INDUSTRY INSIGHTS:

Capital Markets

Summer 2017 Review

Highlights

Corporate borrowing activity in the second quarter was robust, particularly in the middle-market, which exceeded the record volume seen in the first quarter. Debt issuance by clients of Duff & Phelps similarly grew this quarter, among both financial sponsors and corporate borrowers.

Supply and demand for middle-market credit became more balanced as opportunistic issuers came to the market and/or increased issuance size. In spite of continued strong demand, credit providers gravitated toward well-structured offerings with substantive covenant and prepayment protections.

The Fed has thus far stuck to the rate increase schedule outlined earlier this year, having hiked rates another quarter point in June. However, in spite of rising short-term rates mid- and long-term Treasurys rallied, as expectations for long-term growth and, in turn, long-term rates, decreased. This flattening of the yield curve may slow the pace of future rate hikes and shift near-term focus toward the unwinding of the Fed’s balance sheet.

The lack of progress on healthcare, tax and regulatory reform, as well as infrastructure spending, has muted economic growth expectations. Subpar inflation and economic growth were offset by elevated business and consumer sentiment, and the largest year-over-year quarterly increase in corporate profits in five years. As a result, the likelihood of another Fed hike by year-end is now priced at approximately 50% by the markets.

The results of the recent French and, to a lesser extent, British elections alleviated concerns that a populist uprising would pressure a breakup of the European Union, triggering a “relief” rally in European stocks and government bonds and the euro.

Near-term market conditions remain compelling for middle-market issuers. Borrowers are capitalizing on strong institutional appetites by pursuing favorably crafted deals for acquisition, recapitalization and growth financing.

Restrained inflation and GDP growth were offset by buoyant business and consumer sentiment, as well as the largest quarterly year-over-year increase in corporate profits in five years.

Corporate credit issuance was robust, particularly in the middle-market, somewhat relieving the supply-demand imbalance of the first quarter.

The Fed hiked the discount rate another quarter point in June; however, mid- and long-term Treasurys rallied as growth expectations moderated. The flattening of the yield curve may slow the pace of future rate hikes.

Executive Summary

U.S. monetary policy and the Fed's plans and parameters for unwinding its $4.5 trillion balance sheet remained in the spotlight this quarter. However, headlines related to fading prospects for near-term fiscal stimulus and elections in France and Great Britain took center stage. Equity markets were undeterred as volatility remained low in spite of the fourth Fed rate hike in a year and a half and Fed guidance on its plans to unwind its balance sheet by nearly $1 trillion over the next 12 to 18 months. Long-term bonds rallied, with the 10-year Treasury yield declining 8bps and the 30-year Treasury yield declining 17bps, resulting in a further flattening of the yield curve.

Continued delays in congressional approval of repeal-and-replacement of the Affordable Care Act, corporate tax policy, infrastructure spending and a rollback of financial regulation have aggravated concerns about below-target inflation and GDP growth rates. Despite this backdrop, public companies posted their largest year-over-year earnings increase in five years. News was more upbeat in Europe where concerns that a populist uprising would pressure the stability of the E.U. were mitigated after France elected a moderate president and the Conservative Party in Great Britain failed to claim a majority. The results sent French stocks soaring to a nine-year high and triggered a rally in European government bonds and the euro.

Corporate borrowing activity remained robust amid Fed rate hikes, fiscal policy uncertainty and global events. Credit supply and demand moved into balance, as record middle-market loan issuance near record total loan issuance, and reduced loan fund inflows offered opportunity for credit providers hungry for flow. However, despite a seemingly frothy market, credit providers maintained underwriting standards and demand for appropriately structured credits remained intact. Repricings and competition for middle-market credit issues have continued to constrain rates. This backdrop has pressured middle-market private credit funds, especially business development companies, some of which have had to pare back dividends and even consolidate.

Near-term market conditions remained compelling for middle-market issuers in light of continued strong demand and competitive rates. As noted in the first quarter, private non-investment grade issuance continues to dominate overall issuance, with middle-market issuers reaping the benefits of market conditions through repricings, structural enhancements and growth financings.

Indicative Middle-Market Credit Parameters

LEVERAGE MULTIPLES

	EBITDA OF $10MM – $20MM	EBITDA OF $20MM – $50MM
SENIOR	**3.00x – 4.00x**	**3.50x – 4.50x**
TOTAL DEBT	**3.75x – 4.50x**	**4.25x – 5.50x**

Indicative Middle-Market Credit Parameters

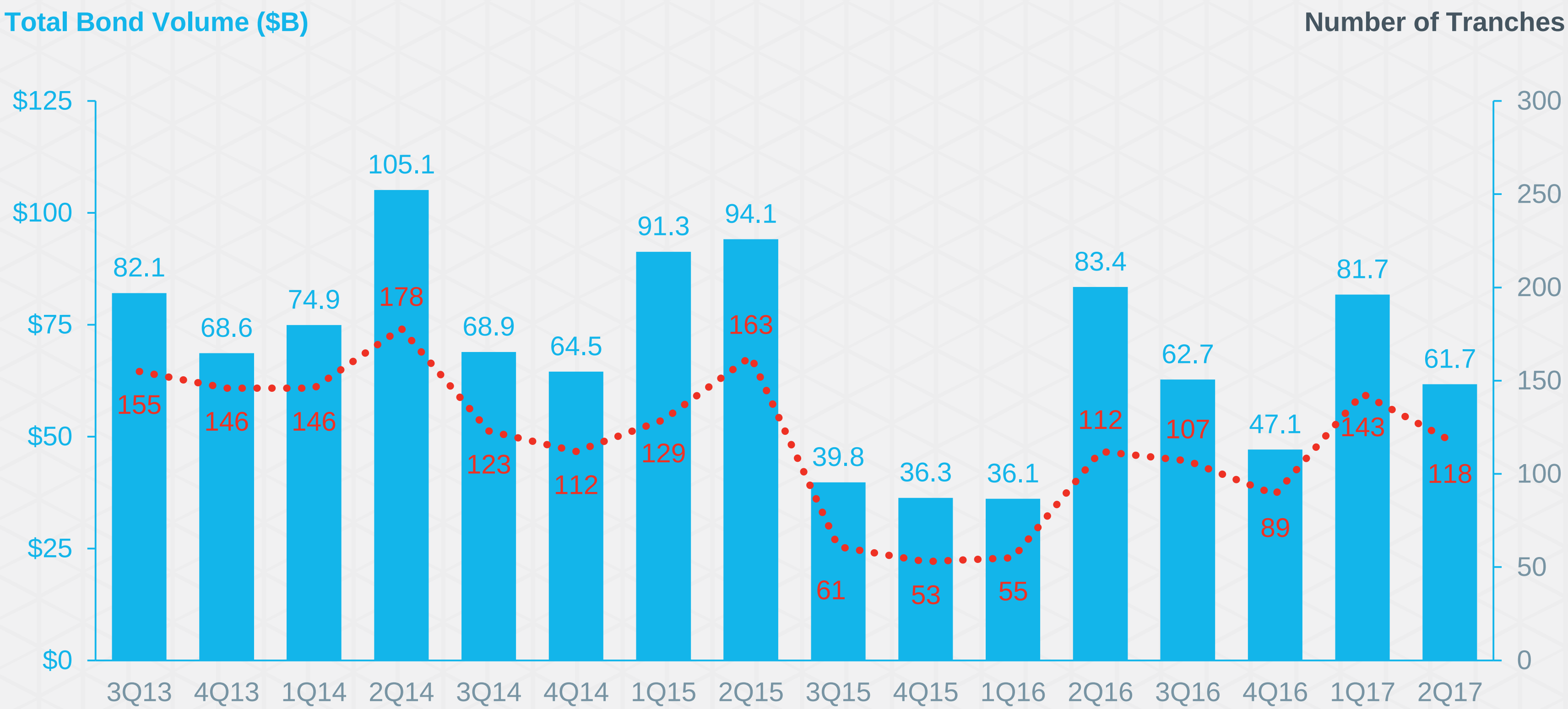
INFORMATION IN RED REPRESENTS PRIOR QUARTER VIEW (WHEN DIFFERENT THAN CURRENT QUARTER)

