William Blair

Leveraged Finance

Q3 2017

Borrower-Friendly Environment Reaches New Heights

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Borrower-Friendly Environment Reaches New Heights

Building on trends that gained momentum throughout the first half of the year, the third quarter saw continued strong market dynamics that led to favorable pricing, leverage, and terms for middle-market borrowers.

Leveraged finance markets remained highly borrower-friendly in the third quarter. Sixty percent of respondents to the William Blair Leveraged Lender Survey indicated that they provided higher leverage and looser terms during the quarter, while 57% reported lower pricing. A more telling sign of the state of the lending environment may be that not a single lender surveyed reported tightening terms, and only one lender reported increasing pricing during the third quarter. In addition, the William Blair Leveraged Lending Index reached its most borrower-friendly level since the metric was instituted in 2014; other key metrics included in the survey also reached record levels.

The positive market conditions were driven by several factors, notably the nearly $30 billion of increased capital flows targeting middle-market credit so far in 2017. These inflows came via fundraising activity for new and existing credit funds and middle-market CLO issuances. The need to deploy this newfound capital is causing more deals to be executed on a sole lender basis versus the historical norm of "clubbing up" a group of two or three lenders. This is causing an already-competitive market to become even more so and driving improved terms for borrowers.

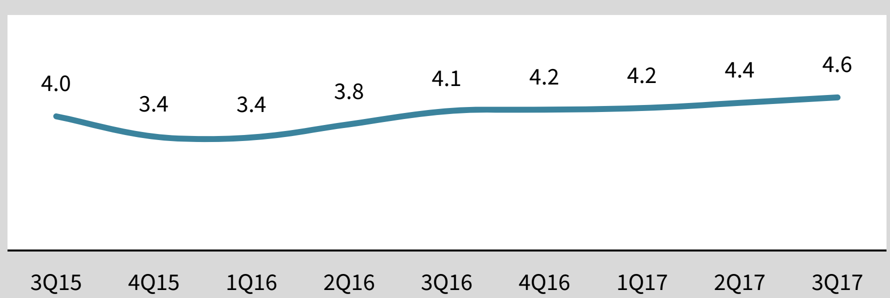
The middle-market sponsor LBO financing environment also remains strong, with LBOs accounting for roughly 50% of total middle-market lending volumes during the third quarter. According to William Blair's proprietary Mid-Market LBO Financing Database, average senior pricing (spread plus LIBOR) in LBOs declined to 5.2%, approximately 45 basis points lower than the second quarter and 85 basis points lower than the third quarter of 2016. A similar yet less dramatic trend was observed in the unitranche market, which saw average pricing decline to 7.2%, five basis points lower than the second quarter and nearly 60 basis points lower than year-ago levels.

Average total leverage across all sectors for financings ranging from $45 million to $500 million decreased slightly from 5.7x in the second quarter to 5.3x. The decline is attributable to a greater proportion of industrial, manufacturing, and financial services transactions in this quarter's sample; these sectors typically garner less-than-peak market leverage. Excluding these transactions, average total leverage would have remained consistent at 5.7x.

With the already borrower-friendly environment showing continued improvement, the natural question is, how much longer can this run continue? The early data suggests that this market is here to stay for at least the next several months. Virtually all

William Blair Leveraged Lending Index Continues Record Climb

Each quarter, William Blair's Leveraged Finance Survey asks middle-market lenders to rate overall conditions in the leveraged finance market on a scale of 1 to 5, with 5 being the most borrower-friendly conceivable. In our latest survey, 97% of respondents indicated that the market was borrower-friendly (a rating of 4 or 5), the highest level ever observed.



respondents to our survey expect stable or even more favorable terms for the remainder of 2017.

Competition Drives Superior Terms

William Blair has observed increasingly aggressive execution terms in situations where there are multiple lenders competing to win a transaction. In the latest Lender Survey, 73% of respondents indicated that they made concessions that they historically would not have made to win a transaction during the third quarter. Not surprisingly, reduced rates and fees were the most often cited concessions.

