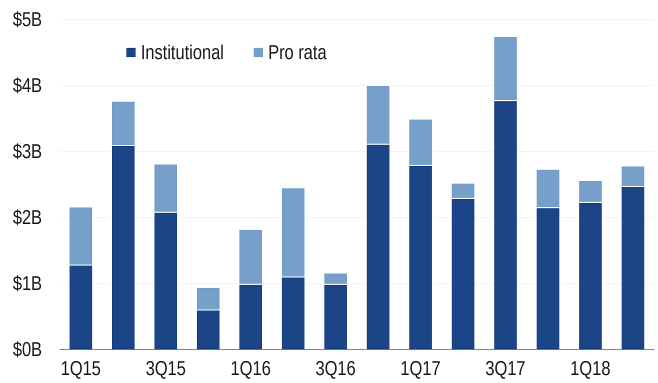
S&P Global
Market Intelligence

LCD Middle Market Review

As pricing levels off, market players focus on structure

Competition for deals in the middle market loan space continued in the second quarter of 2018, though, as in the broader market, pressure on spreads has started to ease, with market players opining that pricing in the sector might finally have hit a floor. Of course, attention remains focused on deal structure and documentation.

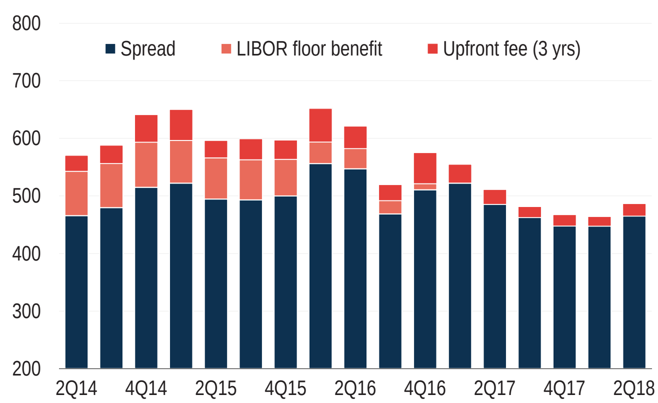
Middle market volume



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

As for activity proper, syndicated institutional middle market issuance totaled $2.47 billion in the second quarter, roughly unchanged from the first quarter (these numbers, and the data that follows, detail activity for issuers with EBITDA of $50 million or less).

Middle market all-in spread (bps)



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

One reason for the increase in spreads late last quarter was the surge of loan issuance in the broader market in May and June, the effects of which carried over into the syndicated middle market space. Another: After the lengthy decline, spreads would be hard-pressed to dip much lower.

“We’re probably at the relative heights [of spread tightening],” says Peter Nolan, a senior managing director at Antares. “What has helped the market deal with spread compression is that CLOs have been able to refinance their debt stack to get lower spreads on their liabilities, so they can tolerate lower spreads on the loans. But it can only go so low. And concerning middle market loans, my guess is there is still room to compress a little bit, but not much.”

“Pricing is one thing that can’t really move much more in the private credit area,” says Ted Koenig, CEO of Monroe Capital. “That’s because debt funds need to generate certain levels of returns to meet investor expectations and make the investors’ allocations worthwhile. While pricing has certainly compressed, I don’t think it’ll go much lower. The market will likely see flexibility in structures being pushed by borrowers, not tightening of pricing.”

Debt structure

As in the broader market, subordinated debt continues to evaporate in the middle market. Second-quarter issuance was almost exclusively focused on first-lien debt, continuing a trend that resumed in earnest in 2017, when first-lien institutional debt accounted for 77% of issuance. That figure has grown to nearly 90% today. In the middle market, the fading of subordinated debt, and second-lien, can partly be attributed to the emergence of the unitranche product.

“There has been a clear shift to the prominence of the unitranche deal,” says Ken Kencel, President and CEO of Churchill Asset Management. “It’s a direct result of sponsors seeking one-stop debt solutions. Unitranche eliminates intercreditor issues. The economics and pricing of the unitranche are also comparable to the two-part debt structure, but with no syndication risk. You can’t be a full-service debt provider today without this capability.”

