DUFF & PHELPS

INDUSTRY INSIGHTS:

Capital Markets

Spring 2018 Review

Highlights

Leveraging costs and structures have become increasingly volatile, as markets react to rising economic growth, inflation concerns and trade tensions.

The new Fed chair, Jerome Powell, continued the monetary policy "normalization" begun by the prior Fed chair, Janet Yellen, increasing rates another quarter-point in March.

U.S. inflation is firming around the Fed's target level of 2.0% year-over-year growth, as the CPI has risen an average of 2.25% year over year in the first three months of 2018. UK inflation of 3.1% is running above target, with similar growth and inflation concerns in Europe having surfaced.

Concern that the markets may be underestimating economic growth and inflation and, in turn, the likelihood that central banks will need to act more quickly, has investors on edge, pressuring corporate borrowing rates and valuations.

Rising Treasury yields have translated into higher corporate borrowing rates for large-cap financings, with high-yield bond indices having risen nearly 50 bps in the first quarter.

Demand for illiquid middle-market new issuance has been robust. The large amount of debt fund "dry powder" is overwhelming the relative dearth of issuance, creating a window for issuers to achieve growth- and recap-related financings on inordinately attractive terms and structures. While we anticipate more tepid public market conditions to ultimately spill over into the illiquid markets, the prevailing differential represents a notable window of opportunity.

The Fed hiked rates another quarter-point in March, as widely anticipated. And while central banks in the UK and Europe held rates steady, the associated investors are skeptical of dovish messaging in light of rising economic growth and inflation data.

Rapidly rising large-cap corporate high-yield borrowing rates hampered first-quarter issuance.

Middle-market issuers/sponsors have the opportunity to attain aggressive terms for growth- and recap-related issuances, due to a decoupling for private illiquid credit from the broader debt markets.

Executive Summary

In Janet Yellen's final meeting as Fed chair in January, the Central Bank held interest rates flat but expressed anticipation of more aggressive inflation than previously forecast. While the benchmark interest rate remained unchanged, Treasury yields began to rise rapidly, triggering a significant equity market correction (–7.5% S&P 500 peak to trough). New Fed chair Jerome Powell's remarks to Congress in February regarding his view on monetary policy further affirmed investor concerns of accelerating economic growth and the potential for less gradual rate hikes. From the beginning of January to its late February peak (2.96% yield), the 10-year Treasury note rose 55 bps (a 23% change). The 10-year note subsequently sold off as fears of trade tensions intensified, settling at 2.74% at quarter-end.

Rising rate concerns weren't limited to the U.S., as the Bank of England warned of earlier, and larger rates hikes for the UK with inflation having run far above target, hitting a five-year high of 3.1%. In continental Europe, strong economic data is convincing investors that central bankers will have to tighten monetary policy, despite contrary messaging.

With rapidly rising base rates posing a major risk, high-yield bond yields jumped 47 bps (an 8% increase) over the quarter and large-cap leverage loan yields increased a more modest 12 bps (a 3% increase). The rise in large-cap bond yields occurred despite a further lowering in default rate expectations. As of March 2018, the U.S. high-yield default rate stood at 3.9%. Moody's forecasts that rate to decline to 1.7% by March 2019, based largely on continuing earnings growth expectations.

The back-up in large-cap leverage conditions and the equity market volatility notwithstanding, demand for illiquid middle-market new issuance has been robust across the U.S., UK and Europe. As of late 2017, North American-focused debt funds had approximately $143 billion in dry powder, a 10% increase from the beginning of 2017. This surge in private market capital availability has, for the moment, overwhelmed the relative dearth of issuance. As a result, we have observed highly favorable rates and structural terms for issuers in recent offerings, as well as a strong bid for middle-market leveraged recapitalizations and acquisition-related financings. We believe the window for middle-market issuers and sponsors to enjoy current market conditions will be transitory as broader market dynamics ultimately spill into the middle market.

Indicative Middle-Market Credit Parameters

U.S. LEVERAGE MULTIPLES

INFORMATION IN RED REPRESENTS PRIOR QUARTER VIEW (WHEN DIFFERENT THAN CURRENT QUARTER)

	EBITDA OF $10MM–$20MM	EBITDA OF $20MM–$50MM
SENIOR	3.50x–4.50x	4.00x–5.00x
	3.25x–4.25x	3.75x–4.75x
TOTAL DEBT	4.25x–5.25x	4.75x–5.75x
	4.00x–5.00x	4.50x–5.50x

UK/EUROPE LEVERAGE MULTIPLES

	EBITDA OF €10MM–€20MM	EBITDA OF €20MM–€50MM
SENIOR	3.25x–4.25x	3.75x–4.75x
	3.00x–4.00x	3.50x–4.50x
TOTAL DEBT	3.75x–4.75x	4.25x–5.50x
	3.50x–4.50x	4.00x–5.25x

U.S. Indicative Middle-Market Credit Parameters

INFORMATION IN RED REPRESENTS PRIOR QUARTER VIEW (WHEN DIFFERENT THAN CURRENT QUARTER)

PRICING	EBITDA OF $10MM–$20MM	EBITDA OF $20MM–$50MM
FIRST LIEN	LIBOR + 2.50%–3.25% (bank) LIBOR + 2.75%–3.50% (bank) LIBOR + 3.50%–5.50% (nonbank) LIBOR + 3.75%–5.75% (nonbank)	LIBOR + 2.25%–3.00% (bank) LIBOR + 2.50%–3.25% (bank) LIBOR + 3.50%–5.50% (nonbank) 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 + 5.50%–8.00% LIBOR + 6.00%–8.50%	LIBOR + 5.00%–7.50% LIBOR + 5.50%–8.00%

UK/Europe Indicative Middle-Market Credit Parameters

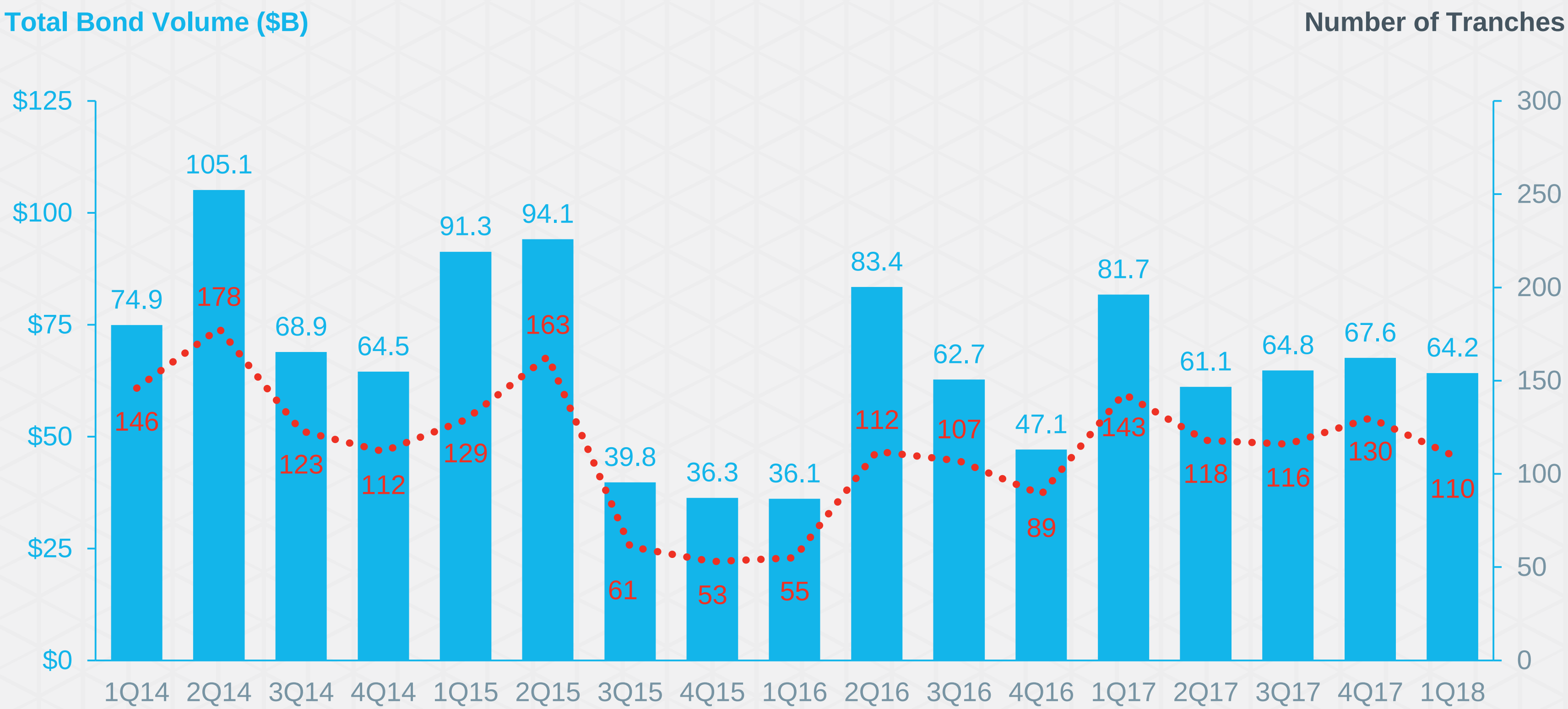
INFORMATION IN RED REPRESENTS PRIOR QUARTER VIEW (WHEN DIFFERENT THAN CURRENT QUARTER)

