Industry Insights:

Capital Markets

Q1 2016

Highlights

Lender demand for new middle-market offerings remains robust in spite of volatility in the high yield and leveraged loan markets

Offerings with strong covenant and call protection are being greeted enthusiastically, in part due to moderating M&A activity

A slowdown in large cap new issuance, combined with superior covenant protection typical of private offerings, has generated a strong crossover bid from public bond (and leveraged loan) investors

Monetary policy concerns weighed heavily on the market for much of the quarter; the Fed's recent downward revision of discount rate expectations has settled investors

The end-of-quarter rally in equities, Treasuries, and commodities bodes well for increased credit risk appetite

Executive Summary

The Fed's more dovish posture of recent weeks has triggered an increase in risk appetite across the credit markets. Most of the first quarter was characterized by muted GDP growth, hawkish domestic monetary policy, slowing growth in China and volatility in U.S. equity and commodity markets. Consequently, credit risk appetite became more dear. However, by mid-March—and in particular after a dovish statement by Fed Chair, Janet Yellen, following the March Fed meeting—credit market conditions improved considerably.

As the quarter progressed, we observed a notable increase in demand for well-structured, privately negotiated credit solutions. Anecdotally, we note both an increase in aggregate demand and an increase in breadth of capital sources. Traditional private investors have expressed to us their frustration at the slowdown in new issuance, attributable largely to a moderation of M&A activity in the quarter. In parallel, crossover public bond and large cap loan investors have expressed to us worries about liquidity availability and the continuing prevalence of covenant-lite structures. Consequently, appetite has migrated to well-structured middle-market transactions offering (implicit) illiquidity premiums. Finally, we note that intermediaries are increasingly able to orchestrate substantive, albeit informal, "staple" processes in tandem with sell-side mandates.

In summary, prospective middle-market issuers are being greeted with robust demand from both traditional private credit investors and crossover participants. This window of opportunity is, we believe, a function of moderating middle-market M&A activity, limited high yield and leveraged loan liquidity and the continued availability of traditional private market covenants.

Indicative Middle-Market Credit Parameters

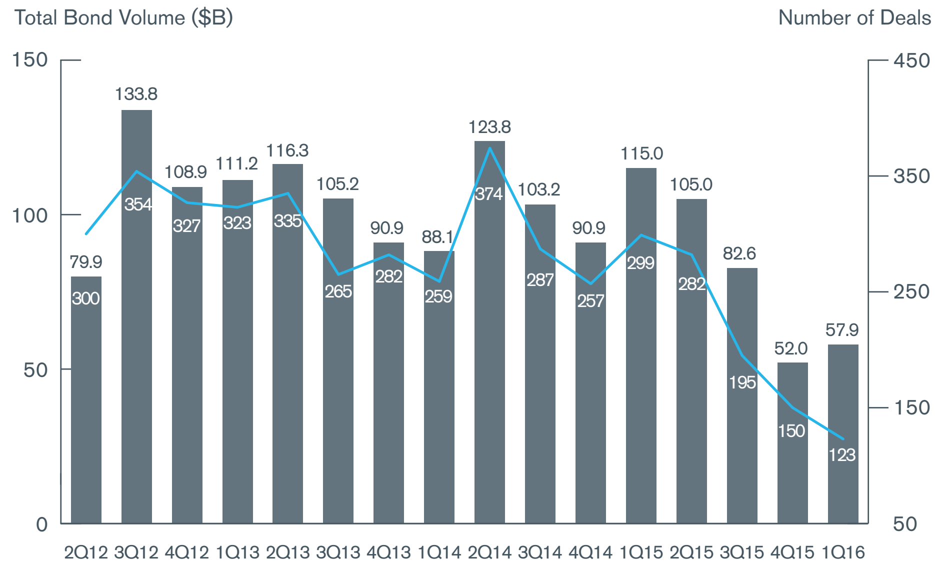
Leverage Multiples	EBITDA of $10MM - $20MM	EBITDA of $20MM - $50MM
Senior Debt	2.25x - 3.25x	2.50x - 3.50x
Total Debt	3.75x - 4.25x	4.00x - 5.00x

Pricing	EBITDA of $10MM - $20MM	EBITDA of $20MM - $50MM
First Lien	Libor + 3.00% - 4.00% (bank) Libor + 4.00% - 6.00% (non-bank)	Libor + 2.75% - 3.50% (bank) Libor + 4.00% - 6.00% (non-bank)
Second Lien	Libor + 6.50% - 9.50%	Libor + 6.00% - 9.00%
Subordinated Debt	11.00% - 13.00%	10.00% - 12.00%
Unitranche	Libor + 6.50% - 9.00%	Libor + 6.00% - 8.50%