Stats, middle market versus large corporate							
Middle market	2012	2013	2014	2015	2016	2017	1H18
RC	23.1%	15.0%	20.0%	19.1%	21.2%	15.4%	9.4%
TLa	10.0%	2.6%	5.5%	7.5%	15.7%	4.4%	0.0%
First-lien institutional	65.0%	74.8%	65.1%	68.0%	60.5%	77.0%	89.0%
Second-lien	1.9%	7.6%	9.4%	5.4%	2.6%	3.2%	1.6%
Large corporate	2012	2013	2014	2015	2016	2017	1H18
RC	21.2%	11.4%	18.1%	18.6%	12.4%	9.0%	11.2%
TLa	10.5%	3.9%	7.3%	14.8%	10.4%	4.6%	5.0%
First-lien institutional	64.9%	78.1%	68.6%	64.1%	75.6%	84.1%	81.3%
Second-lien	3.5%	6.6%	6.1%	2.5%	1.7%	2.4%	2.5%

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

Middle market leveraged loan volume							
MM total leveraged loan volume	2012	2013	2014	2015	2016	2017	1H18
Split BBB/BB or higher	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
BB+/BB/BB-	0.0%	4.5%	0.0%	0.0%	2.1%	0.0%	0.0%
Split BB/B	0.0%	0.0%	0.0%	6.9%	3.7%	0.0%	4.6%
B+/B/B-	39.6%	51.5%	57.9%	42.8%	28.8%	62.3%	65.4%
Split B/CCC, CCC	6.2%	5.0%	4.4%	2.1%	0.0%	0.0%	5.3%
NR	54.2%	39.1%	37.7%	48.2%	65.4%	37.7%	24.7%
Total volume	$10.1B	$13.4B	$14.9B	$9.6B	$9.4B	$13.5B	$5.3B
MM institutional lev. loan volume	2012	2013	2014	2015	2016	2017	1H18
Split BBB/BB or higher	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
BB+/BB/BB-	0.0%	5.3%	0.0%	0.0%	0.0%	0.0%	0.0%
Split BB/B	0.0%	0.0%	0.0%	8.1%	4.8%	0.0%	4.2%
B+/B/B-	45.1%	52.9%	66.5%	49.2%	39.0%	67.5%	66.1%
Split B/CCC, CCC	8.5%	5.7%	4.4%	2.4%	0.0%	0.0%	5.3%
NR	46.5%	36.1%	29.1%	40.3%	56.1%	32.5%	24.4%
Total volume	$6.9B	$10.7B	$11.3B	$7.1B	$6.2B	$11.0B	$4.7B

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

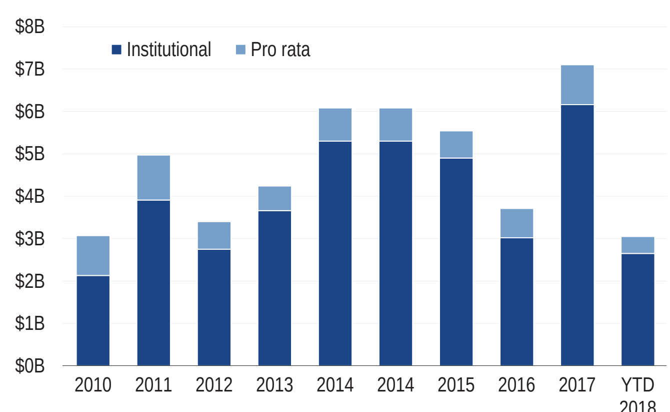
First-lien debt issuance was exclusively from borrowers at the lower rungs of the ratings ladder in 2Q18. During that period, single-B issuers accounted for 70% of syndicated middle market issuance, with no activity in the double-B segment, according to LCD. Of course, this mirrors activity in the broader market (especially so far in July).

M&A/LBOs

As in the broader market, LBO activity and overall M&A issuance in the syndicated middle market falls short of the pace set in 2017.