PRICING	EBITDA OF €10MM–€20MM	EBITDA OF €20MM–€50MM
FIRST LIEN	LIBOR/EURIBOR + 3.50%–4.00% (bank) LIBOR/EURIBOR + 4.50%–6.00% (nonbank) LIBOR/EURIBOR + 4.50%–5.50% (nonbank)	LIBOR/EURIBOR + 3.25%–3.75% (bank) LIBOR/EURIBOR + 4.00%–6.00% (nonbank) LIBOR/EURIBOR + 4.50%–6.50% (nonbank)
SECOND LIEN	LIBOR/EURIBOR + 8.00%–10.00%	LIBOR/EURIBOR + 7.50%–9.50%
SUBORDINATED DEBT	10.50%–12.50%	9.50%–11.50%
UNITRANCHE	LIBOR/EURIBOR + 5.75%–8.00% LIBOR/EURIBOR + 6.00%–8.50%	LIBOR/EURIBOR + 5.25%–8.00% LIBOR/EURIBOR + 5.50%–8.00%

New Issuance

First quarter U.S. high-yield issuance volume of $64 billion, and number of new issuances of 110, declined from the previous quarter by 5% and 15%, respectively. We attribute the softness to a combination of rising yields, the large volume of refinancings that took place in 2017 and to fewer, but larger, transactions.

Total U.S. High-Yield Bond Issuance

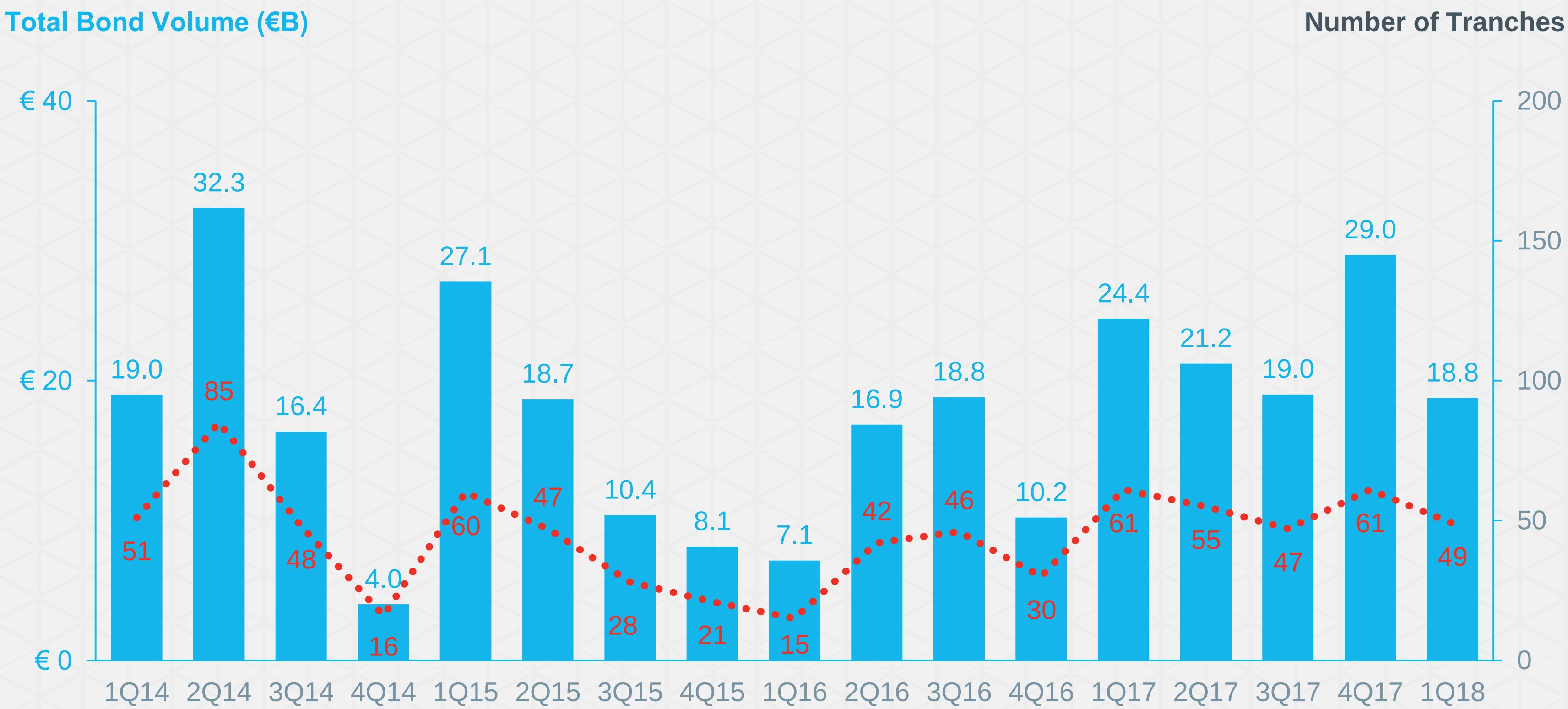


Source: LCD Comps

New Issuance

European first quarter high-yield issuance volume of €19 billion, and number of issuances, at 49, were significantly lower versus the prior quarter by 35% and 20%, respectively. Similar to the U.S. high-yield market, rising yields and a shift toward M&A-related issuances and away from refinancings contributed to the declines.

