DUFF & PHELPS

Capital Markets Insights

Q4 2016 Review

Highlights

Investors enjoyed a strong rally in equities, energy and the dollar in the final quarter of 2016, while Treasurys and precious metals largely traded downward. A newly hawkish Federal Reserve policy, combined with an incoming administration biased to fiscal stimulus and tax reduction, accounted for much of the reaction of the capital markets.

Corporate credit costs for middle-market (non-investment grade) issuers held roughly constant. The sharp Treasury sell-off was largely offset by a tightening of corporate spreads. And while we attribute most of the spread tightening to improving fundamental conditions, increasingly issuer friendly technical conditions contributed as well. We observed robust fundraising, especially among capital pools oriented toward floating rate loan strategies.

Energy bond issuance, having been moribund for much of the year, increased dramatically - a 17% increase in volume over the third quarter of 2016 and over 450% increase over the fourth quarter of 2015 - as oil reached its highest price since July 2015.

Dividend recap issuance surged prior to the election due to concerns about a potential slowdown in growth under the broadly anticipated new Democratic administration. Upon the election's outcome, recap activity significantly diminished.

Finally, we note that the 90-day LIBOR rate pierced 1%, the floor oftentimes incorporated into corporate loans, for the first time since the Great Recession. Consequently, floating rate loan costs have become directly linked to monetary policy changes for the first time in more than seven years.

Following the quarter-point December rate hike and hawkish Fed statement, U.S. monetary policy lessened as a source of market volatility.

A surge in demand for new credit issuance contributed to increasingly competitive pricing and, in particular, structural terms for middle-market issuers.

Energy-related issuance surged in recent months as commodity markets reacted to increased demand and OPEC-led supply discipline.

Executive Summary

Market conditions at the fourth quarter's outset largely reflected expectations of continued (albeit modest) economic growth and accommodative monetary policy. At mid quarter, the presidential election results portended a period of fiscal stimulus and tightening monetary policy. Further, the first significant OPEC-led oil supply contraction in eight years triggered a firming of energy prices. Overall, the quarter witnessed a sharp rally in equities, tightening credit spreads, a downturn in Treasury prices and a strengthening of the U.S. dollar.

The broad S&P 500 index rallied 3.0% in the quarter (4.8% since the election), while the Nasdaq rallied 1.3% (4.0% since the election). Much of the post-election rally was attributable to the market's anticipating a period of regulatory relief, fiscal stimulus and tax cuts under the new administration. In parallel, the Treasury market sold off, as the combination of more restrictive monetary policy and inflation concerns surfaced. The 10 year yield, having reached a trough of 1.37% in July, rose from 1.60% to 2.45% over the quarter.

As interest rates began to correct, spurred upward in no small part by the Fed's announcing plans to raise the Fed funds rate by 75 basis points in 2017, asset managers are revisiting their asset allocation strategies. In recent weeks, we have observed numerous middle-market credit managers announcing the launch and/or closure of new funds, as well as the reallocating of assets among pension funds, multi-strategy managers and life insurance companies.

Anecdotally, Duff & Phelps has observed a significant broadening of the universe of bidders for our recent middle-market credit offerings as a result of new entrant participation. The competition for new issues has empowered agents to negotiate aggressively with respect to cost of capital and, at least as important, unusually favorable structural terms.

Dividend recapitalizations accelerated into the election on anticipated changes to tax policy and slow growth assumptions, with October volume alone exceeding that of the third quarter. Post-election recaps subsided as macroeconomic concerns abated.

The relevance of interest rate floors in floating rate loans has begun to wane in recent weeks. The 90-day LIBOR rate rose above the 1% floor typical of non-bank loans during the quarter. Consequently, lenders are enjoying direct linkage to base rate increases for the first time since the financial crisis in 2009.

We believe prevailing credit market conditions are compelling for prospective middle-market issuers. Technical conditions are unusually favorable, with a flurry of new vehicles coming to market and asset managers increasing allocations to fixed income. And, while base interest rates and, to a lesser degree, credit spreads are expected to correct, currently prevailing all-in rates are largely unchanged from the beginning of the quarter. Finally, favorable market conditions have garnered issuers exceptionally flexible structural terms.

Indicative Middle-Market Credit Parameters

LEVERAGE MULTIPLES

	EBITDA OF $10MM — $20MM	EBITDA OF $20MM — $50MM
SENIOR	**2.50x — 3.50x**	**3.00x — 4.00x**
TOTAL DEBT	**3.50x — 4.50x**	**4.00x — 5.50x**

