Duff & Phelps

INDUSTRY INSIGHTS:

# Capital Markets

Fall 2017 Review

# Highlights

Borrowing costs for middle-market credit seekers generally declined over the quarter, despite a modest increase in base yields. Non-investment grade bonds rallied approximately 17bps and leverage loan spreads were essentially unchanged.

The Fed, as widely expected, left benchmark interest rates unchanged in the third quarter. The Fed did, however, announce a program to gradually reduce its balance sheet from $4.5 trillion (a result of recessionary quantitative easing) to $3 trillion over the next three years. Additionally, Fed guidance through 2018 was reaffirmed with another 25-bps increase planned in 2017 and three 25-bps increases planned for 2018.

Monetary policymakers remained cautious that underlying low inflation against the backdrop of higher labor and capacity utilization could trigger a deflationary environment. Undeterred by this risk, the Fed remains committed to building sufficient “dry powder” to weather the next economic cycle. The Federal Reserve Board Chair believes the persistence of undesirably low inflation will pass as short-term factors abate.

Accelerating GDP growth, rising business and consumer optimism, and increasing wages and corporate profits could push inflation higher. Even in the absence of notable inflationary pressure, this backdrop could nevertheless catalyze more restrictive monetary policy.

Consequently, we believe an attractive window may exist for opportunistic middle-market issuers. Lower prevailing rates, greater leveragability and continued strong demand from capital sources have contributed to the attractive credit market. We note, however, that the elongated economic expansion cycle has caused credit providers to be more selective about the sectors they view as potentially overvalued and/or cyclical.

With the backdrop of strengthening GDP growth and inflation data in the third quarter, the Fed proceeded to outline a $1.5 trillion balance sheet reduction to occur over the next three years. Fed guidance also remained in place for another quarter-point rate hike in 2017.

Corporate credit issuance remained robust, despite the summer lull, with transaction count and volume exceeding that of the third quarter of 2016.

High-yield bond yields rallied this quarter, possibly a result of confidence in a benign corporate issuer default rate outlook, even as the quantum of debt and leverage multiple of corporate borrowers rose.

# Executive Summary

As widely expected, the Fed left benchmark rates unchanged in the third quarter. A balance sheet normalization program was announced, to reduce the current $4.5 trillion balance sheet, the result of the program known as quantitative easing, to $3 trillion over the next three years. Fed officials reduced future projected rate hikes by one in 2019. We expect another 25-bps increase in 2017, three 25-bps increases in 2018 and two in 2019. Following the announcement, the 2-year Treasury yield increased to its highest level since 2008, resulting in additional flattening of the yield curve as the 10-year ended the quarter largely as it began.

At this writing, no major fiscal agenda item has been accomplished. A tax reform push will begin in earnest in late October following the passage of a new federal budget. While an initial plan for revised tax policy has been outlined, the details are yet to be ironed out. Meanwhile, GDP growth appears to be accelerating (+2.7% estimate for Q3, after taking into account an estimated 0.5% negative impact from several major hurricanes), business and consumer optimism are rising, as are wages and corporate profits, as economic expansion continues.

While Fed policymakers are seemingly desirous of tightening policy, they have remained somewhat constrained by inflation readings remaining below the stated 2% target, a condition they view as transitory. Despite having the lowest unemployment rate in 16 years (4.2%), average core price index inflation remained stubbornly around 1.5%. The Fed recently indicated that it may have previously overstated the strength of the labor market and rate of inflation, but has remained committed to tightening policy as it views those conditions as strengthening. Even so, the market does not appear thus far to be factoring in Fed guidance on monetary tightening.

Despite increased corporate debt and leverage levels, borrowing costs for middle-market debt issuance generally declined during the third quarter, possibly a result of confidence in a benign default outlook. The U.S. high-yield default rate is expected to drop from Q4 2016’s 5.6% to 3.2% in Q4 2017, and to 2.8% by Q2 2018, according to Moody’s. This pattern runs counter to historical norms when rising debt levels (debt-to-internal funds or liquidity) and leverage are generally followed by rising default rate expectations. With increasing indebtedness, the current upturn’s longevity will largely be contingent on the continuation of corporate profit growth.

