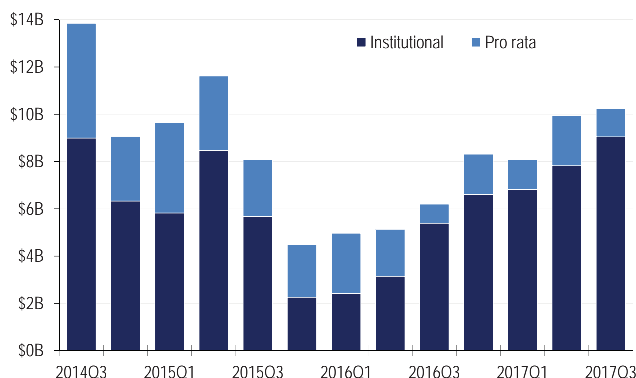
S&P Global Market Intelligence

LCD Middle Market Review

Middle market volume builds again in 3Q; cov-lite activity surges

Bucking a trend of easing activity in the broader market, U.S. middle market leveraged loan issuance totaled $10.2 billion in 2017's third quarter, more than in either of the previous two quarters, according to LCD. In fact, the 3Q issuance was highest volume of any quarter since 2Q15.

Middle market volume (≤ $350M)



Source: LCD, an offering of S&P Global Market Intelligence

Middle market issuance—defined here as deals of $350 million or less—was $28.3 billion in the first nine months of the year, already topping the 2016 full-year total of $24.6 billion.

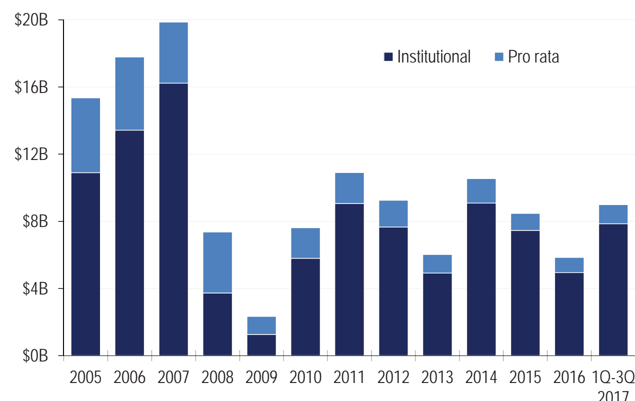
In the broader market, overall activity eased in the third quarter from the torrid pace earlier in the year, as refinancings slowed considerably and retail investors took pause from a stretch of cash inflows.

As in the broadly syndicated market, however, sponsor activity was a big driver of 3Q middle market issuance, accounting for just shy of $4 billion in LBO loans during the quarter. That's the most since 3Q07, according to LCD.

This recent sponsor activity brought middle market LBO issuance to $9 billion during the first three quarters of the year (that's institutional plus pro rata), more than in all of last year and the most since 2014.

Dividend loans were a notable driver of middle market activity, with $1.7 billion of recap deals in the third quarter, up 88% from 2Q. Total dividend volume in the first three quarters was $3.89 billion, accounting for roughly 14% of this year's total loan volume.

Middle market LBO volume (≤ $350M)



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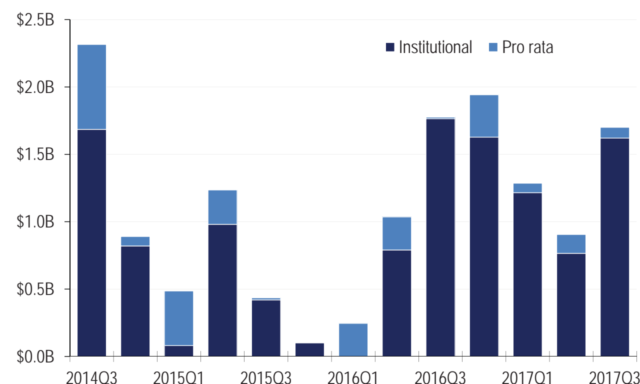
Middle market dividend volume (≤ $350M)



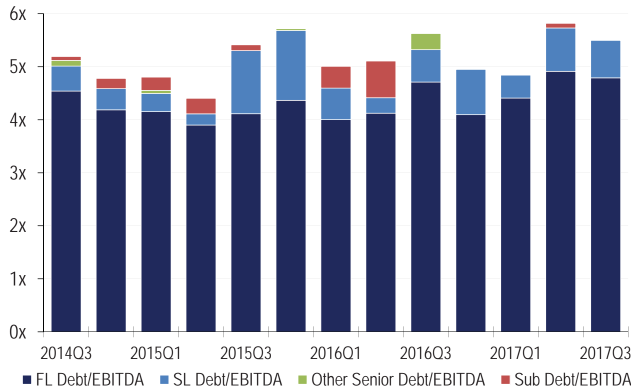
Source: LCD, an offering of S&P Global Market Intelligence

Leverage, yields

Middle market leverage through the first-lien ticked down in the quarter, to 4.79x, from 4.91x in 2Q. Total leverage dipped to 5.50x from 5.82x. Average yields on first-lien debt financing of middle market borrowers compressed further, to 6.17% at the end of the third quarter, from 6.34% at the end of the 2Q.

