DUFF & PHELPS

November 2015

Industry Insights:
Capital Markets

Highlights

Credit activity remains robust despite recent volatility in global markets

"Flight to quality" has contributed to a modest increase in non-investment grade bond and leveraged loan yields over Q3 2015

Moderate increase in yields of middle market credits has been tempered by fuller covenant packages and continued robust investor demand for private (and illiquid public) debt exposure

Traditional bank lenders tightened credit parameters citing macroeconomic volatility and energy sector weakness, leading to a partial reallocation of capital structures

Market volatility in China triggered a global slowdown in demand for commodities and finished goods

Executive Summary

The third quarter began rather benignly for the credit markets and became increasingly volatile as the months progressed. While domestic macroeconomic fundamentals steadily improved over the quarter, the ongoing uncertainty concerning the timing and magnitude of monetary policy adjustments garnered considerable market attention. More significant, the sharp slowdowns experienced in the Eurozone and Asia—China in particular—soon carried over into the commodity and equity markets. Increases in credit spreads soon followed. Non-investment grade bond yields increased by over 150bp over the quarter (Barclays U.S. Corporate High Yield Index) while leveraged loan spreads experienced a 40bp increase (S&P/LSTA U.S. Leveraged Loan 100 Index).

The middle market, the focus of our private capital markets practice at Duff & Phelps, moved in tandem with the public markets, though with a few key differences. First, we observed a relatively modest (~50bps) increase in private note yields. Second, a trimming in first lien debt appetite resulted in a higher proportion of second lien and junior debt in capital structures. We believe the fuller covenant packages typical of the private market, combined with unabated growth in private investor capital formation, have served to differentiate middle market conditions from those of the broader liquid markets. Thus, while the weighted average cost of debt for middle market issuers has increased modestly, credit availability—both in terms of leverage multiples and cost—is robust.

Indicative Middle-Market Credit Parameters

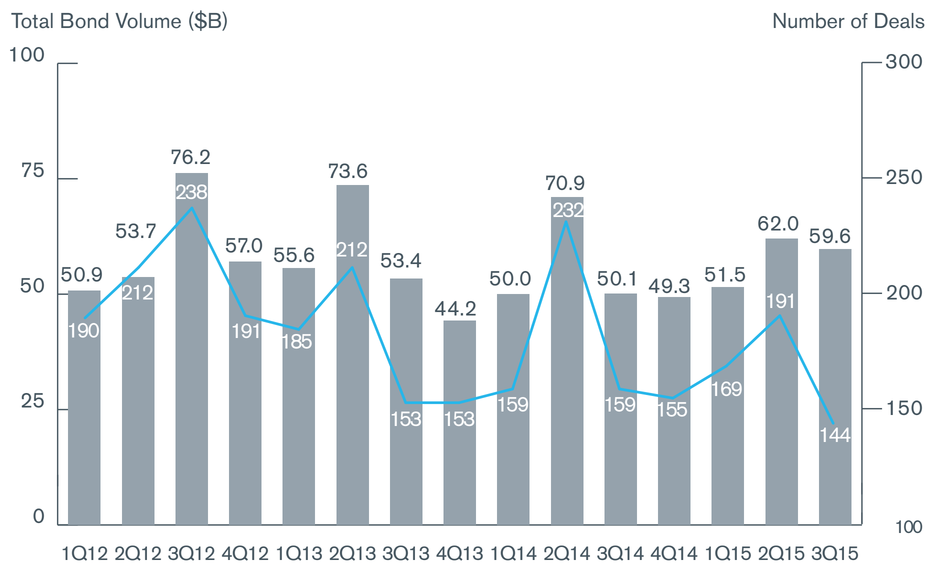
Leverage Multiples	EBITDA of $10MM - $20MM	EBITDA of $20MM - $50MM
Senior Debt	2.50x - 3.25x	2.00x - 4.00x
Total Debt	3.75x - 4.50x	4.00x - 5.25x

Pricing	EBITDA of $10MM - $20MM	EBITDA of $20MM - $50MM
First Lien	Libor + 3.00% - 4.00%	Libor + 2.75% - 3.50%
Second Lien	Libor + 6.50% - 9.50%	Libor + 6.00% - 9.00%
Subordinated Debt	11.00% - 13.00%	10.00% - 12.00%
Unitranche	Libor + 6.50% - 9.00%	Libor + 6.00% - 8.50%