Consequently, we believe that an attractive window exists for opportunistic middle-market issuers. A combination of lower prevailing borrowing rates, higher available leveragability and continued strong demand from capital sources is helping to provide beneficial market conditions. However, with the elongated current economic expansion cycle, we have noted that credit providers are being somewhat selective about the sectors they view as overvalued and/or cyclical. This dynamic hasn’t changed the ability to raise capital around all industries, but requires advisors to be astute in how they structure new issuances. We don’t know how long current conditions will remain in place, as signs of accelerating economic growth and monetary tightening may add pressure to currently low corporate borrowing rates.

# Indicative Middle-Market Credit Parameters

## LEVERAGE MULTIPLES

| | EBITDA OF \$10MM–\$20MM | EBITDA OF \$20MM–\$50MM |
|---|---|---|
| **SENIOR** | **3.25x–4.25x** | **3.75x–4.75x** |
| **TOTAL DEBT** | **4.00x–5.00x** | **4.50x–5.50x** |

# Indicative Middle-Market Credit Parameters

| PRICING | EBITDA OF \$10MM–\$20MM | EBITDA OF \$20MM–\$50MM |
|---|---|---|
| **FIRST LIEN** | LIBOR + 2.75%–3.50% (bank)<br>LIBOR + 3.75%–5.75% (nonbank) | LIBOR + 2.50%–3.25% (bank)<br>LIBOR + 3.75%–5.75% (nonbank) |
| **SECOND LIEN** | LIBOR + 6.00%–9.00% | LIBOR + 5.50%–8.50% |
| **SUBORDINATED DEBT** | 10.50%–12.50% | 9.50%–11.50% |
| **UNITRANCHE** | LIBOR + 6.00%–8.50% | LIBOR + 5.50%–8.00% |

# New Issuance

High-yield issuance volume increased slightly over the second quarter. Refinancings continued to drive issuance, accounting for 58% of overall supply, while M&A- and LBO-related financings were up nearly 20% over the second quarter. A few large deals accounted for a large amount of new issuance volume; notable deals in September included the Caesars Growth and Resort Properties $1.7 billion financing and the Avantor $1.6 billion financing.

## Total High-Yield Bond Issuance

Total Bond Volume ($B)

Number of Tranches

$125
$100
$75
$50
$25
$0

300
250
200
150
100
50
0

| Quarter | Total Bond Volume ($B) | Number of Tranches |
|---|---|---|
| 4Q13 | 68.6 | 146 |
| 1Q14 | 74.9 | 146 |
| 2Q14 | 105.1 | 178 |
| 3Q14 | 68.9 | 123 |
| 4Q14 | 64.5 | 112 |
| 1Q15 | 91.3 | 129 |
| 2Q15 | 94.1 | 163 |
| 3Q15 | 39.8 | 61 |
| 4Q15 | 36.3 | 53 |
| 1Q16 | 36.1 | 55 |
| 2Q16 | 83.4 | 112 |
| 3Q16 | 62.7 | 107 |
| 4Q16 | 47.1 | 89 |
| 1Q17 | 81.7 | 143 |
| 2Q17 | 61.7 | 118 |
| 3Q17 | 64.8 | 116 |

Source: LCD Comps

# New Issuance

Corporate loan issuance was robust despite typically muted new deal volume over the summer months, with transaction count and volume exceeding that of the third quarter of 2016. A combination of strong demand from credit sources, low rates and declining default rate expectations likely contributed to strong volume.

## Total Loan Issuance

Total Loan Volume ($B)

Number of Deals

| Quarter | Total Loan Volume ($B) | Number of Deals |
|---|---|---|
| 4Q13 | 607.2 | 1,177 |
| 1Q14 | 481.5 | 994 |
| 2Q14 | 620.6 | 1,173 |
| 3Q14 | 507.3 | 1,098 |
| 4Q14 | 672.0 | 1,111 |
| 1Q15 | 437.0 | 848 |
| 2Q15 | 662.9 | 1,172 |
| 3Q15 | 603.6 | 951 |
| 4Q15 | 605.8 | 1,067 |
| 1Q16 | 399.0 | 804 |
| 2Q16 | 695.9 | 1,079 |
| 3Q16 | 499.3 | 943 |
| 4Q16 | 715.8 | 1,049 |
| 1Q17 | 636.1 | 1,028 |
| 2Q17 | 727.2 | 1,121 |
| 3Q17 | 605.0 | 1,008 |

Source: SDC Platinum
Volume data includes deals reported as of 10/16/2017

# New Issuance

Middle-market loan issuance trends were largely reflective of those observed for total loan issuance. Third quarter activity also reflected reduced middle-market M&A related issuance. Like broader loan issuance, 2017 middle-market loan issuance appears on track to significantly exceed previous years.