Indicative Middle-Market Credit Parameters

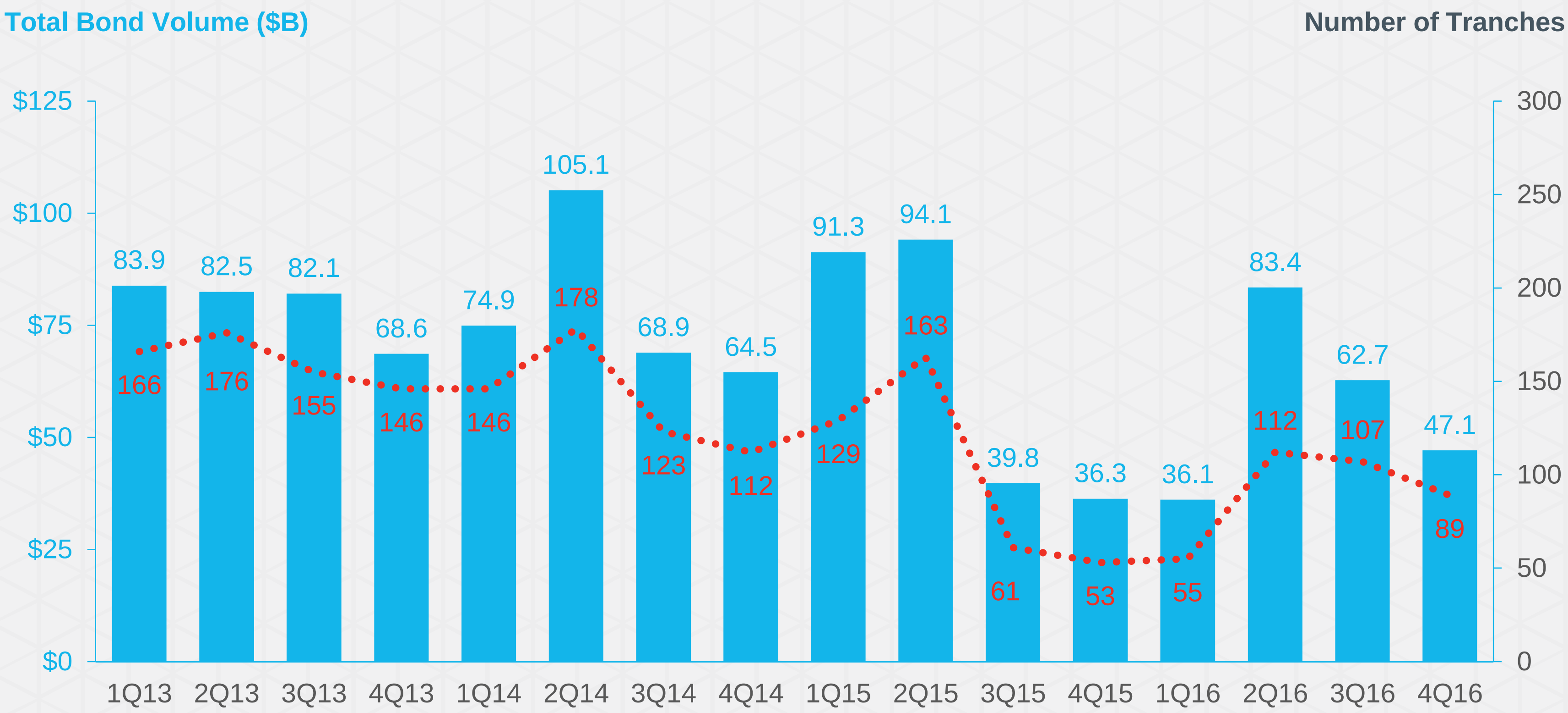
INFORMATION IN RED REPRESENTS PRIOR QUARTER VIEW

PRICING	EBITDA OF $10MM — $20MM	EBITDA OF $20MM — $50MM
FIRST LIEN	LIBOR + 2.75% — 3.50% (bank) LIBOR + 4.00% — 6.00% (non-bank)	LIBOR + 2.50% — 3.25% (bank) LIBOR + 4.00% — 6.00% (non-bank)
SECOND LIEN	LIBOR + 6.50% — 9.50%	LIBOR + 6.00% — 9.00%
SUBORDINATED DEBT	11.50% — 13.50% 11.00% — 13.00%	10.50% — 12.50% 10.00% — 12.00%
UNITRANCHE	LIBOR + 6.50% — 9.00%	LIBOR + 6.00% — 8.50%

New Issuance

High-yield volume declined for the third consecutive quarter, with dollar volume falling by 25% and deal volume declining by 17% versus the third quarter. Uncertainty around the election outcome and monetary policy muted issuance in October and November; a meaningful uptick followed in December (highest December since 2013) as issuers changed course and sought to lock in rates. A significant increase in new energy issuance, largely due to OPEC's decision to reduce production, accounted for the highest issuance by any sector in the quarter and totaled 35% of 2016 issuance.

Total High-Yield Bond Issuance

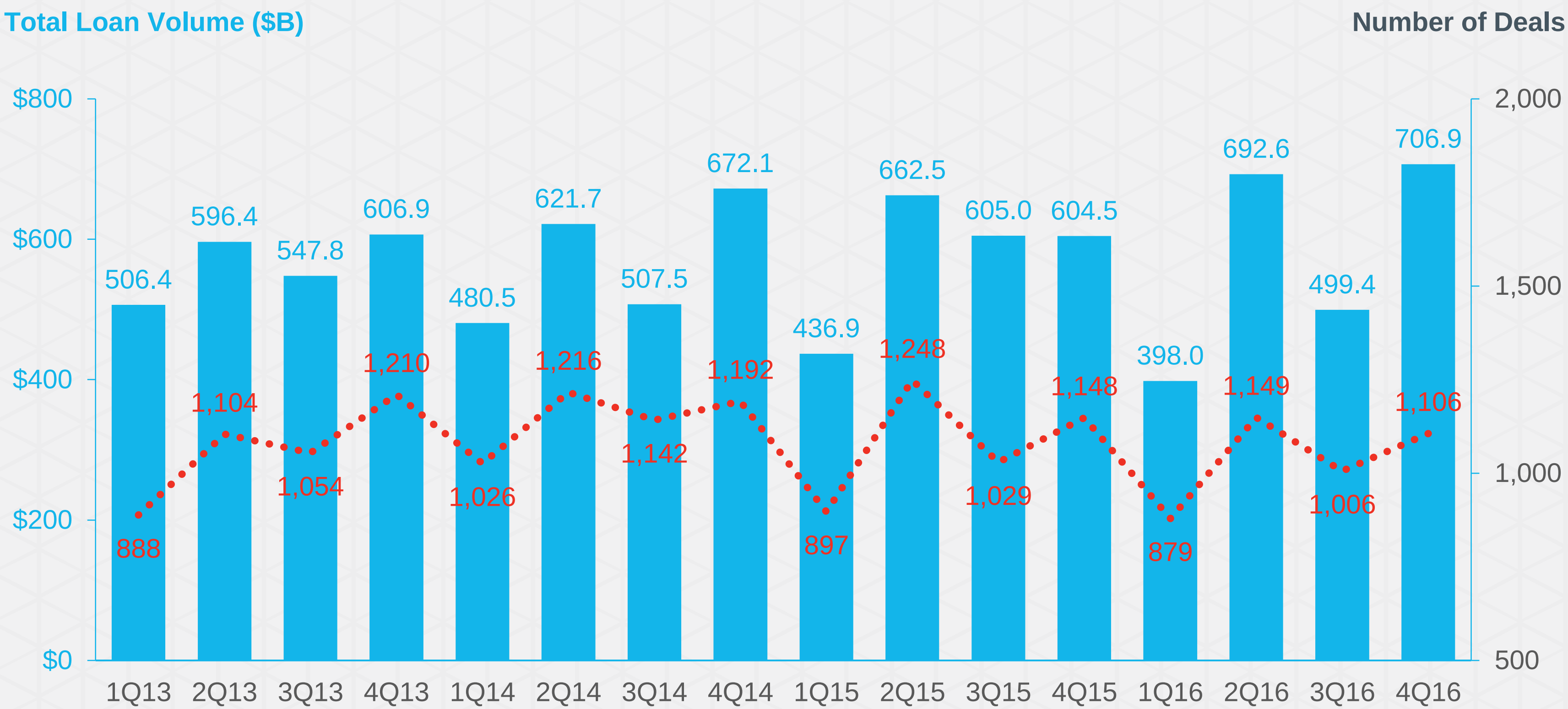


Source: LCD Comps

New Issuance

Dollar volume of new loan issuance reached the highest mark we have seen in recent quarters, while number of transactions reverted toward the mean. Refinancings constituted the largest share of uses of proceeds, followed by M&A activity and leveraged recaps.