Total European High-Yield Bond Issuance

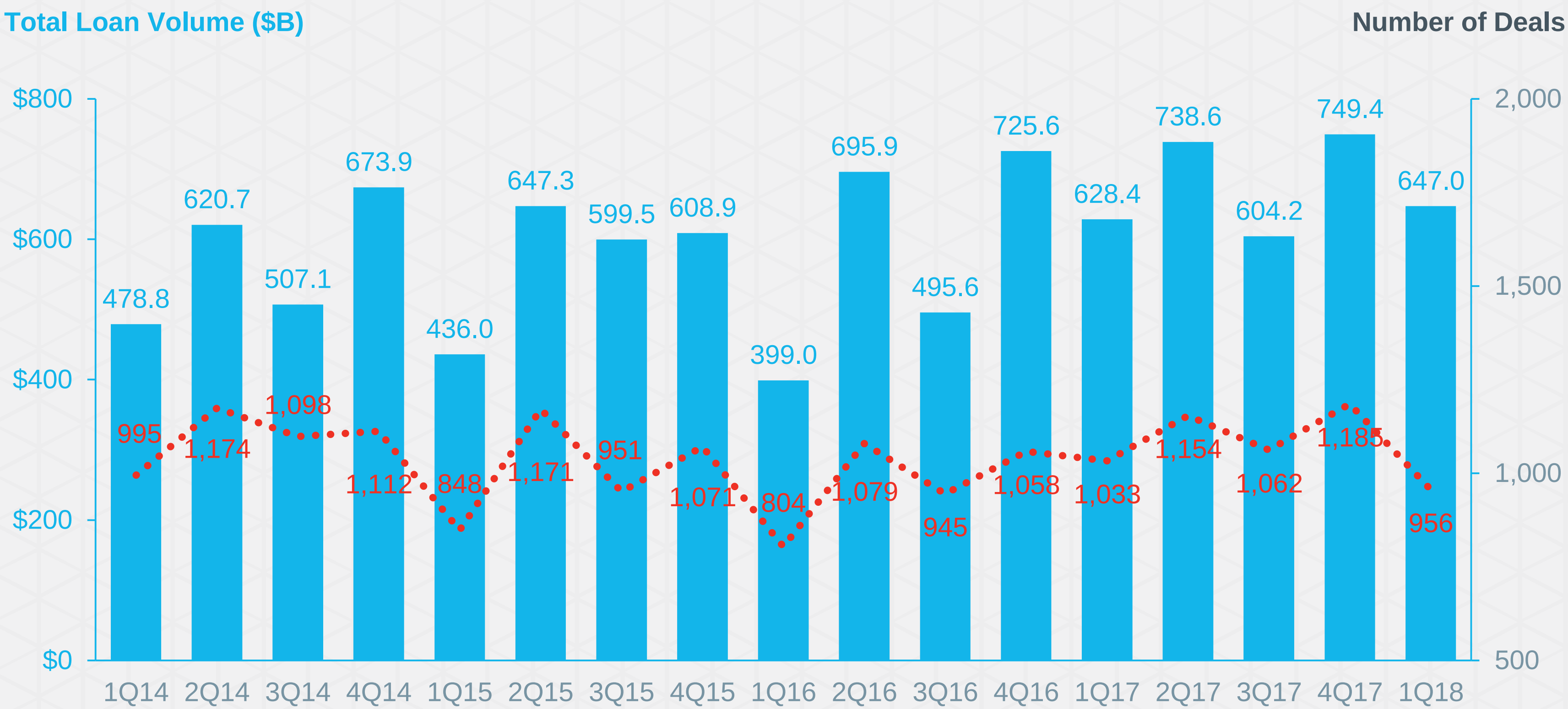


Source: LCD Comps

New Issuance

First-quarter U.S. loan issuance was $647 billion on 956 deals; while down relative to the fourth quarter, volume increased 3% year over year. Investors confidently absorbed new issuances, with yields on loans only backing up modestly, despite base rates having risen.

U.S. Total Loan Issuance

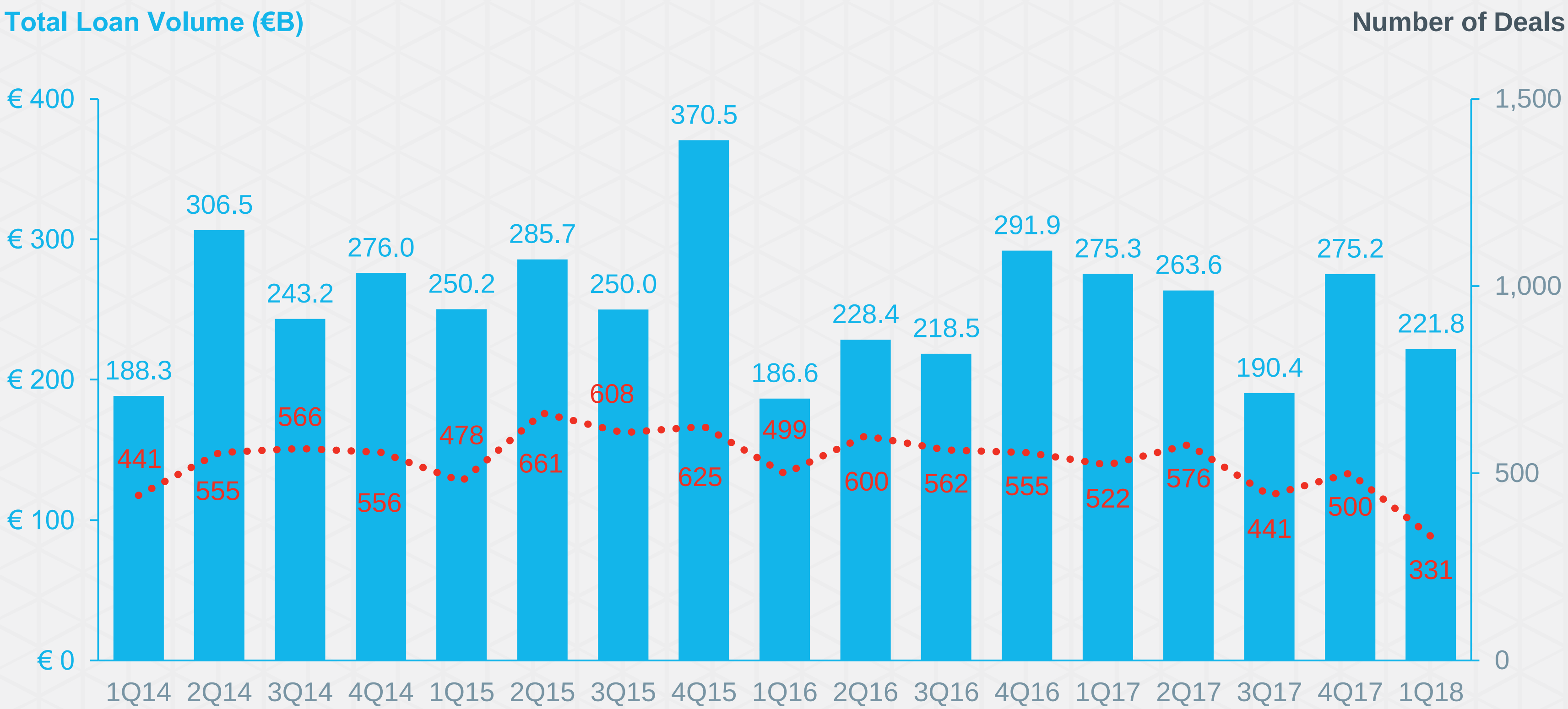


Source: SDC Platinum
Volume data includes deals reported as of 4/5/2018

New Issuance

First-quarter European loan issuance totaled €222 billion, down 19.4% over the fourth quarter of 2017. Like the European high-yield market, loan issuance skewed toward M&A-related financings. The 40% decline in number of issuances versus the fourth quarter of 2017 was offset by a few large transactions, notably KKR's acquisition of Flora Food Group.