PRICING	EBITDA OF $10MM – $20MM	EBITDA OF $20MM – $50MM
FIRST LIEN	LIBOR + 2.75% – 3.50% (bank) LIBOR + 3.75% – 5.75% (nonbank)	LIBOR + 2.50% – 3.25% (bank) LIBOR + 3.75% – 5.75% (nonbank)
SECOND LIEN	LIBOR + 6.00% – 9.00%	LIBOR + 5.50% – 8.50%
SUBORDINATED DEBT	10.50% – 12.50% 11.00% – 13.00%	9.50% – 11.50% 10.00% – 12.00%
UNITRANCHE	LIBOR + 6.00% – 8.50%	LIBOR + 5.50% – 8.00%

New Issuance

High-yield issuance declined in the second quarter, following a first quarter resurgence in issuance—primarily for refinancings. Issuers rushed to opportunistically cut borrowing costs in the first quarter on the expectation that interest rates would rise; however, the urgency to issue has abated somewhat due to the ongoing low rate environment. Dollar volume decreased by 24.5% and deal volume decreased by 17.5% versus the first quarter of 2017.

Total High-Yield Bond Issuance

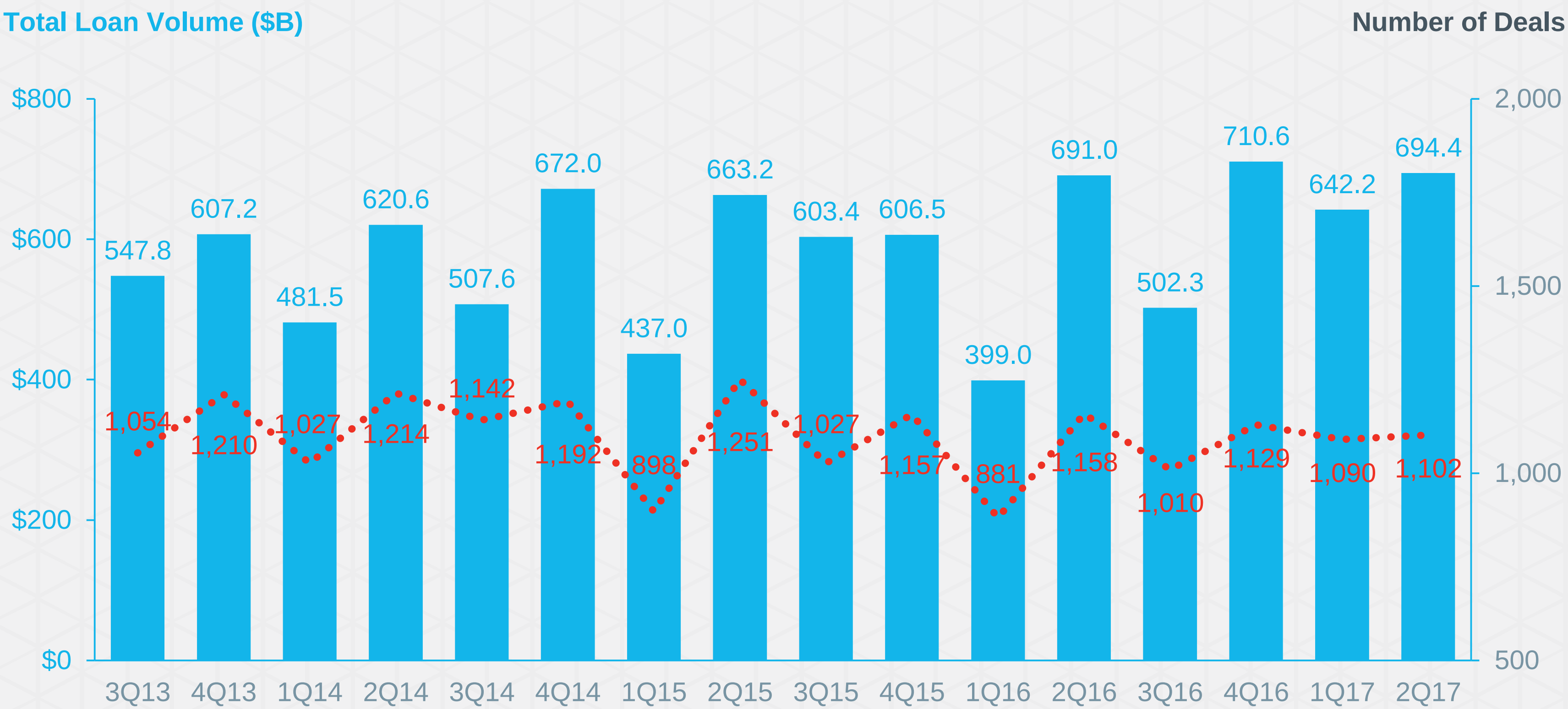


Source: LCD Comps

New Issuance

The volume and number of new loans issued came close to the record levels of the fourth quarter of 2016, up 8% in terms of dollar volume and 1% in terms of number of deals from the previous quarter. This growth was driven by a mix of strong M&A activity and refinancings, each accounting for roughly 40% of total loan issuance.

