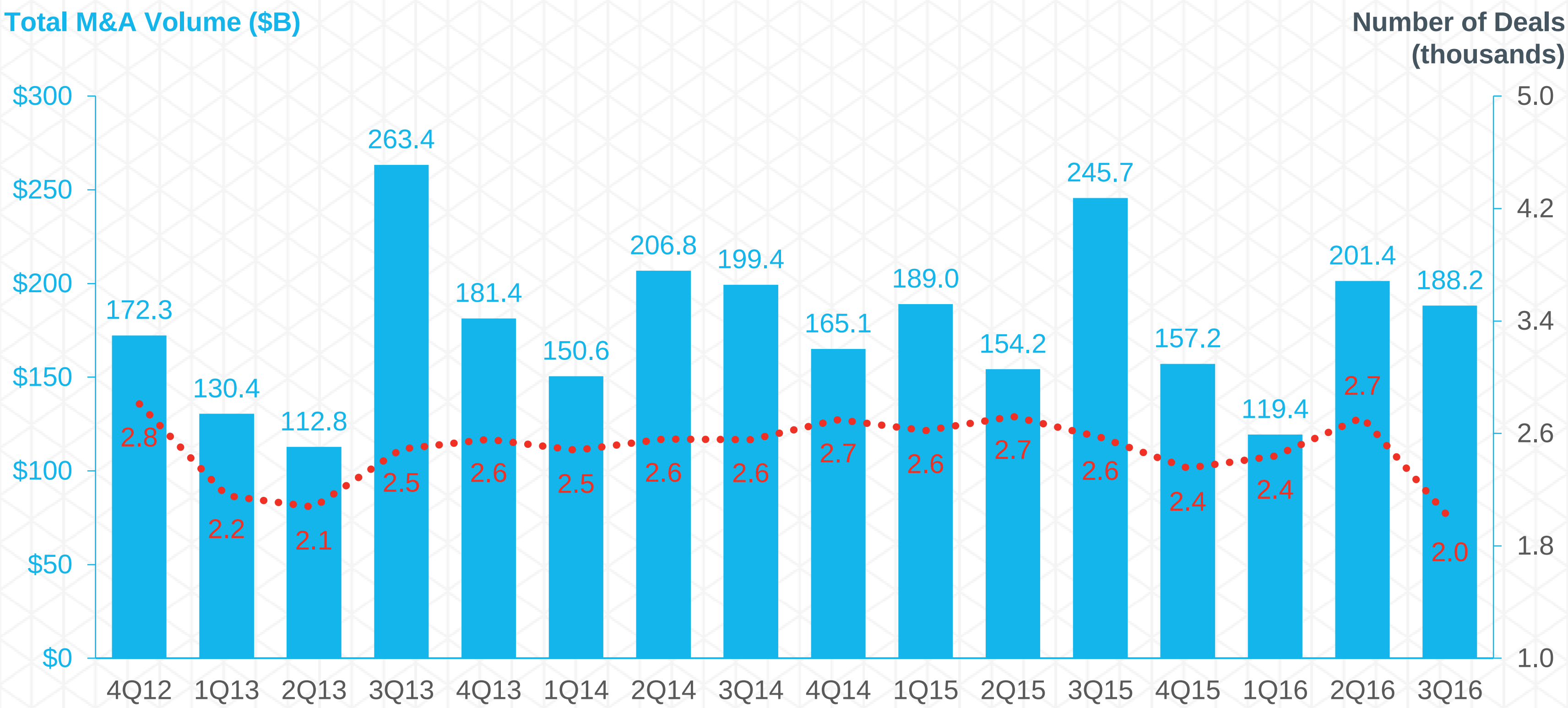


Source: SDC Platinum

Transaction Volume

Middle-market M&A transaction volume declined modestly versus last quarter, though aggregate transaction value held nearly constant. The recent increase in leveraged recap activity contributed to what we believe was an aberrant M&A slowdown.