European Total Loan Issuance

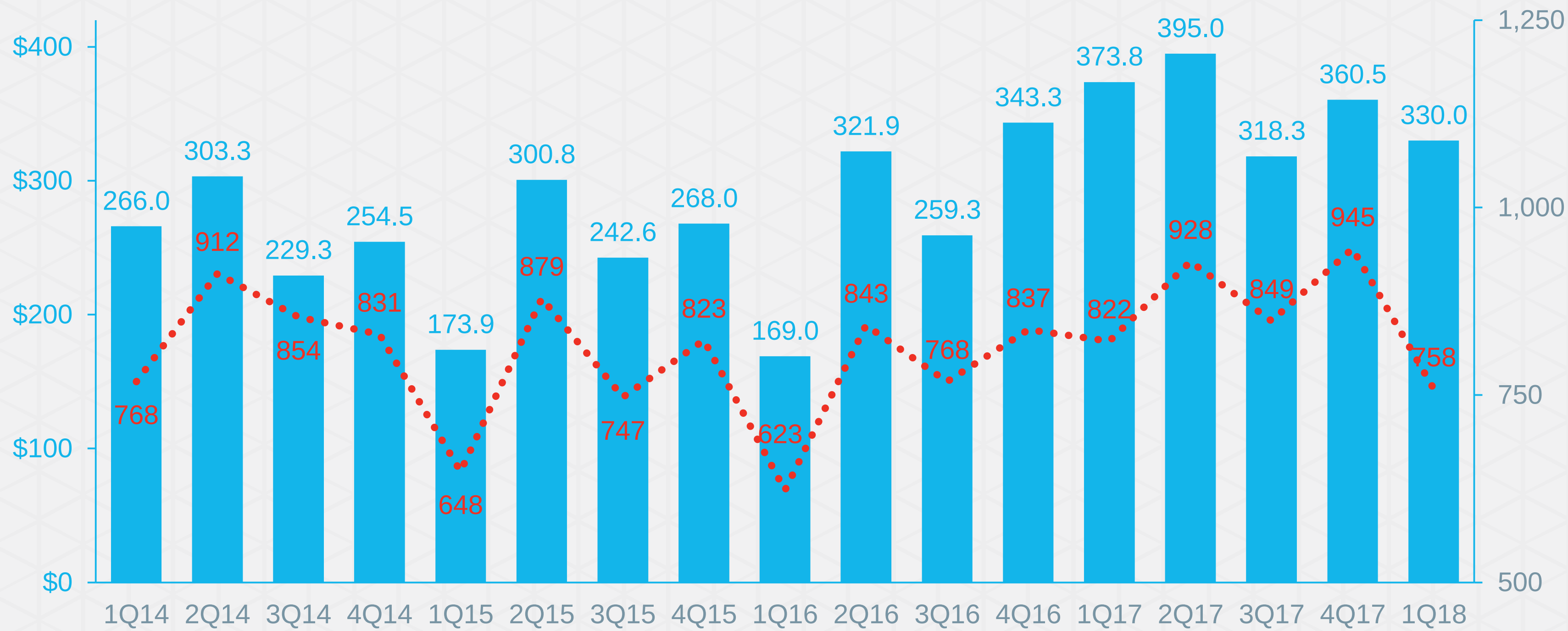


Source: SDC Platinum
Volume data includes deals reported as of 4/5/2018

New Issuance

U.S. middle-market loan volume declined to $330 billion, on a significantly lower transaction count. With refinancing activity largely behind us, M&A-related and, to a lesser extent, leveraged recaps, drove issuance. Transaction sizes also skewed larger than in recent quarters as the transaction count declined to a greater extent than volume.

U.S. Total Loan Issuance (EBITDA < $50MM)



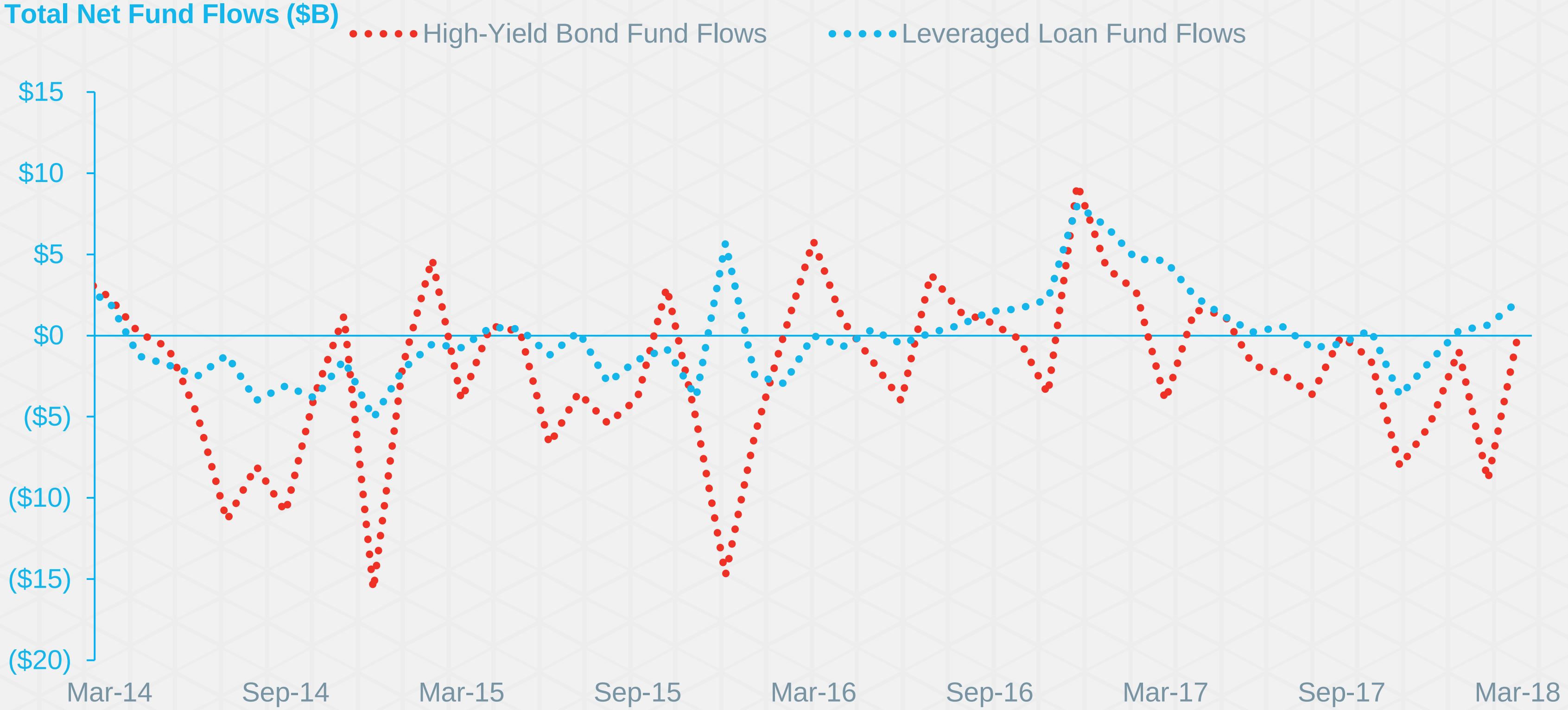
Source: SDC Platinum
Volume data includes deals reported as of 4/5/2018

Fund Flows

The movement into bond funds in January quickly reversed itself in February, as investors rapidly rebalanced fixed-income portfolios from fixed-rate to floating-rate securities, resulting in net outflows from bond funds and net inflows to loan funds for the quarter.

Mutual Fund Flows

Total Net Fund Flows ($B)

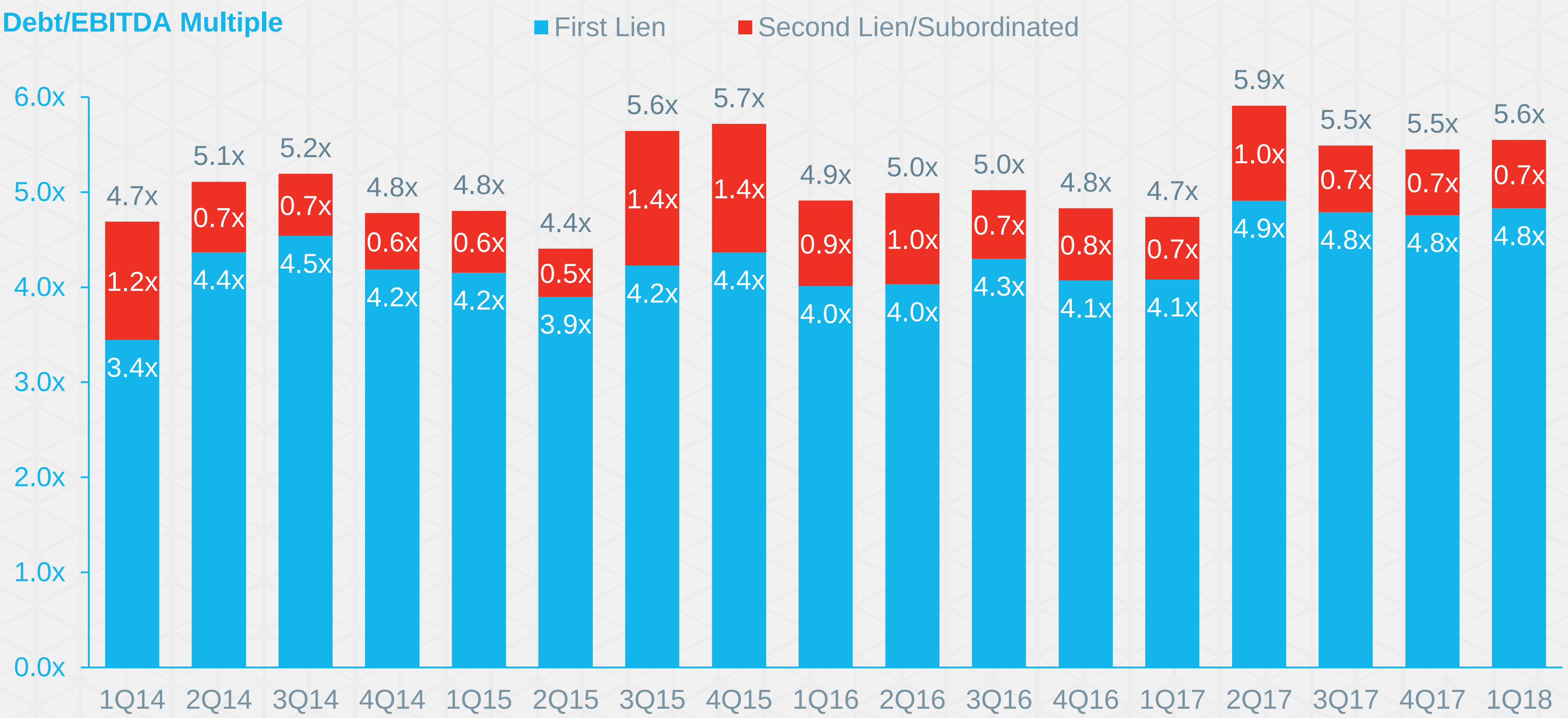


Sources: Investment Company Institute; Lipper FMI; LCD Comps

Leverage

U.S. middle-market first lien and total leverage have held steady at approximately 4.8x and 5.6x, respectively, over the last several quarters. We have observed an uptick in private middle-market transaction leverage of roughly 0.25x on both senior and total leverage over the last quarter, which we largely attribute to the substantial supply of capital relative to the number and volume of new issuance.

