DUFF & PHELPS

Protect, Restore and Maximize Value

Capital Markets Insights

Summer 2018 Review

Highlights

Interest rate volatility observed in the first quarter continued into the second quarter of 2018. Base rates peaked in May and then retreated somewhat in June as trade tensions increased.

Economic indicators continued to point to increased economic expansion as the U.S. PPI and CPI showed the largest respective increases in over six years. Further the latest second-quarter estimate of real GDP growth indicated a nearly 4% increase.

In light of continued economic expansion, the Fed hiked interest rates an additional quarter-point in June and increased guidance toward two additional quarter-point rate increases in 2018 (to a total of four in 2018) and three quarter-point hikes in 2019.

In this environment of rising high-yield bond yields and shifting investor preferences toward floating-rate securities, high-yield issuance plunged, with year-to-date volume down 23% year over year. This development boded well for middle-market issuers as the search for leveraged loans is attracting new CLOs and direct lenders crossing over from the broadly syndicated loan market.

In the UK the BOE held rates flat this quarter, despite having previously signaled a potential need for earlier and larger interest rate hikes than the market anticipated. The ECB, facing a different dynamic in the Eurozone economy, indicated that rates will remain at current levels through the summer of 2019.

Demand for illiquid middle-market issuance continues to be very strong, as demand from traditional private lenders is further enhanced by cross over investor penchant. The resulting buildup in dry powder is driving appetite for new issues and resulting in increasingly issuer friendly spreads and structures.

The Fed hiked rates another quarter-point in June, as widely anticipated, but adjusted guidance toward a total of four rate hikes in 2018 versus the three previously messaged.

Fixed-income investors seeking higher yields continue to cross over from the broadly syndicated market, driving private middle-market demand higher.

Rising base rates were the primary driver of the 35bps rise in high-yield bond yields this quarter. With base rates expected to continue higher, investors are increasingly shifting to floating-rate alternatives.

Executive Summary

Following the June meeting, the Fed Chair announced a widely anticipated quarter-point rate hike; however, in a more hawkish statement than in the past, the Fed then provided guidance toward a fourth quarter-point rate hike in 2018 (the market had anticipated three) and three quarter-point increases in 2019. Sustained solidly rising economic growth, strong labor market conditions and inflation near the medium-term objective all contributed to the Fed's hawkish messaging. Despite further tightening, the yield curve continues to flatten, as recent macro factors have impacted long-term investor expectations.

In the UK and Europe, despite prior statements indicating a heightened need to raise rates, the BOE and ECB left rates unchanged and took a somewhat softer tone this quarter, with the ECB indicating that rates may not rise until this time next year.

The rise, though volatile, in U.S. base borrowing rates has driven fixed-rate yields up an additional 35bps this quarter. Largely as a result, high-yield bond issuance has dropped 23% YTD versus the prior year. As yields rise, fixed-income investors—and others—are shifting their focus to direct illiquid middle-market lending.

The strengthening cross-over bid from syndicated markets to private markets bodes well for middle-market issuers. As excess dry powder builds—a result of new funds being raised, new direct lenders coming to market and to new CLO issuance—we observe ever-fiercer competition from private-market lenders on rates, fees and structures. We have noted lenders playing to their relative strengths. For example: banks and BDCs (rate), pension funds and insurance companies (tenor), and credit funds (structure). Issuances for recapitalizations and growth purposes, including committed growth lines, are becoming more mainstream. While the current environment appears to have become the status quo, macro factors pose a significant risk to market conditions. At this time, there is an attractive opportunity for financial sponsors and owners of closely held businesses seeking liquidity or growth capital, as an alternative to a sale process, to access the private credit markets.

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	3.75x–4.75x	4.25x–5.25x
	3.50x–4.50x	4.00x–5.00x
TOTAL DEBT	4.50x–5.50x	5.00x–6.00x
	4.25x–5.25x	4.75x–5.75x

UK/EUROPE LEVERAGE MULTIPLES

	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	4.00x–5.00x	4.50x–5.50x
	3.75x–4.75x	4.25x–5.50x

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 + 2.25%–3.00% (bank) LIBOR + 2.50%–3.25% (bank) LIBOR + 3.50%–5.50% (nonbank)	LIBOR + 2.00%–2.75% (bank) LIBOR + 2.25%–3.00% (bank) LIBOR + 3.50%–5.50% (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 + 5.00%–7.50%

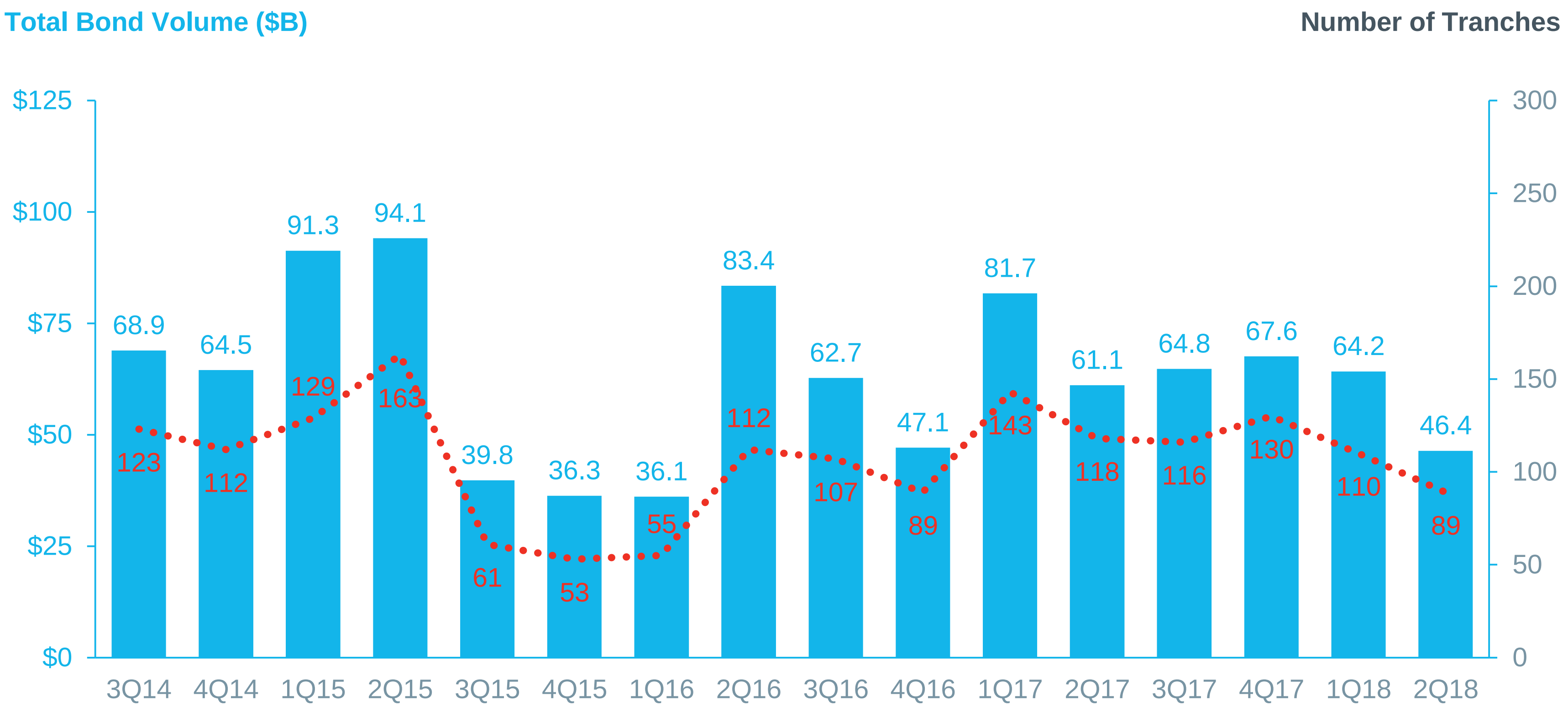
UK/Europe Indicative Middle-Market Credit Parameters

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 + 3.25%–3.75% (bank) LIBOR/EURIBOR + 4.00%–6.00% (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 + 5.25%–8.00%

New Issuance

Second-quarter U.S. high-yield issuance volume of $46 billion and number of new issuances (89) declined from the previous quarter by 28% and 19%, respectively. We attribute the softness primarily to issuers continuing to favor the floating rates available in the leveraged loan market.