Total Loan Issuance

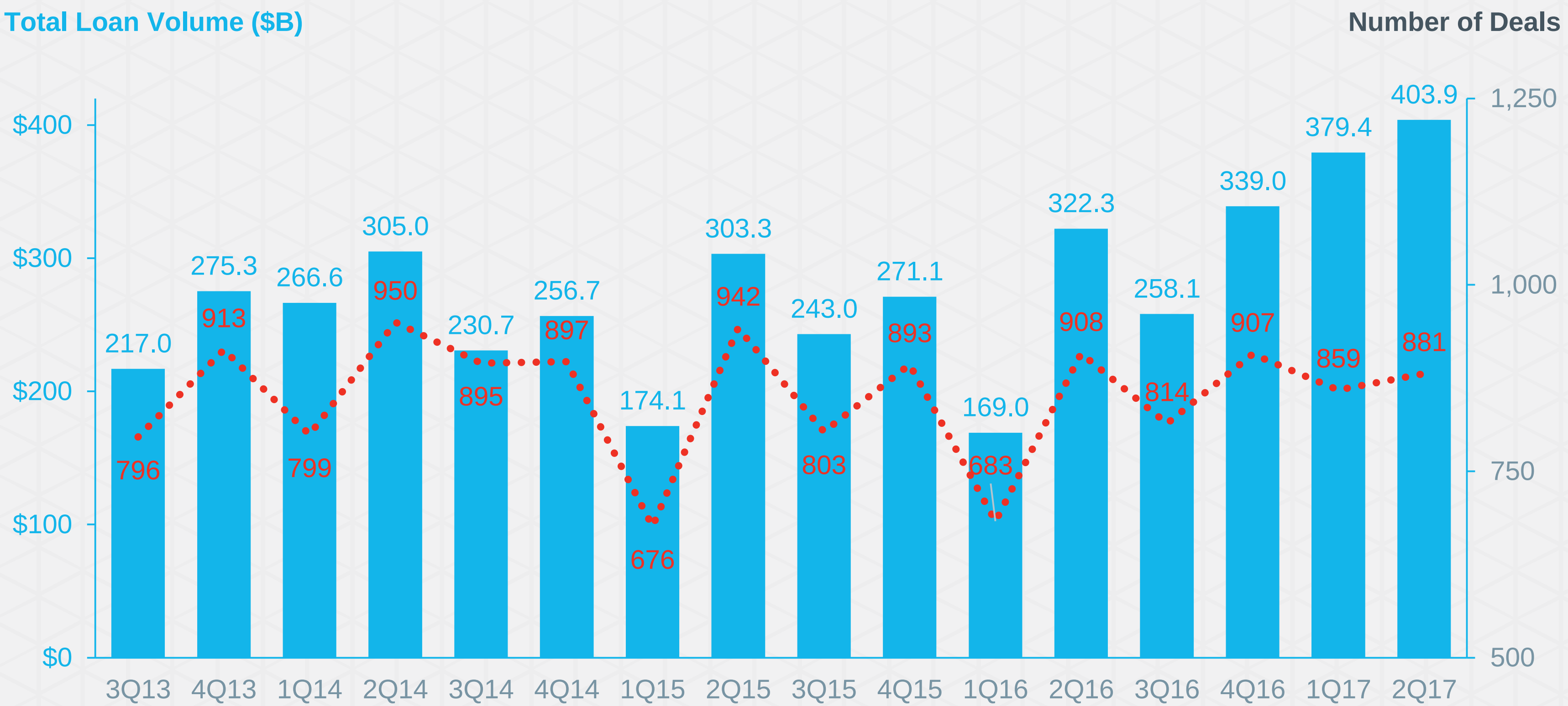


Source: SDC Platinum
Volume data includes deals reported as of 7/10/2017

New Issuance

Middle-market loan issuance as measured by total loan volume set yet another record this quarter, following a very strong first quarter. Another robust quarter of M&A activity and the continuance of opportunistic refinancings drove issuance.

Total Loan Issuance (EBITDA < $50MM)

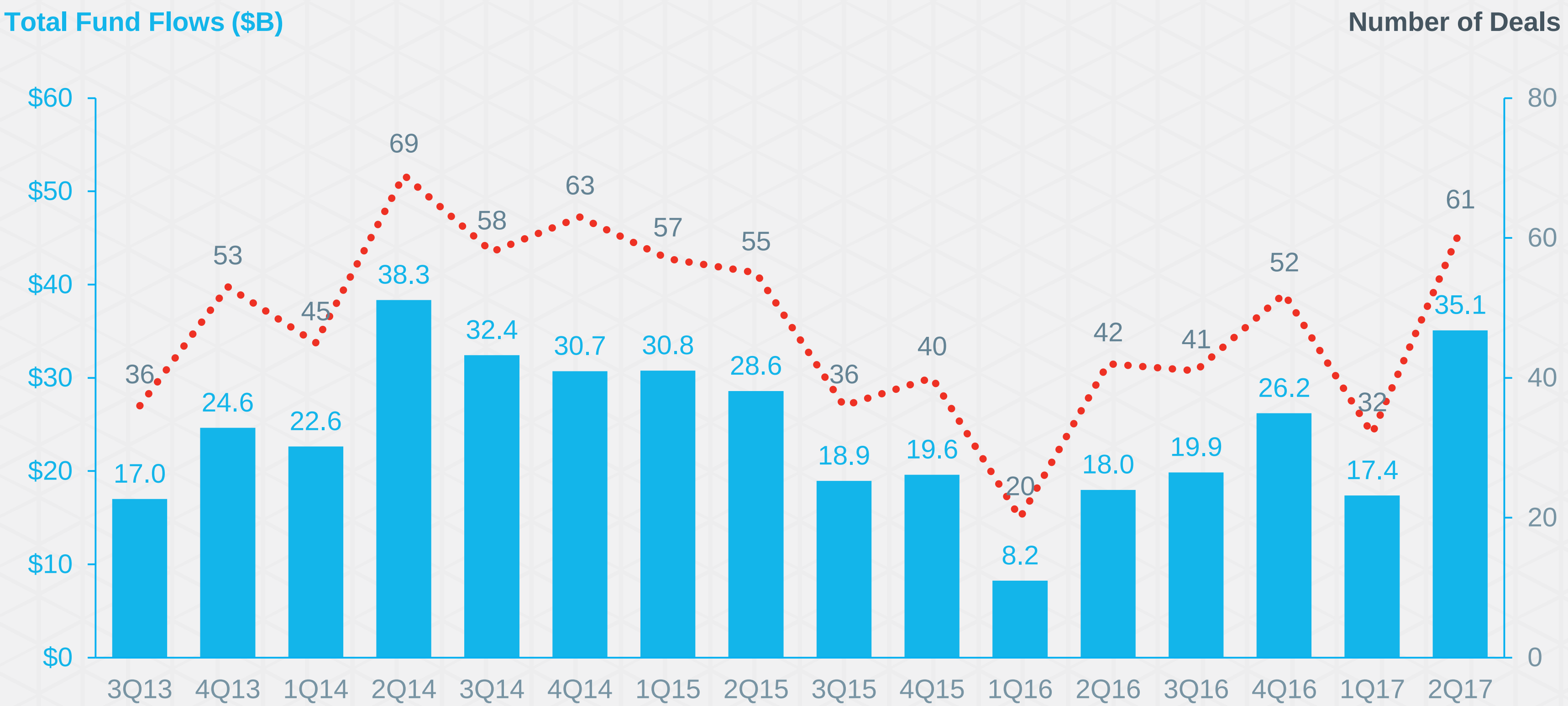


Source: SDC Platinum
Volume data includes deals reported as of 7/10/2017

Fund Flows

The number of Collateralized Loan Obligations (CLOs) issued attained the highest level in three years, logging $35.1 billion in flow on 61 transactions. June was the second most active month for new issues since CLO market statistics were first tracked. Strong demand from investors for CLO tranches of various credit quality supported higher CLO issuance this quarter.