New Issuance

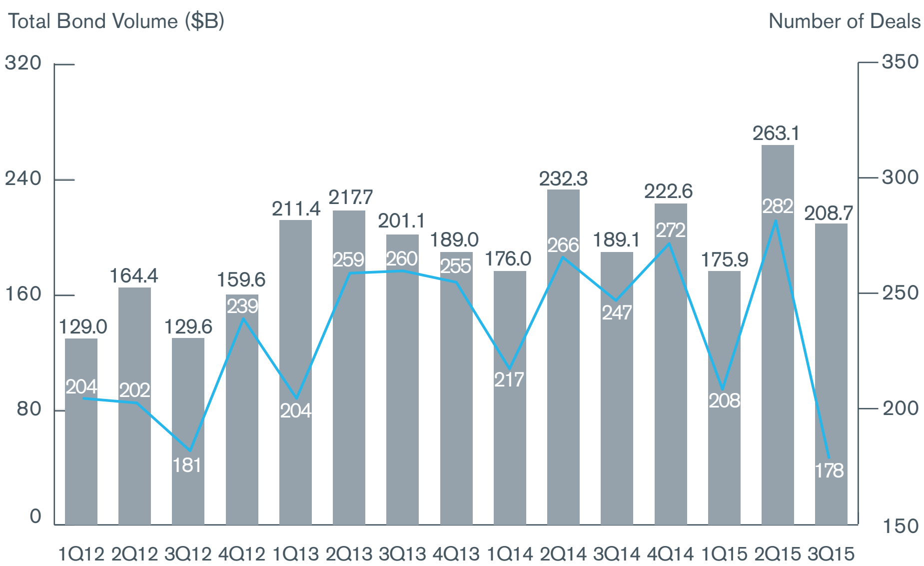
New issuance volume of high yield bonds and leveraged loans was strong for most of the third quarter, having largely kept pace with activity levels in the first two quarters of 2015. Market volatility late in the third quarter led to a material slowdown in primary issuance, however. Notably, the slowdown in leveraged loan issuance was materially greater than that experienced in the bond market, presumably reflecting the expectation of increasing short term interest rates.