Total U.S. High-Yield Bond Issuance

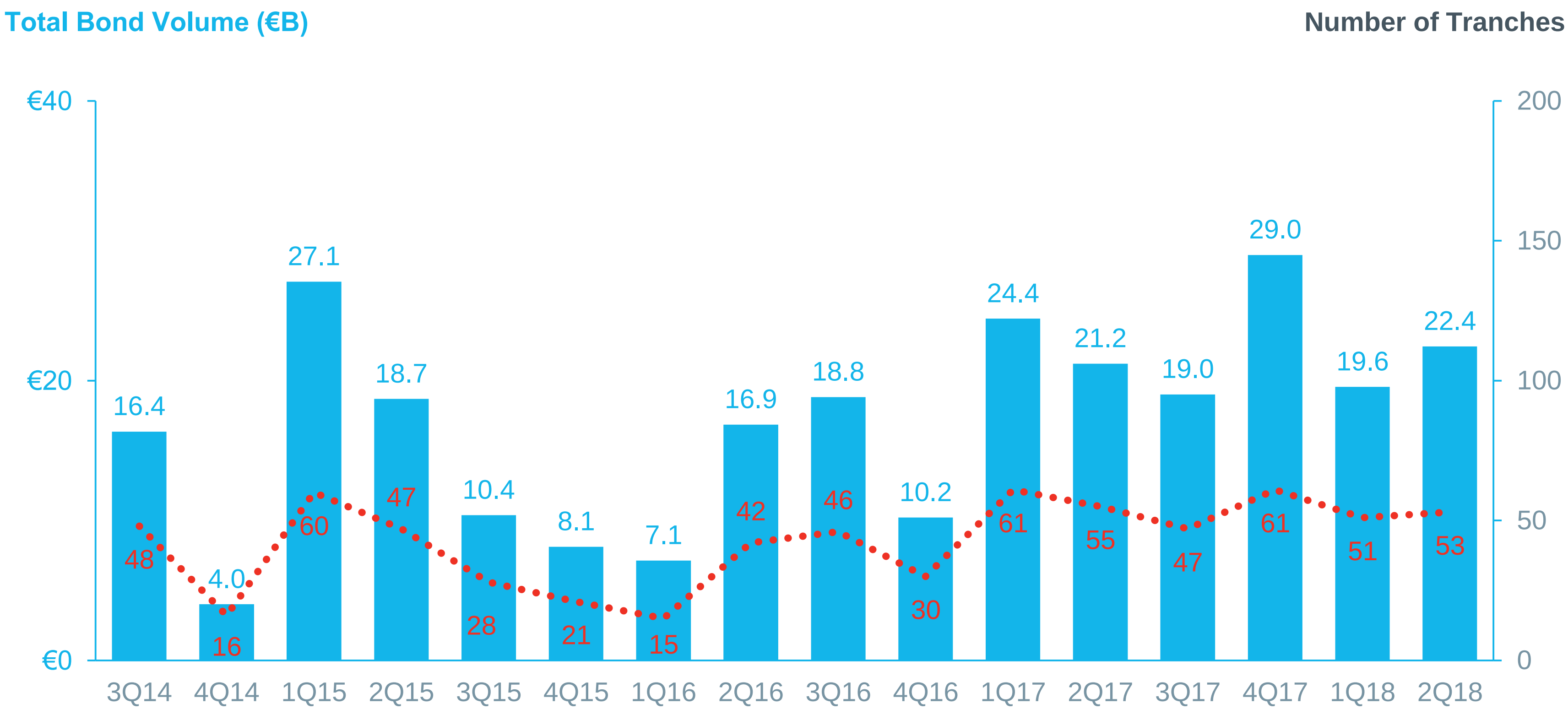


Source: LCD Comps

New Issuance

Second-quarter high-yield issuance volume of €22 billion and number of new issuances (53) were higher versus the prior quarter by 15% and 4%, respectively.

Total European High-Yield Bond Issuance

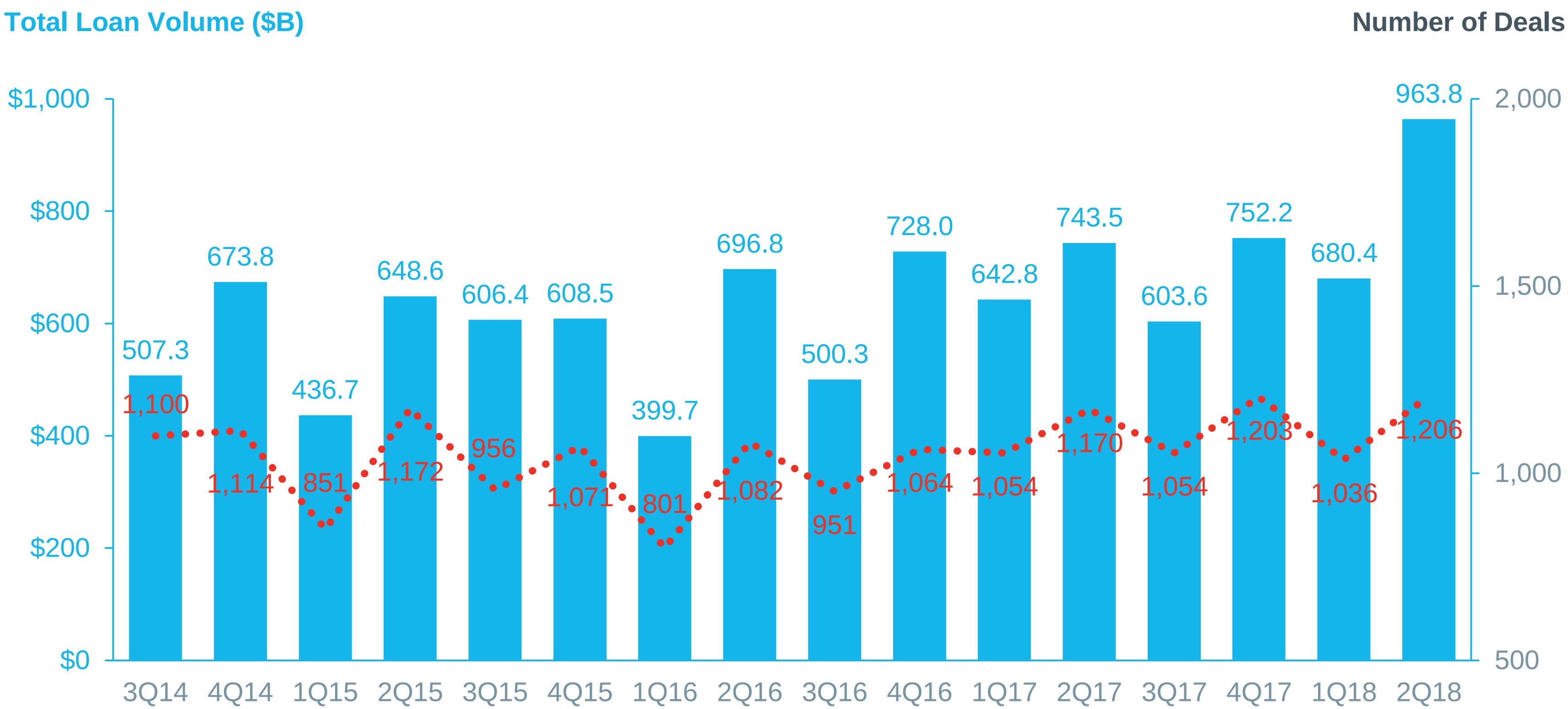


Source: LCD Comps

New Issuance

Second-quarter U.S. loan issuance was $964 billion on 1,206 deals, representing significant increases of 41% and 16%, respectively. Investors confidently absorbed new issuances as rates have risen in the U.S. and are widely expected to rise further over the next 18 months.