Total CLO Issuance

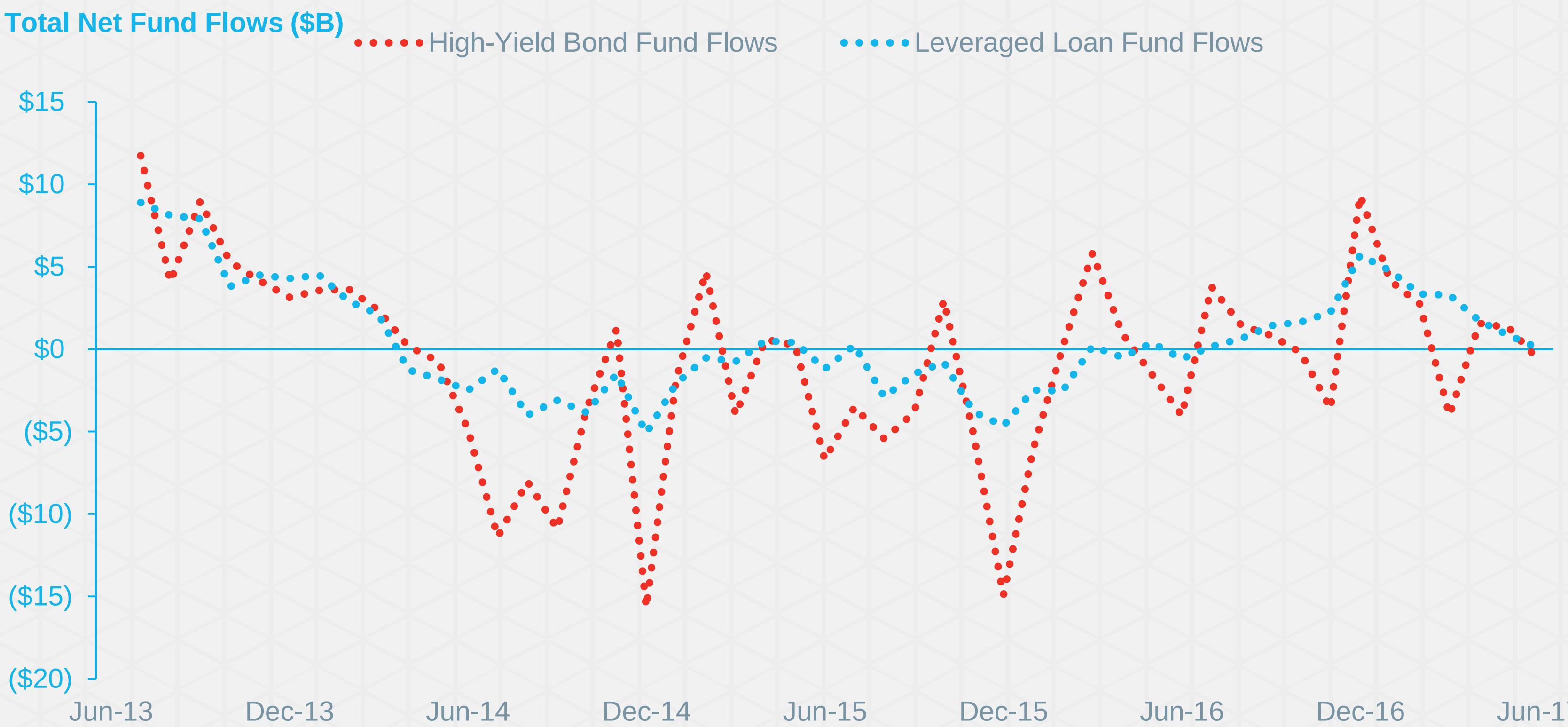


Source: LCD Comps

Fund Flows

Net leveraged loan mutual fund inflows averaged approximately $0.9 billion in each month of the second quarter. High-yield bonds experienced an outflow of $0.7 billion in June after two consecutive months of inflows.

Mutual Fund Flows



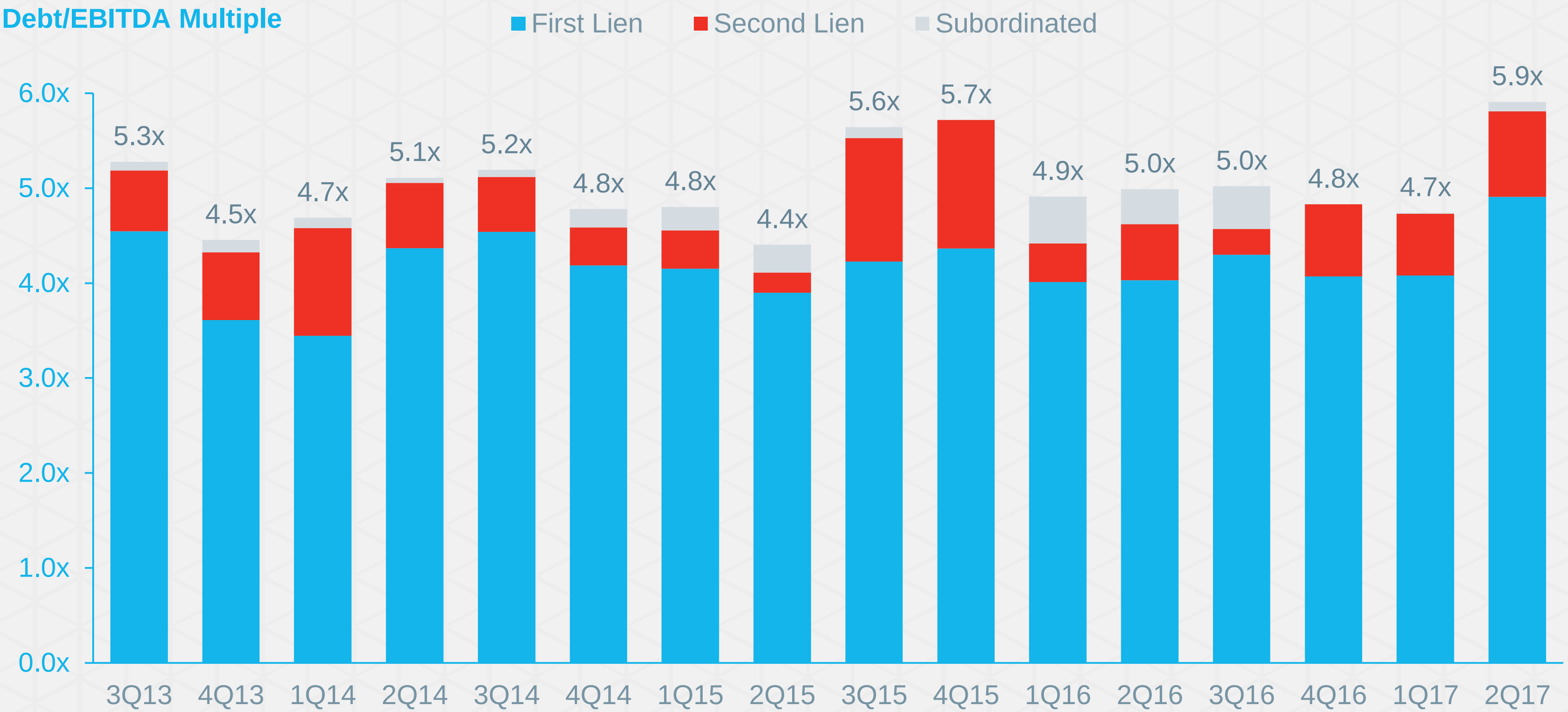
Sources: Investment Company Institute; Lipper FMI; LCD Comps

Leverage

First lien leverage increased to nearly 5.0x, reflecting the aggressive bid for unitranche issuance in the middle-market. With unitranche rate spreads now roughly equivalent to the blended rate of senior/junior structures, middle-market borrowers are increasingly electing unitranche structures versus more structurally cumbersome alternatives (we note that total leverage jumped more than a full turn, but suspect this multiple was skewed by several large aberrational transactions). We continue to observe middle-market credit providers adhering to rigorous underwriting standards, in spite of strong demand and limited supply of new issuance.