New Issuance

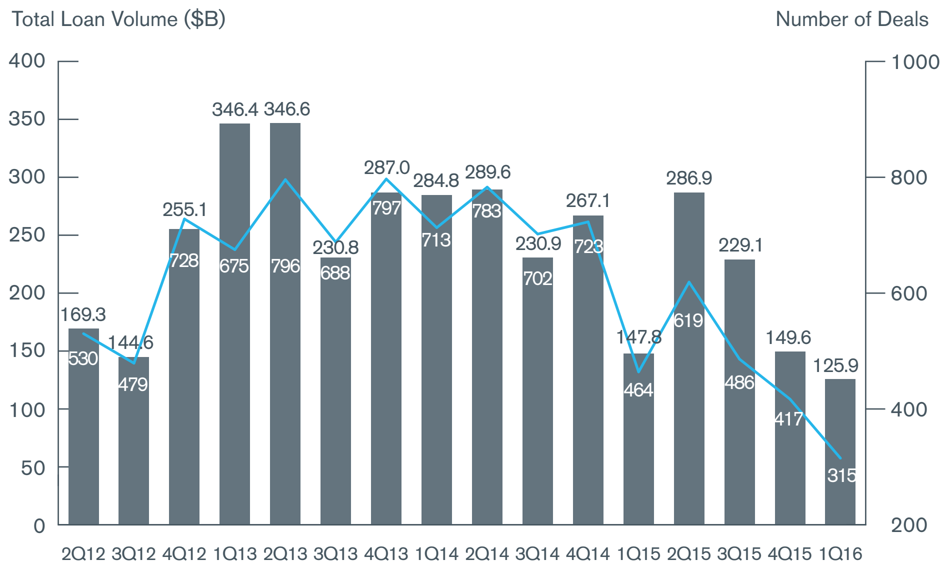
Loan issuance continued to decline as the quarter came to a close for both middle-market and large cap transactions. Volatile equity and credit markets deterred investors in the first half of the quarter, but funds began flowing again as the market righted itself in March.