U.S. Total Loan Issuance

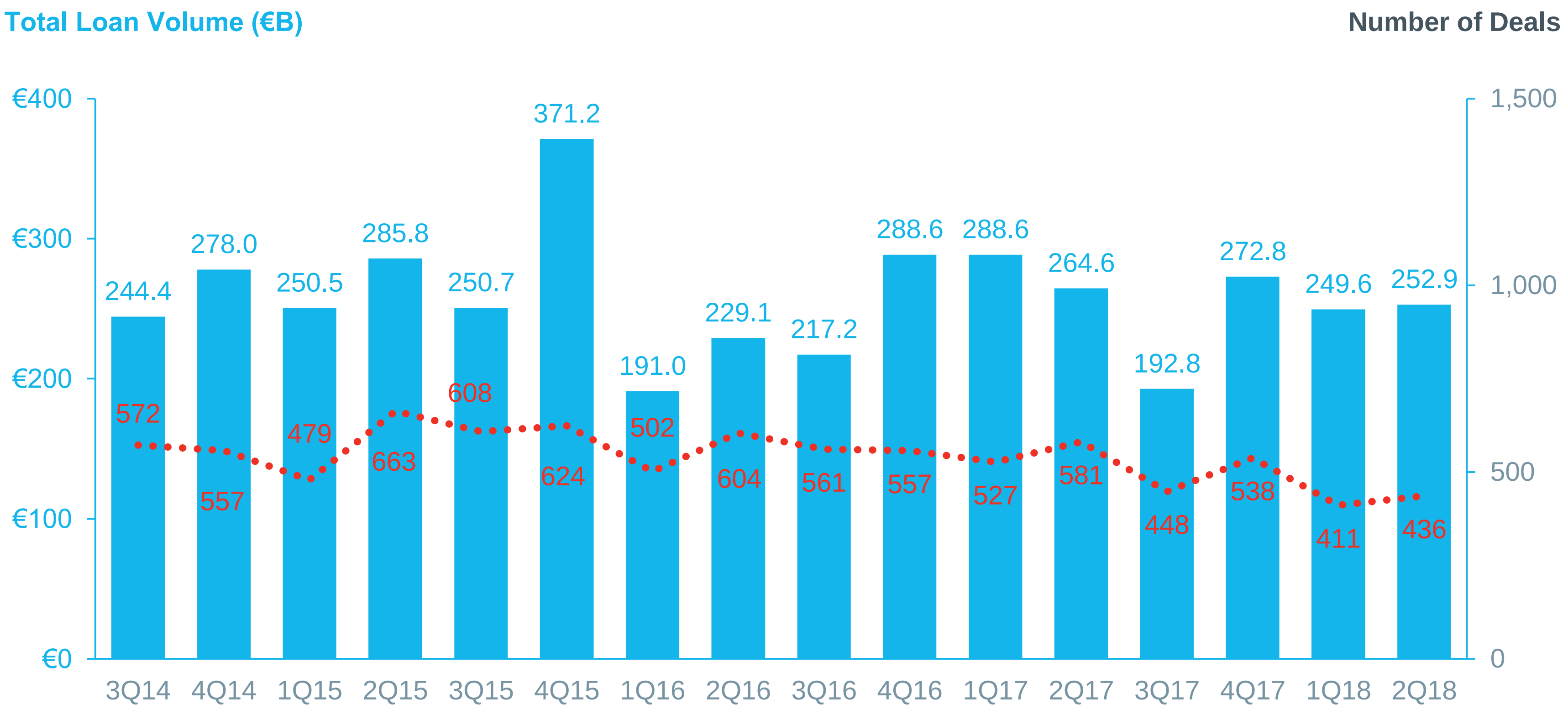


Source: SDC Platinum
Volume data includes deals reported as of 7/11/2018.

New Issuance

Second-quarter European loan issuance totaled €253 billion, up a modest 1.3% over the first quarter. The 6% increase in number of issuances versus the first quarter is largely a factor of normalization in deal size after a few outsized individual deals in the first quarter.

European Total Loan Issuance

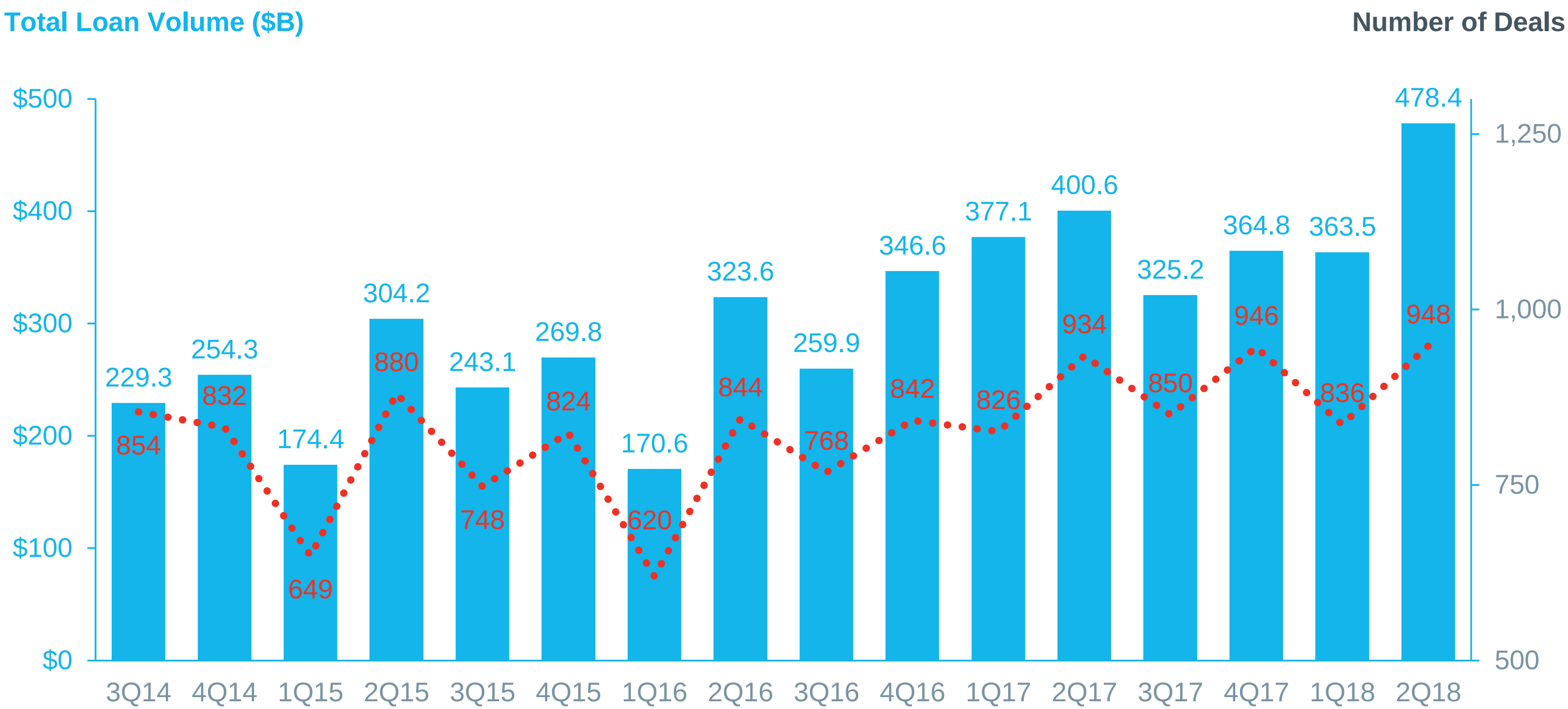


Source: SDC Platinum
Volume data includes deals reported as of 7/11/2018.