U.S. Leverage Multiple (EBITDA < $50MM)

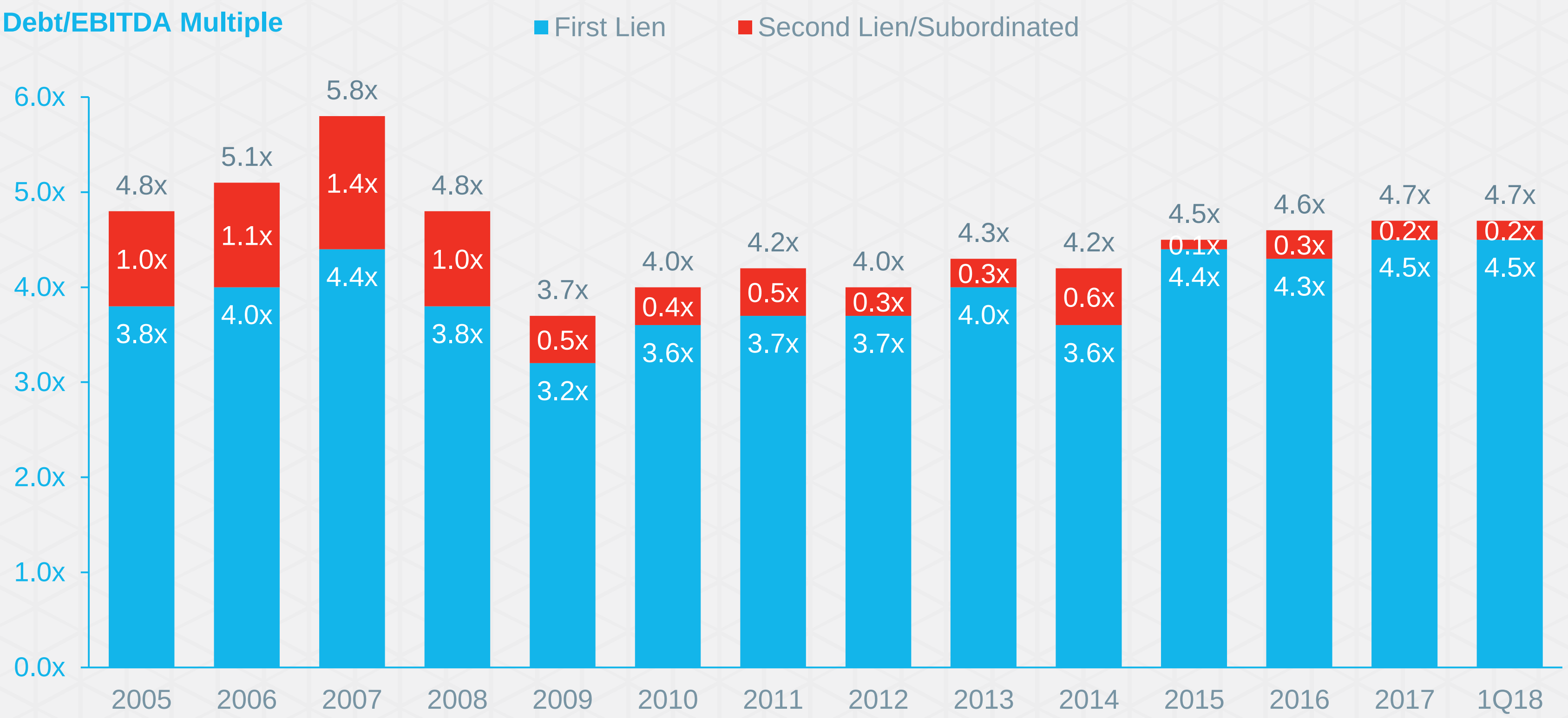


Source: LCD Comps

Leverage

European middle-market leverage remained at the elevated levels of the prior quarter, with first lien and total leverage at 4.5x and 4.7x, respectively. The European debt market continued to display an affinity for first lien debt, which is likely a result of a shallower market for second lien and subordinated notes than in U.S. markets. European private debt markets, similarly to the U.S., reflected a roughly 0.25x increase in senior and total leverage over the prior quarter.

European Leverage Multiple (EV < €350MM)

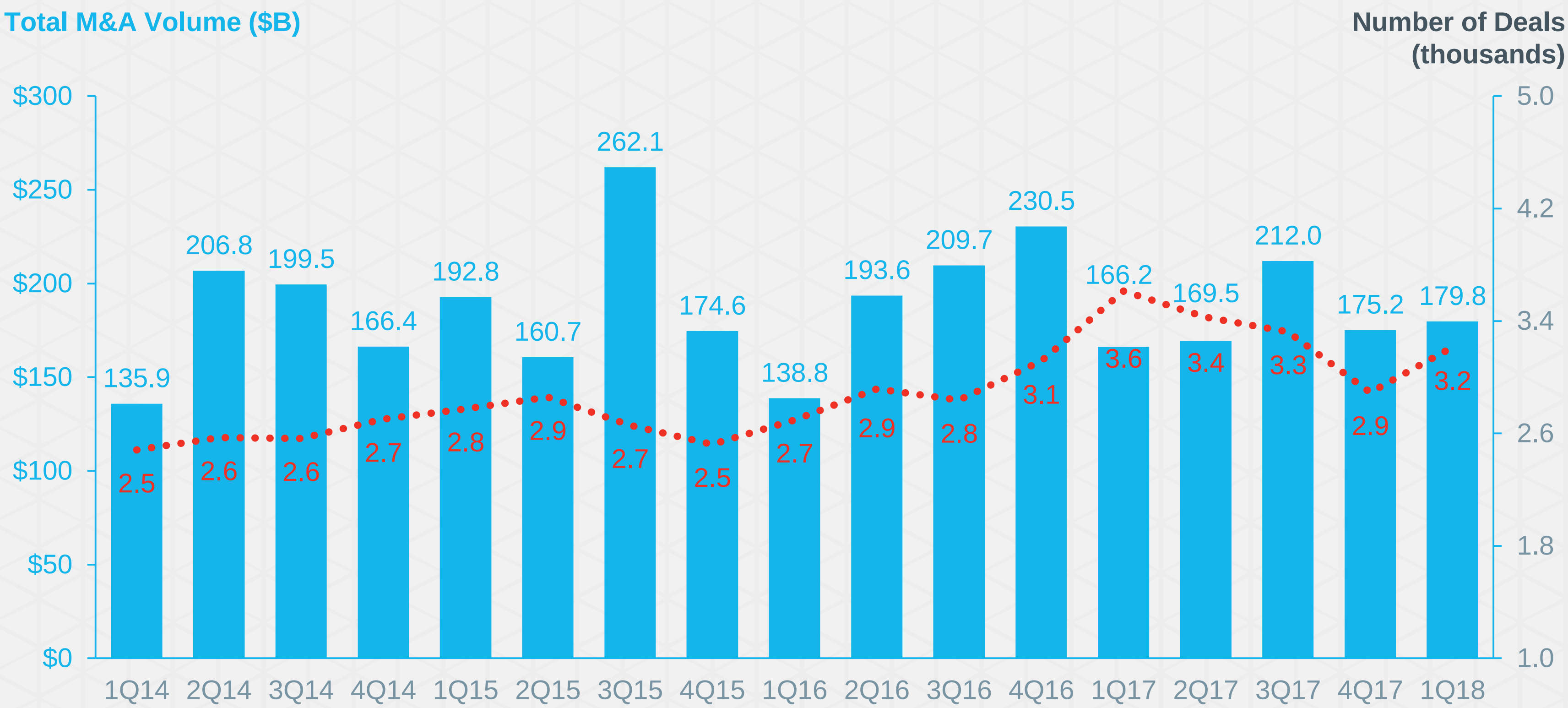


Source: LCD Comps

Transaction Volume

Continued strong U.S middle-market M&A activity increased 10% in number of deals and 3% in total dollar volume.