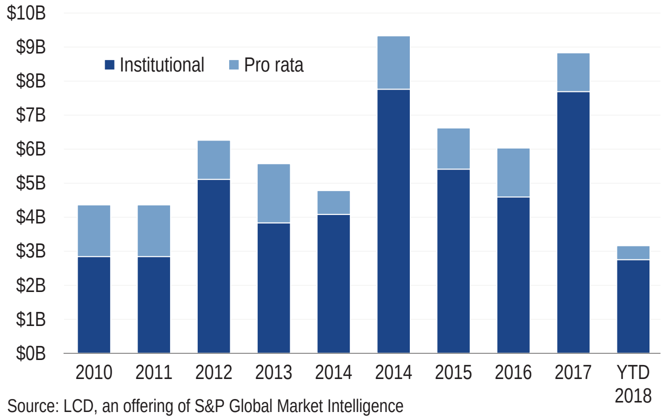
On these sponsored transactions—LBOs and other deals—syndicated middle market loan arrangers are doing business with bigger borrowers.

Leveraged buyout middle market volume



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

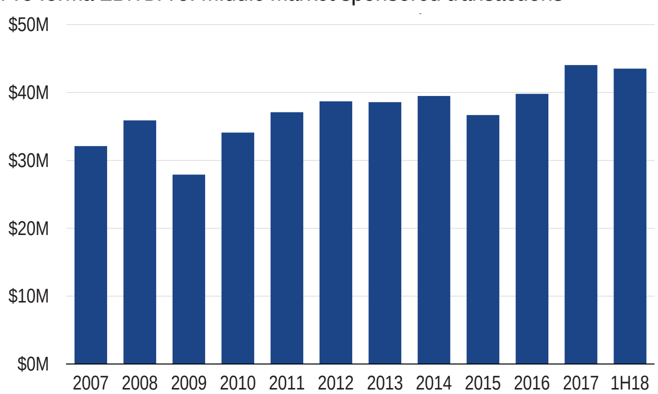
Acquisition-related middle market volume



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

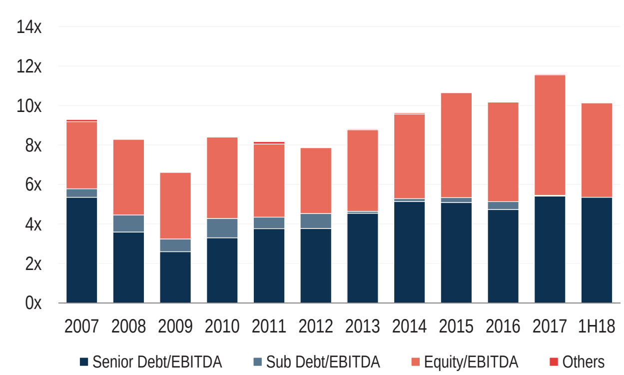
In 2Q18, the average EBITDA of issuers in sponsored deals was $48.2 million, the highest quarterly total on record.

Pro forma EBITDA of middle market sponsored transactions



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

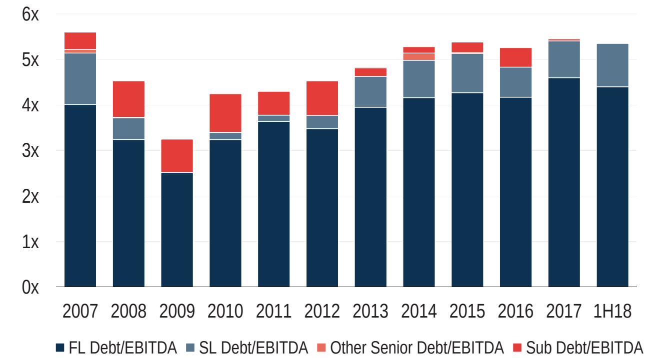
Middle market LBO purchase price multiples



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

And deals remain expensive, even as purchase price multiples on LBOs retreated to 10.2x on middle market transactions in the first half, from a sky-high 11.6x in 2017. While lower than last year, PPMs have increased considerably from 2012, when they averaged 7.9x. And for the record, they're well higher than the 9.3x in 2007, at the peak of the last credit cycle.