New Issuance

U.S. middle-market loan volume and the number of issuances increased dramatically to $478 billion and 948, respectively, representing growth of 32% and 14%, respectively. Middle-market issuers have continued to find reliable access to capital for refinancings and leveraged recapitalizations.

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

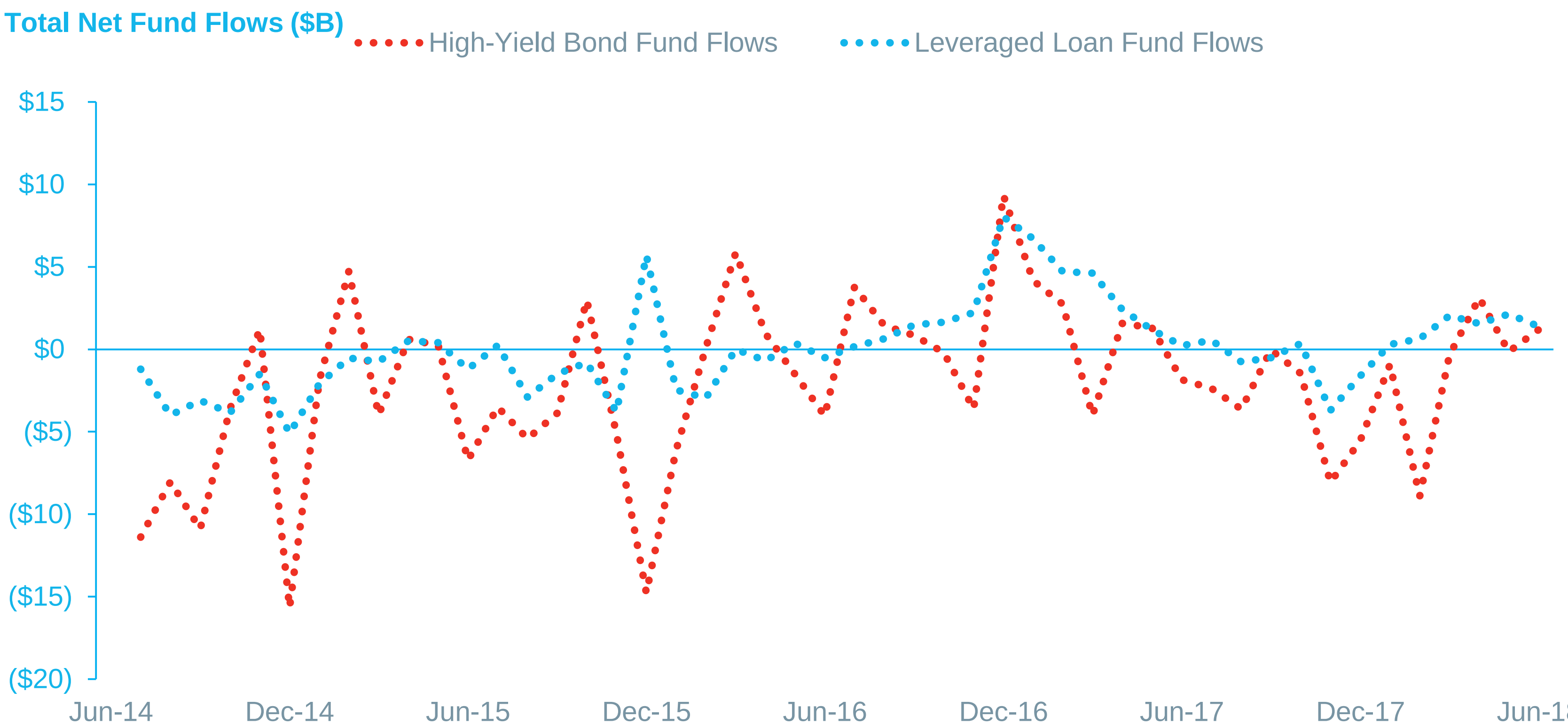


Source: SDC Platinum
Volume data includes deals reported as of 7/11/2018.

Fund Flows

Both bond funds and leveraged loan funds saw gains in inflows. In particular, bond funds experienced a net inflow of more than $4 billion in the second quarter after an outflow of more than $10 billion in the first quarter. Leveraged fund flows continued to improve through the second quarter after strong gains in the first quarter.