Middle-Market M&A Volume (Target EBITDA < $50M)



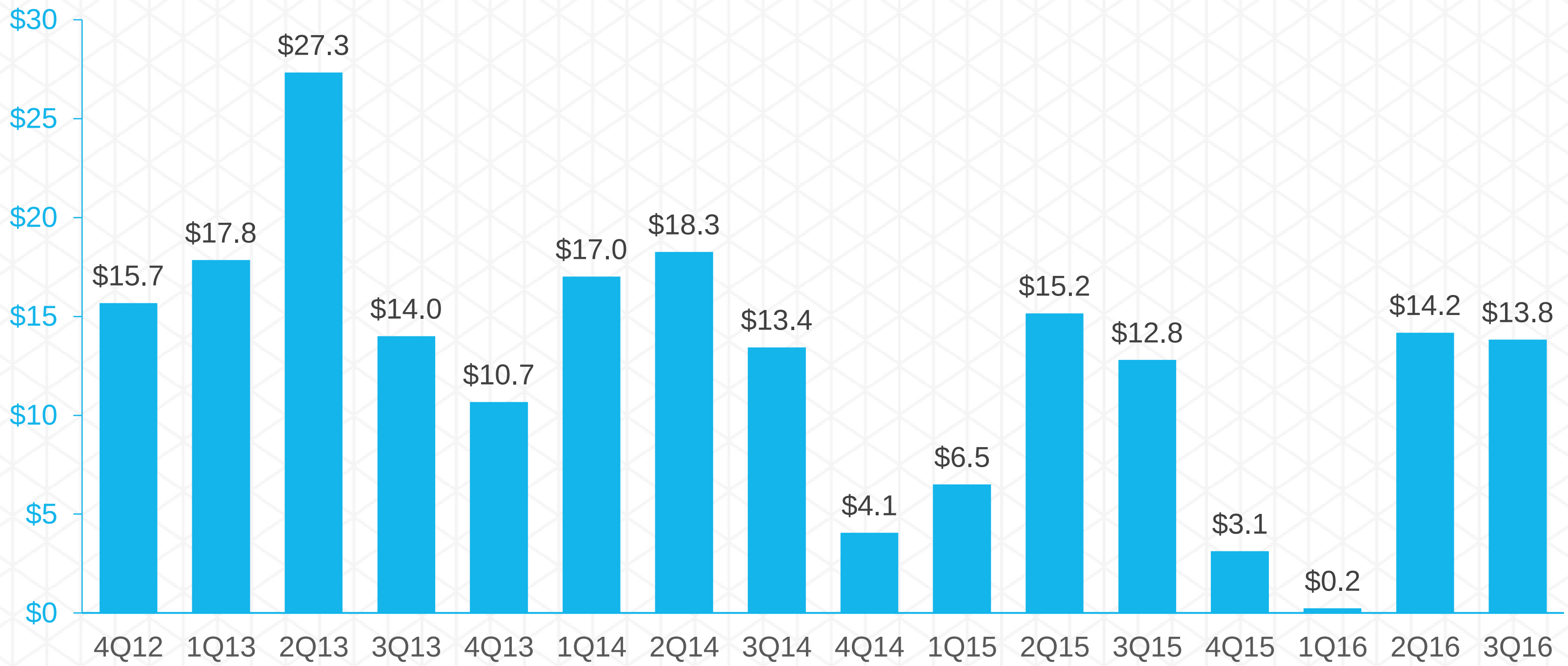
Source: SDC Platinum

Transaction Volume

Dividend recapitalizations for both sponsor- and management-owned businesses represented an atypically large proportion of loan and private note activity this quarter. The return of lender appetite for recaps, combined with attractive risk-adjusted leverage costs and friendly call terms, triggered broad consideration of recaps in lieu of asset sales.