Average debt ratio of middle market LBO loans

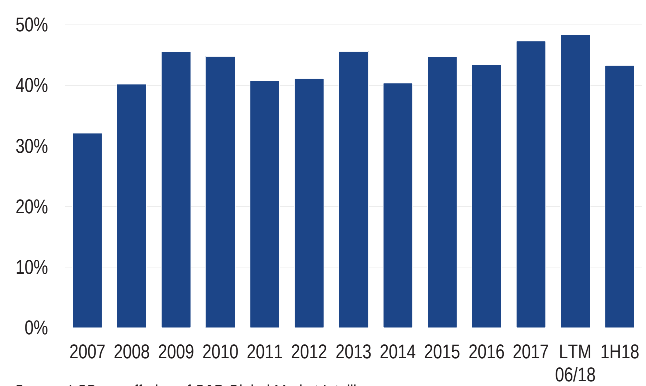


Source: LCD, an offering of S&P Global Market Intelligence

Likewise, overall leverage remains at lofty levels. The debt/EBITDA ratio on LBO deals over the last 12 months for syndicated middle market LBOs was 5.4x, down slightly from 5.5x in 2017. In addition, leverage through the first-lien debt has averaged 4.4x this year, down slightly from 4.6x in 2017.

Turning to equity contributions, private equity sponsors are kicking in a higher share on middle market LBOs than in the pre-crisis period. By the first half of 2018, that number had hit 43% (after dipping a bit from 2017). Toward the peak of the last credit cycle, sponsors were chipping in a relatively paltry 32%.

Equity contribution percentages for MM LBOs



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

"Lenders continue to insist on minimum cash equity contributions and steer away from thinly capitalized deals," writes Stefan Shaffer, of SPP Capital, in a monthly market update. "As a general proposition, a minimum of 40–50% base level equity is required. As leverage levels creep up, however (in excess of 5x), 40–50% equity is becoming the new normal."

There are also purely competitive factors pushing leverage higher. "New private debt firms formed in the last few years tend to push the envelope on leverage and covenants, among other things," Koenig says.

As ever, the question on leverage is, how high can it go?

"To maintain healthy interest coverage levels, it doesn't seem possible to go much higher [than 7x]," Nolan says. "There has been discussion around different forms of leverage, like PIK preferred, but from a cash-pay perspective, I think we're at the high. We've also expected LIBOR to increase for years, and now it is doing that. That will also serve as a limitation of how much debt can be put on a company."

Middle market recoveries

A flood of capital chasing relatively limited deals over the past few years has taken a toll on loan structures, of course, with covenant-lite loans becoming increasingly commonplace in the middle market.

Roughly 45% of total middle market loan issuance in 2Q was covenant-lite, in line with a 44% cov-lite figure in 2017. Beyond covenant-lite, middle market loan structures are loosening. That overall trend of structural deterioration has lenders and investors wary, as it may well impact recovery levels, in cases of default.

Average discounted recovery, US leveraged loans

Average for default event	Average discounted recovery	Coefficient of variation (CV)
Negative or zero EBITDA	43%	0.75
Middle market ($50M or less)	62%	0.40
Large corporate (more than $50M)	59%	0.47

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

Historically, middle market loan investors have enjoyed slightly higher recovery rates than investors in the broadly syndicated loan world, in part due to what traditionally have been simpler capital structures and a shorter time in bankruptcy.

Specifically, the average discounted recovery on middle market credits—again, issuers with $50 million or less in EBITDA—is 62%, versus a 59% discounted recovery on large corporate issues, according to S&P Global's LossStats. These numbers are as of the end of 1Q18.

(For purposes of this analysis LCD has used discounted recoveries, as opposed to nominal recoveries. Because restructurings can last years, eliminating the noise of time is important to maintain comparability. The discounted recovery time-values the nominal recovery back to the date of default using the pre-petition default rate, normalizing recoveries over long periods of analysis, and creating parity among the recovery outcomes from various events.)

However, structures have become undoubtedly looser than in the past. For example, 44% of middle market loan issuance was cov-lite in 2017, versus 11% in 2007.

Again, this has been cause for much consternation. While recovery rates (in the BSL market) were actually higher for covenant-lite leveraged loans during the last credit cycle—back then, only better-quality issuers would be afforded cov-lite—there are few expectations for that dynamic to hold whenever the current cycle turns. And recent analysis by LossStats and LCD indicates that recoveries on recent-vintage cov-lite loans might indeed be lesser, when compared to covenant-lite loans undertaken earlier.