Mutual Fund Flows

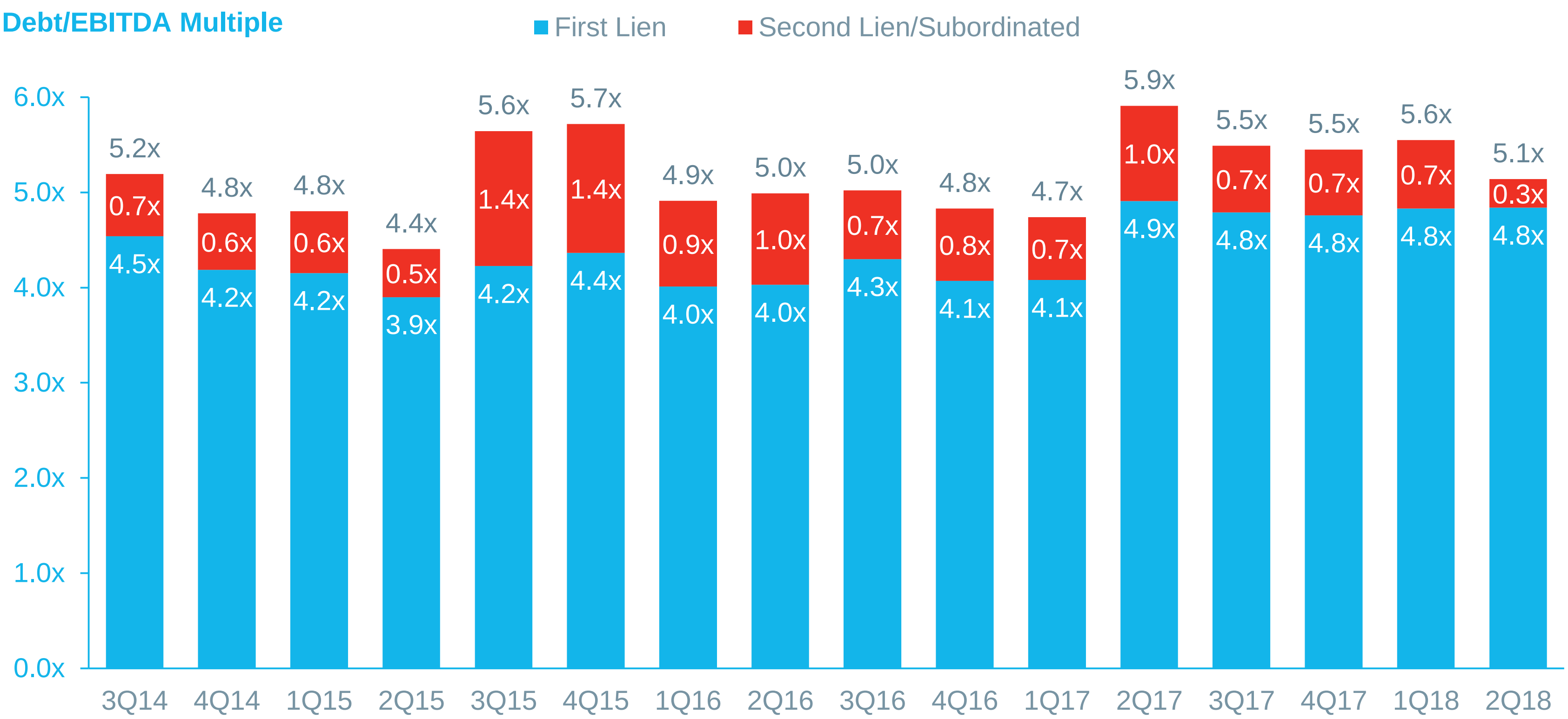


Sources: Investment Company Institute; Lipper FMI; LCD Comps

Leverage

U.S. middle-market first-lien leverage has held steady at approximately 4.8x, while second-lien/subordinated leverage decreased approximately 0.4x. Issuers have continued to find favorable pricing with unitranche lenders, resulting in a lower blended cost of capital than senior/subordinated structures.

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

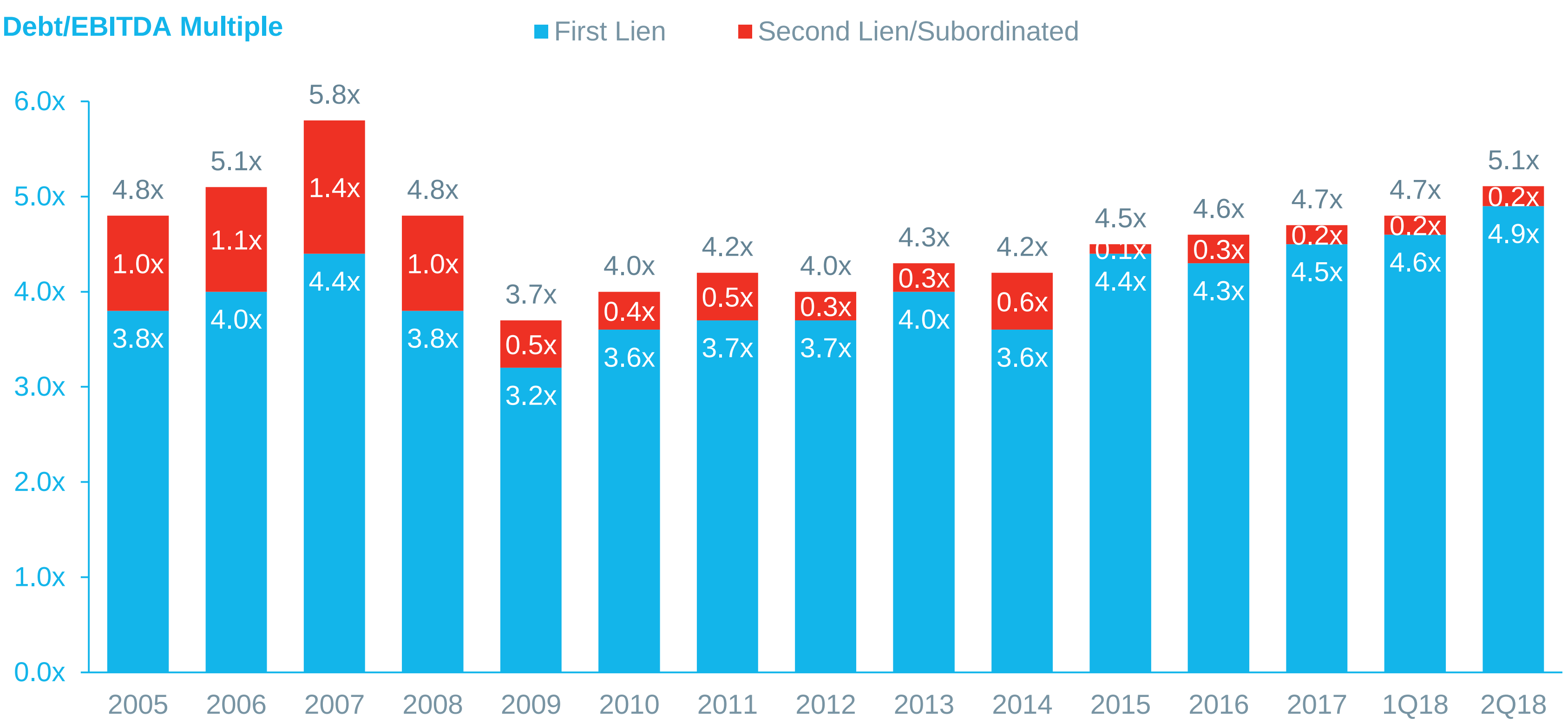


Source: LCD Comps

Leverage

European middle-market leverage levels continued to increase, with first-lien and total leverage at 4.9x and 5.1x, respectively.

European Leverage Multiple (EV < €350MM)