Total High-Yield Bond Issuance



Source: SDC Platinum

Total Loan Issuance

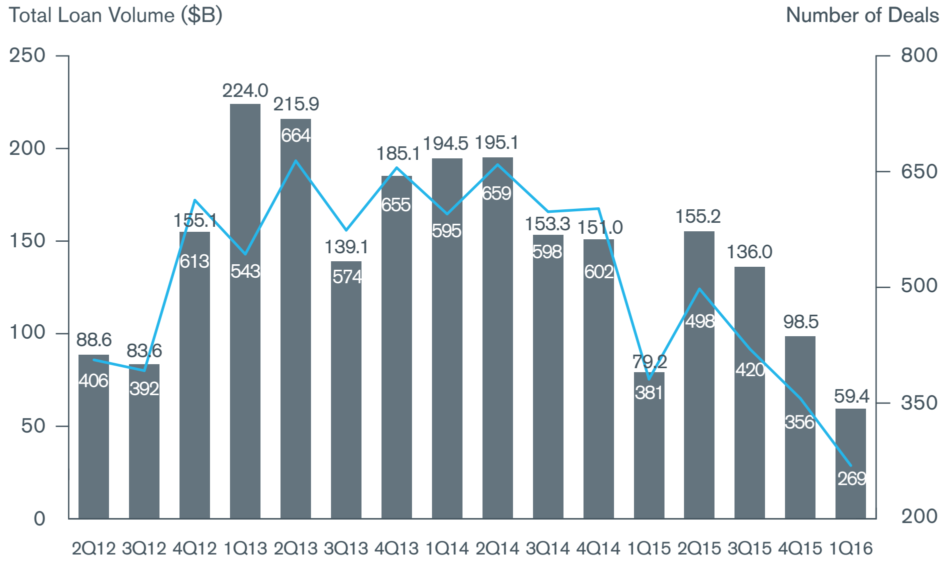


Source: SDC Platinum

New Issuance - Continued

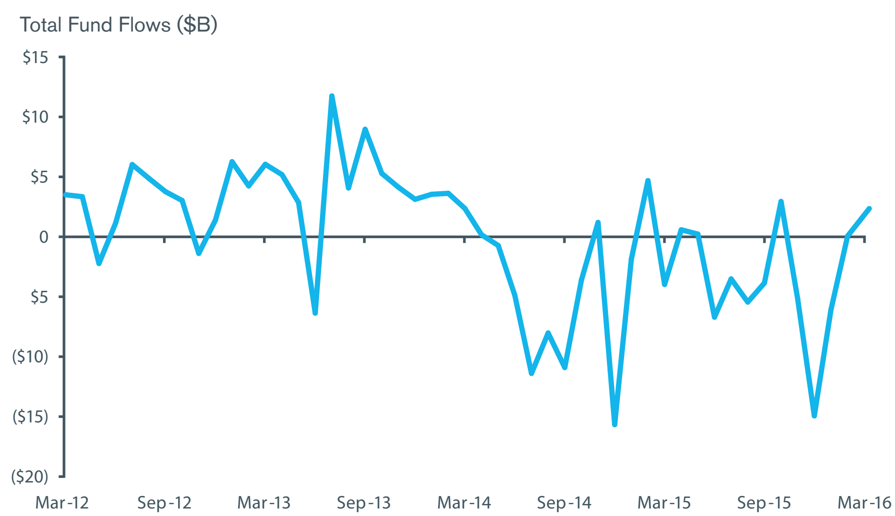
As a reflection of the tightening credit supply, CLO issuance and high yield bond fund flow dropped nearly 75% in number and volume quarter-over-quarter.

Total Loan Issuance (EBITDA < $50MM)



Source: SDC Platinum

High Yield Bond Mutual Fund Flows

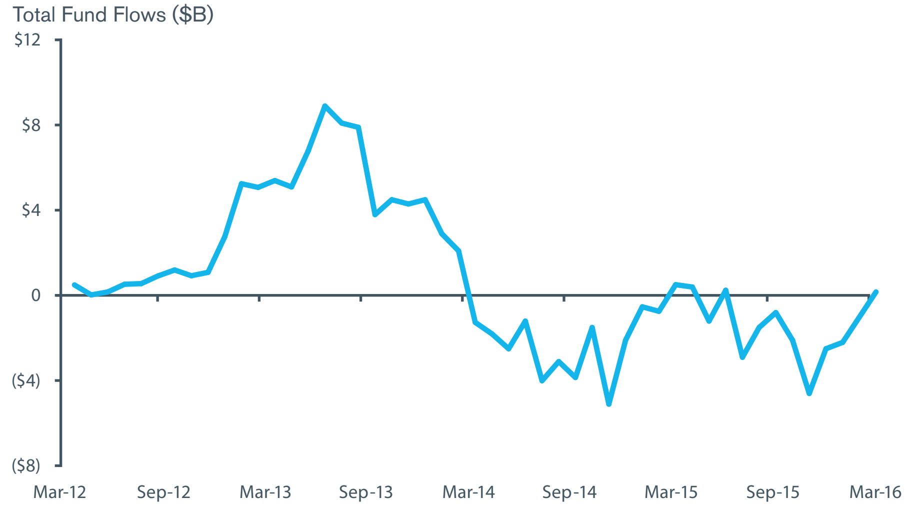


Source: Investment Company Institute

New Issuance - Continued

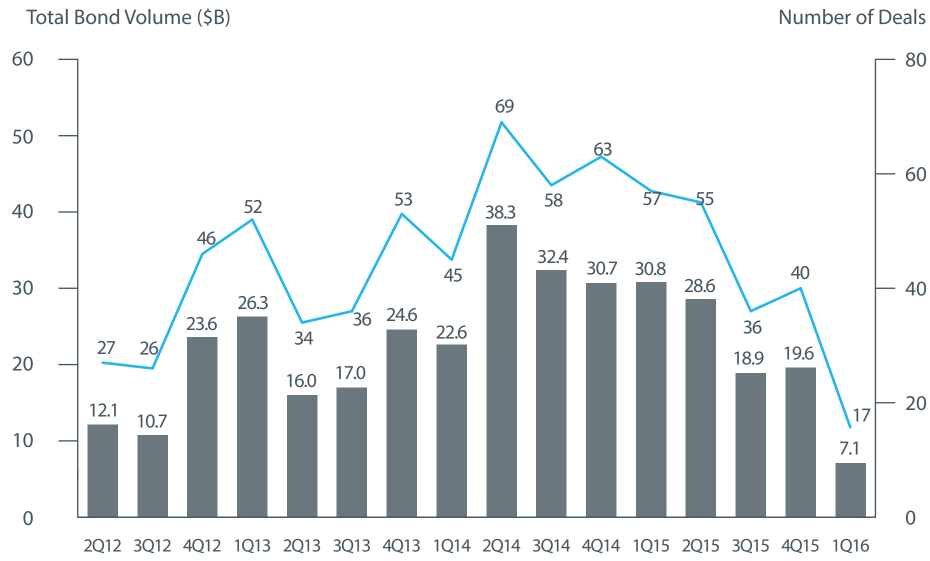
High-yield bond issuance in the energy sector remained severely depressed despite a significant recovery in oil prices. Energy issuance fell 82% by volume in the first quarter compared to the first quarter of 2015.