"We think that overall recovery rates will be lower due to the availability of covenant-lite structures for smaller, lower middle markets companies which tend to be less durable during downturns," Mitch Drucker, managing director at Garrison Investments, says. "During the last cycle, the smaller companies weren't able to obtain covenant-lite structures. From a lender's point of view, you have no structural protections in a covenant-lite deal. You have to remain idle, and watch as value is eroded. It hampers a lender's ability to maximize recovery levels, and this may be a problem, specifically in the lower middle market."

Structure

Digging more deeply into the looser structures that have characterized broadly syndicated and middle market loans of late, excess cash flow continues under scrutiny.

"What's generally important to the private equity sponsor in a loan agreement is flexibility," Joseph D'Angelo, partner at Carl Marks Advisors, explains. "Specifically, the negotiation typically concerns the flexibility surrounding excess cash flow. They want to be able to use excess cash to pay themselves back or reinvest in the company."

Historically, it would be necessary to use excess cash flow to pay down debt. "The mandatory use of 100% of excess cash flow to pay down debt is pretty rare now," D'Angelo says. "Things like proceeds from an insurance settlement used to be mandatory prepayment, but now it's not mandatory. During the course of a loan, before a default, there's all this flexibility with excess cash flow to do things they weren't able to the last time around."

The mechanics of how excess cash flow sweeps are being reduced is more complicated, of course.

"Most borrowers and sponsors are pushing for step-downs on excess cash flow sweeps, based on leverage," explains Steven Ellis, partner and co-head of the Private Credit Group at Proskauer. "For example, if a borrower hits a certain leverage parameter, then the excess cash sweep percentage would drop down. The sweep could begin as high as 75%, and ultimately step down to 25%."

This type of step-down has become more widespread in middle market loan documentation over the past quarter. According to Proskauer Private Credit Group's proprietary data report, in the first half 2018, 58% of middle market deals (less than $50M in EBITDA) had a step-down at greater than 4x, a significant increase from the 41% in 2017.

Flexibility regarding excess cash flow sweeps isn't the only recent example of loosening structures in the middle market, of course. Other examples include run-rate synergy expense add-backs and grower baskets. For deals backing companies with less than $15 million of EBITDA, run-rate synergy expenses were added back 29% of the time in the second half of 2017, according to Proskauer. In the first half of 2018 that figure surged to 45%.

The use of grower baskets has increased as well. "In the first half of 2018, 22% of lower middle market deals for companies with less than $25 million in EBITDA had grower baskets. That's definitely more than it was last year," Ellis says.

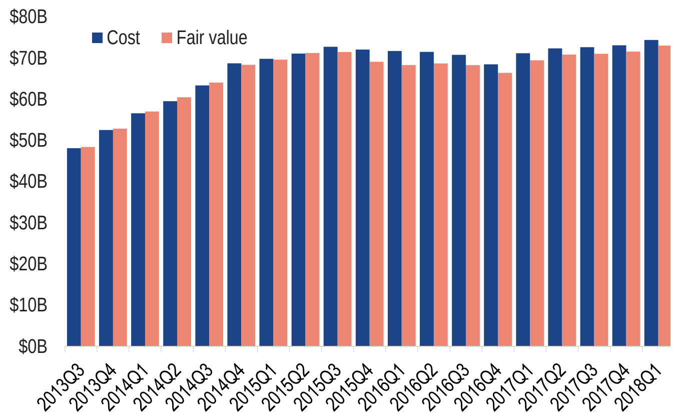
While covenant deterioration in the middle market over the past few years has been undeniable, we'll conclude this topic by noting that toward the end of 2018's second quarter there was demonstrable evidence—in the BSL market, certainly—that investors had begun to push back (albeit amid a surge of issuance).

Along with the rise in spreads, investor-friendly price flexes—where a loan's pricing is changed during syndication due to market demand—outnumbered issuer-friendly flexes for the first time since early in 2016.

BDCs

BDC assets continue to increase at a healthy pace, climbing 2% over the last quarter and roughly 5% since 1Q17, according to LCD. Some 15 BDCs are trading at or above NAV, perhaps in part due to the prospect of increased leverage employed by these concerns, made possible by the recent passage of the Small Business Credit Availability Act.