U.S. Middle-Market M&A Volume (Target EBITDA < $50MM)

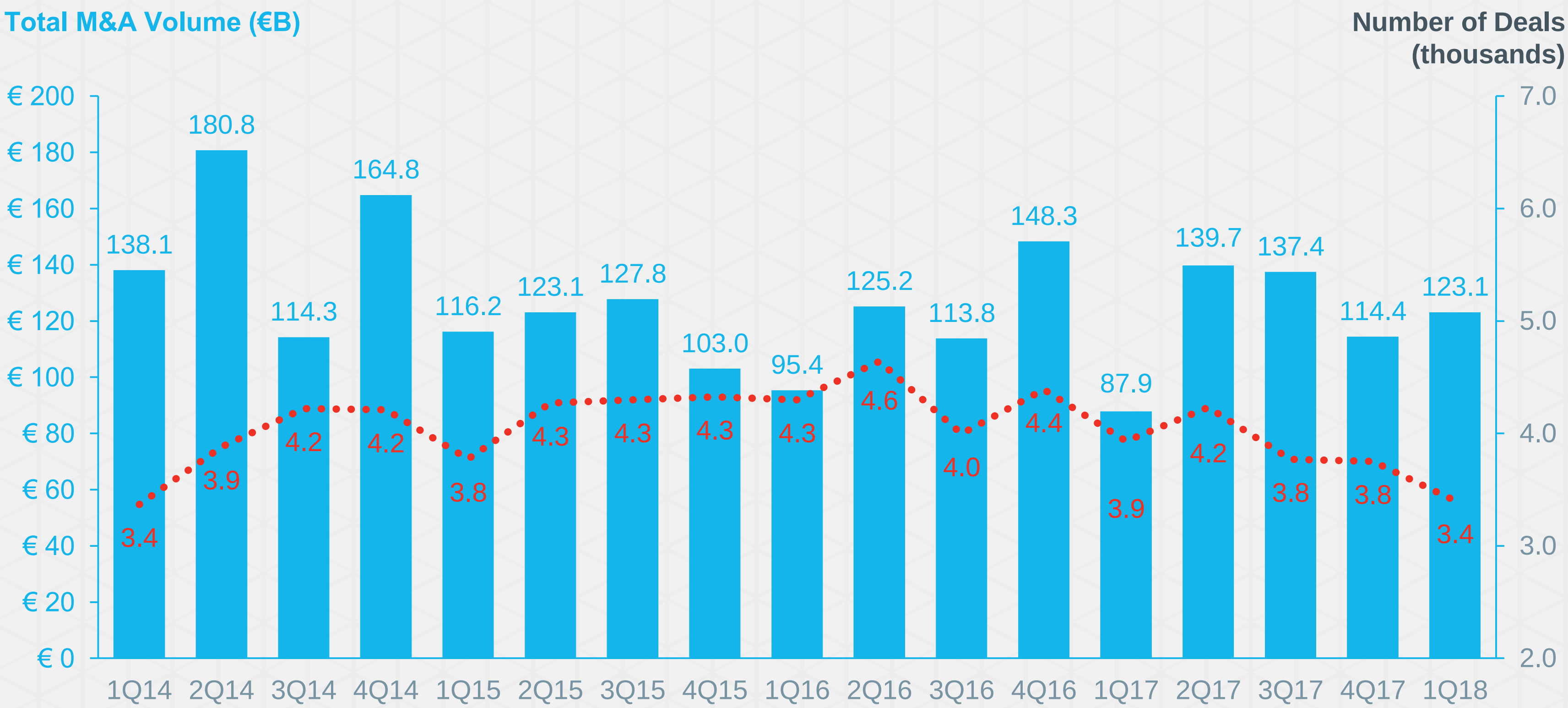


Source: SDC Platinum
Volume data includes deals reported as of 4/5/2018

Transaction Volume

European middle-market M&A deal making ticked higher in the first quarter, with transaction volume rising 8% over the prior quarter. However, transactions skewed toward larger deals, resulting in a decline in number of deals over recent quarters.

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

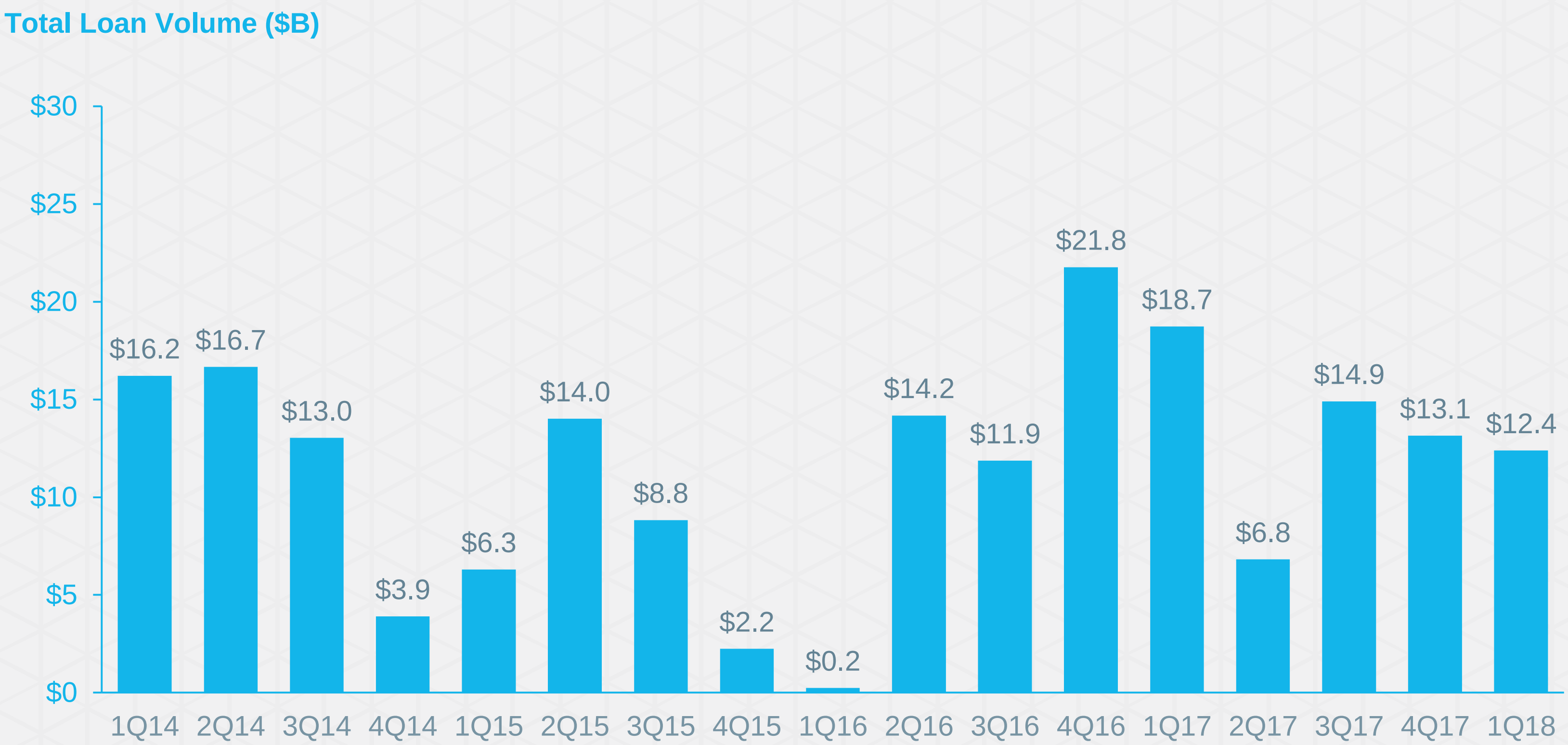


Source: SDC Platinum
Volume data includes deals reported as of 4/5/2018

Transaction Volume

Leveraged dividend recapitalizations declined 5% in the first quarter from the fourth quarter of 2017. Despite this trend, we have noted both a strong desire from sponsors and strong support from lenders for leveraged recap–related transactions.