Leveraged Loan Mutual Fund Flows



Source: Lipper FMI

Total CLO Issuance

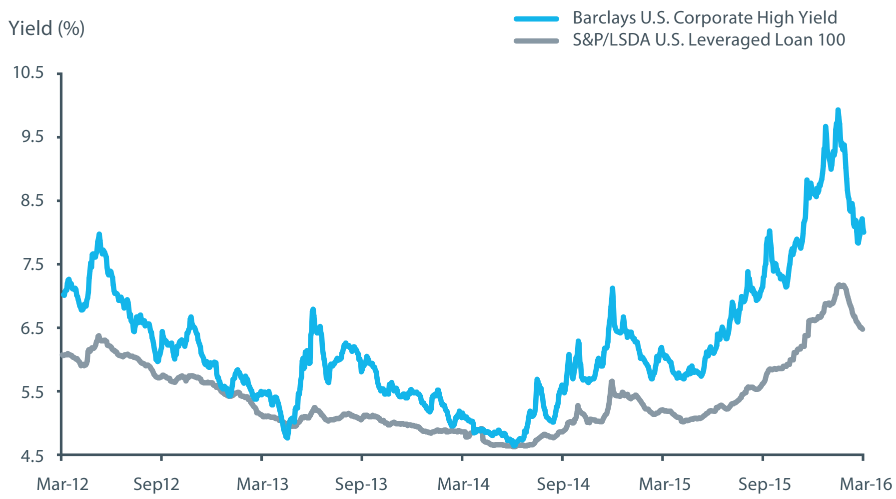


Source: SDC Platinum

Yields

Yields on high yield bonds and leveraged loans fell 40bps and 10bps, respectively, this quarter. Yields finished the quarter lower despite increasing by as much as 150bps and 55bps, respectively, in the first half of the quarter. Yields on high yield debt increased largely due to continued concerns in the energy space, as well as macro-economic uncertainty. Yields moderated following Fed commentary in mid-March.

