Duff & Phelps

Industry Insights:

Capital Markets

Q2 2016

Highlights

Credit providers vigorously pursued well-structured offerings by middle-market issuers throughout the second quarter

Demand for new issuance was driven by a strong crossover bid, a build-up of credit fund “dry powder” and modestly growthful macroeconomic conditions

Acquisitive middle-market issuers capitalized on lenders’ increased risk appetite by entering into attractively priced and structured financings, including facilities consisting of both immediately drawn and open ended acquisition tranches

While U.S. monetary policy took center stage briefly in June, weak labor market data kept the Fed largely on hold throughout the quarter

The dramatic rally in Treasury yields (and other safe haven assets) triggered by the “Brexit” referendum at quarter’s end, augurs well for further improvement in domestic credit market conditions

Executive Summary

Middle-market issuers enjoyed another quarter of strong demand from credit providers. Competition among lenders for new offerings triggered a rally in pricing, covenant protection, and, in particular, prepayment terms. Further, leverage levels moved up by approximately a half turn of EBITDA over the prior quarter.

Investment demand was strong among most genres of private market participants, in particular credit funds approaching investment period limits. Crossover interest from high-yield and leveraged loan buyers, resulting from a modest pace of large cap deals, added further to competition for middle-market new issuance.

We observed a marked increase in risk appetite this quarter among commercial banks in transactions offered by Duff & Phelps. Conversely, we noted continued tepid demand from the mainstream BDC community.

Opportunistic borrowers have increasingly called on us to provide financing in support of contemplated bolt-on acquisitions. Such financings oftentimes are structured as dual-tranche facilities that include both an immediately drawn portion and an unfunded acquisition line. The combination of attractively priced debt and modest macroeconomic growth suggests continued activity of this type in the coming quarter.

We believe market conditions for middle-market issuers are compelling. Attractive base interest rates, credit spreads, leverage levels and prepayment terms allow issuers to craft contracts tailored to reflect idiosyncratic priorities. While exogenous risks—“Brexit” contagion, energy supply disruptions, terrorist attacks—remain chronic concerns, risk appetite among credit providers continues to be keen.

Indicative Middle-Market Credit Parameters

Leverage Multiples	EBITDA of $10MM - $20MM	EBITDA of $20MM - $50MM
Senior Debt	2.50x - 3.50x 2.25x - 3.25x	3.00x - 4.00x 2.50x - 3.50x
Total Debt	4.00x - 4.50x 3.75x - 4.25x	4.50x - 5.50x 4.00x - 5.00x

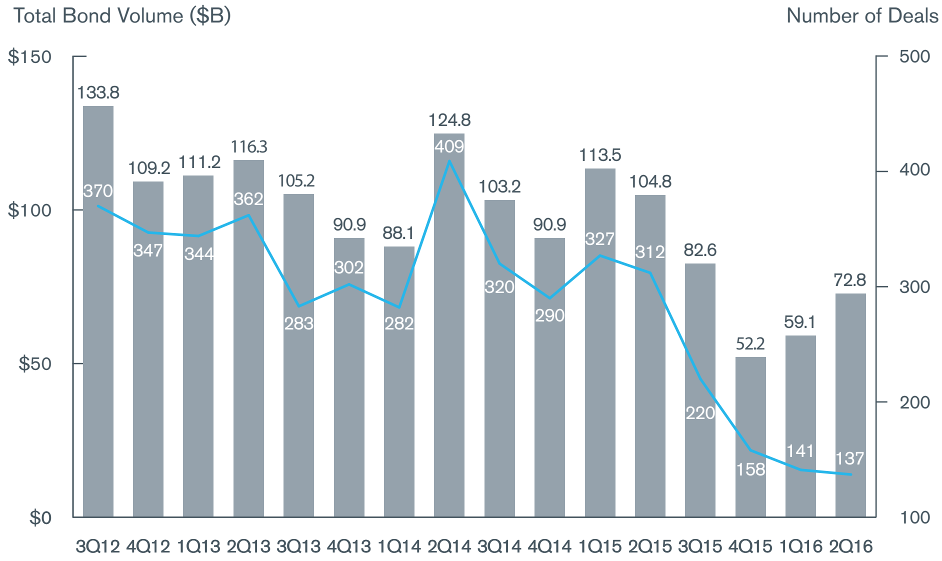
Pricing	EBITDA of $10MM - $20MM	EBITDA of $20MM - $50MM
First Lien	Libor + 2.75% - 3.50% (bank) Libor + 3.00% - 4.00% (bank) Libor + 4.00% - 6.00% (non-bank)	Libor + 2.50% - 3.25% (bank) Libor + 2.75% - 3.50% (bank) Libor + 4.00% - 6.00% (non-bank)
Second Lien	Libor + 6.50% - 9.50%	Libor + 6.00% - 9.00%
Subordinated Debt	11.00% - 13.00%	10.00% - 12.00%
Unitranche	Libor + 6.50% - 9.00%	Libor + 6.00% - 8.50%