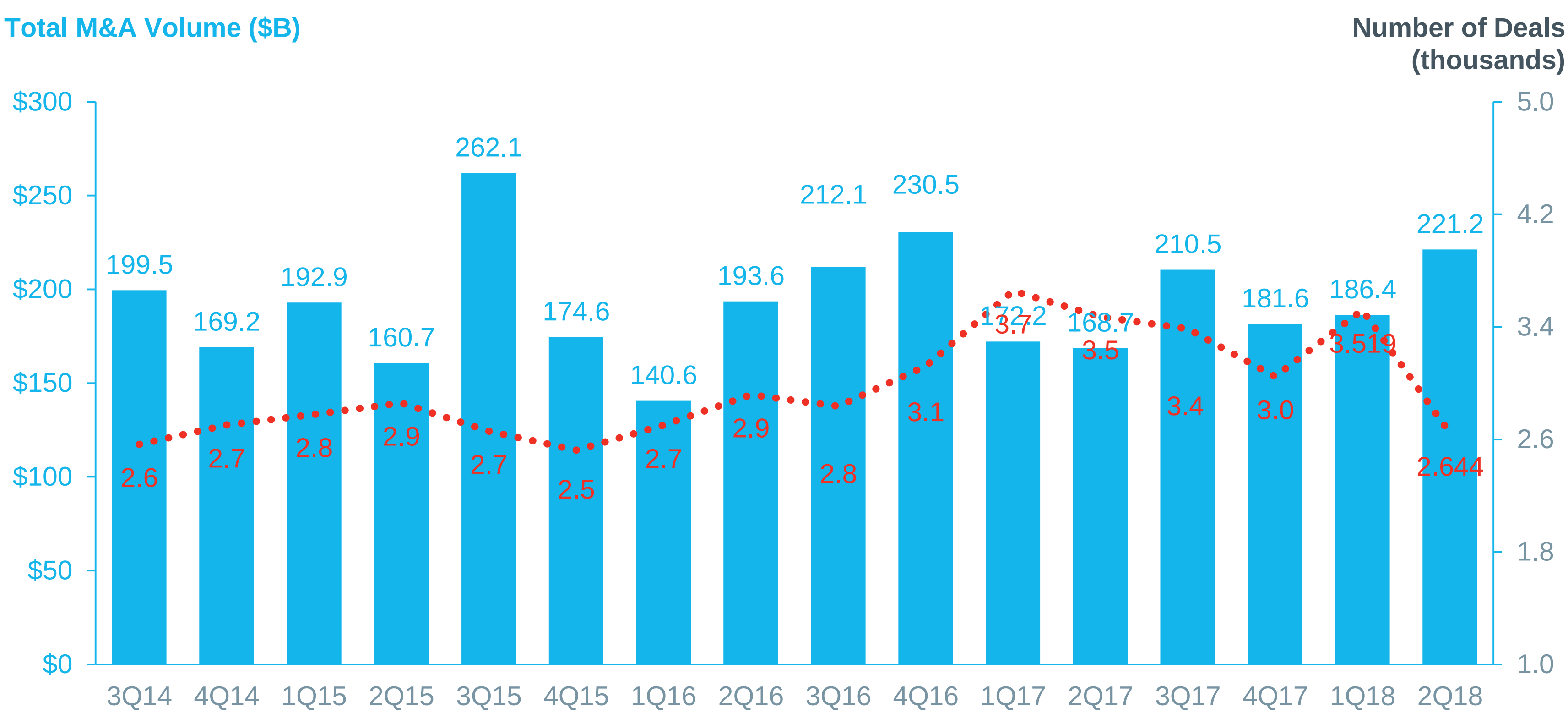


Source: LCD Comps

Transaction Volume

Second-quarter middle-market M&A volume rose 19% over the first quarter, while deal count saw a substantial decrease of nearly 25%.

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

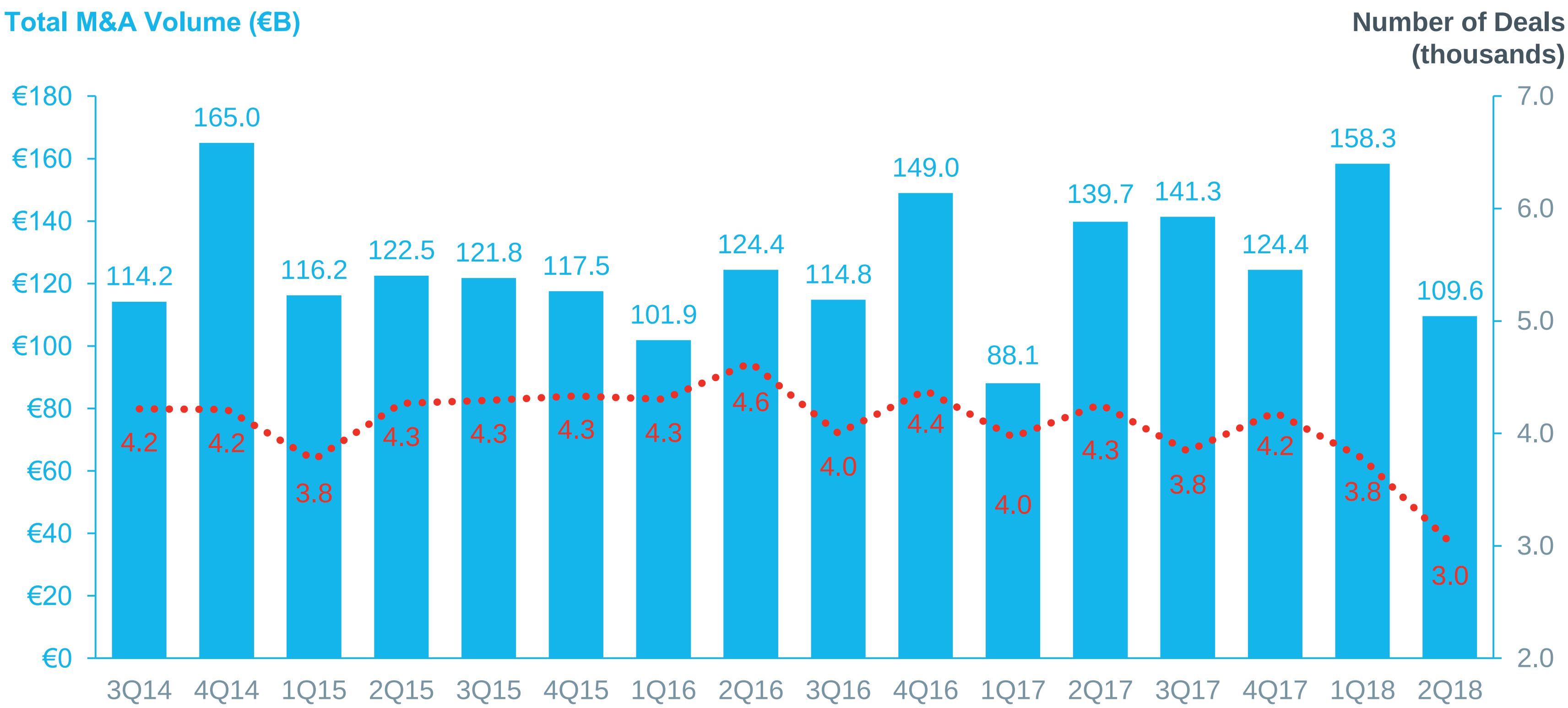


Source: SDC Platinum
Volume data includes deals reported as of 7/11/2018.

Transaction Volume

European middle-market M&A deal-making fell in the second quarter, with transaction volume declining 31% and the number of deals declining 20% over the prior quarter.

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



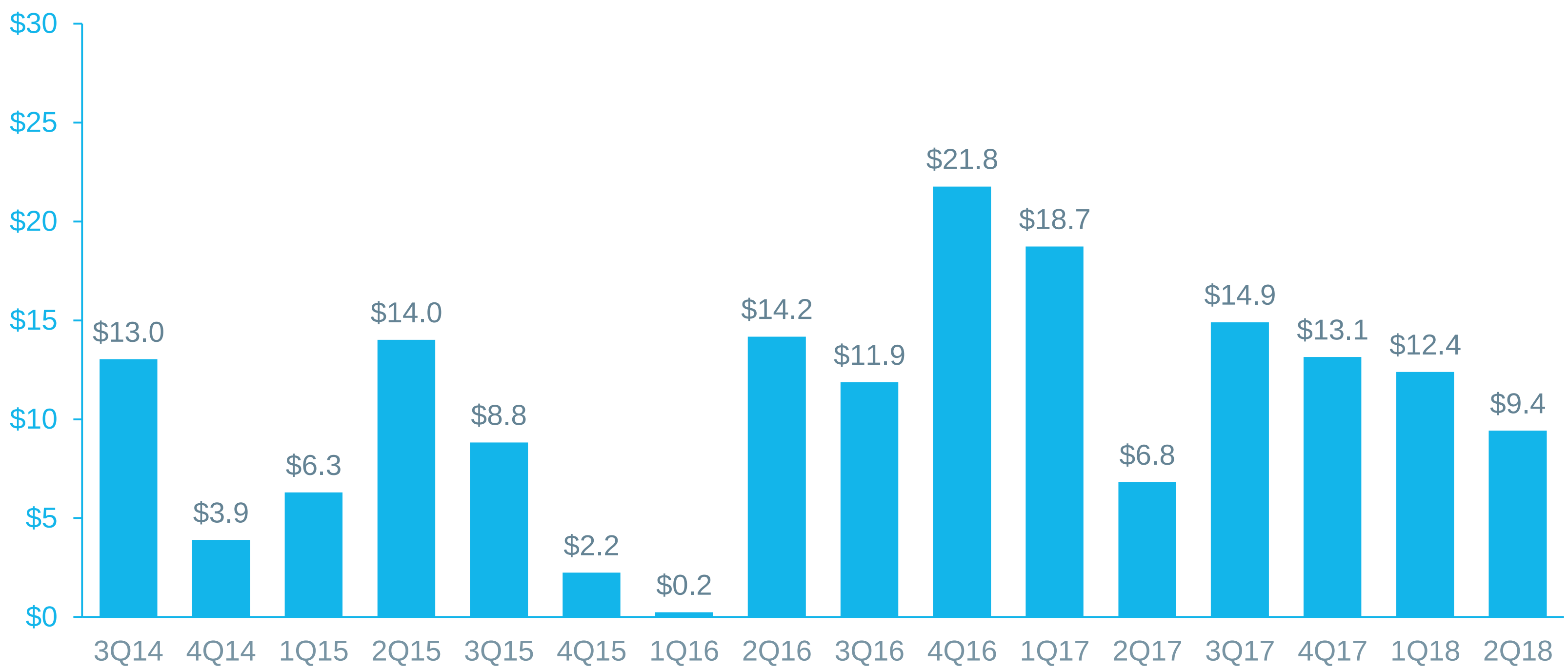
Source: SDC Platinum
Volume data includes deals reported as of 7/11/2018/