Loan Issuance for Dividend Recapitalizations

Total Loan Volume ($B)

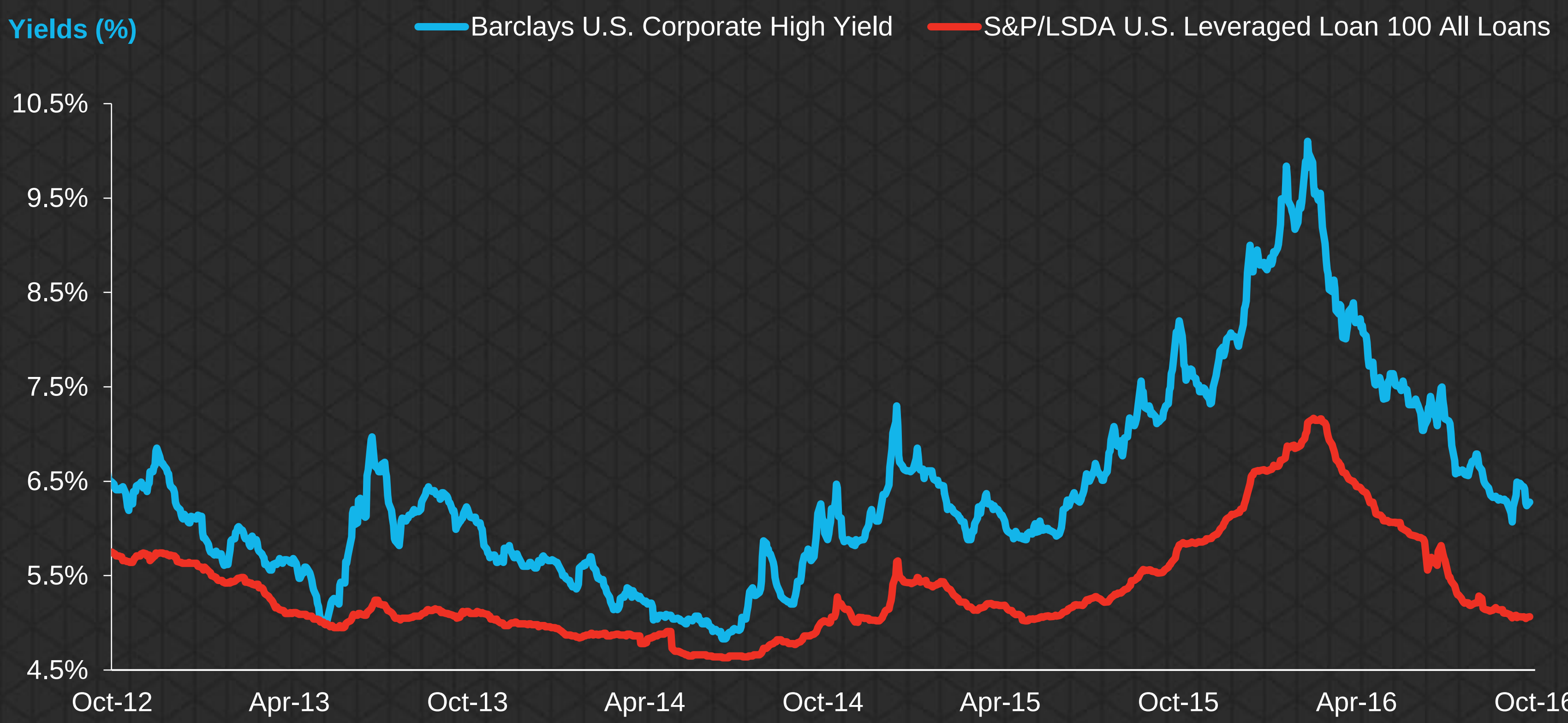


Source: SDC Platinum

Yields

Yields on high-yield bonds and leveraged loans fell approximately 100bps and 60bps respectively this quarter. Two notable drivers of the corporate rally are the rally in oil prices providing some breathing room for highly leveraged energy companies and continued monetary stimulus in Europe and Japan.