Total cost vs. total fair value for main portfolios



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

Notable here is how quickly a number of public BDCs opted to move forward with approvals to employ 2:1 leverage. And a handful quickly moved to reduce base management fees in the process, including Goldman Sachs BDC, Apollo Investment Corp., and Solar Capital. This suggests that the additional leverage could be used to buy more liquid, lower-yielding assets—like senior loans.

BDCs that are heavily involved in the senior loan space, such as Ares, Golub, TPG, Franklin Square, and CCT, are presumably the most major beneficiaries of this leverage.

The question is: Will this actually increase the demand for middle market senior loans?

"An increase in senior loan demand at the level of public BDCs isn't necessarily going to skyrocket demand for senior loans," Christopher Testa, head of research at National Securities, says. "Private debt fundraising for senior loans across the board has been very strong. Public BDCs aren't indicative of a total senior loan demand. I don't think 2:1 leverage on the public BDC side will move the needle. And ultimately, I don't think that will materially change demand or pricing for middle market loans."

With increased leverage and investment in safe, lower-yielding credits, reduced fees could result in additional income flowing through to shareholders, sources say, so the recent actions by these concerns could make it clear which BDCs "are credit investors, and which BDCs are asset gatherers …. Who wants to create value, and who wants more fees," Testa says.

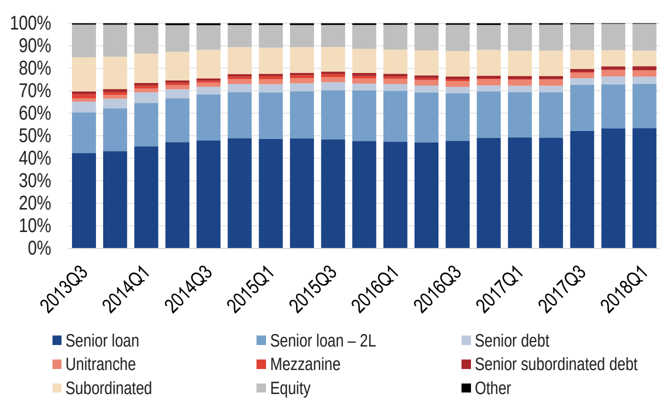
Over the past quarter, overall BDC investment in senior loans has remained flat, accounting for roughly 53% of BDC assets. For context, in 2Q14, senior loans made up 47% of BDC assets. Subordinated debt has continued to drop in BDC portfolios. It now constitutes only 6.87% of portfolios. Last quarter, subordinated debt made up 7.19% of BDC assets, and in 2Q14 they accounted for 12.76%.

The sentiment among private debt funds is that the credit cycle is aging, and a shift to more senior secured loans is prudent. However, there can be more to this data, which is based on public BDC filings, than meets the eye.

"There are still many BDCs that are likely window dressing—they have loans that they can define as senior secured, but these loans are in many cases unitranche, and have higher leverage (5.5–6x) than a traditional first-lien loan (3.5–4x)," Testa says. "There are still many BDCs not breaking out unitranche loans as a separate classification."

There's other activity in the BDC market, aside from leverage and fees.

Cost by debt type



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

"There has been a real push by some of the larger BDCs into debtor-in-possession financing arrangements," says John Mahon, partner at Schulte Roth & Zabel. "In particular, as banks have backed off on the space, returns have gone up. BDCs were players in both the Sports Authority and Toys R Us bankruptcies, for example. Often, that can mean acquiring syndicated debt positions in the secondary market in advance of a bankruptcy so a fund can get a seat at the table when the DIP financing gets negotiated."

Going with what you know

There has been considerable focus by BDC managers on incumbent borrowers.

"We currently are only closing on about 3–4% of the transactions we review for new companies, and we continue to stress backing our strongest incumbent borrowers," said Kipp deVeer, CEO of ARCC, on the company's first-quarter earnings call.

Michael Forman, CEO of FSIC, echoed this sentiment in FSIC's first-quarter earnings call: "So clearly, maintaining those incumbency positions is a focus of ours and we like to make loans to existing borrowers we feel comfortable with and we expect that to continue."

Other senior BDC managers agreed.