Total Loan Issuance

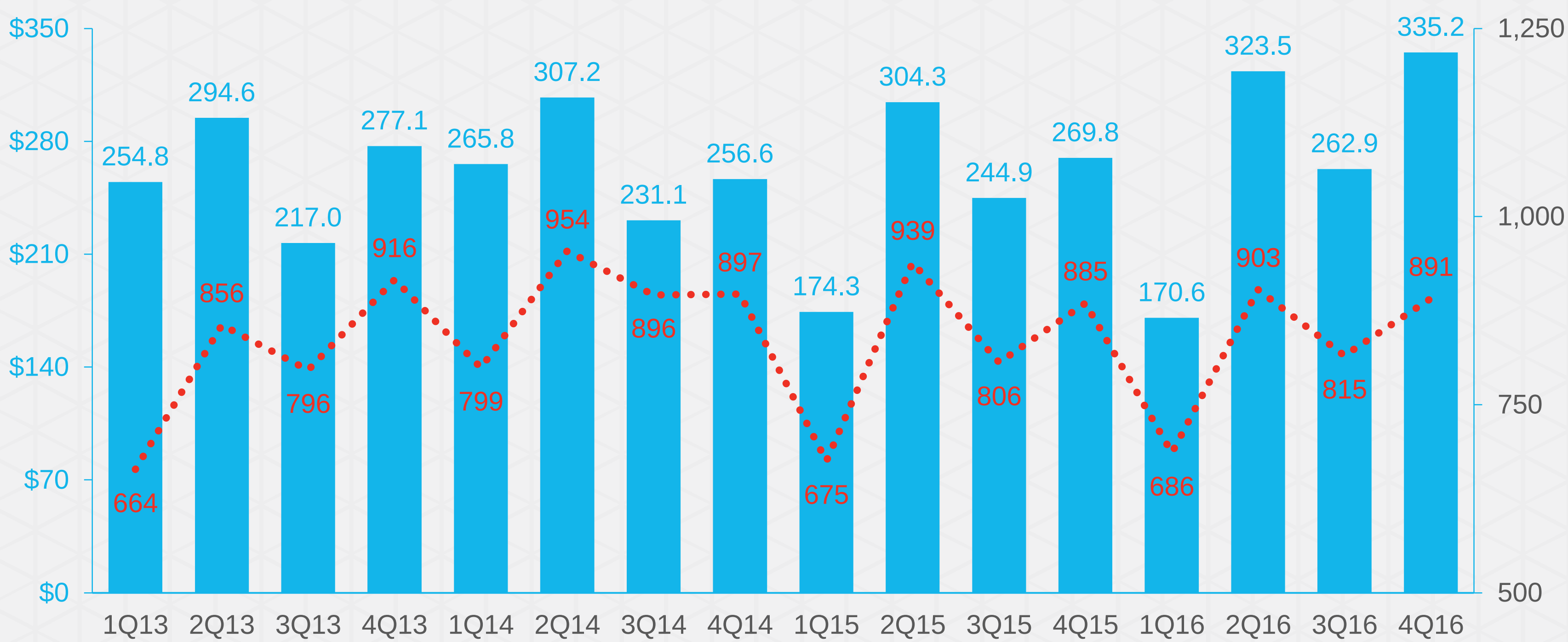


Source: SDC Platinum
Volume data includes deals reported as of 1/15/2017

New Issuance

Total middle-market loan issuance rebounded strongly in the fourth quarter.

Total Loan Issuance (EBITDA < $50MM)

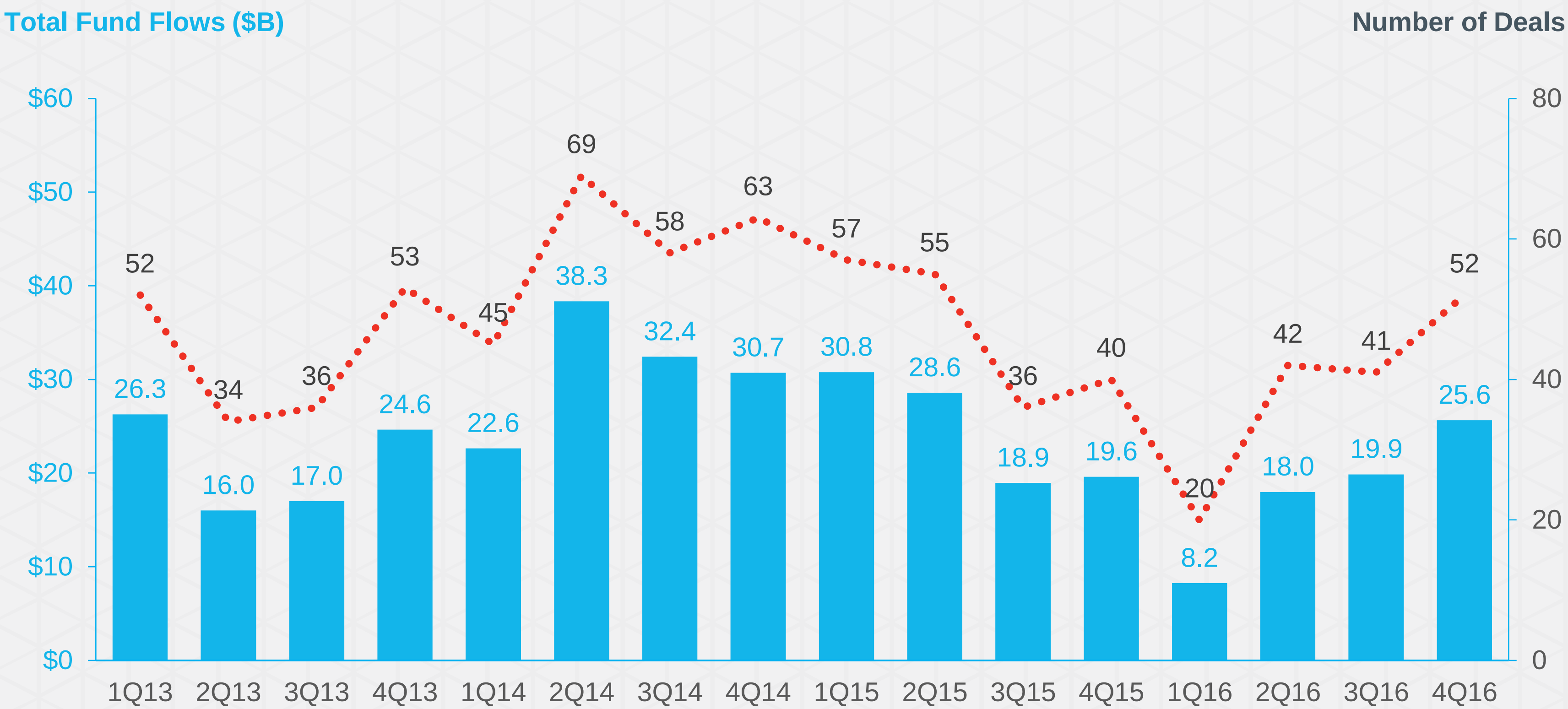


Source: SDC Platinum
Volume data includes deals reported as of 1/15/2017

Fund Flows

Collateralized loan obligation (CLO) issuance increased for the fourth consecutive quarter, as managers and investors prepared for stricter risk retention rules under Dodd-Frank.