## Total Loan Issuance (EBITDA < $50MM)

Total Loan Volume ($B) — Number of Deals

| Quarter | Total Loan Volume ($B) | Number of Deals |
| --- | --- | --- |
| 4Q13 | 275.3 | 913 |
| 1Q14 | 266.3 | 798 |
| 2Q14 | 305.0 | 952 |
| 3Q14 | 230.5 | 897 |
| 4Q14 | 256.7 | 897 |
| 1Q15 | 174.1 | 676 |
| 2Q15 | 303.0 | 942 |
| 3Q15 | 243.3 | 803 |
| 4Q15 | 270.5 | 895 |
| 1Q16 | 168.4 | 680 |
| 2Q16 | 323.9 | 911 |
| 3Q16 | 258.3 | 817 |
| 4Q16 | 344.2 | 912 |
| 1Q17 | 375.1 | 870 |
| 2Q17 | 394.4 | 946 |
| 3Q17 | 321.4 | 824 |

Source: SDC Platinum
Volume data includes deals reported as of 10/16/2017

# Fund Flows

Year-to-date, $88 billion of Collateralized Loan Obligations (CLOs) have priced, up 45% from the same period last year. The number and volume of CLOs issued this quarter, while down from the prior quarter, remained above the average of the last several years. We largely attribute the downtick to the summer lull. However, comments from the U.S. Treasury that risk retention rules should not apply to CLOs may help maintain CLO volume going forward.

## Total CLO Issuance

| Quarter | Total Fund Flows ($B) | Number of Deals |
|---|---|---|
| 4Q13 | 24.6 | 53 |
| 1Q14 | 22.6 | 45 |
| 2Q14 | 38.3 | 69 |
| 3Q14 | 32.4 | 58 |
| 4Q14 | 30.7 | 63 |
| 1Q15 | 30.8 | 57 |
| 2Q15 | 28.6 | 55 |
| 3Q15 | 18.9 | 36 |
| 4Q15 | 19.6 | 40 |
| 1Q16 | 8.2 | 20 |
| 2Q16 | 18.0 | 42 |
| 3Q16 | 19.9 | 41 |
| 4Q16 | 26.2 | 53 |
| 1Q17 | 17.4 | 32 |
| 2Q17 | 35.1 | 61 |
| 3Q17 | 30.0 | 55 |

Source: LCD Comps

# Fund Flows

Net leveraged loan mutual fund flows were roughly flat, with outflows averaging approximately $0.1 billion in each month of the third quarter. High-yield bonds experienced significant outflows of $2.3 billion in July, and $3.6 billion in August, and an average of about $2 billion monthly over the quarter. The third quarter net outflows from the bond market appear to be a result of investor concerns that long-term rates will begin to rise based on signs of accelerating economic growth and as a result of more hawkish monetary policy.

**Mutual Fund Flows**

**Total Net Fund Flows ($B)**

High-Yield Bond Fund Flows
Leveraged Loan Fund Flows

$15
$10
$5
$0
($5)
($10)
($15)
($20)