Note: Data in red reflects change vs. Q1, if applicable.

New Issuance

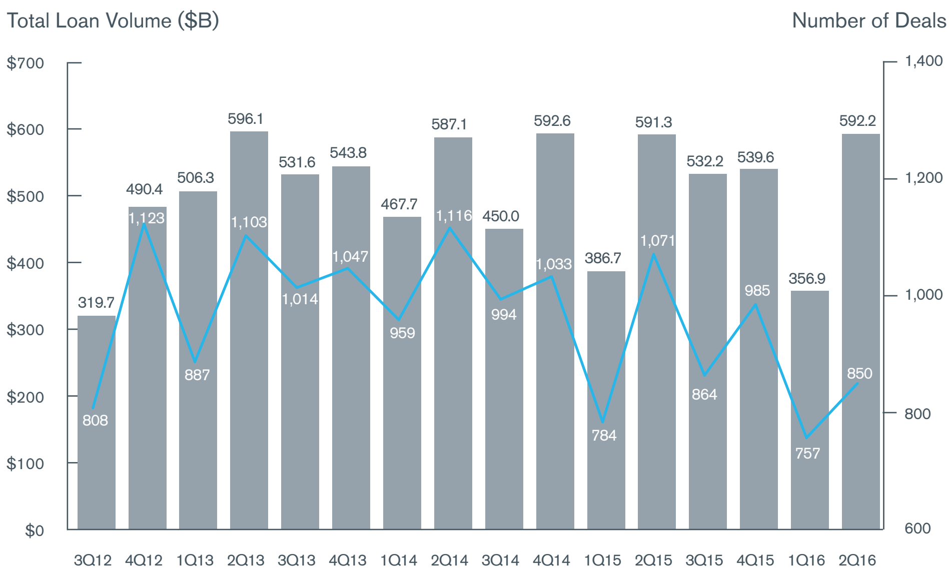
The number of high-yield issuances this quarter reflected a modest decline in activity. (However, dollar volume improved due to a handful of aberrational large offerings). The number, and, to a greater extent, dollar volume of new loan issuance improved this quarter as a result of pent up demand and increasing risk appetite.