Total CLO Issuance

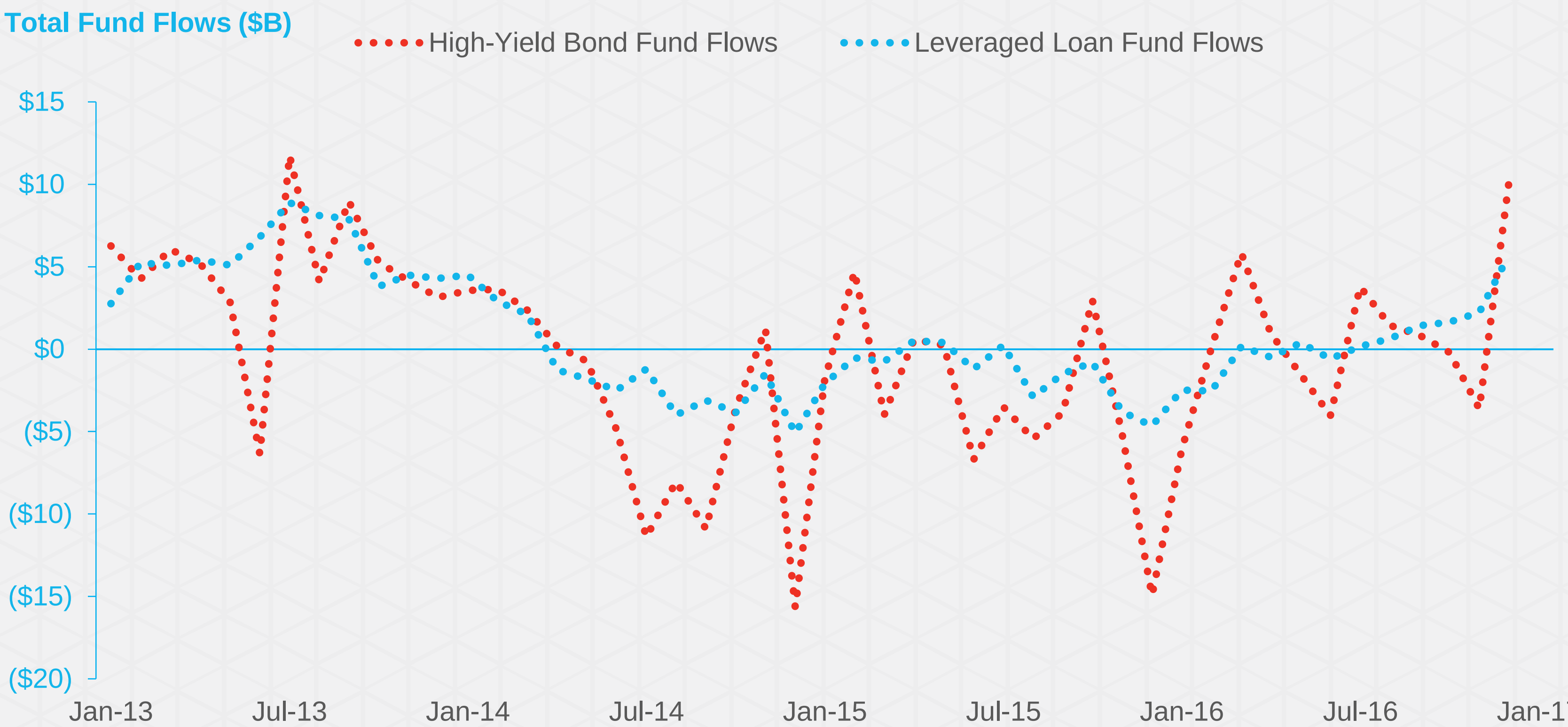


Source: LCD Comps

Fund Flows

Leveraged loan funds in the fourth quarter enjoyed inflows at the highest rate since the first quarter of 2014 as mutual fund investors positioned themselves for a rising yield environment. Given relative uncertainty around interest rates prior to the December Fed meeting, high-yield bond fund flows fluctuated before sharply increasing at quarter's end.

Mutual Fund Flows

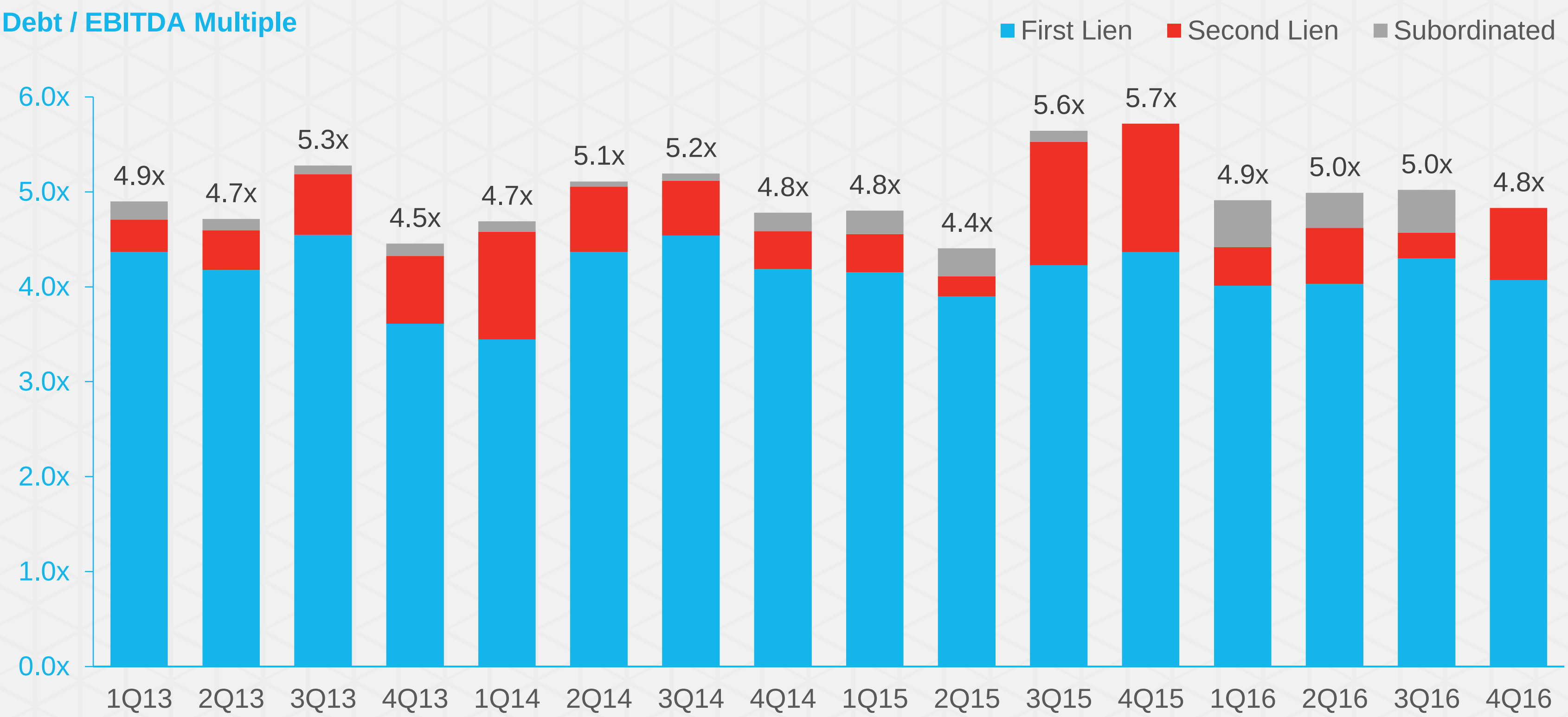


Source: Investment Company Institute; Lipper FMI

Leverage

Mean total leverage multiples for middle-market financings tightened slightly this quarter. Second lien debt represented a significantly larger portion of capital structures than in the third quarter. While commercial banks continued to demonstrate modest risk appetite, credit funds and BDCs, among others, filled the void with unitranche solutions.