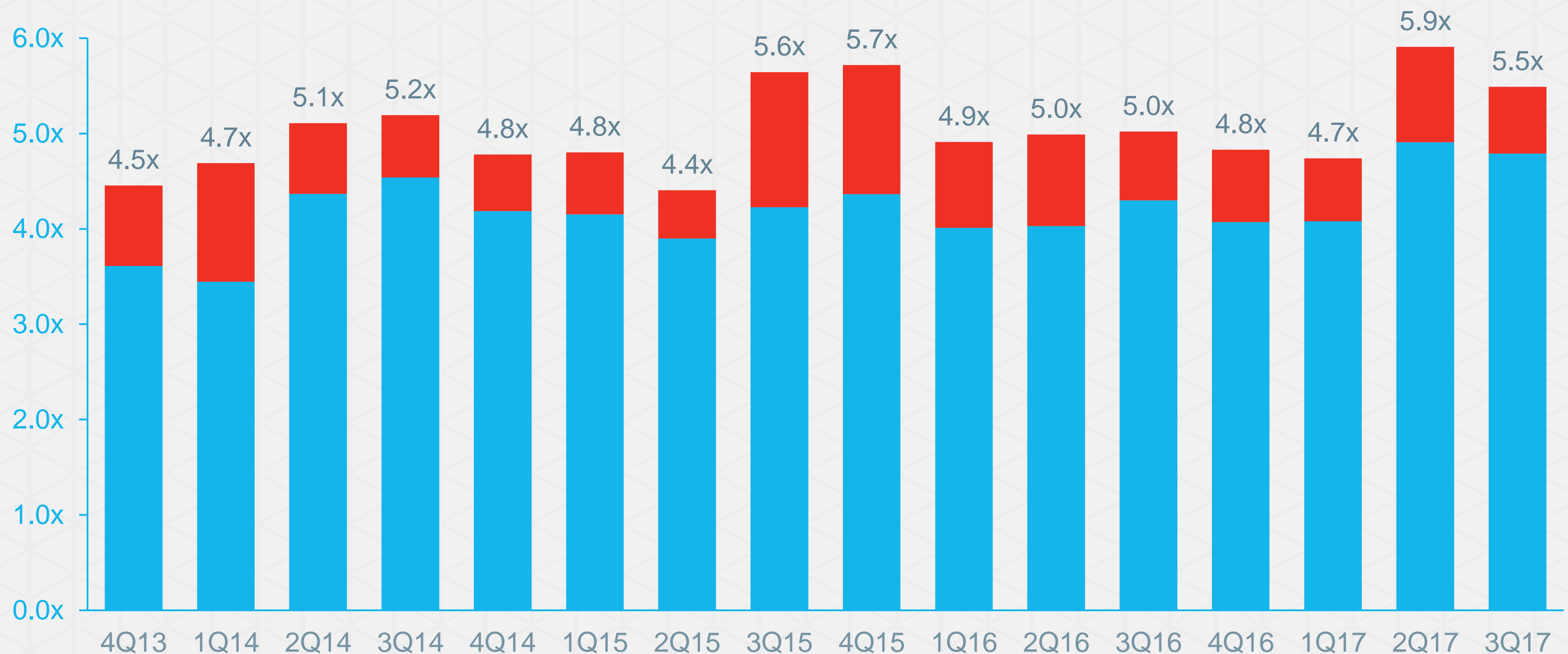
Sep-13 Mar-14 Sep-14 Mar-15 Sep-15 Mar-16 Sep-16 Mar-17 Sep-17

Sources: Investment Company Institute; Lipper FMI; LCD Comps

# Leverage

First lien and total leverage multiples appear to have increased roughly a half-turn in 2017 versus 2016, with year-to-date average first lien and total leverage of 4.6x and 5.4x, respectively, versus 4.1x and 4.9x in 2016. The primary drivers appear to be a stronger unitranche bid, higher valuations and lower default rate expectations.