Total High-Yield Bond Issuance



Source: SDC Platinum

Total Loan Issuance

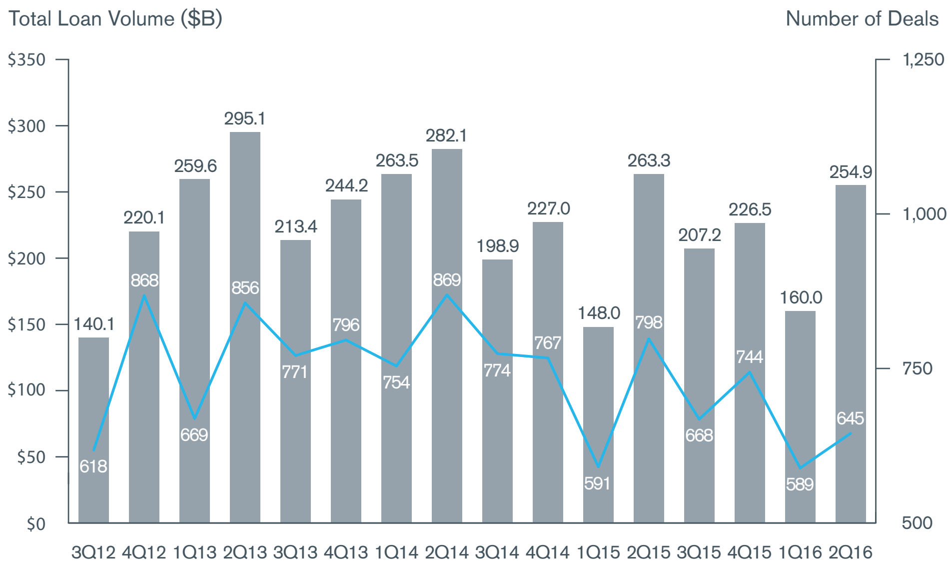


Source: SDC Platinum

New Issuance - Continued

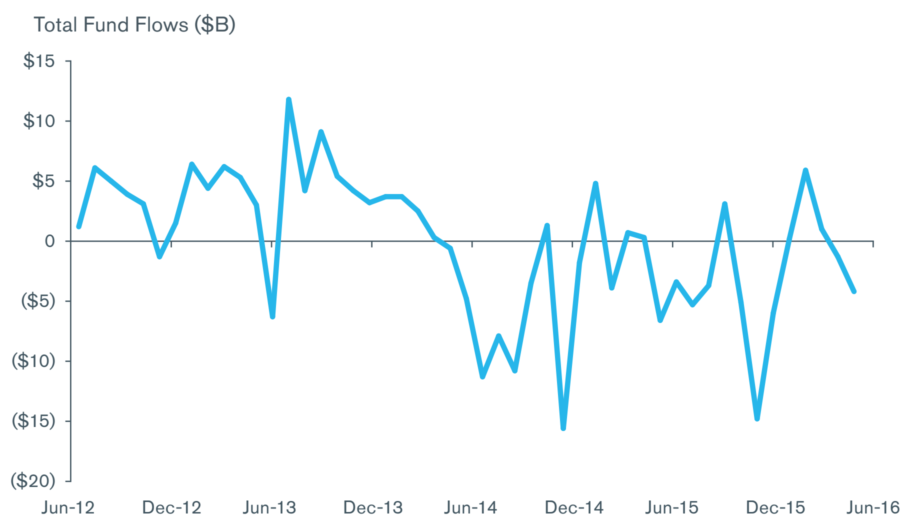
CLO issuance rebounded to levels seen in the third and fourth quarters of last year, in terms of both number and volume. Leveraged loan funds remained largely constant. High-yield bond funds, however, continued to experience net outflows.

Total Loan Issuance (EBITDA < $50MM)