In general, the middle market remains extremely competitive and issuer-friendly, with piles of investor cash chasing relatively few deals. This increased demand for paper comes from a number of sources, including traditional large-corporate lenders looking downmarket in search of yield, asset-managers entering the seemingly ever-growing private credit space, and

Middle market leverage ($50M or less EBITDA)



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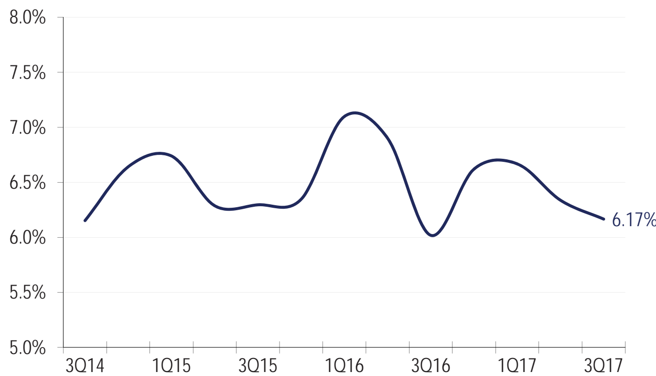
Middle market first-lien YTM



Source: LCD, an offering of S&P Global Market Intelligence

ramped up CLO issuance. To this last point: So far in 2017 there has been $9.65 billion of middle market CLO issuance, compared to $6.7 billion in all of last year, according to LCD.

This amped-up demand has led to rising covenant-lite activity in the middle market. Those loans totaled $3.78 billion in the third quarter, the most since the first quarter of 2014.

Covenant erosion

Indeed, across the middle market, the talk is of cov-lite structures creeping into smaller deals.

Ken Kencel, CEO of Churchill says, "We see credit facilities as small as $250 million in size that are being done cov-lite. Three years ago that would not have been the case. As a result, the upper middle market has become more syndicated, more distributed, and more underwritten to sell. Lenders in this space have shifted from the 'storage business' into the 'moving business' —often at the expense of covenants and other structural protections, with lower pricing and higher leverage. This is something that has happened increasingly in the last several months."

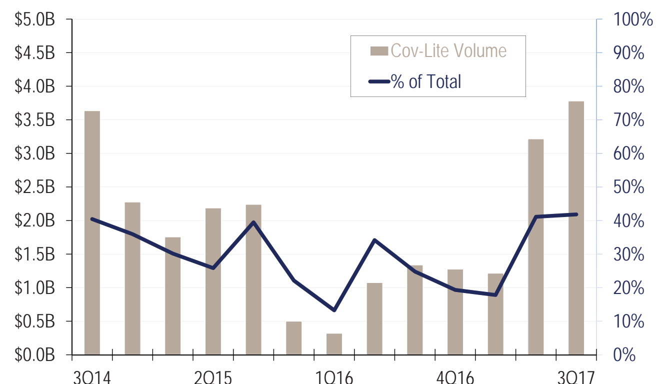
As bigger lenders and investment banks are tapping the upper middle markets for deal flow, issuers are benefitting from lower pricing and more lax covenant packages typical of the broadly syndicated markets.

Some recent examples of cov-lite penetration in smaller syndicated deals include a $210 million first-lien term loan due 2024 (L+425, 1% LIBOR floor) that backed the buyout of **OB Hospitalist** by Gryphon Investors, which was priced by Antares Capital, and a Jefferies-led $240 million TLB due 2024 (L+400, 1% floor) financing New Mountain Capital's acquisition of **Sparta Systems**.

Traditional middle market lenders are contending with similar dynamics amid a competitive environment. Tight pricing, looser covenant packages, and aggressive structure are common for clubbed deals in a push to put money to work, participants say. In terms of EBITDA, players are seeing cov-lite crop up where it hasn't been seen before.

"Cov-lite structures have not gotten into transactions for companies with EBITDA in the teens," said Jens Ernberg, Co-head of Private Credit Asset Management at Capital Dynamics. "Around the $25 million EBITDA business—you are seeing cov-lite structures go there, even though a direct

Middle market covenant-lite volume (≤ $350M)



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lender may win the transaction versus an arranger agent that is seeking to syndicate the facility."

Jay Alicandri, Partner at Dechert LLP, echoes this opinion. "If you're talking from $50 million to $20 million, we absolutely see very aggressive deal terms."