**Leverage Multiple (EBITDA < $50MM)**

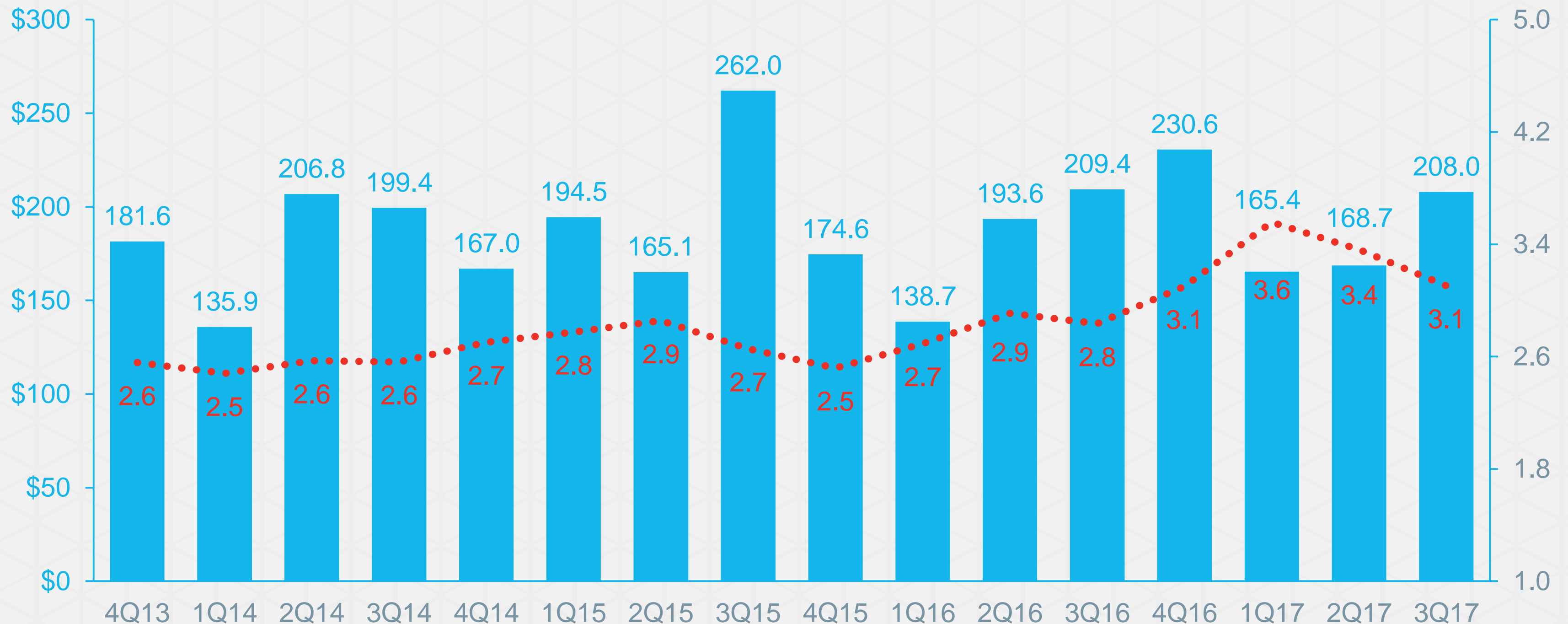



Source: LCD Comps

# Transaction Volume

Middle-market M&A volume increased 25% over the prior quarter on fewer transactions than in the prior two quarters this year.

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




Source: SDC Platinum
Volume data includes deals reported as of 10/16/2017

# Transaction Volume

After taking a breather in the second quarter, as rates moderated due to uncertainty around economic momentum, loan issuance for debt-financed dividend recapitalizations has bounced back. We believe the resurgence of leveraged recap issuance is being driven, to a great degree, by issuer concern that corporate borrowing costs will rise in the near-term.

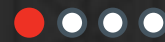
## Loan Issuance for Dividend Recapitalizations

**Total Loan Volume ($B)**

| Quarter | Total Loan Volume ($B) |
|---|---|
| 4Q13 | $9.5 |
| 1Q14 | $16.2 |
| 2Q14 | $16.7 |
| 3Q14 | $13.0 |
| 4Q14 | $3.9 |
| 1Q15 | $6.3 |
| 2Q15 | $14.0 |
| 3Q15 | $8.8 |
| 4Q15 | $2.2 |
| 1Q16 | $0.2 |
| 2Q16 | $14.2 |
| 3Q16 | $11.9 |
| 4Q16 | $21.8 |
| 1Q17 | $18.7 |
| 2Q17 | $6.8 |
| 3Q17 | $14.9 |

Source: LCD Comps

# Yields



High-yield bond yields decreased by 17bps this quarter, reflecting a continued strong bid for contractual returns and modest default rate expectations. Widely traded leveraged loan yields rose slightly over the quarter, but remained largely in check.

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

Yields (%)

Barclays U.S. Corporate High Yield
S&P/LSDA U.S. Leveraged Loan 100 All Loans

10.5%
9.5%
8.5%
7.5%
6.5%
5.5%
4.5%

Sep-13 Mar-14 Sep-14 Mar-15 Sep-15 Mar-16 Sep-16 Mar-17 Sep-17

Source: Bloomberg; LCD Comps

# Yields

Spreads between the Barclays U.S. Corporate High Yield index and the 10-year Treasury yield decreased 20bps during the quarter to a spread of 312bps. Spreads compressed due to a decline in U.S. high-yield default rate expectations, which dropped from Q4 2016's 5.6% to 3.2% in Q4 2017 and are expected to be 2.8% by Q2 2018[(1)], and continued investor demand for higher-yielding corporate debt.

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



Source: Bloomberg; LCD Comps
(1) Source: Moody's

# Yields

The yield curve continued to flatten as the 2-year Treasury yield hit a new nine-year high of 1.48%, a 10-bps increase over the quarter, while 5-year and 10-year yields increased 5bps and 3bps, respectively. Investor expectations around long-term growth are keeping longer-term rates down, while the Fed's actions and guidance toward tighter monetary policy pushed short-term yields higher.