U.S. Corporate High Yield Bonds & Leveraged Loans

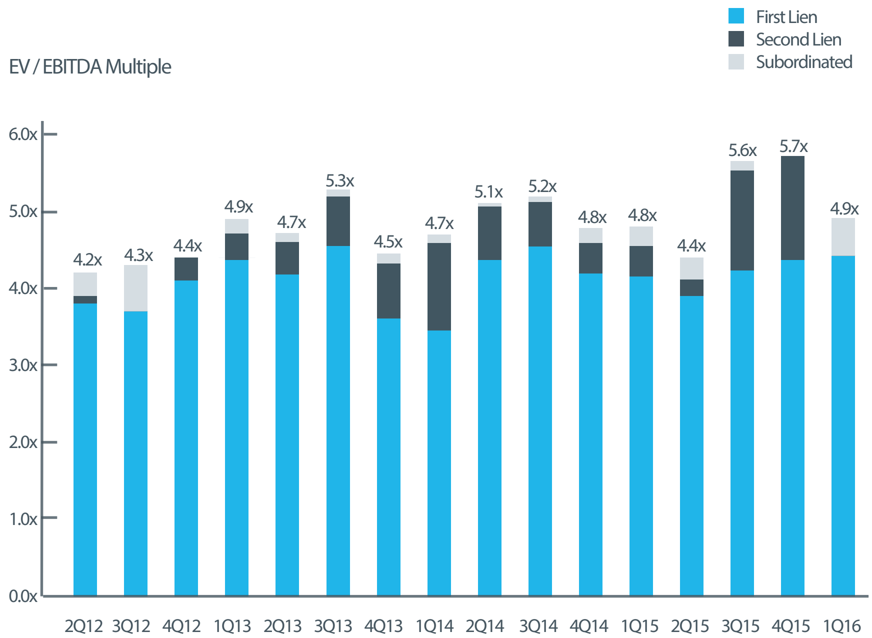


Source: SDC Platinum

Acquisition Financing

Leverage multiples for middle-market change-of-control financings fell from the highs in the second half of 2015. We observed a reemergence of subordinated lending as traditional senior lenders have reduced leverage appetite. We continue to observe a considerable tightening of underwriting criteria by commercial banks and BDCs, while non-banks and credit funds are filling the resulting void.

Leverage Multiples (EBITDA < $50MM)

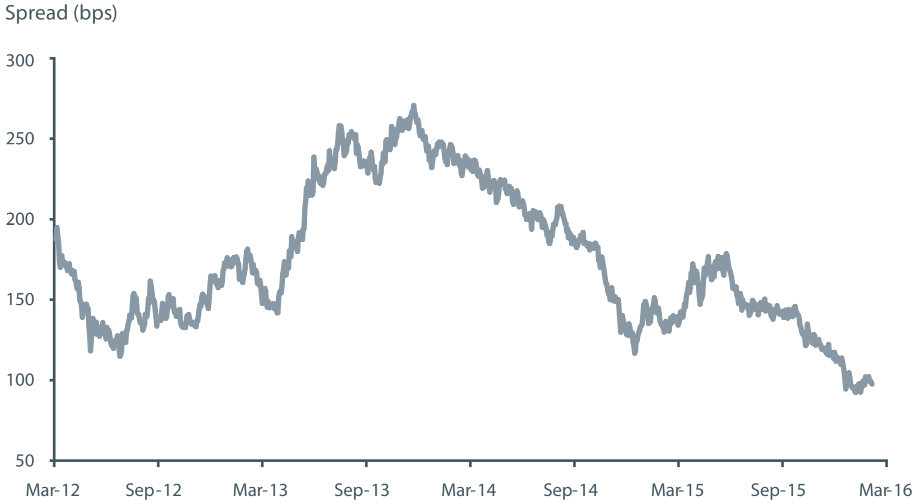


Source: SDC Platinum

Macroeconomic Update

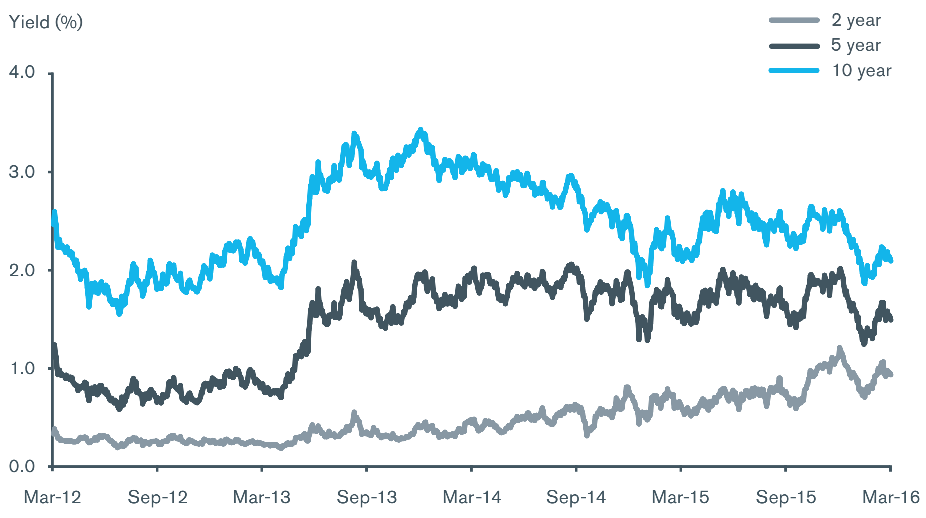
Evolving monetary policy, commodity price volatility and geopolitical events all garnered keen attention from markets. Concerns around slowing growth in China, foreign policy tensions with Iran, Russia and North Korea, and acts of terrorism, also weighed on market participants. The Federal Reserve's March meeting, and subsequent commentary, reduced expectations for quarter-point rate hikes from four to two for the coming year. The Fed cited relatively weak GDP growth and below-target inflation, as well as the effect of negative rates in Europe and Asia on the strength of the dollar, as reasoning for the delayed tightening schedule.