Source: SDC Platinum

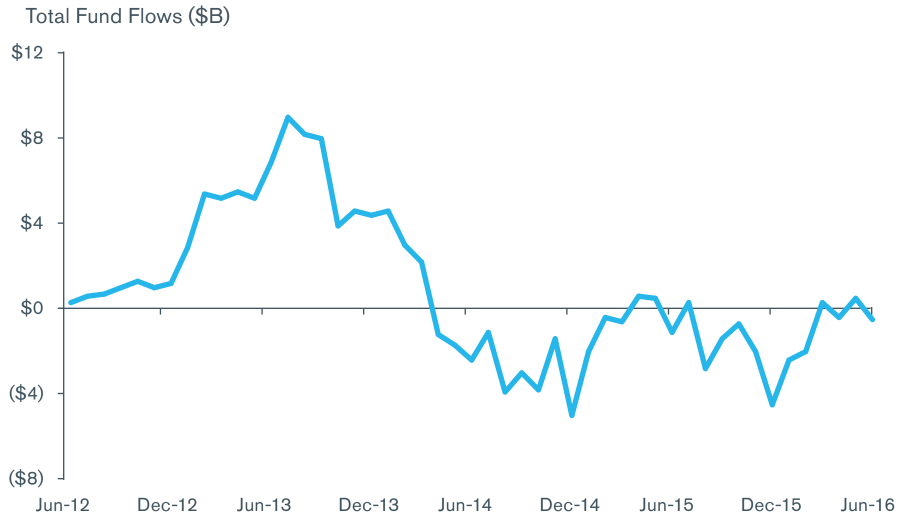
High-Yield Bond Mutual Fund Flows



Source: Investment Company Institute

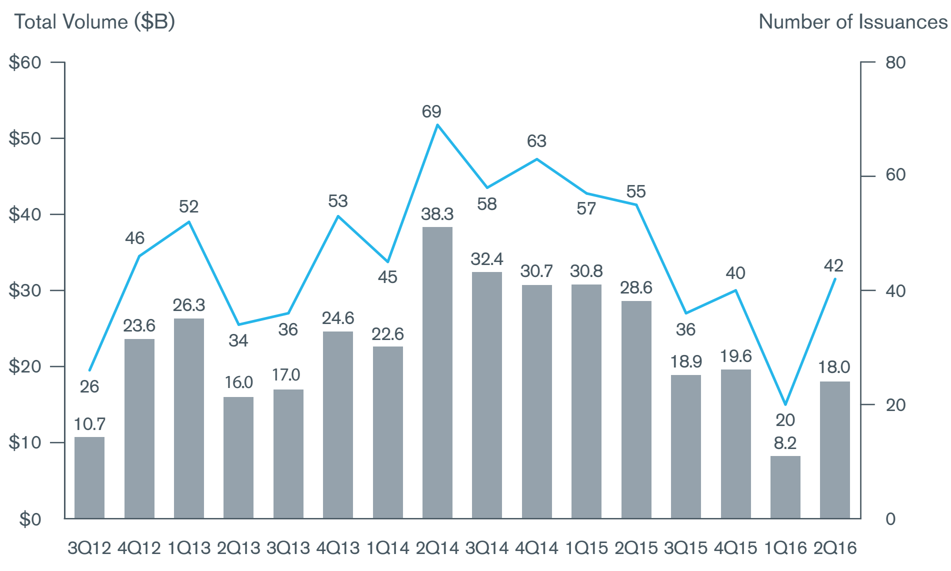
New Issuance - Continued

Leveraged Loan Mutual Fund Flows



Source: Lipper FMI

Total CLO Issuance



Source: SDC Platinum

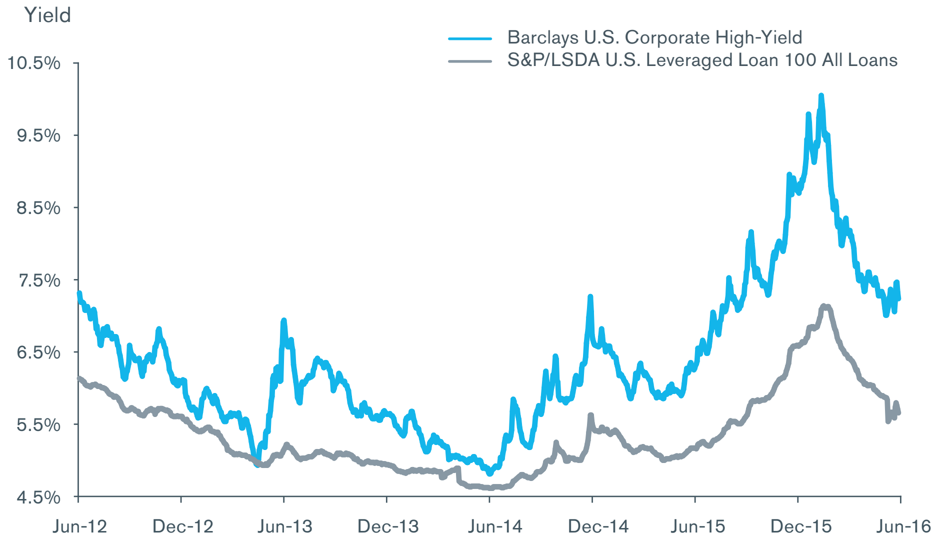
Yields

Yields on high-yield bonds and leveraged loans rallied 90 bps and 80 bps, respectively, during the quarter. Modestly positive economic growth, benign monetary policy and tepid labor market conditions all contributed to the rally. The rally accelerated sharply in the last two weeks of the quarter on the heels of the "Brexit" vote and subsequent flight to quality.