**2-, 5- and 10-Year Treasury Yields**

Yield (%)

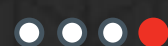
2-Year 5-Year 10-Year

4.0%
3.0%
2.0%
1.0%
0.0%

Sep-13 Mar-14 Sep-14 Mar-15 Sep-15 Mar-16 Sep-16 Mar-17 Sep-17

Source: Bloomberg

# Yields



The spread between the yield on the 2- and 10-year Treasury decreased by approximately 7bps over the quarter. The yield curve attainted its flattest level since before the financial crisis during the third quarter, with the spread between the 2-year and the 10-year notes reaching a low of 77bps.

**2-Year vs. 10-Year Treasury Spread**

**Spread (bps)**

300
250
200
150
100
50
0

Sep-13 Mar-14 Sep-14 Mar-15 Sep-15 Mar-16 Sep-16 Mar-17 Sep-17

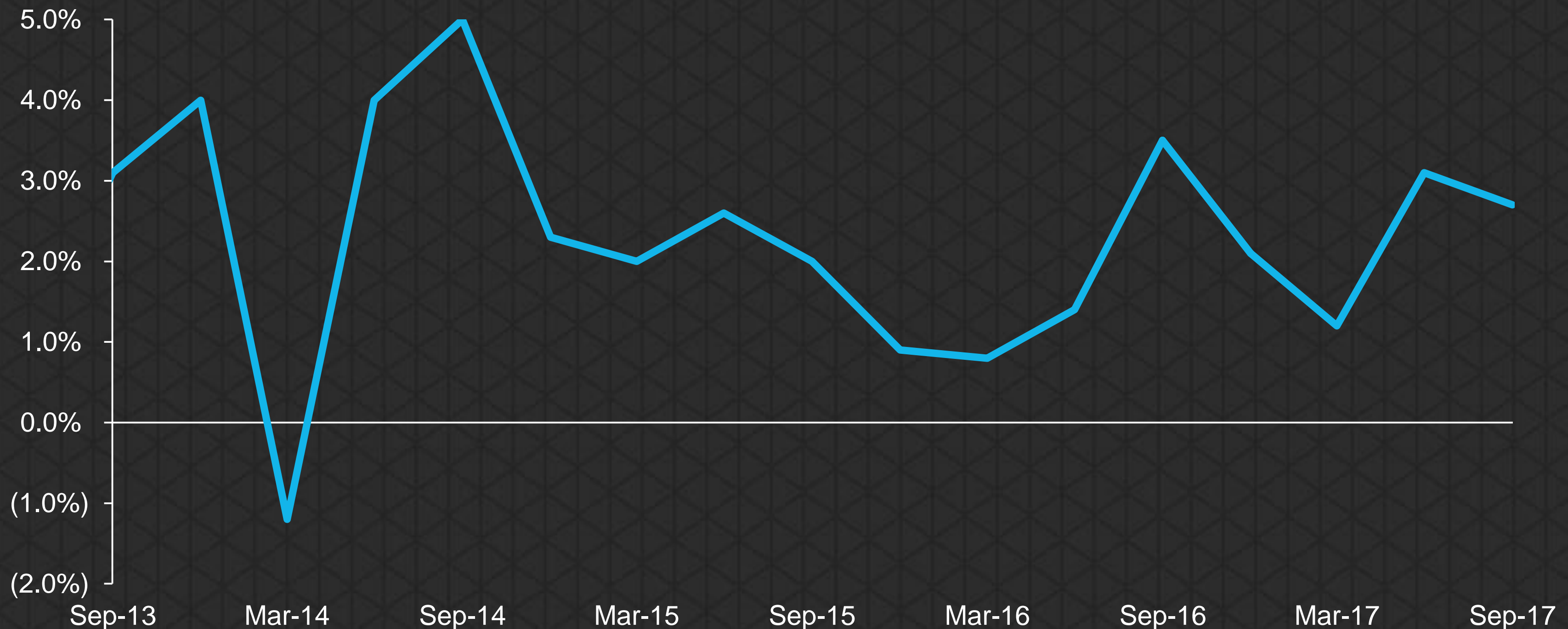
Source: Bloomberg

# Macroeconomic Update

The latest GDPNow forecast of 2.7% for the third quarter indicates that the economic growth rate has fallen slightly following a 3.1% increase in the second quarter. Lower third quarter growth reflects a roughly half-point impact of hurricanes Harvey, Irma and others. The temporary hurricane impact is expected to add to the fourth quarter growth as new construction begins in impacted areas. The employment picture continued to improve, as the unemployment rate fell to 4.2% in September and the labor force participation rate increased to 63.1%.