Total High-Yield Bond Issuance



Source: SDC Platinum

Total Loan Issuance

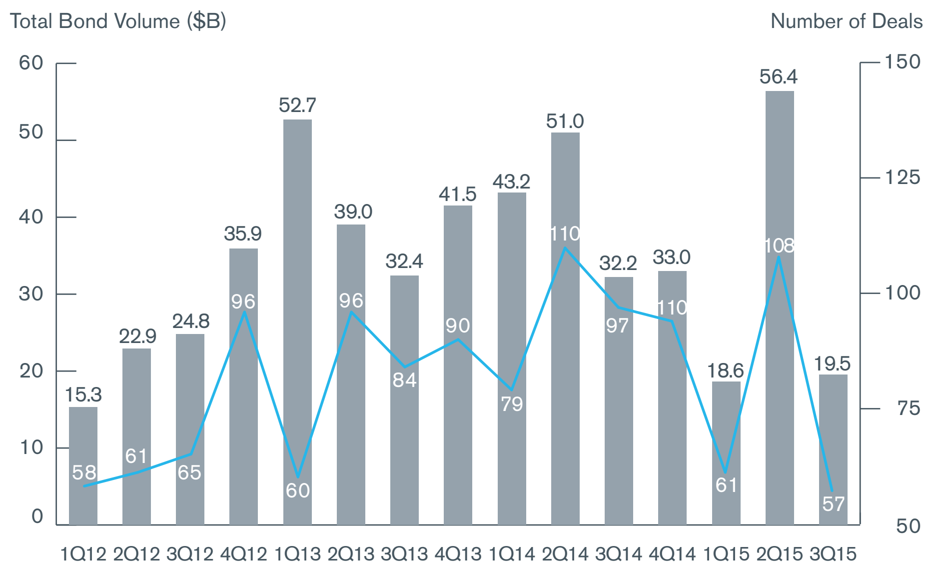


Source: SDC Platinum

New Issuance - Continued

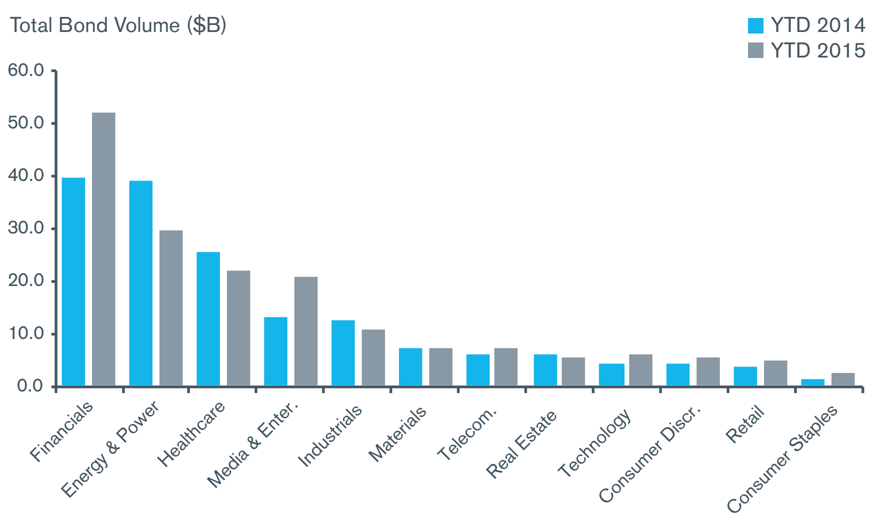
The energy and power vertical experienced the sharpest drop in activity, a decline of 54% in the quarter and 25% YTD versus last year (by dollar volume). As collateral bases continue to decline in the space, we anticipate further shrinking in bank debt exposure (largely through redeterminations).

Total Loan Issuance EBITDA < $50MM



Source: SDC Platinum

U.S. High Yield Bonds by Industry (YTD through Q3)

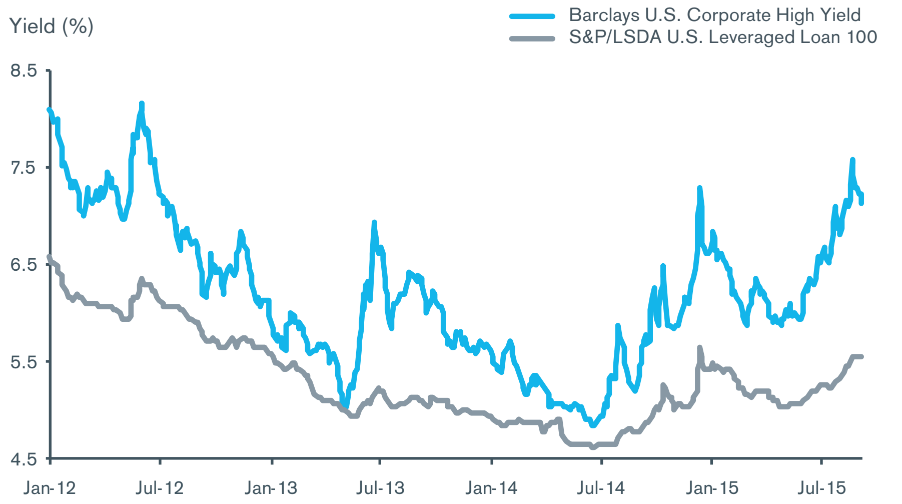


Source: SDC Platinum

Yields

Yields on high yield bonds and leveraged loans rose 153bps and 42bps, respectively, this quarter. A modest "flight to quality"—especially as the slowdown in economic activity in China became apparent—drove Treasury yields down. The increase in risk premiums, however, dominated as the quarter progressed.