Spreads between high-yield bonds and leveraged loans tightened significantly since the yield spike at the beginning of 2016. Spreads narrowed approximately 145 bps since January, as the risk of fixed rate versus floating rate debt diminished.

The spread between the two year and the ten year Treasury yields narrowed further, reflecting the expectation of a continued low interest rate environment.

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



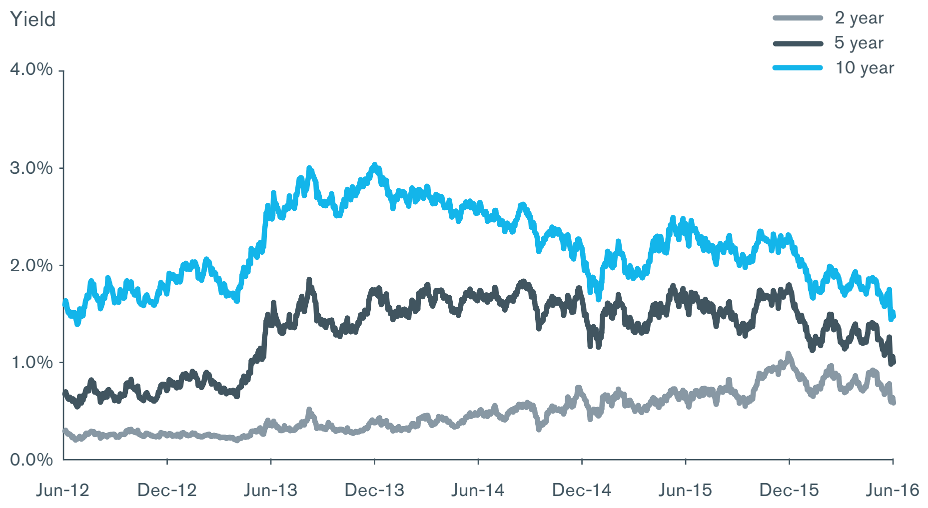
Source: SDC Platinum

2 Year vs. 10 Year Treasury Spread

Source: SDC Platinum

Yields - Continued

2, 5, and 10 Year Treasury Yields

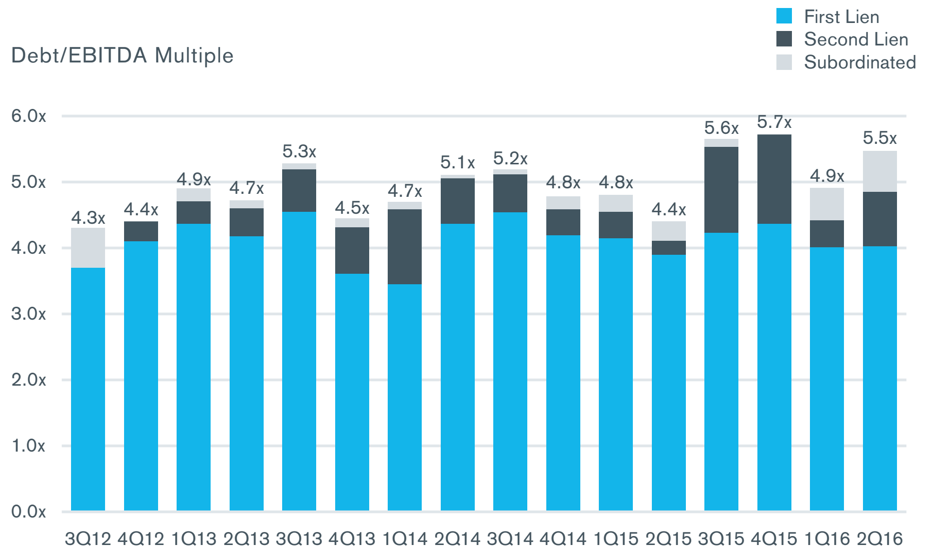


Source: SDC Platinum

Acquisition Financing/Dividend Recapitalization

Leverage multiples for middle-market change-of-control financings regained the recent highs seen in the second half of 2015. While traditional senior lenders generally held to leverage levels of the prior quarter, second lien and subordinated lenders increased total leverage appetite by approximately half a turn of EBITDA.