Leverage Multiple (EBITDA < $50MM)

Debt/EBITDA Multiple

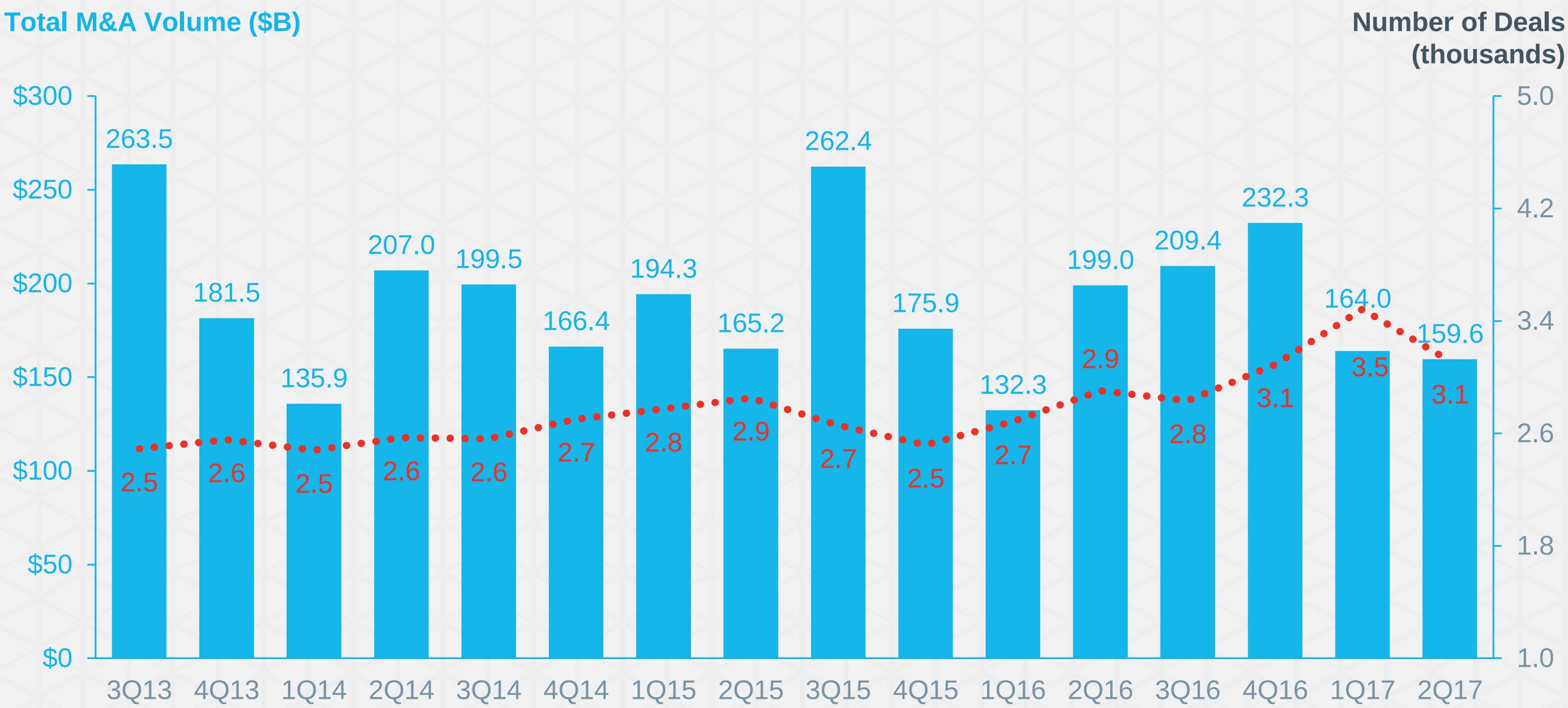


Source: LCD Comps

Transaction Volume

The number of lower middle-market M&A transactions decreased from the record-breaking pace of the first quarter; however, middle-market M&A activity remained robust. Transaction count, particularly in the lower middle-market, has been fueled by current economic conditions and the availability of leverage to support such transactions.

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



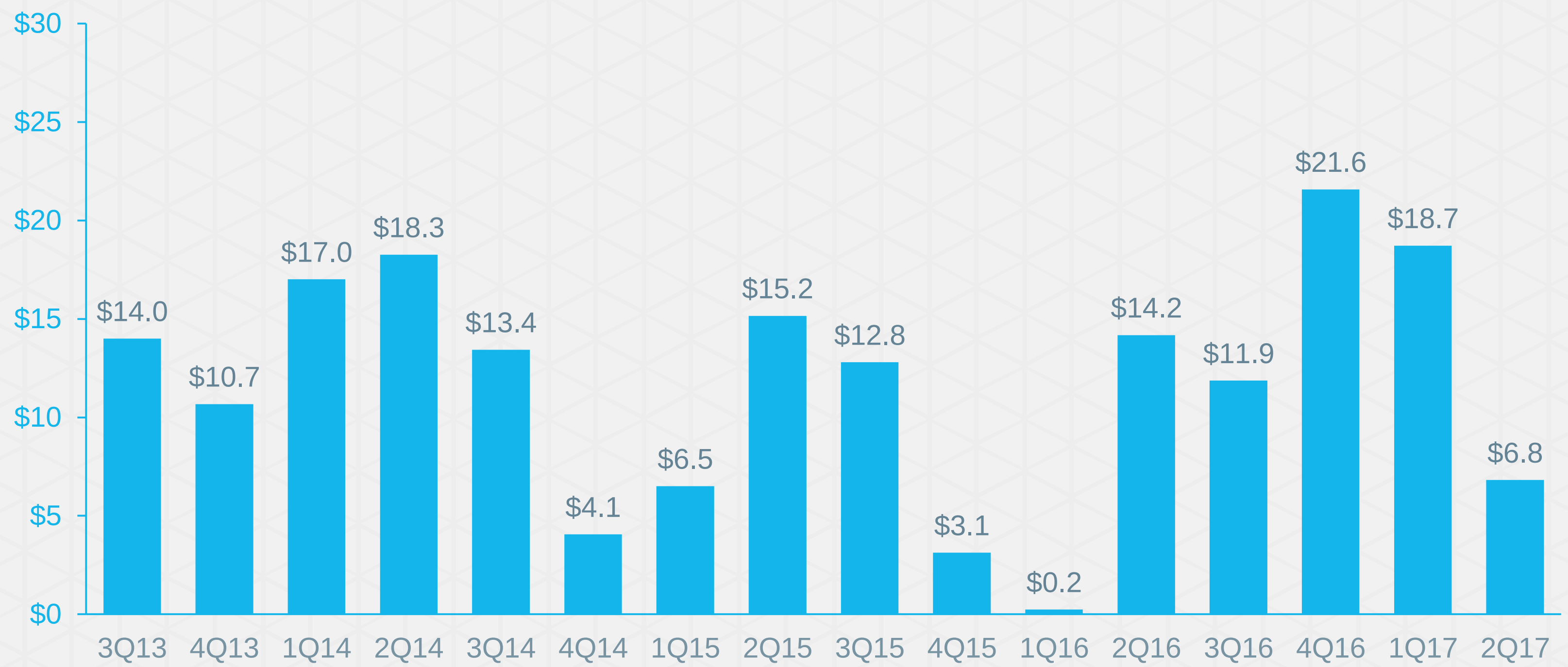
Source: SDC Platinum
Volume data includes deals reported as of 7/5/2017