U.S. Corporate High-Yield Bonds & Leveraged Loans

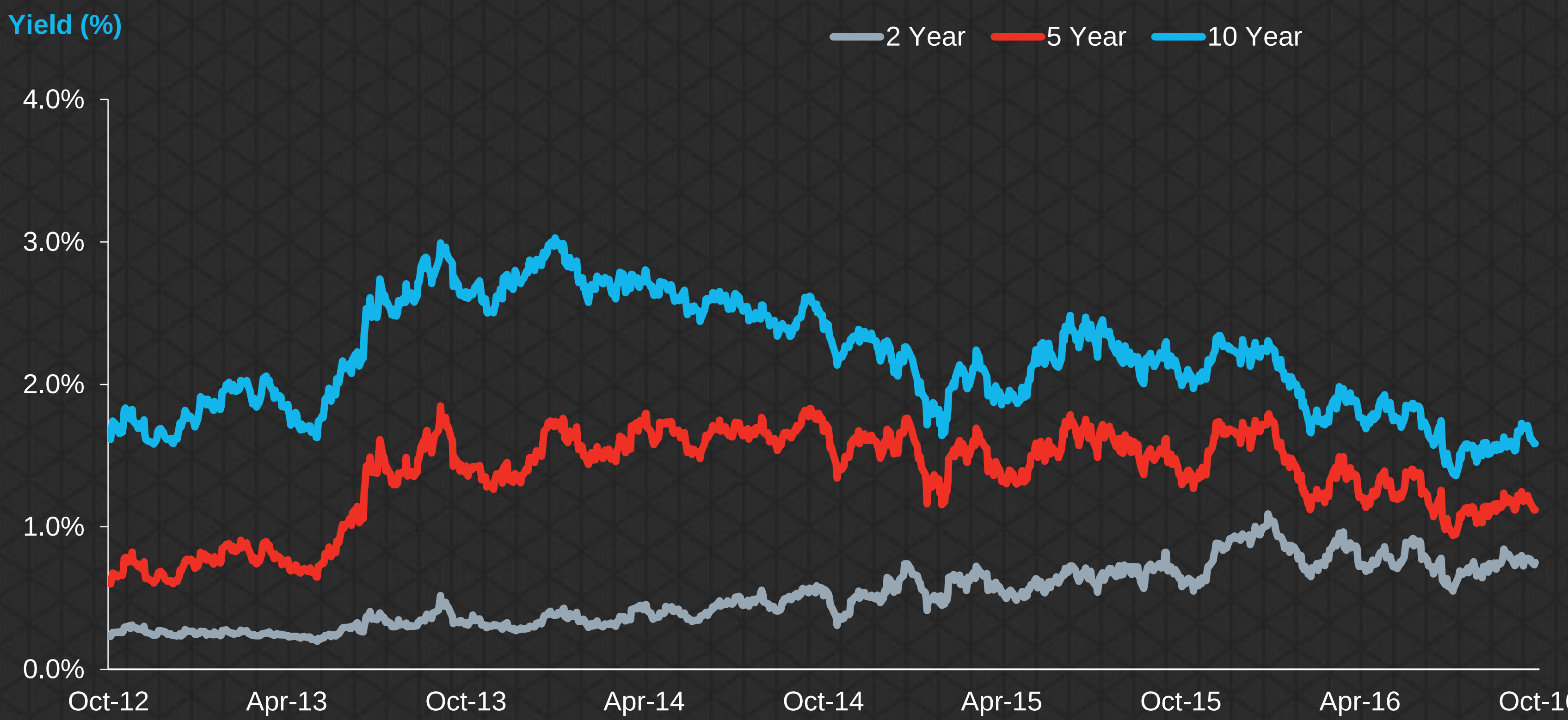


Source: SDC Platinum

Yields

Treasury yields were volatile during the third quarter, fluctuating in a ~35bps band for 10-year Treasury bonds, but ultimately ending nearly unchanged as the major central banks largely stood pat for the quarter. Geopolitical developments and macroeconomic strengthening had little lasting impact on market conditions.