U.S. Corporate High Yield Bonds and Leveraged Loans



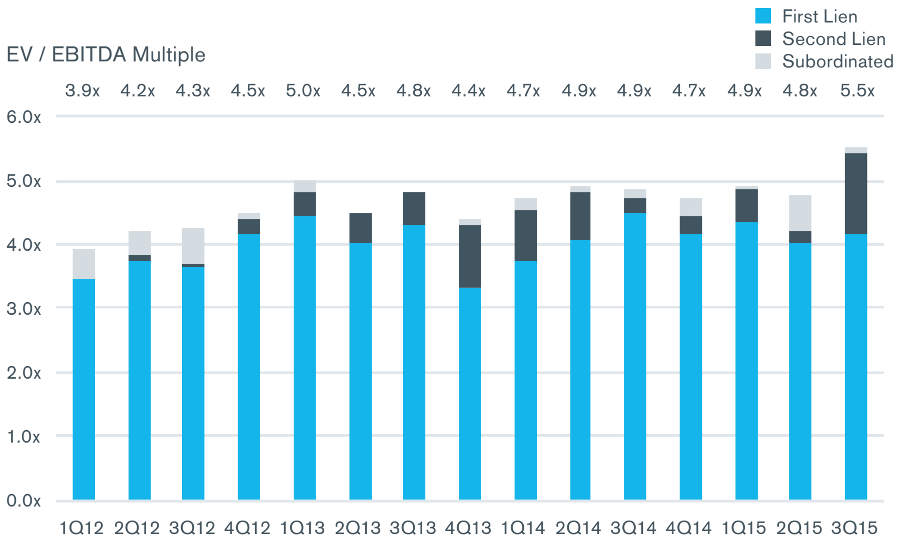
Source: SDC Platinum

Acquisition Financing

Leverage multiples for middle market change-of-control financings increased by approximately a half turn of EBITDA in the quarter, to ~5.5x, attributable in part to a higher proportion of larger deals. Notably, the increase was funded almost wholly by junior capital providers.

Anecdotally, in recent weeks we have observed a considerable tightening of credit parameters among regional banks (and, to a lesser degree, money center banks). Lenders with whom we transact attribute the tightening to worries about energy-oriented exposure at least as much as macroeconomic conditions. We anticipate, at this writing, a reordering of capital structures on de novo financings such that one half to a full turn of leverage will reside in a junior position until present challenges are resolved.

LBO Leverage Multiples (EBITDA < $50 MM)



Source: SDC Platinum

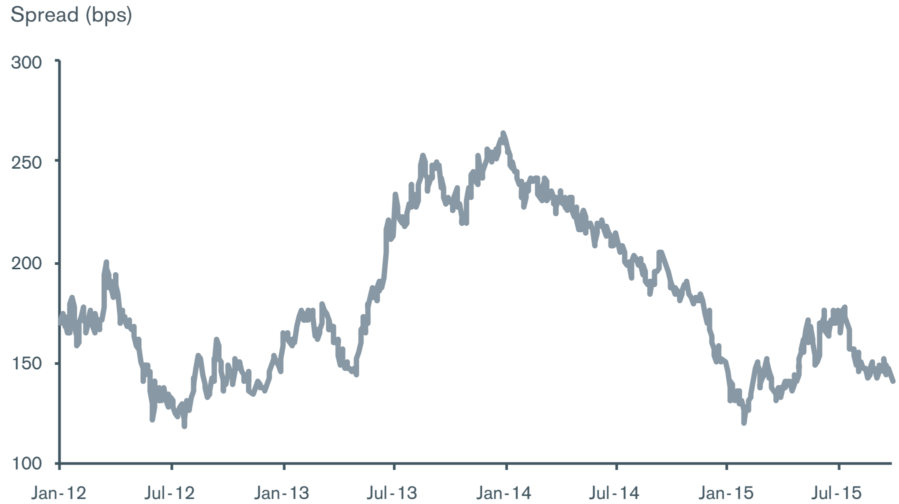
Macroeconomic Update

In spite of continuing improvement in domestic economic conditions, particularly the labor market, the quarter was characterized by a steady stream of exogenous cross currents.

Slowdowns in Southern Europe, Brazil, and China, Japan and South Korea led to a relative strengthening of the US dollar as well as a sharp downturn in commodity demand. The European Central Bank and central banks in Japan and China moved aggressively to cut interest rates, employ quantitative easing and selectively intervene in public capital markets.

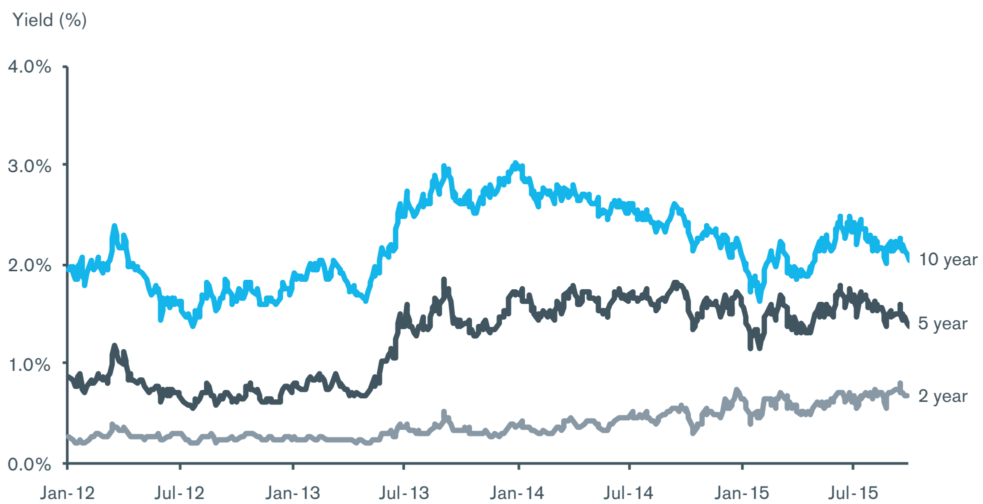
Expectations for most of the quarter of a tightening in US monetary policy (accompanied by a flattening of the yield curve) were dashed in deference to continuing global weakness and the associated decline in U.S. export related activity.