Financial covenants, or the lack thereof, is another area of negotiation where lenders have been able to differentiate themselves from competitors. More than half of the respondents indicated increasing covenant cushions or reducing the number of financial covenants (usually to a single leverage test). We have observed and heard of single-covenant deals where the covenant is set "high, wide, and flat." This effectively provides borrowers with a covenant-lite transaction because the covenant is set at a significant cushion to closing leverage—which, in an LBO, typically represents peak leverage—and remains at that level for the life of the deal. In addition, 17% of respondents indicated that they had executed on a covenant-lite basis to win a transaction. Lenders may be more willing to execute with a high, wide, and flat covenant versus going covenant-lite, as lenders may still be able to obtain fund leverage on the transaction if it maintains a financial covenant.

While pricing, leverage, and covenants are the most notable benefits for borrowers, competition among lenders also has caused other documentation points to become more borrower-friendly. Lenders are increasingly comfortable with more generous EBITDA add-backs, looser restricted payments terms, and larger baskets.

Middle-Market High-Yield Issuances: Significant Inflows Drive Strong Demand

U.S. high-yield funds experienced an inflow of $2.2 billion in the third quarter, followed by a $967 million inflow in the first full week of October. These large inflows have deepened the supply and demand imbalance in the markets, causing many mutual funds to participate in middle-market non-index-eligible (sub-$250 million) high-yield offerings. There have been 15 high-yield transactions of approximately $250 million or less completed year-to-date. These offerings, which had an average yield of 8.1%, were on average 244 basis points higher than the BAML U.S. High-Yield Index on issuance date.

Demand for these transactions is a result of several factors, including bespoke structures, greater access to diligence and management teams, and the ability to capture middle-market yield premiums relative to larger deals with similar risk profiles. A number of industry participants have told William Blair that they pursued smaller issue sizes in response to tightening spreads across the broader high-yield market during 2017. Market sources have also noted increased appetite for issuers in the consumer products, IT/software, and media and telecom sectors.

Portability Enters the Middle Market

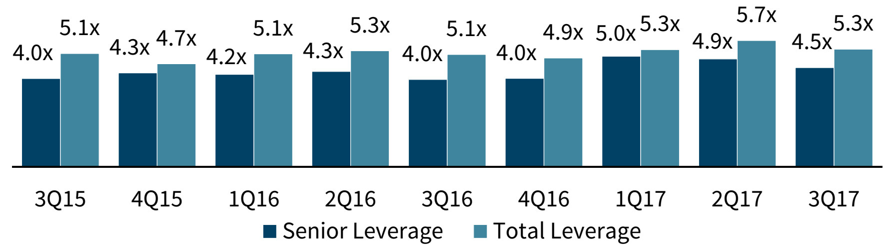
Portability, documentation language permitting the future sale of the borrower without triggering change-of-control provisions, is well-established for larger, rated borrowers. It now has become an option for select middle-market borrowers. Lenders today are more willing to entertain granting portability for middle-market borrowers when enterprise value is readily ascertainable and is typically subject to certain leverage and potential buyer qualifications at the time of the sale. In the latest William Blair Lender Survey, 32% of lenders indicated that they executed at least one transaction with portability language in the third quarter. Portability can be an effective tool when paired with a pre-capitalization transaction, allowing the sponsor to monetize a portion of its investment in advance of running a full sale process, demonstrating the "financeability" of the business and establishing a leverage floor for potential buyers.

Leveraged Finance Market Analysis

Each quarter we look behind the numbers to examine the market dynamics that are driving trends in pricing and volume in leveraged finance transactions.

Middle-Market LBO Leverage Multiples

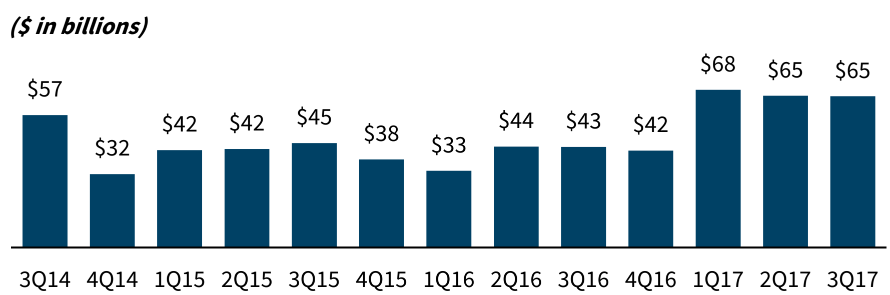
Average total leverage multiples for middle-market LBOs remained healthy in the third quarter, despite a greater proportion of deals from sectors that historically garner lower leverage.