Transaction Volume

Loan volume for syndicated leveraged recapitalizations declined 24% in the second quarter from the first quarter. Despite this trend, we have noted both a strong desire from sponsors and strong support from lenders, in the private markets, for leveraged recap-related transactions.

U.S. Loan Issuance for Dividend Recapitalizations

Total Loan Volume ($B)

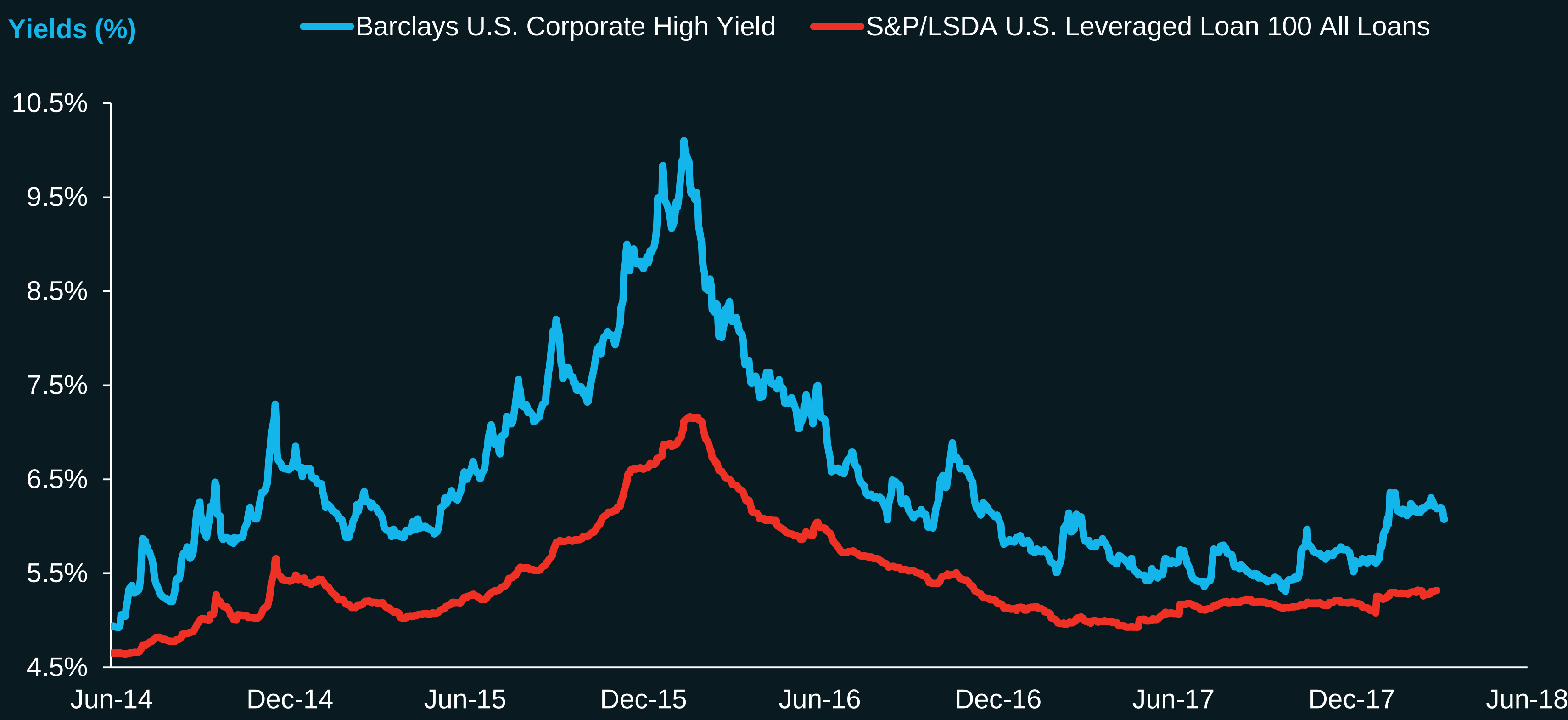


Source: LCD Comps

Yields

U.S. non-investment-grade bond yields increased 35bps this quarter. Spreads on widely traded leveraged loans increased 49bps over the previous quarter.

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



Sources: Bloomberg; LCD Comps

Yields

Spreads between the 10-year Treasury and the U.S. high-yield bond index narrowed from 351bps to 342bps, an 8bps difference, from the first quarter to the second quarter of 2018.

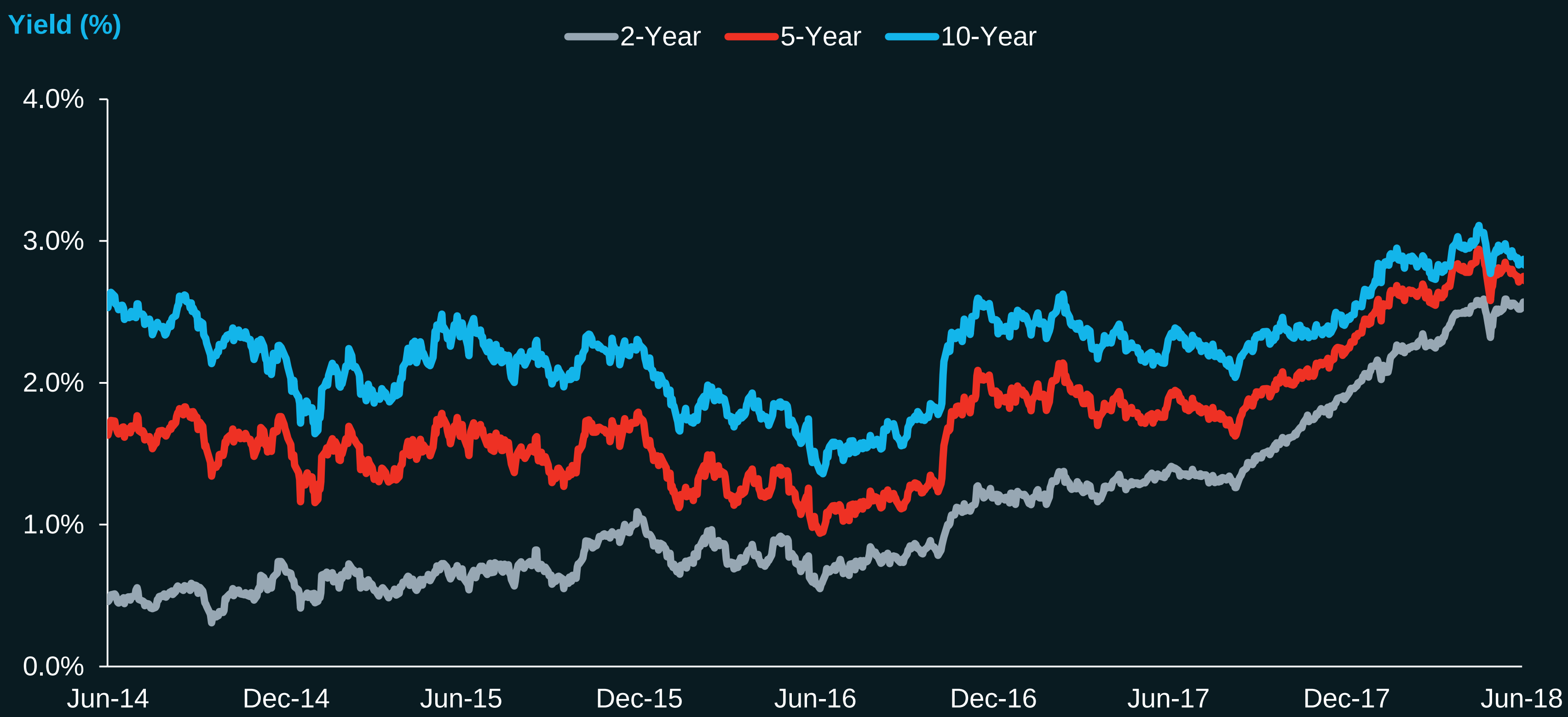
U.S. Corporate High-Yield Bond vs. 10-Year Treasury Spread