Leverage Multiple (EBITDA < $50MM)

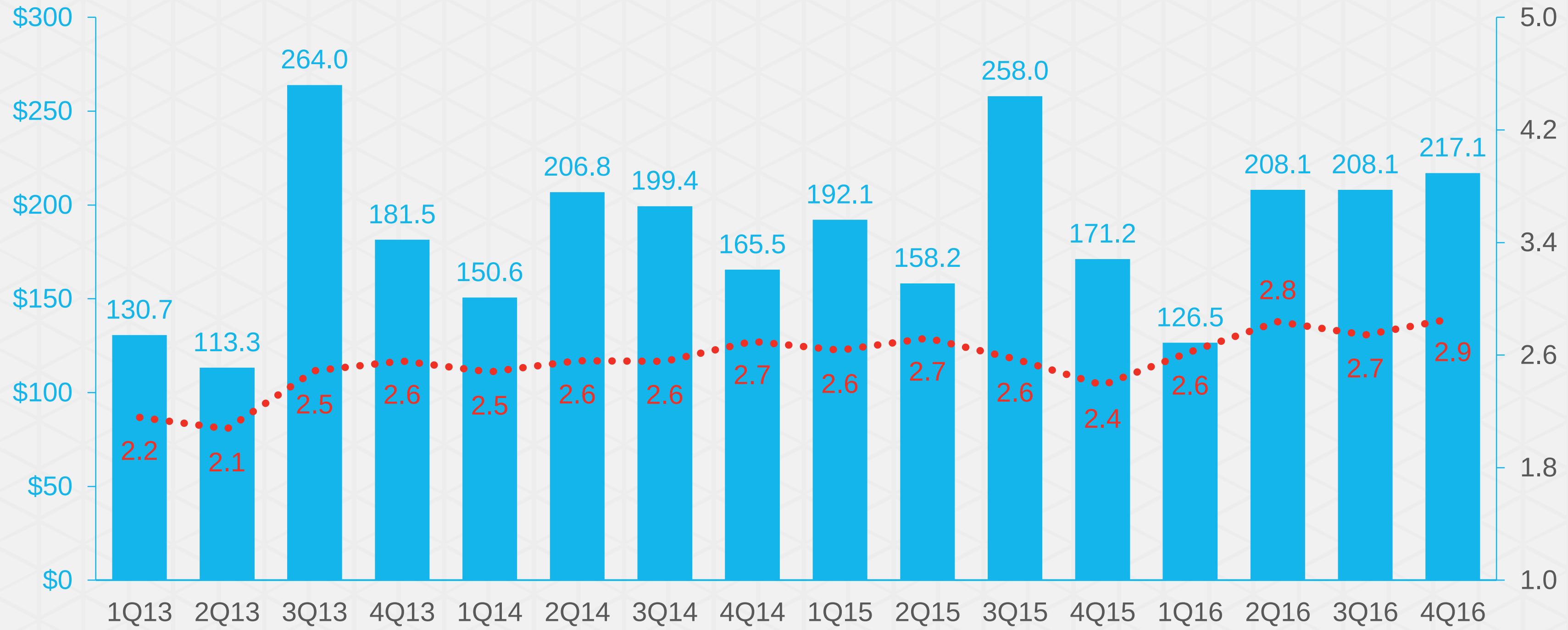


Source: LCD Comps

Transaction Volume

Middle-market M&A activity continued at the robust pace of the prior two quarters.