2, 5 and 10 Year Treasury Yields

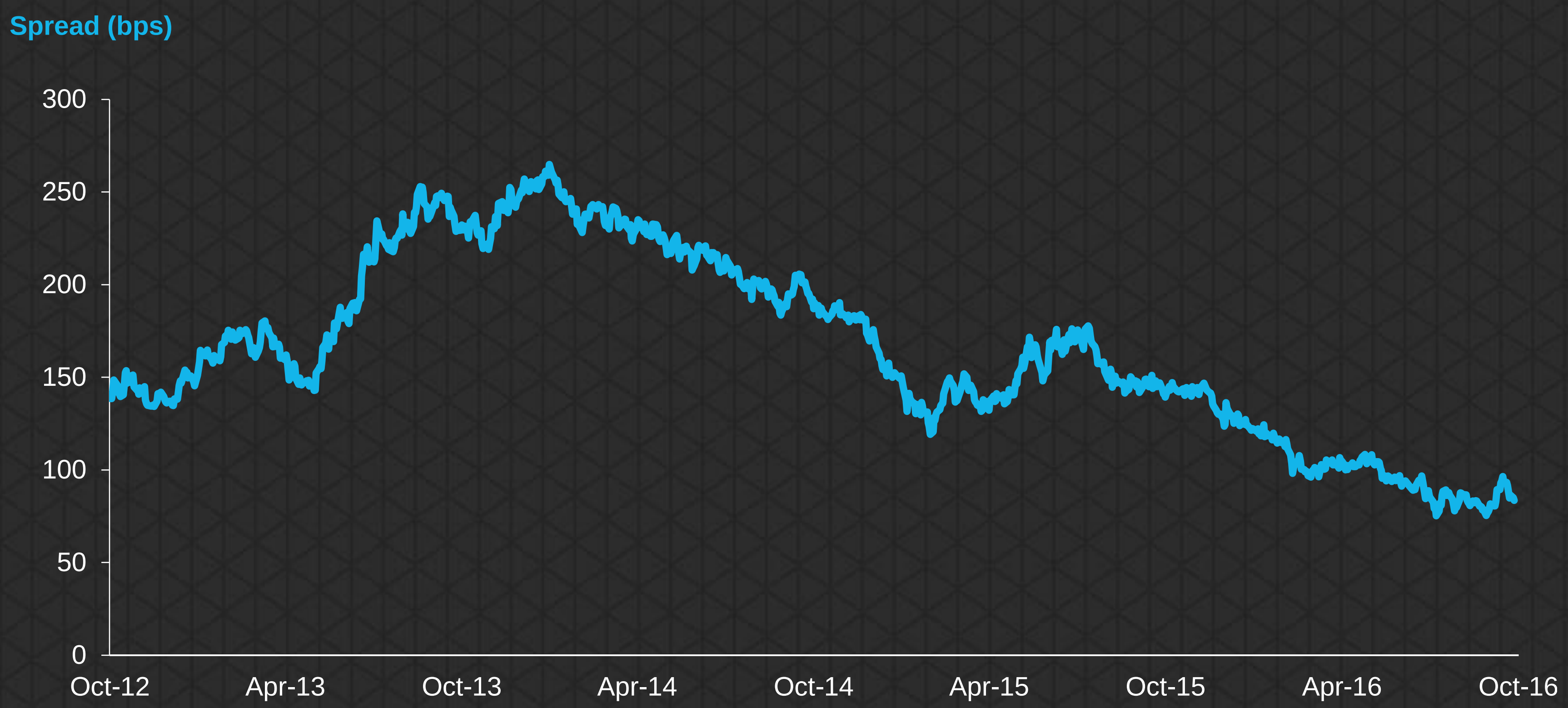


Source: SDC Platinum

Yields

Spreads between long-term and short-term Treasury yields decreased only 5bps during the quarter, after several quarters of yield curve flattening.