Source: Bloomberg

Yields

In May 2018, Treasury yields reached their highest level since 2011 due in large part to macroeconomic strength, including positive job market news and rising inflation. The Fed's statements toward tolerating core-CPI volatility around the 2.0% inflation target and stepped-up trade tensions caused yields to recede from their May peaks in June.

2-, 5- and 10-Year Treasury Yields



Source: Bloomberg

Yields

The spread between 2- and 10-year Treasury yields decreased by approximately 14bps over the quarter, ending at a spread of 33bps as the yield curve continued to flatten.

2-Year vs. 10-Year Treasury Spread

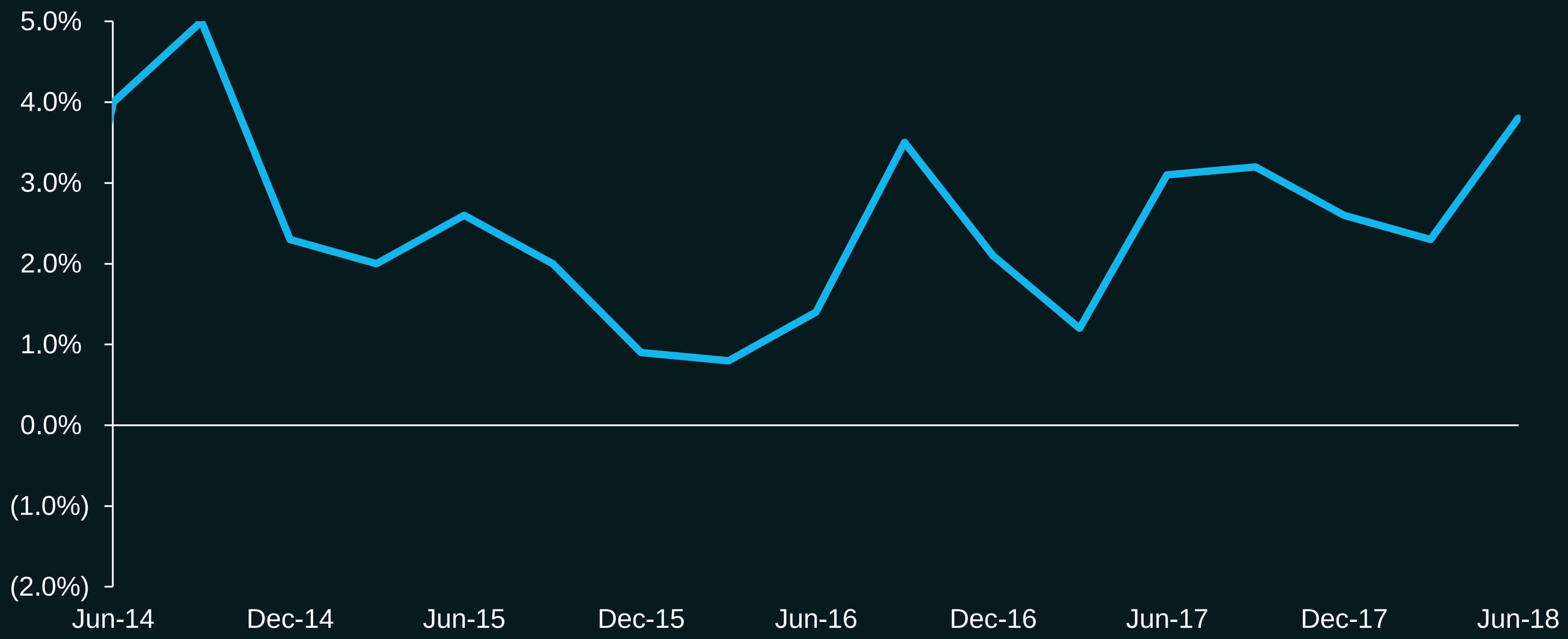
Source: Bloomberg

Macroeconomic Update

The latest U.S. GDPNow forecast of 3.8% for the second quarter indicates a significant increase in the GDP growth rate from the first quarter's 2.8%. The job market continued to strengthen, with unemployment at 4.0% and solid wage growth of 3.2% in June.

Real GDP Growth

GDP Growth Rate



Sources: Federal Reserve; European Central Bank
First-quarter data represents Atlanta Fed GDPNow projection as of 7/9/2018.

Protect, Restore and Maximize Value

CONTACT

Bob Bartell, CFA
Global Head of Corporate Finance
+1 312 697 4654
bob.bartell@duffandphelps.com

Steve Burt
Global Head of M&A
+1 312 697 4620
steve.burt@duffandphelps.com

Josh Benn
Head of New York Corporate Finance
+1 212 450 2840
joshua.benn@duffandphelps.com

Joshua Osher
Director
U.S. Private Capital Markets
+1 212 871 0669
josh.osher@duffandphelps.com

Greg Forde
Vice President
European Debt Advisory
+44 (0)20 7089 4940
gregory.forde@duffandphelps.com

Michael Brill
Managing Director
U.S. Private Capital Markets
+1 212 871 5179
michael.brill@duffandphelps.com

About Duff & Phelps
Duff & Phelps is the global advisor that protects, restores and maximizes value for clients in the areas of valuation, corporate finance, investigations, disputes, cyber security, compliance and regulatory matters, and other governance-related issues.
We work with clients across diverse sectors, mitigating risk to assets, operations and people. With Kroll, a division of Duff & Phelps since 2018, our firm has nearly 3,500 professionals in 28 countries around the world.

M&A advisory, capital raising and secondary market advisory services in the United States are provided by Duff & Phelps Securities, LLC. Member FINRA/SIPC. Pagemill Partners is a Division of Duff & Phelps Securities, LLC. M&A advisory, capital raising and secondary market advisory services in the United Kingdom are provided by Duff & Phelps Securities Ltd. (DPSL), which is authorized and regulated by the Financial Conduct Authority. M&A advisory and capital raising services in Germany are provided by Duff & Phelps GmbH, which is a Tied Agent of DPSL. Valuation Advisory Services in India are provided by Duff & Phelps India Private Limited under a category 1 merchant banker license issued by the Securities and Exchange Board of India.