## U.S. Real GDP Growth

### GDP Growth Rate



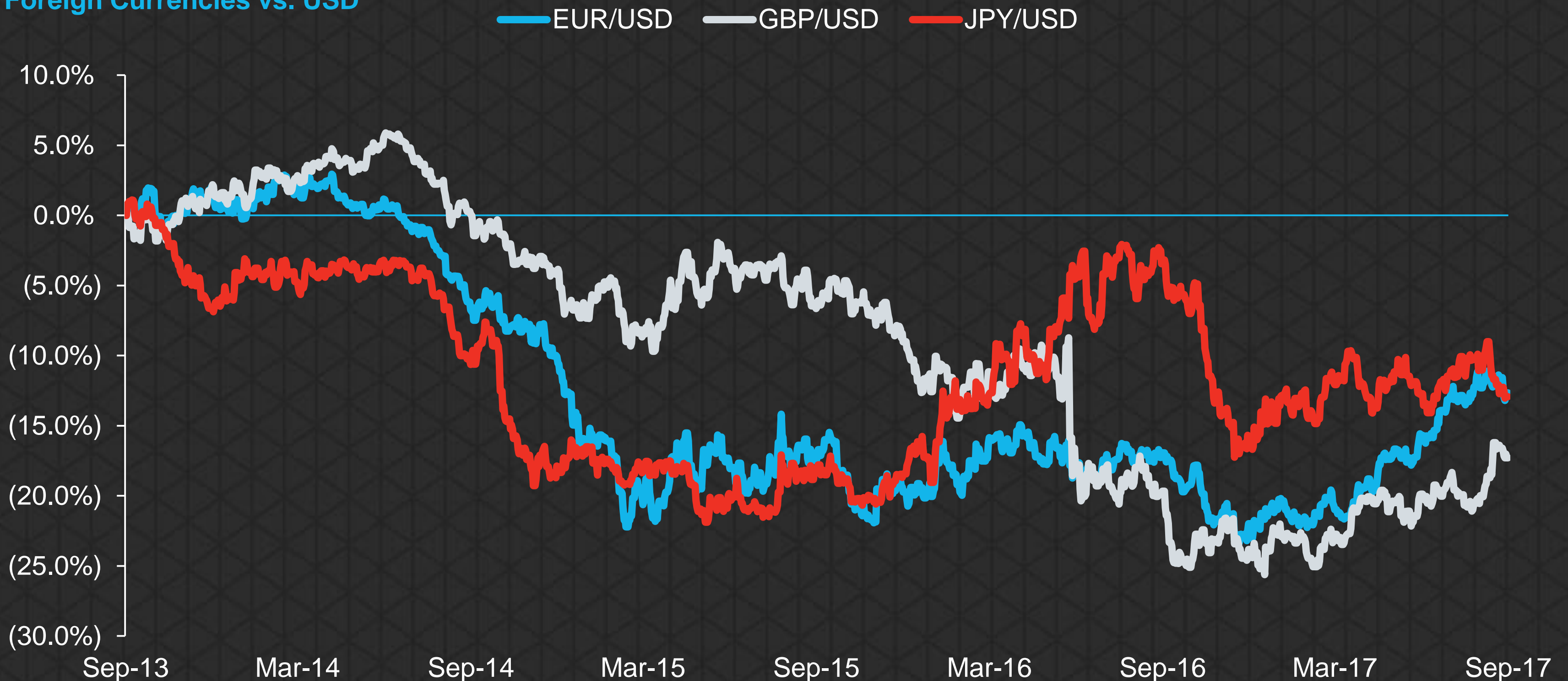

Source: Federal Reserve
First quarter data represents Atlanta Fed GDPNow Projection as of 10/2/17

# Macroeconomic Update

The U.S. dollar fell against the euro and pound in the third quarter while staying flat against the yen. Euro strengthening of about 3.4% against the dollar was led by expectations of tighter monetary policy from the ECB as the eurozone economies continued to strengthen. The pound gained ground as the Bank of England tentatively forecasted a rate hike in 2018.

**U.S. Dollar Foreign Exchange Rates**

## Foreign Currencies vs. USD




Source: Capital IQ

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