Transaction Volume

Dividend recapitalization activity declined significantly in the second quarter, following nearly $70 billion of issuance over the previous four quarters. That spike in volume resulted from a pull forward of activity because of concerns involving the election last year and rising rates this year. Now that rates appear to be moderating, the sense of urgency that previously existed has abated. In addition, we have anecdotal evidence that businesses are using their cash and access to credit for growth-oriented purposes such as bolt-on acquisitions.

Loan Issuance for Dividend Recapitalizations

Total Loan Volume ($B)

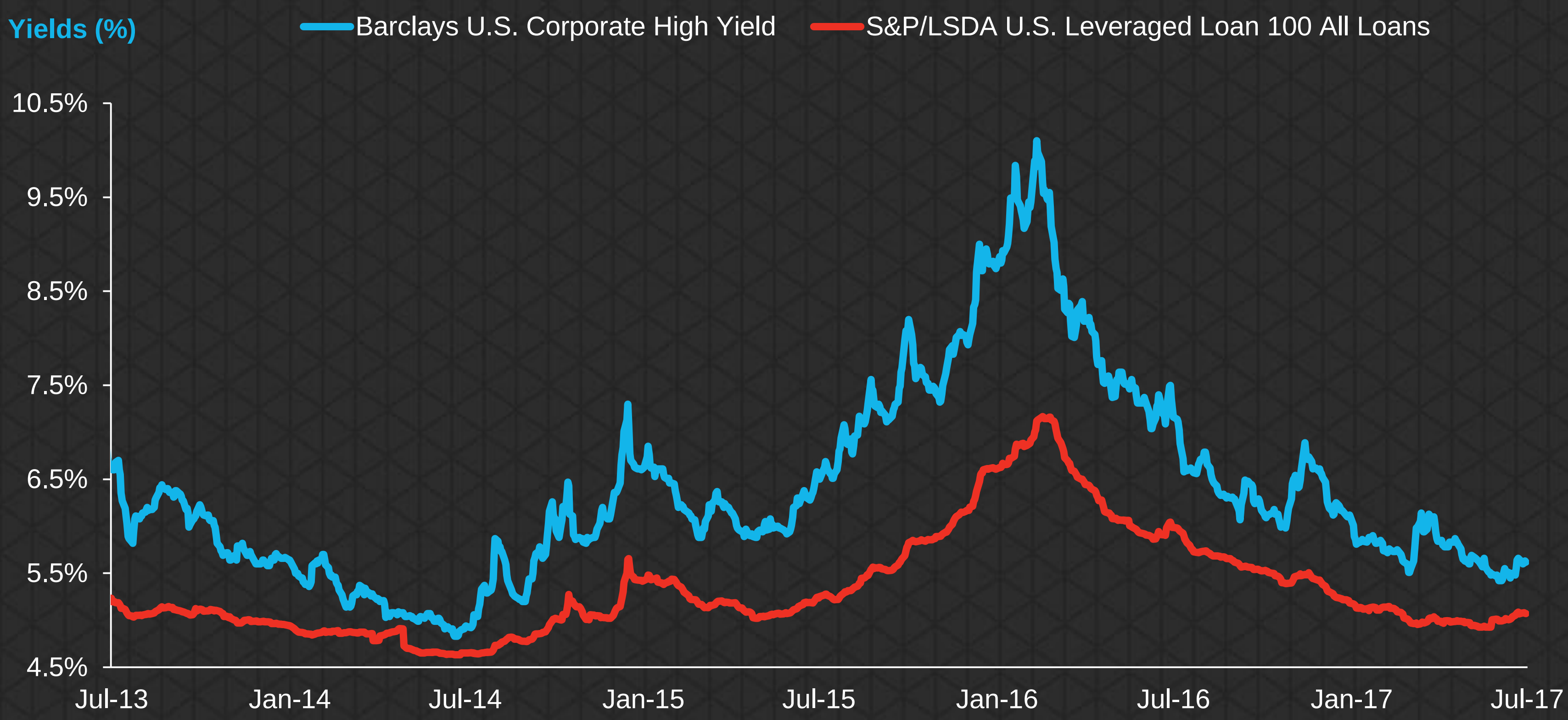


Source: LCD Comps

Yields

Yields on widely traded leveraged loans increased 8bps this quarter, while yields on high-yield bonds decreased by 22bps. Refinancings drove down spreads and yields to maturity, as investors allocated more capital to lower-quality bonds in search of yield.