Leverage Multiples (EBITDA < $50MM)

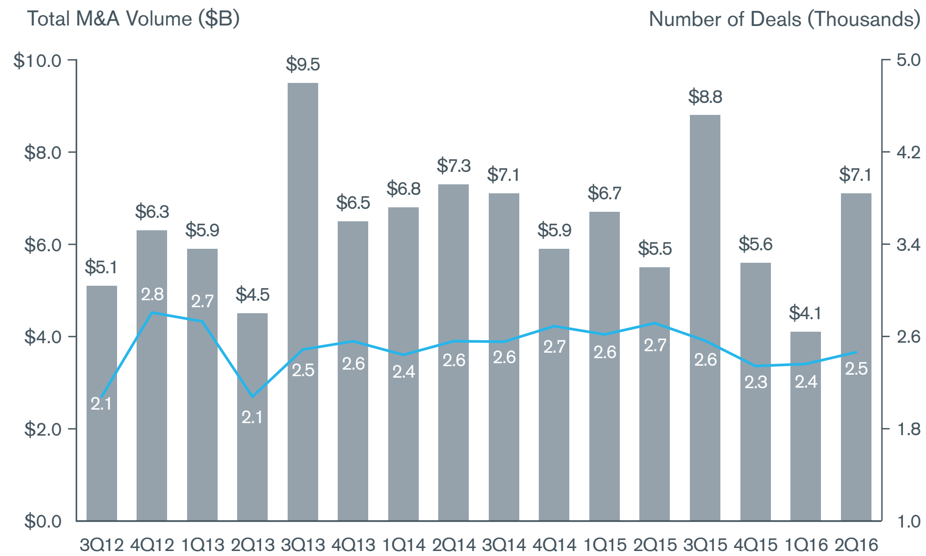


Source: SDC Platinum

Acquisition Financing/Dividend Recapitalization - Continued

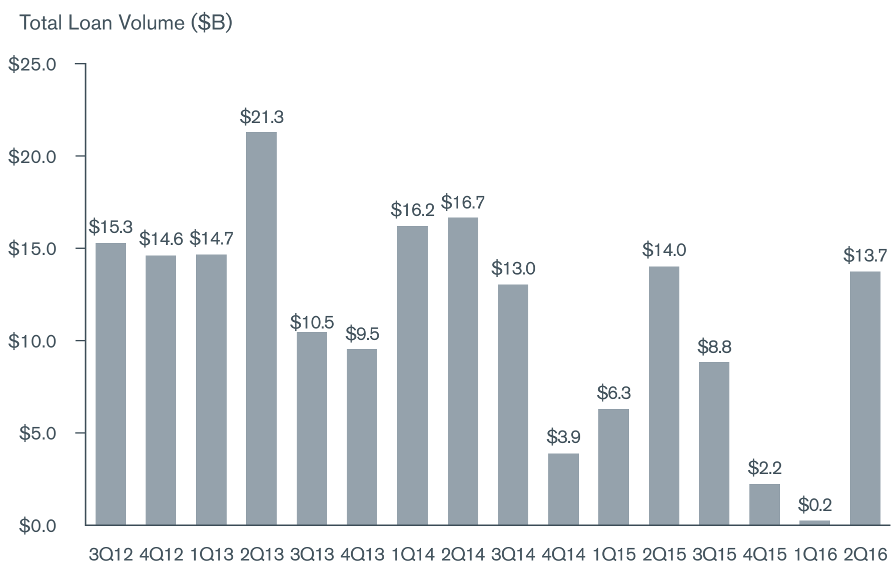
Leveraged recapitalizations resurfaced this quarter, after two quarters of de minimis activity. Exit constraints (most notably, a tepid IPO environment) combined with strong credit conditions suggest a strong environment for recaps in the coming quarter.