"There's two-fold reasoning behind it," Testa explains. "One: a BDC does not have to do a whole new credit check. They know the people running the company, and they don't have to spend time and energy on due diligence. Reason two is, there is very little new-issue loan volume. Refi and recap are driving the market. If a borrower wants to refinance, a BDC wants to refinance them because it does not want to let the portfolio run off. The borrowers know that the BDC wants to keep them, so when they come back to the table to negotiate the refinancing, the borrower is in the driver's seat."

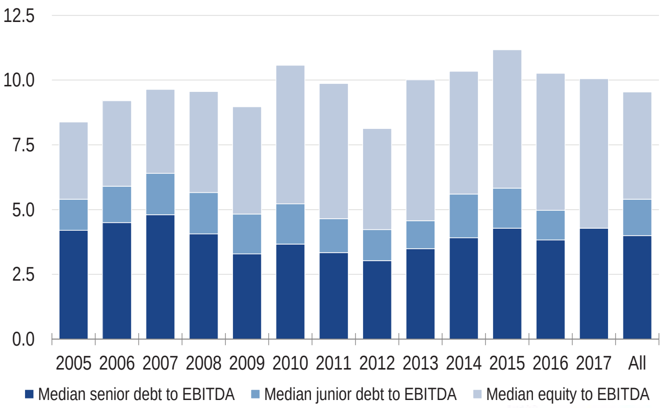
If a BDC's portfolio shrinks, of course, earnings could come under pressure, and thus dividends may be cut, which is decidedly not helpful for a BDC's stock price. Hence, BDCs cater to existing borrowers regarding refinancings.

For the record, 55.7% of all syndicated middle market deals in the second quarter backed refinancings. More broadly, refis have accounted for more than $90 billion of institutional loan issuance this year, according to LCD.