2 Year vs. 10 Year Treasury Spread



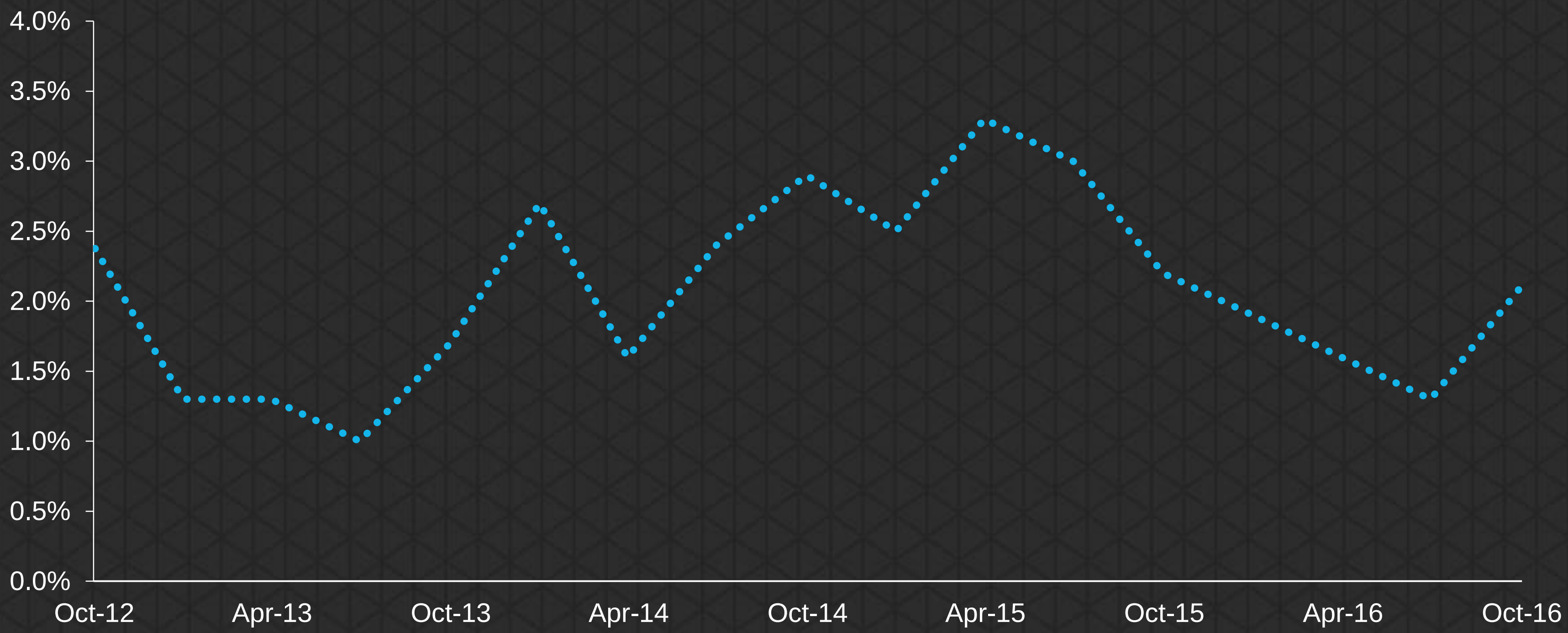
Source: SDC Platinum

Macroeconomics Update

Macroeconomic conditions in the U.S. continued to strengthen in the quarter. Positive jobs reports and strong GDP growth projections buoyed markets. According to the Federal Reserve the unemployment rate stayed essentially flat at 5.0%, as the labor force participation rate rose to 62.9% in September. Given this backdrop, and the absence of near-term fiscal stimulus, monetary policy continued to warrant analysts' focus.

U.S. Real GDP Growth

GDP Growth Rate



Source: Federal Reserve

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