Source: William Blair Proprietary Mid-Market LBO Financing Database

Institutional M&A Volume

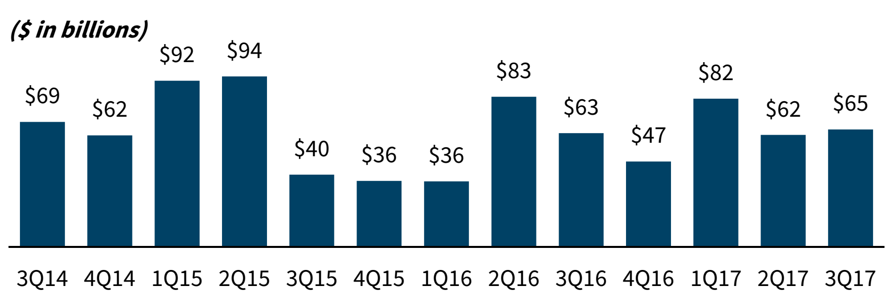
M&A continues to be a strong driver of lending activity. In the third quarter, M&A accounted for 61% of total volume, a steady increase from 40% in the first quarter. The $65 billion of M&A volume represented the strongest third quarter in history, and the $198 billion of YTD volume is already 23% greater than full year 2016 levels.



Sources: S&P LCD

High-Yield Bond Volume

New-issuance high-yield volume remained strong in the third quarter, and 2017's YTD volume already is 91% of full year 2016 levels. M&A accounted for 28% of third-quarter volume, the highest proportion since the first quarter of 2016.



Sources: S&P LCD

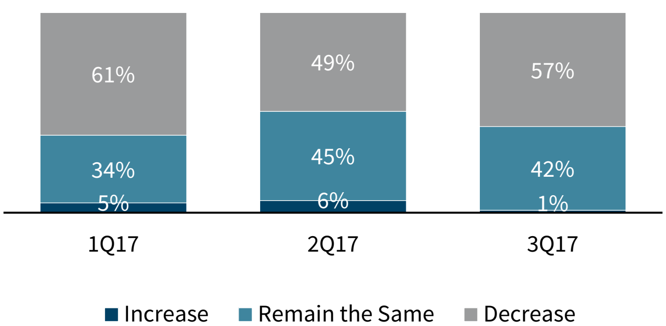
Highlights From William Blair's Third Quarter 2017 Leveraged Finance Survey

Each quarter William Blair surveys middle-market leveraged finance professionals representing leading credit funds, BDCs, commercial finance companies, commercial banks, and other credit providers to measure sentiment in the leveraged finance market. The data reflects the responses from the 88 leveraged finance professionals who participated in the survey this quarter.

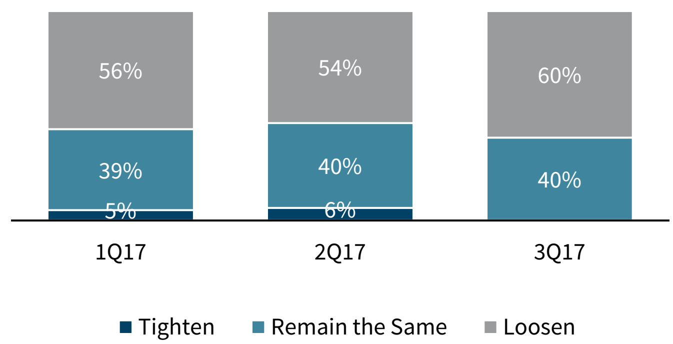
Middle-Market Leveraged Lending Environment Favors Borrowers

Pricing and terms have followed the borrower-favorable trends seen over the first half of 2017. In the third quarter, nearly 60% of respondents experienced decreased pricing, higher leverage, and looser terms.