— Shivan Bhavnani

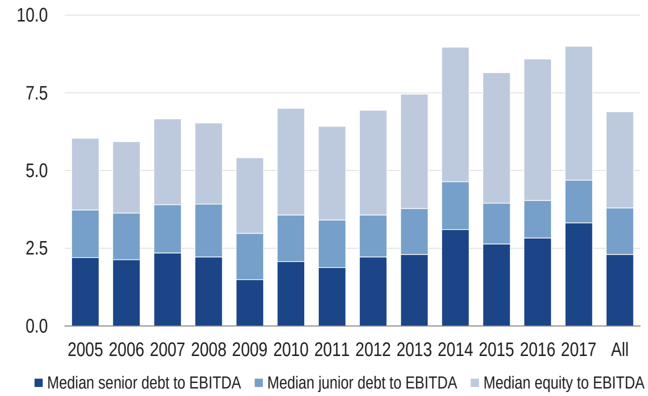
Direct lending stats from CEPRES

Private debt financing structure at entry: Europe



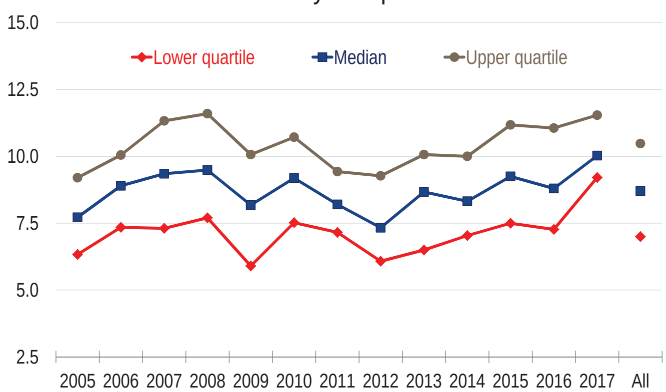
Source: CEPRES PE.Analyzer

Private debt financing structure at entry: North America



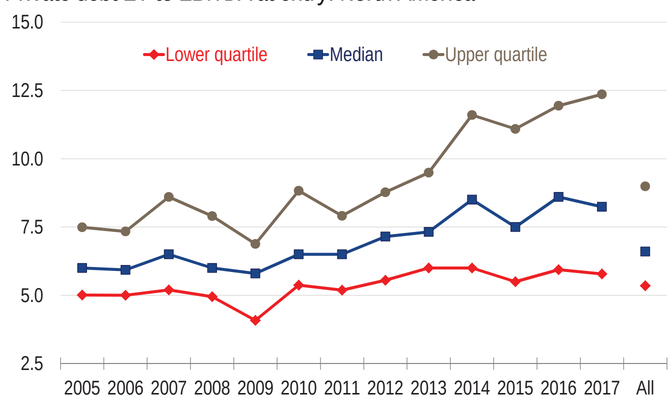
Source: CEPRES PE.Analyzer

Private debt EV to EBITDA at entry: Europe



Source: CEPRES PE.Analyzer

Private debt EV to EBITDA at entry: North America



Source: CEPRES PE.Analyzer

CEPRES Private Debt: https://www.cepres.com/private-equity-database

Leveraged Commentary & Data

LCD Managing Director
Ruth Yang (212) 438-2722
ruth.yang@spglobal.com

LCD News – U.S.
Tim Cross (212) 438-2724
tim.cross@spglobal.com

John Atkins (212) 438-1961
john.atkins@spglobal.com

Jon Hemingway (212) 438-0192
jonathan.hemingway@spglobal.com

Rachelle Kakouris (212) 438-7258
rachelle.kakouris@spglobal.com

Richard Kellerhals (917) 622-4457
richard.kellerhals@spglobal.com

Gayatri Iyer (212) 438-2726
gayatri.iyer@spglobal.com

Andrew Park (212) 438-3256
andrew.park@spglobal.com

Alan Zimmerman (646) 415-8143
alan.zimmerman@spglobal.com

Shivan Bhavnani (212) 438-0335
shivan.bhavnani@spglobal.com

Mairin Burns (212) 438-0584
mairin.burns@spglobal.com

Jakema Lewis (212) 438-0537
jakema.lewis@spglobal.com

James Passeri (212) 203-2151
james.passeri@spglobal.com

Tyler Udland (212) 438-0296
tyler.udland@spglobal.com

Copy Editing
Brenn Jones (212) 438-2704
brenn.jones@spglobal.com

Bob Matthes (212) 438-3592
robert.matthes@spglobal.com

Michael Baron (212) 438-4816
michael.baron@spglobal.com

Jamie Tebaldi (212) 438-1462
jamie.tebaldi@spglobal.com

LCD News – Europe
Luke Millar (44-20) 7176-3926
luke.millar@spglobal.com

David Cox (44-20) 7176-7829
david.j.cox@spglobal.com

Nina Flitman (44-20) 7176-3995
nina.flitman@spglobal.com

Rachel McGovern (44-20) 7176-3925
rachel.mcgovern@spglobal.com

Isabell Witt (49-173) 231-5018
isabell.witt@spglobal.com

Copy Editing
Alex Poole (44-20) 7176-3933
alexander.poole@spglobal.com

LCD Global Research
Marina Lukatsky (212) 438-2709
marina.lukatsky@spglobal.com

Miyer Levy (212) 438-2714
miyer.levy@spglobal.com

Taron Wade (44-20) 7176-3661
taron.wade@spglobal.com

Cuong Huynh (212) 438-5202
cuong.huynh@spglobal.com

Sara Shehata (212) 438-4441
sara.shehata@spglobal.com

Nicholas Boekel (212) 438-3847
nicholas.boekel@spglobal.com

Priscilla Sheng (212) 438-6604
priscilla.sheng@spglobal.com

Tim Stubbs (212) 438-3034
timothy.stubbs@spglobal.com

Whitman Cossaboom (212) 438-2712
whitman.cossaboom@spglobal.com

Leonie Dackham (44-20) 7176-6025
leonie.dackham@spglobal.com

Alejandro Martinez (212) 438-2410
alejandro.martinez@spglobal.com

Igor Silva (212) 438-5837
igor.silva@spglobal.com

Shaundra Edmonds (434) 951-7658
shaundra.edmonds@spglobal.com

Tim Mastracci (434) 951-4512
timothy.mastracci@spglobal.com

Marketing/Sales
Neslyn D'Souza (212) 438-2708
neslyn.dsouza@spglobal.com

Vanessa Greaves (212) 438-2292
vanessa.greaves@spglobal.com

Chris Polanco (212) 438-3231
christopher.polanco@spglobal.com