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

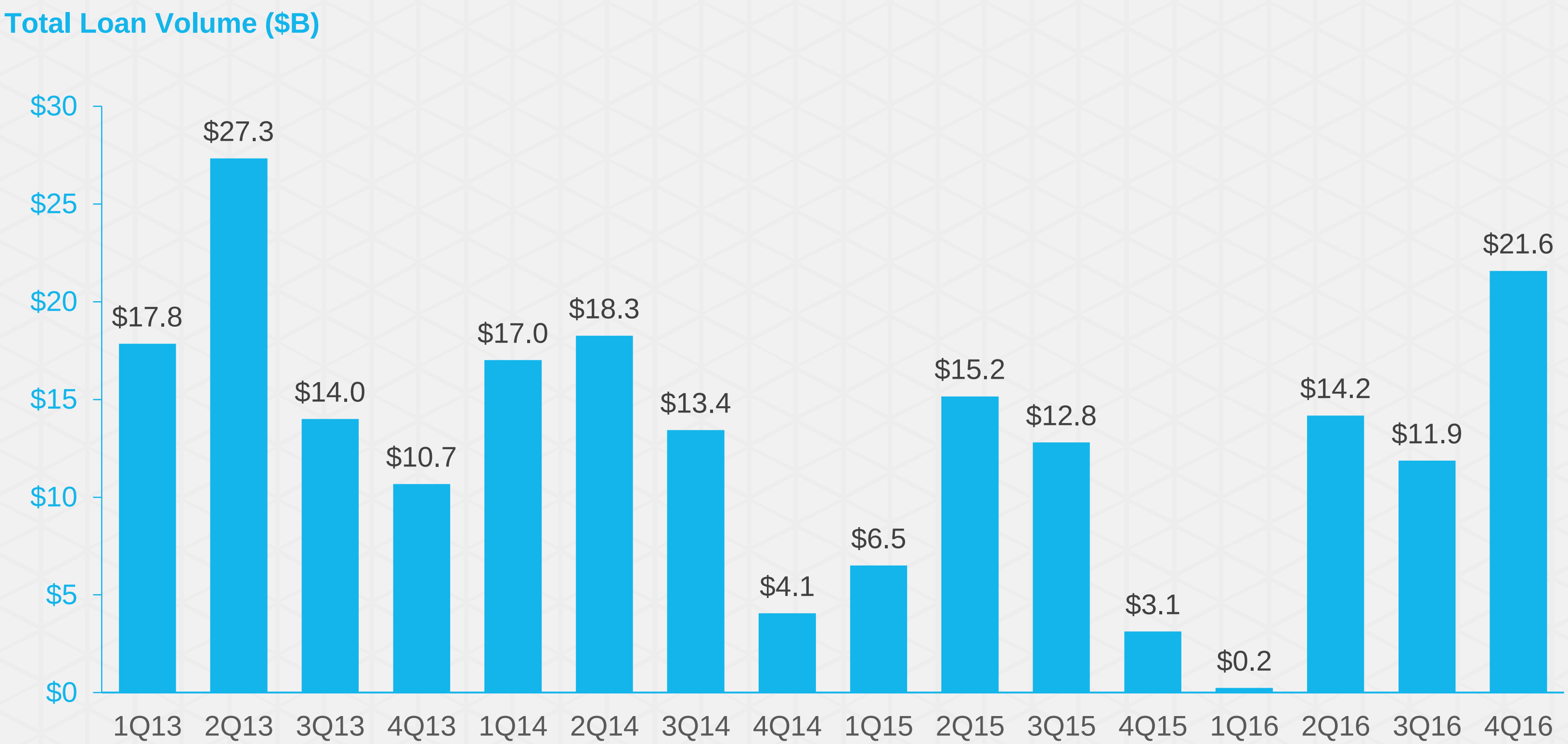


Source: SDC Platinum
Volume data includes deals reported as of 1/15/2017

Transaction Volume

Dividend recapitalization activity increased to a three-year high this quarter. Prior to the election, recap volume was largely driven by concerns around unfavorable tax and growth policy. Upon President Trump's election, recap volume subsided as macroeconomic concerns abated.

Loan Issuance for Dividend Recapitalizations

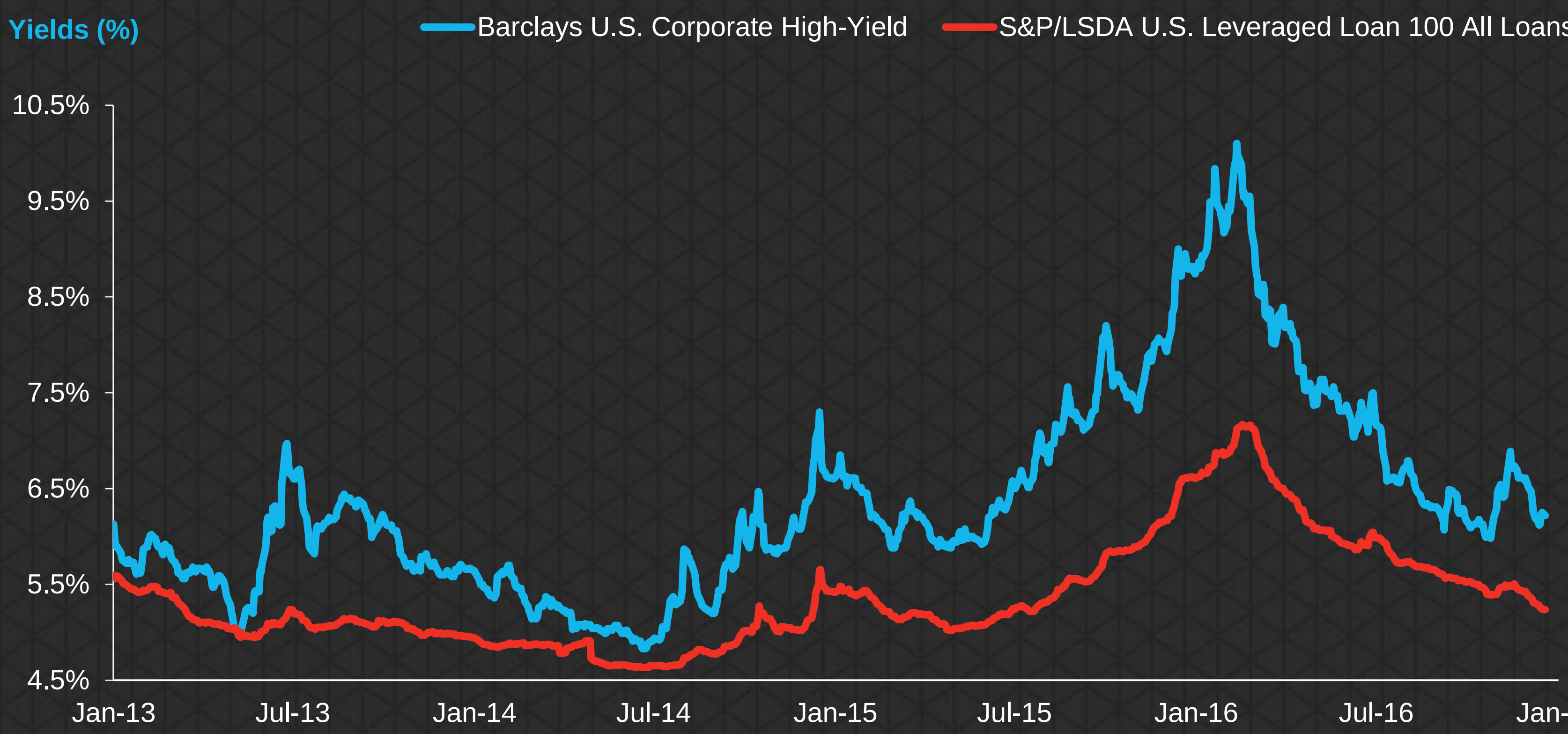


Source: LCD Comps

Yields

Yields on widely traded leveraged loans fell approximately 35bps this quarter while yields on high-yield bonds ended the quarter essentially flat. Despite the announcement of a Fed rate hike in December, the continued improvement in energy market conditions kept yields in check.