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



Source: SDC Platinum

Loan Issuance for Dividend Recapitalizations



Source: SDC Platinum

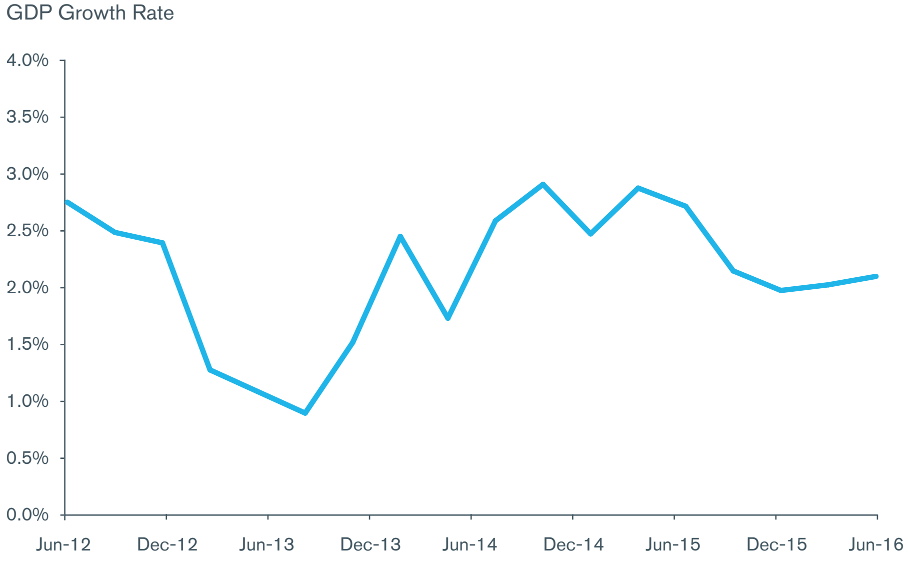
Macroeconomic Update

Muted hiring, in conjunction with low inflation readings, hampered the Fed's plans for a June rate hike. The Fed remains data driven, with markets now expecting just one rate hike this year.

The U.S. economy grew at a 2.1% rate in the quarter, representing a modest improvement over the prior quarter. Equity markets were volatile, particularly in June, but indexes ultimately increased approximately 1.5%, on average. Meanwhile, commodities continued the rally begun in the first quarter, with gold and oil prices up 18% and 7%, respectively. In spite of significant volatility, most notably in June, the quarter ended positively.

The recent referendum in Great Britain to exit the European Union, surprised investors (and policy makers). The "Brexit" vote triggered a dramatic flight to traditional safe haven assets, resulting in sharp rallies in U.S. Treasury and precious metal markets, in particular. M&A activity, as well as bank lending, in the UK has already slowed, pending further policy clarity. (At this writing, the contemplated pace of UK decoupling from the EU is slowing, with market conditions having already largely reverted to pre-"Brexit" circumstances).

U.S. Real GDP Growth



Source: Federal Reserve Bank of St. Louis

DUFF & PHELPS

Global Capital Markets Commitment

Duff & Phelps provides our clients worldwide institutional investor coverage, with dedicated Capital Markets teams resident in New York, London and Hong Kong. Our comprehensive footprint allows us to access capital in all geographies and across the panoply of investment strategies.

Contact Us

U.S. Contacts

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

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

Dave Althoff
Global Co-head of Industrials M&A
+1 312 697 4625
david.althoff@duffandphelps.com

Josh Benn
Global Head of Consumer, Retail, Food, and Restaurants
+1 212 450 2840
josh.benn@duffandphelps.com

Brian Cullen
Head of U.S. Restructuring
+1 424 249 1645
brian.cullen@duffandphelps.com

Brooks Dexter
Global Head of Healthcare M&A
+1 424 249 1646
brooks.dexter@duffandphelps.com

Kevin Iudicello
Managing Director, Technology M&A
+1 650 354 4065
kiudicello@pmib.com

Jon Melzer
Global Co-head of Industrials M&A
+1 212 450 2866
jon.melzer@duffandphelps.com

Jim Rebello
Global Head of Energy M&A
+1 713 986 9318
james.rebello@duffandphelps.com

Canadian Contacts

Ross Fletcher
Head of Canada M&A
+1 416 361 2588
ross.fletcher@duffandphelps.com

Brian Pawluck
Managing Director, Canada Restructuring
+1 416 364 9756
brian.pawluck@duffandphelps.com

UK Contact

Ken Goldsbrough
Managing Director, European Debt Advisory
+44 (0) 20 7089 4890
ken.goldsbrough@duffandphelps.com

For more information please visit: www.duffandphelps.com

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