2 Year vs. 10 Year Treasury Spread



Source: Bloomberg

2, 5 and 10 Year Treasury Yields

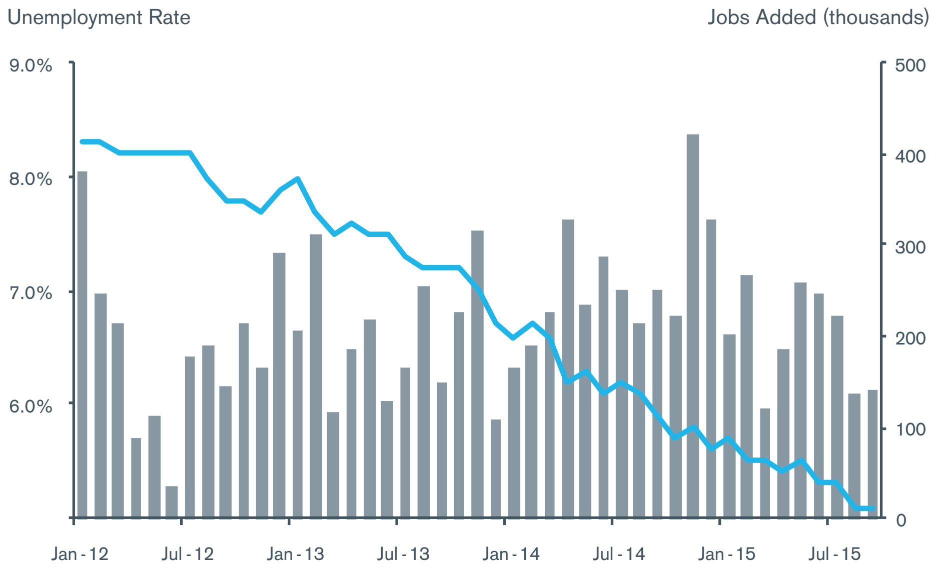


Source: Bloomberg

Macroeconomic Update - Continued

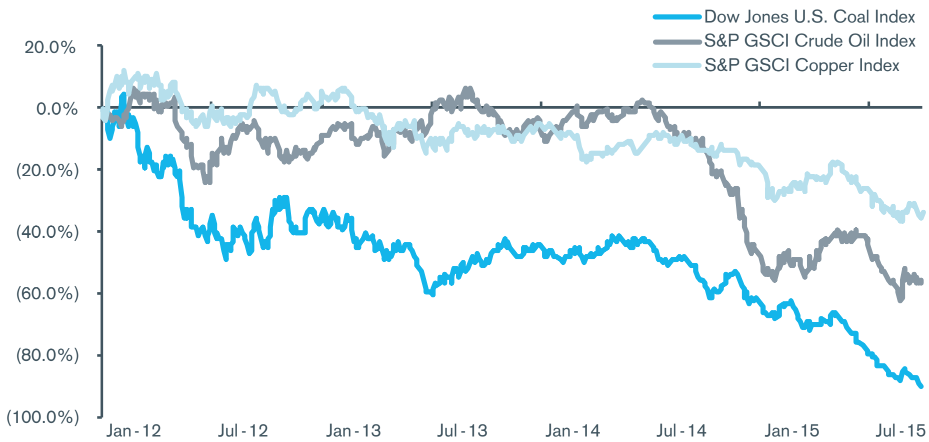
The availability and cost of leverage for middle market issuers held up quite well relative to those of the public markets in the third quarter. A combination of fuller covenant protection for private securities and unabated private investor demand largely offset the effects of the quarter's macroeconomic headwinds. Consequently, middle market issuers continue to enjoy the benefits of "full" leverage, albeit at a slightly higher weighted cost reflecting greater reliance on junior capital.

U.S Employment



Source: Federal Reserve

Global Commodity Indices



Source: Capital IQ

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