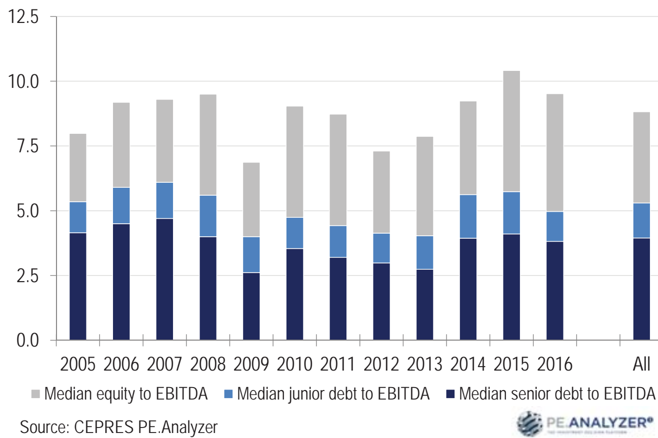
In a survey conducted by Dechert and the Alternative Credit Council, 49% of private credit managers agree that loan offerings contain less demanding covenants than three years ago. Recently, deals have been labeled "covenant-fake," featuring covenants with excessive headroom and cushion or extremely flexible definitions of EBITDA and allowance for add-backs.

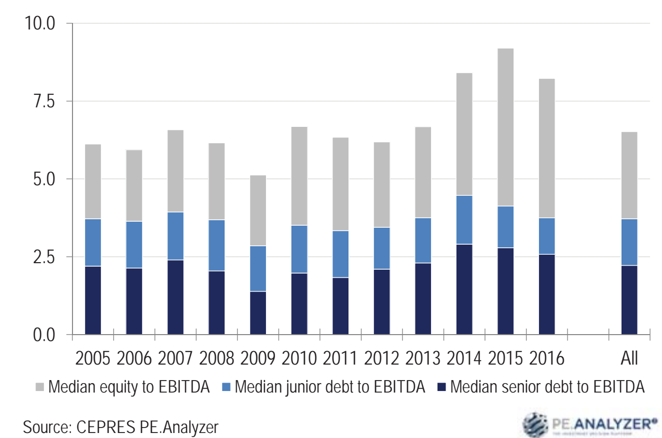
Kencel of Churchill warns against the pitfalls of the spread of cov-lite. "The justification of cov-lite for BSL loan investors is that they have liquidity, investors holding BSL loans can just trade the loan. You can't do that in the middle market, because you have limited or no liquidity. In a period of market dislocation, upper middle market investors will experience this first-hand when they try to sell the loan, and find there's no bid for it."

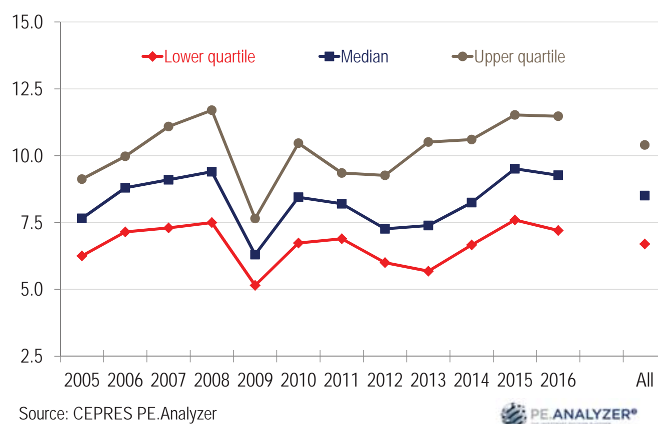
Kencel says that staying away from syndicated cov-lite structures can, counterintuitively, be beneficial for sponsors, even though syndication usually means better pricing. "If you're in the large cap world and you have fifty lenders holding your deal, and you want to tweak it, the process can be cumbersome," he says. "The agent may not even own any of the deal. You may have to pay for a new deal, instead of going to the three or four lenders in the deal and upsizing. Some of the smarter sponsors have realized that a club execution with two or three lenders actually gives them more control over the deal."

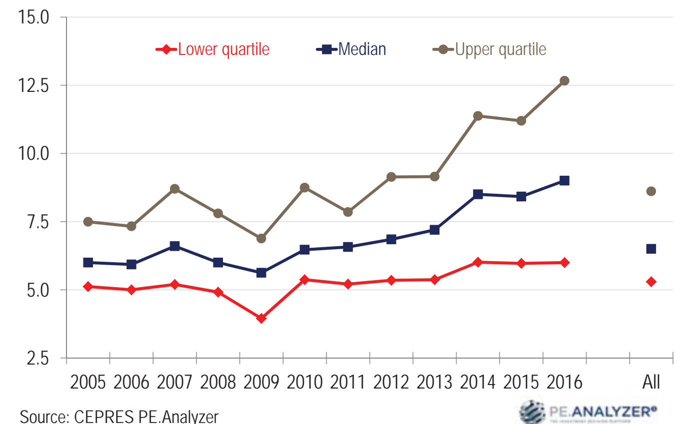
— Shivan Bhavnani

Direct lending stats from CEPRES









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