U.S. Loan Issuance for Dividend Recapitalizations

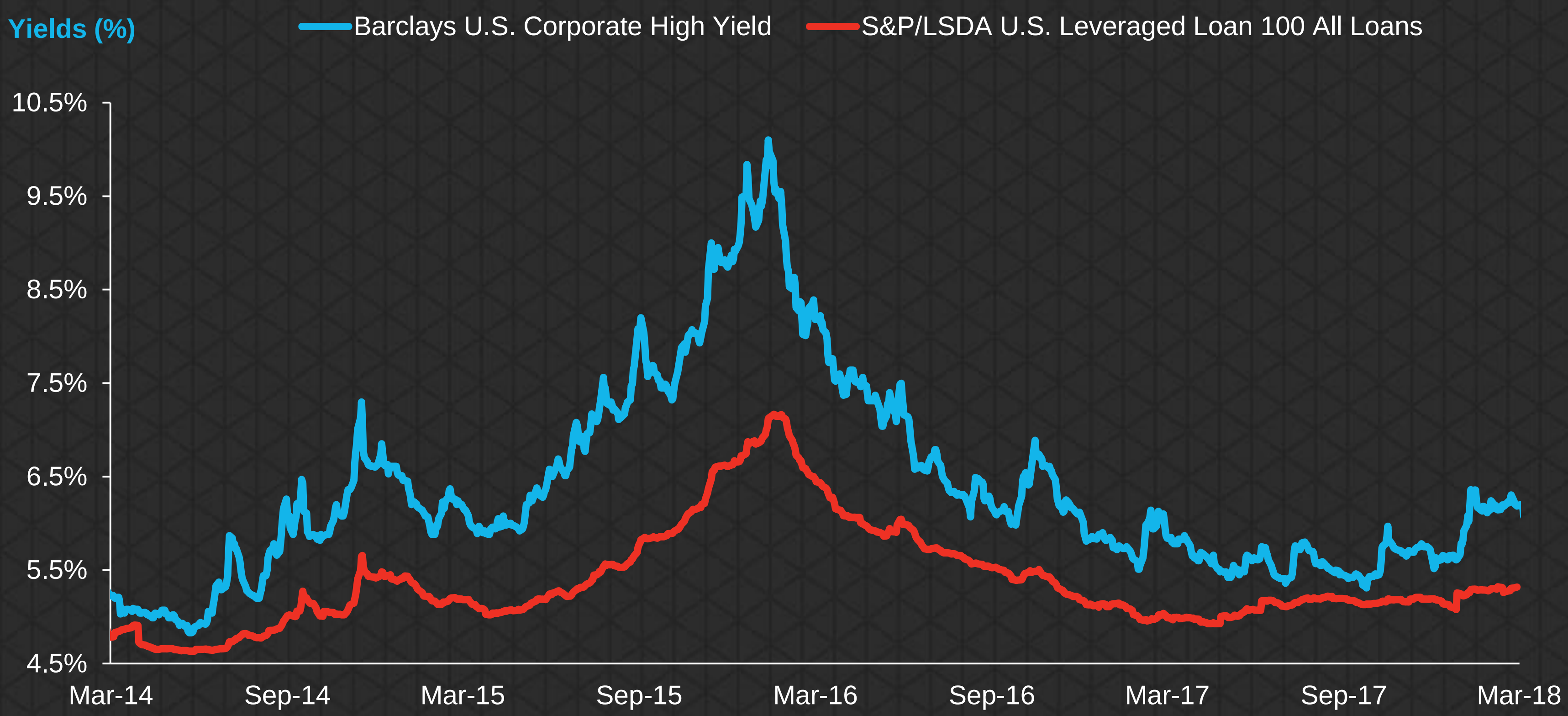


Source: LCD Comps

Yields

U.S. high-yield bond yields increased 47 bps this quarter, indicating both a slight widening of spreads and higher base rates. Meanwhile, widely traded leveraged loan spreads compressed, with yields up only 12 bps despite LIBOR having risen 60 bps, likely reflecting increased investor demand for floating-rate securities.

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



Source: Bloomberg; LCD Comps

Yields

Spreads between the 10-year Treasury and the U.S. high-yield bond index widened by 9 bps from 341 bps to 350 bps.

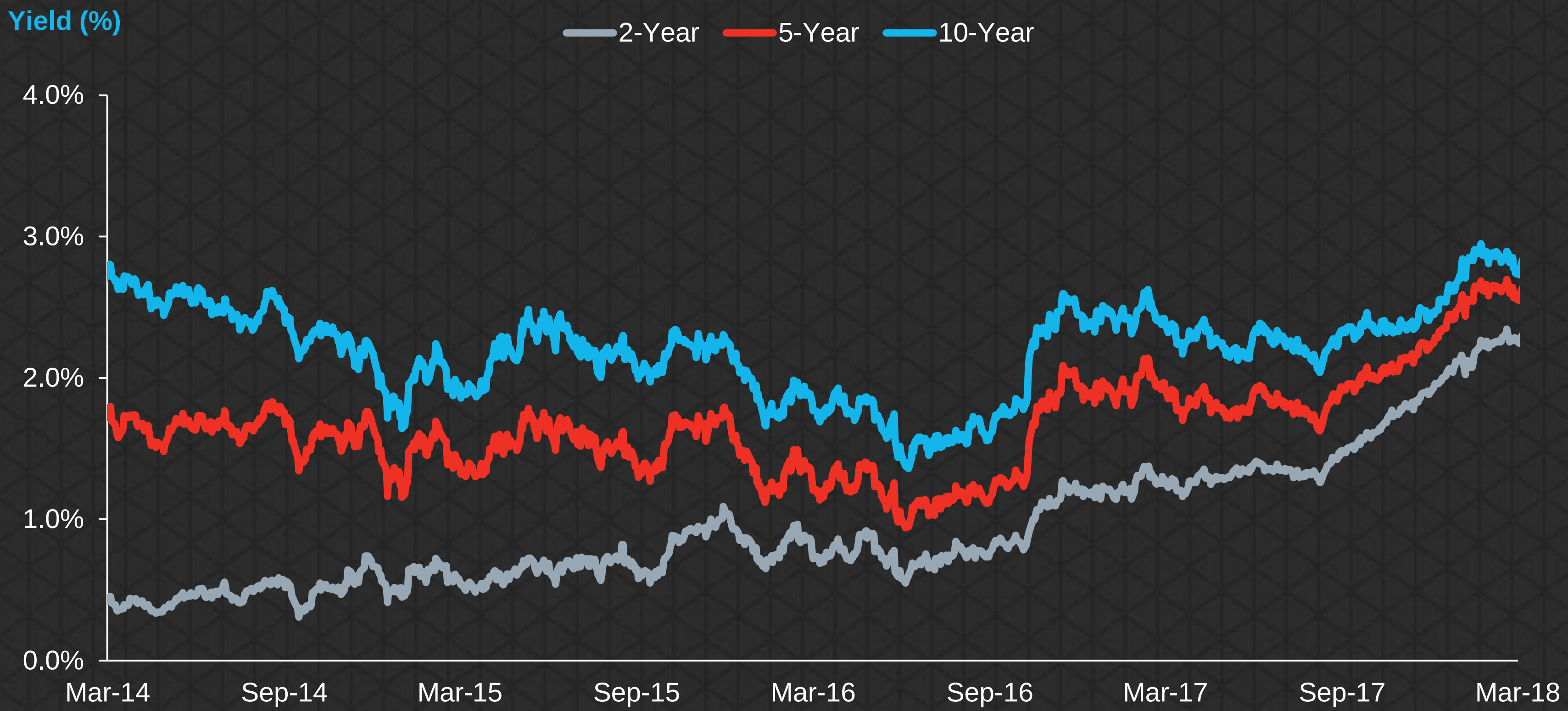
U.S. Corporate High-Yield Bond vs. 10-Year Treasury Spread

Source: Bloomberg

Yields

The 2-year Treasury yield hit a new high of 2.27%, a 38-bp increase over the quarter, while the 5-year Treasury yield increased by 35 bps to 2.56%. The 10-year yield increased 33 bps during the quarter to finish at 2.74%. The 10-year yield rose sharply in February, peaking at a yield of 2.96%, a 55 bps (23% movement) in a matter of weeks, before falling on trade fears.