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

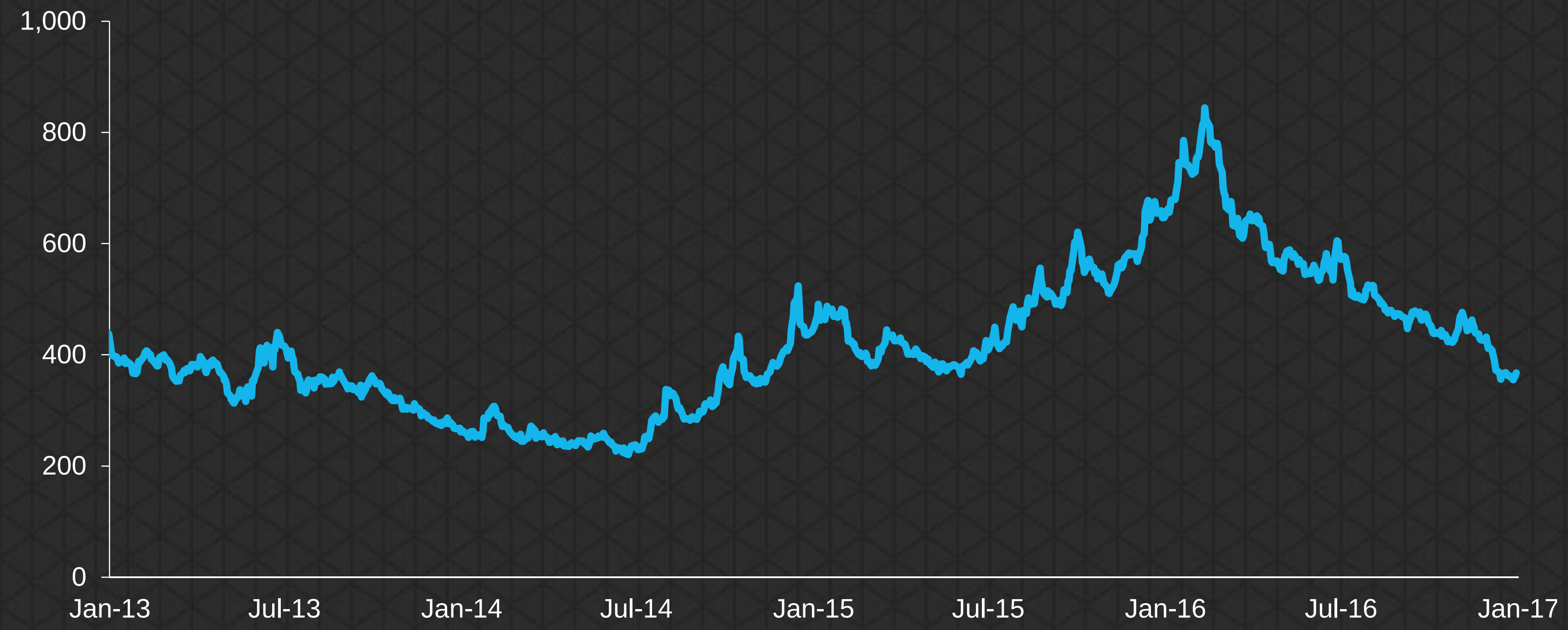


Source: SDC Platinum

Yields

Spreads between U.S. corporate high-yield bonds and the 10-year Treasury decreased by approximately 90bps during the quarter, reflecting an overall increase in perceived fundamental credit quality across sectors. This rally in credit spreads largely offset rising base rates to keep bond yields essentially flat for the quarter.

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

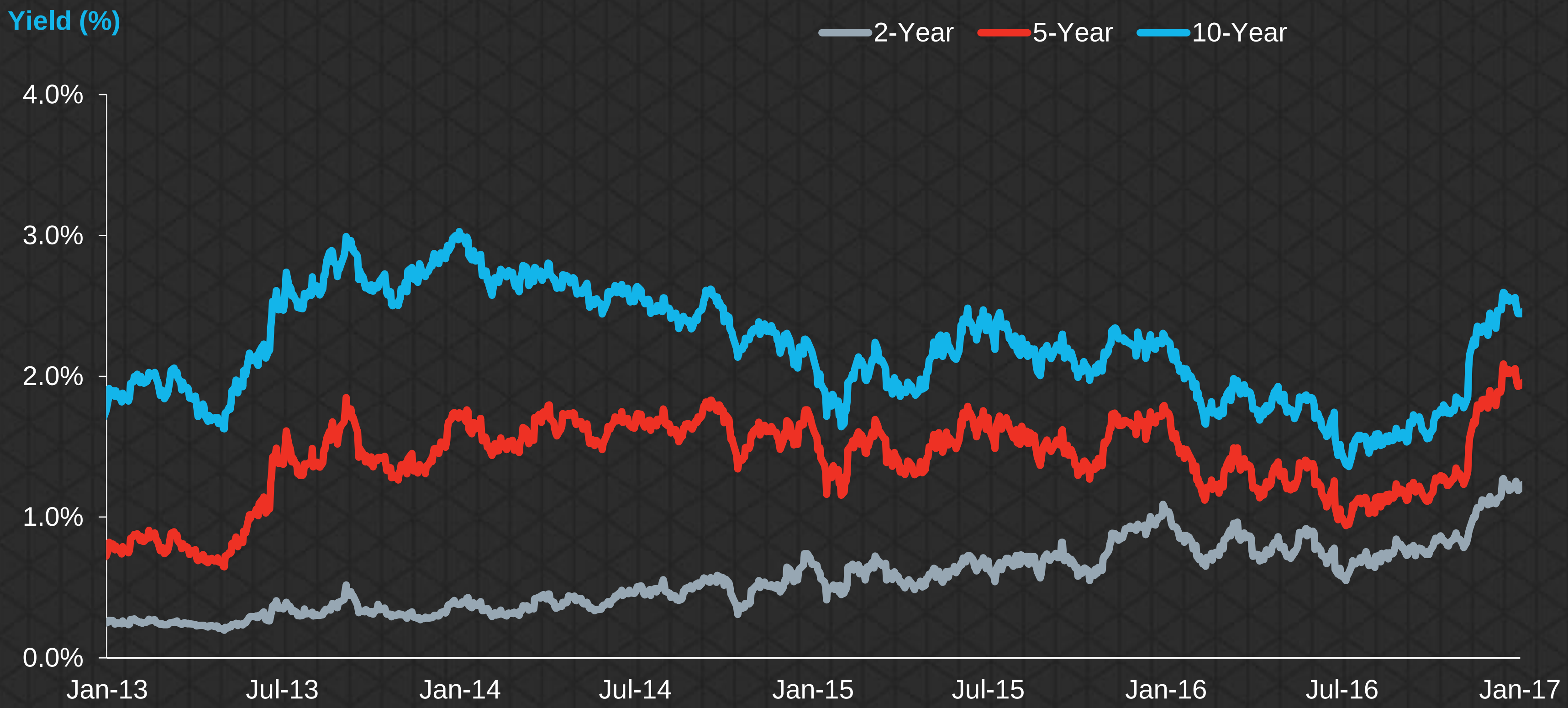


Source: Bloomberg; LCD Comps

Yields

Treasury yields increased significantly in the fourth quarter, driven almost entirely by monetary policy, with 10-year yields increasing approximately 85bps. The combination of the announcement of the Fed rate hike and the associated guidance to three more 25bps rate hikes in 2017 pushed yields higher.

2-, 5- and 10-Year Treasury Yields



Source: Bloomberg

Yields

Spreads between long-term and short-term Treasury yields increased by approximately 40bps during the quarter.