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

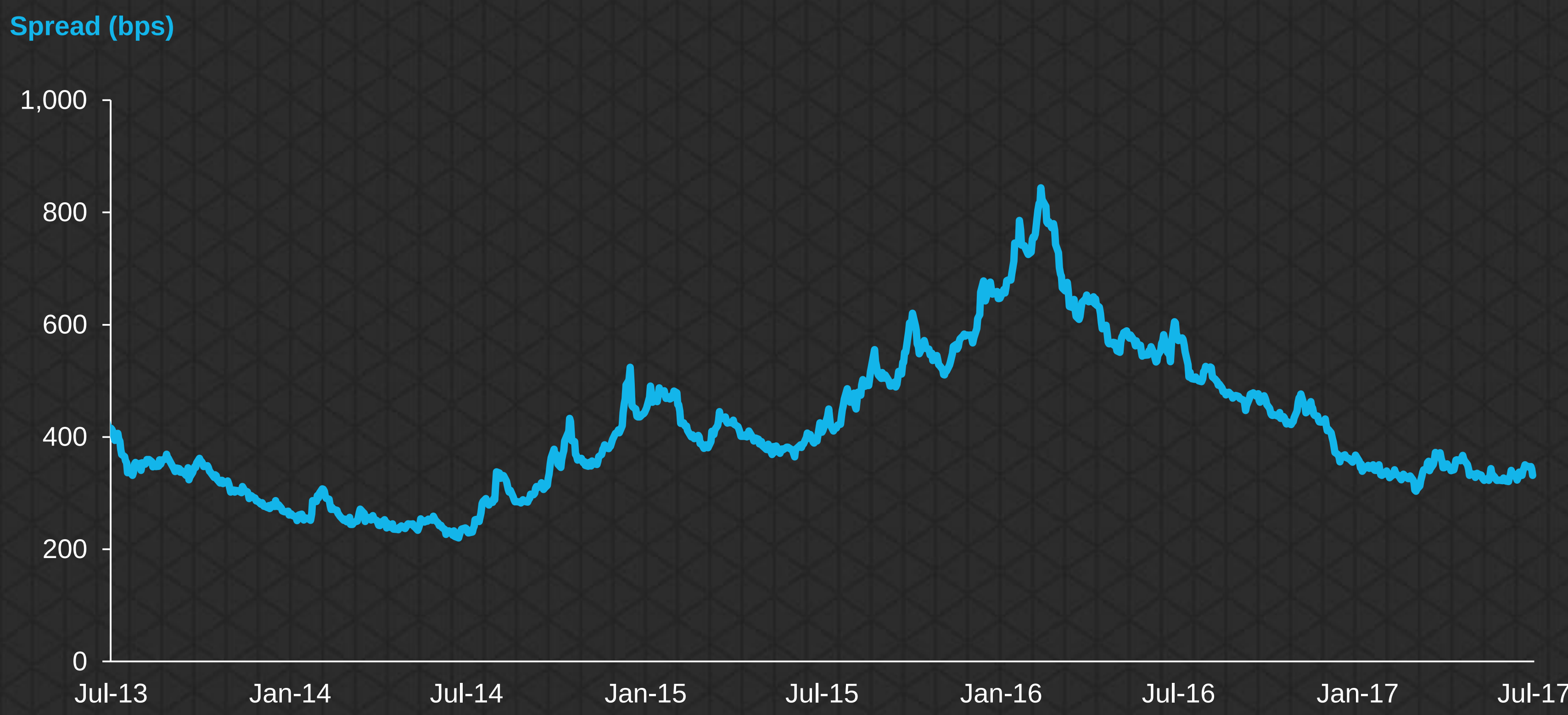


Source: Bloomberg; LCD Comps

Yields

Spreads between the Barclays U.S. Corporate High Yield index and the 10-year Treasury yield declined modestly, decreasing 14bps during the quarter to a spread of 332bps. Spreads compressed because of the outlook for interest rates moderating and issuer liquidity improving on the back of corporate profits.

U.S. Corporate High-Yield Bond vs. 10-Year Treasury Spread

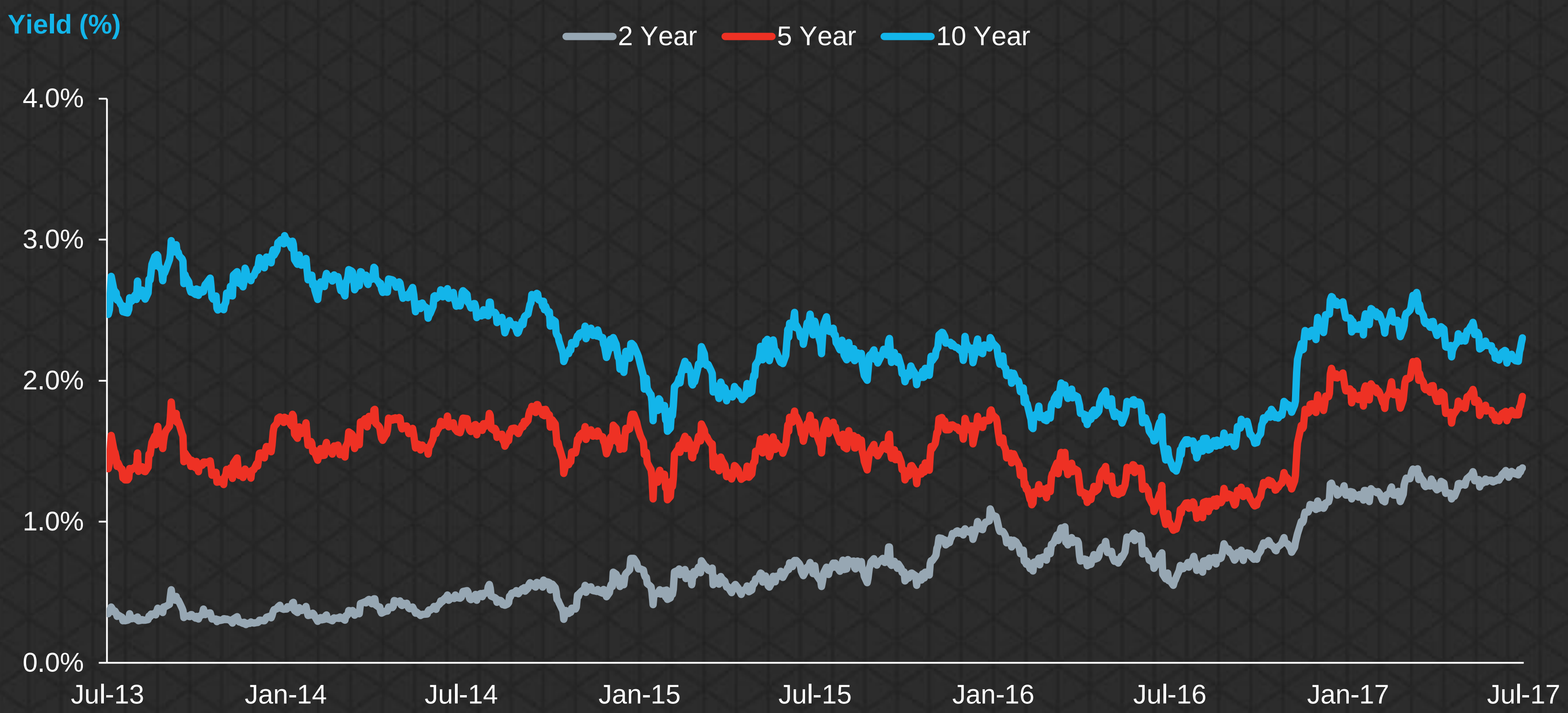


Source: Bloomberg; LCD Comps

Yields

There was a divergence of Treasury yields between short-term rates and mid- and longer-term rates, as the 10-year Treasury yield decreased 8bps, while the 2-year yield increased 13bps.

2-, 5- and 10-Year Treasury Yields



Source: Bloomberg

Yields

Spreads between 2- and 10-year Treasury yields decreased by approximately 21bps over the quarter. The short end of the curve shifted up as the Fed raised interest rates in June for the second time this year, while future growth expectations pushed the longer end of the curve down.