2-, 5- and 10-Year Treasury Yields



Source: Bloomberg

Yields

The spread between 2- and 10-year Treasury yields decreased by approximately 5 bps over the quarter, ending at a spread of 47 bps; this represented a continued flattening of the yield curve.

2-Year vs. 10-Year Treasury Spread

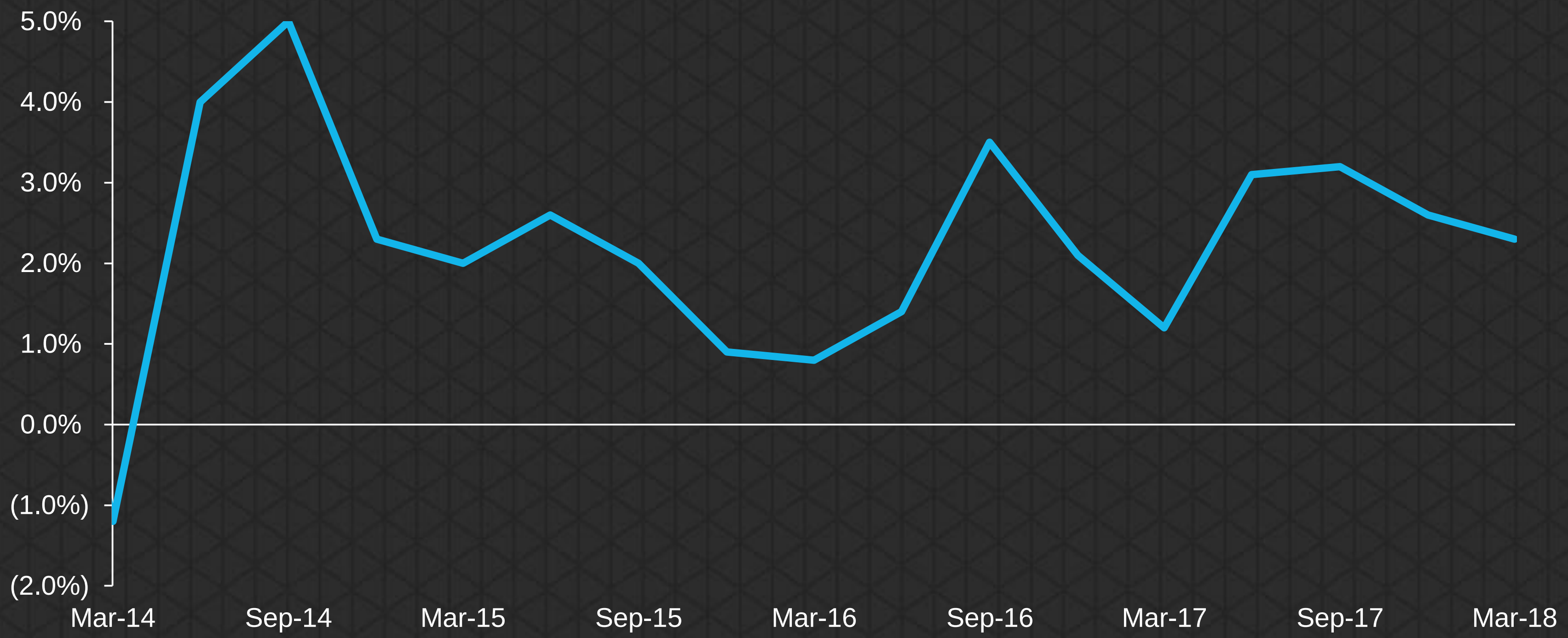
Source: Bloomberg

Macroeconomic Update

The latest U.S. GDPNow forecast of 2.3% for the first quarter indicates a modest decrease in the GDP growth rate from the fourth quarter's 2.6%. The job market continued to strengthen, with unemployment at 4.1% and wage growth hitting the highest level since 2009.

Real GDP Growth

GDP Growth Rate



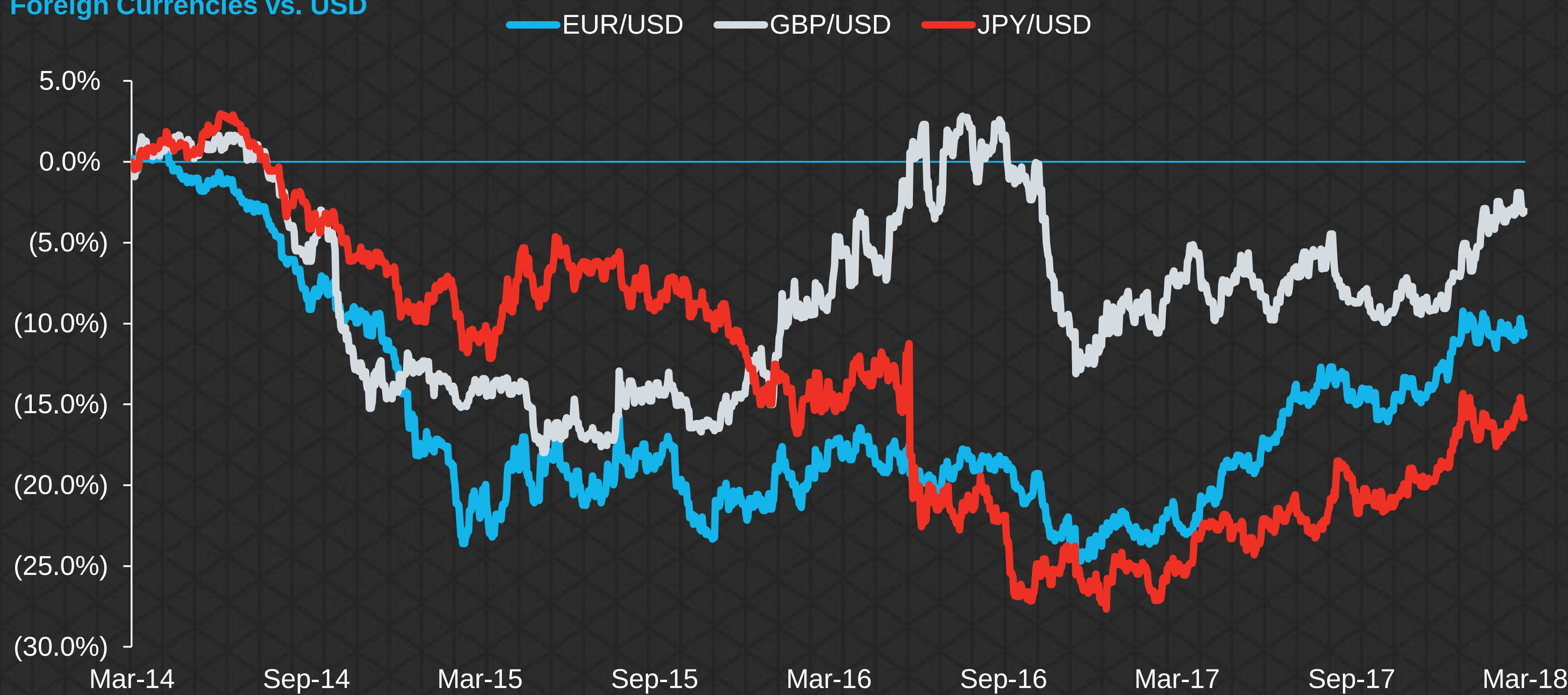
Source: Federal Reserve and European Central Bank
First quarter data represents Atlanta Fed GDPNow Projection as of 4/5/2018

Macroeconomic Update

The U.S. dollar declined against major currencies due to continued strengthening of the "global economy" relative to the U.S. The Euro and British pound, in particular, strengthened as investors believe the BoE and ECB will each need to act more quickly than previously communicated to raise rates.

U.S. Dollar Foreign Exchange Rates

Foreign Currencies vs. USD



Source: S&P Capital IQ

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