2-Year vs. 10-Year Treasury Spread

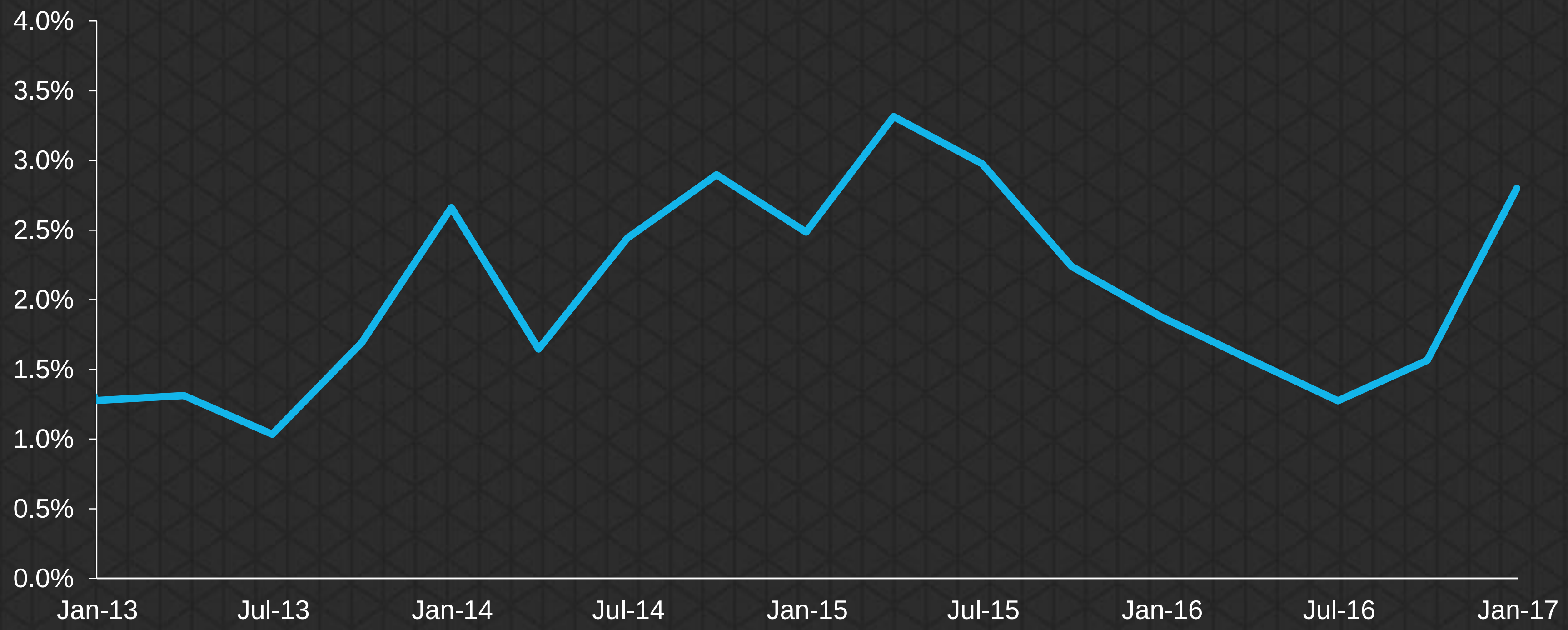
Source: Bloomberg

Macroeconomic Update

Macroeconomic conditions in the U.S. continued to strengthen in the quarter. Positive employment reports, the U.S. election outcome and strong GDP growth projections contributed to the market rally in equities. The unemployment fell to 4.7% as the labor force participation rate rose to 62.7% in December.

U.S. Real GDP Growth

GDP Growth Rate



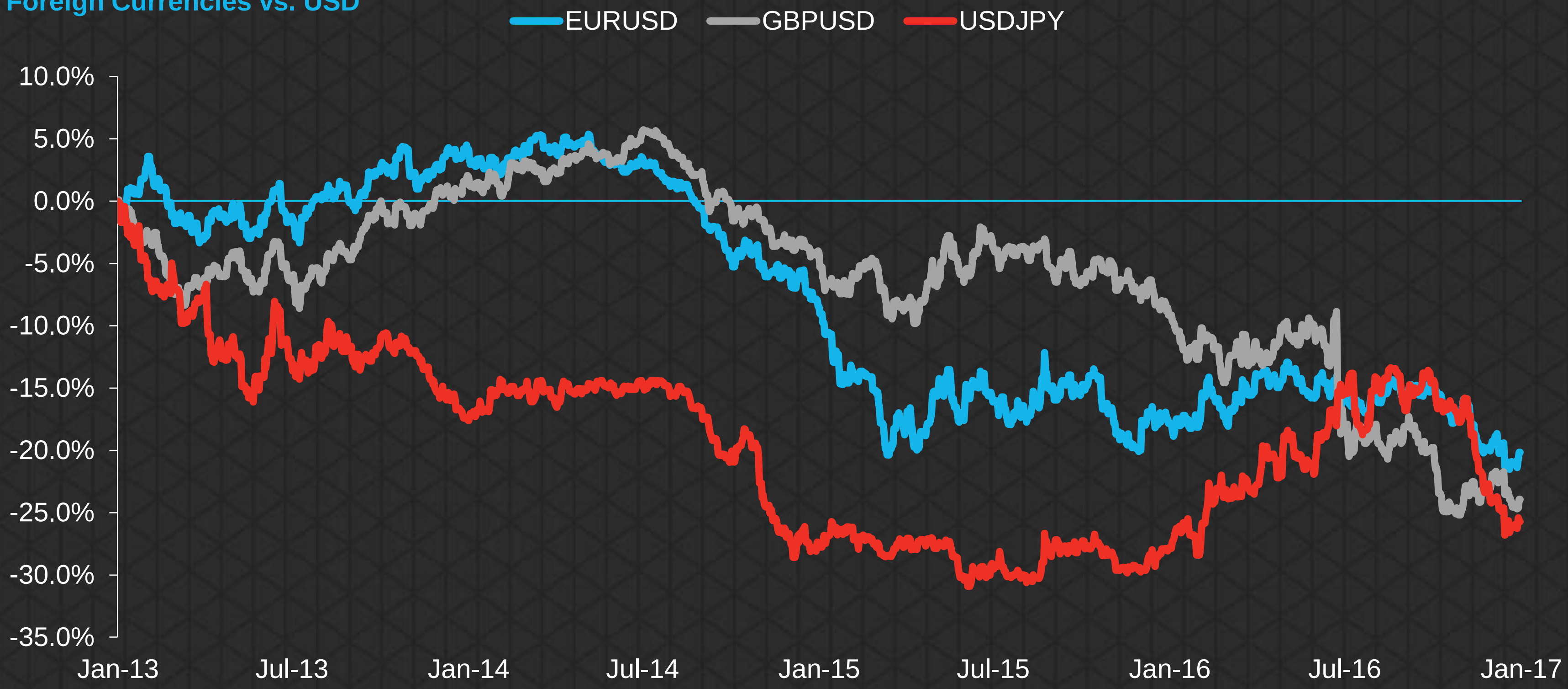
GDP Chart Source: Federal Reserve
Labor Statistics Source: U.S. Bureau of Labor Statistics
Fourth quarter data represents Atlanta Fed GDPNow Projection as of 1/15/2017

Macroeconomic Update

In recent months, we have seen a significant strengthening of the U.S. dollar compared to other major benchmark currencies. The primary drivers of the rally are a strengthening U.S. economy and a tightening of U.S. monetary policy.

U.S. Dollar Foreign Exchange Rates

Foreign Currencies vs. USD



Source: Federal Reserve

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