2 Year vs. 10 Year Treasury Spread



Source: Bloomberg

2, 5, and 10 Year Treasury Yields

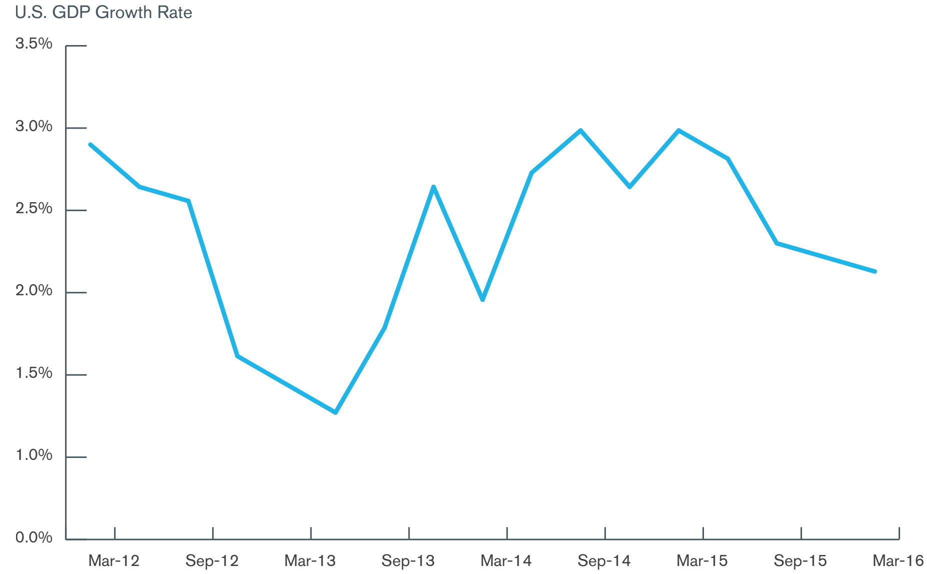


Source: Bloomberg

Macroeconomic Update - Continued

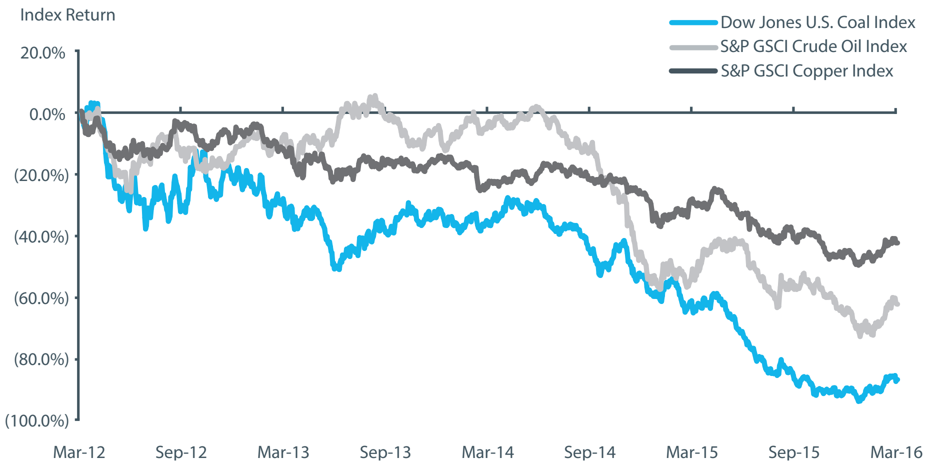
Domestic labor conditions were particularly affirming, as the job market continued unabated. Equity markets suffered large losses in January and February, though the S&P 500 ended slightly positive for the quarter. The energy sector, despite rising oil prices, remains troubled as reserves continue to be high, and the specter of widespread restructuring continues.

U.S. GDP Growth



Source: Federal Reserve Bank of St. Louis

Global Commodity Indices



Source: Capital IQ

Conclusion

Middle-market issuers of well-structured credit instruments are enjoying broad interest among market participants. While much of the first quarter of 2016 was hampered by a hawkish Fed and modest global growth, the end of quarter rally in financial assets and commodities carried over into a much improved environment for middle market corporate borrowers.

Appetite from traditional private credit sources continues unabated. In addition, a marked slowdown in large cap issuance, as well as reduced bond and loan liquidity, has triggered a strong crossover bid. The resulting window of opportunity is, we believe, inordinately compelling for opportunistic borrowers.

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