2-Year vs. 10-Year Treasury Spread

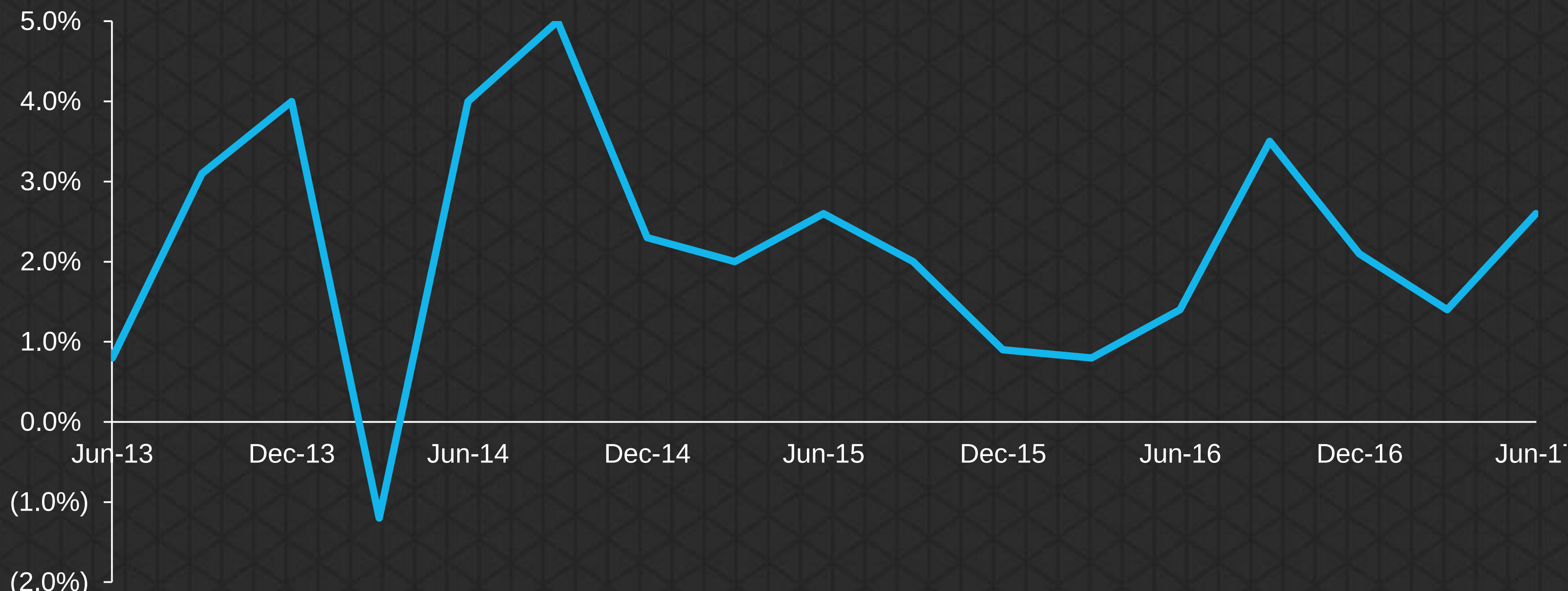
Source: Bloomberg

Macroeconomic Update

The latest GDPNow forecast of 2.6% for the second quarter indicates that economic activity is picking up following a growth rate of only 1.4% in the first quarter. Business and consumer optimism appear to be overcoming the delay in fiscal stimulus as corporate profits posted their best quarter in five years. Employment was stable, as the unemployment rate rose slightly to 4.4% in June and the labor force participation rate remained around 62.8%.

U.S. Real GDP Growth

GDP Growth Rate



Source: Federal Reserve

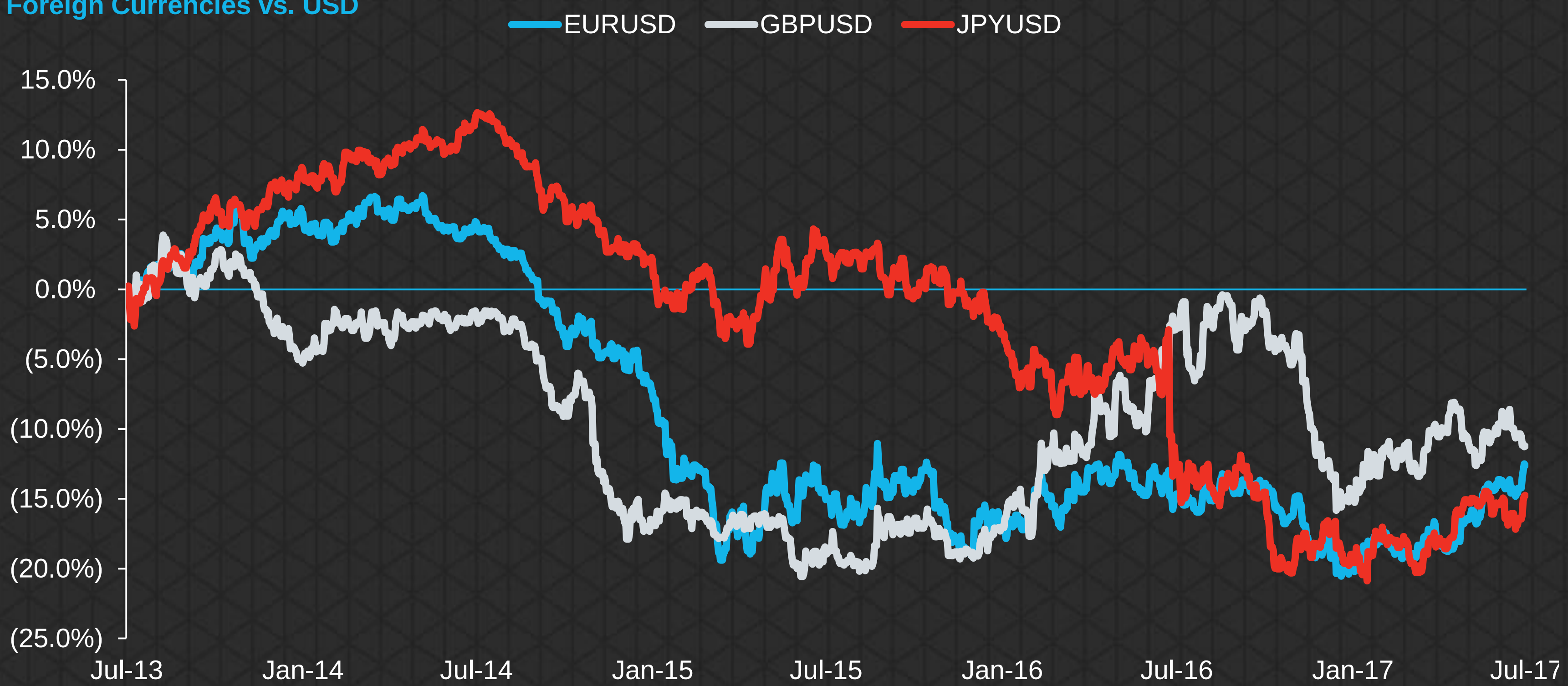
First quarter data represents Atlanta Fed GDPNow Projection as of 7/11/17

Macroeconomic Update

The U.S. dollar weakened against the euro this quarter because of reduced expectations for U.S. economic growth versus increased expectations in the Eurozone as well as speculation that the European Central Bank will soon reveal a plan for a reduction in quantitative easing. In contrast, the U.S. dollar strengthened against the pound as uncertainty continued to surround the UK economy following the June election and lack of a parliamentary majority.

U.S. Dollar Foreign Exchange Rates

Foreign Currencies vs. USD



Source: Capital IQ

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