Pricing



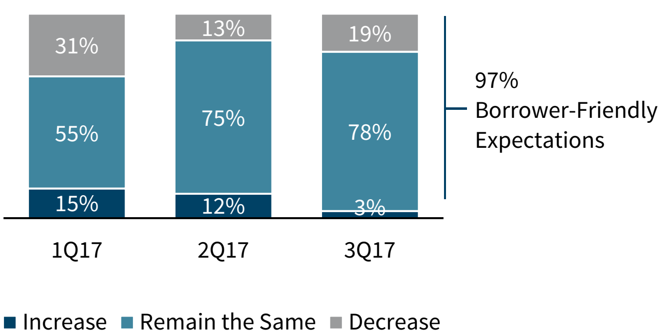
Leverage and Terms



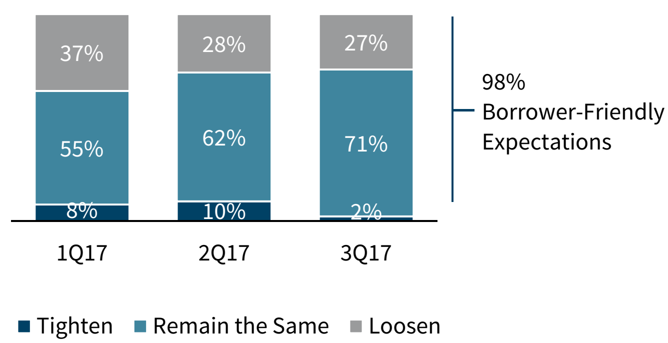
Lending Expectations for Remainder of 2017

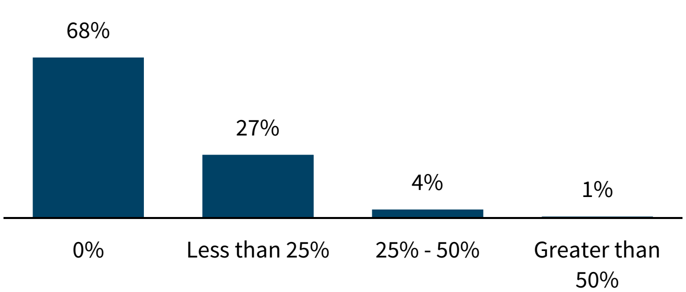
Market participants expect the middle-market lending environment to remain favorable for borrowers over the remainder of the year.

Pricing



Leverage and Terms





Portability Enters the Middle Market

This quarter we surveyed lenders to understand how deep the concept of portability has penetrated the middle market. Nearly one-third of lenders noted executing at least one transaction with portability during the quarter. Given the increasing use of borrower-favorable documentation, it will be interesting to see whether this percentage continues to rise over the next several quarters.

Drawing on our deep product expertise and the strength of our relationships, William Blair has built a leading leveraged finance franchise. Sponsors and business owners turn to us for outstanding execution in support of their capital-raising objectives.

Recent transactions include:

$255,000,000 Hudson Technologies Split Lien Credit Facilities October 2017	$80,000,000 Seaspan Senior Notes October 2017	$80,000,000 Unifund Multi-Draw Credit Facility September 2017
$250,000,000 enova financial Senior Notes September 2017	Not Disclosed Stampede Meat Split Lien Credit Facilities June 2017	$46,000,000 Alegeus Second Lien Term Loan April 2017

William Blair by the Numbers

90+

completed leveraged finance transactions since 2012

$14.5bn+

arranged financing since 2012

400+

lender and alternative credit provider relationships

William Blair's Leveraged Finance team structures and arranges debt capital in support of acquisitions, recapitalizations, and growth through its well established relationships with debt capital providers globally.

- $10.0 billion of completed/pending financing arranged since 2014
- Specialists who are experts in complex engagements, including those requiring insightful credit positioning and the arrangement of multiple layers of capital
- Robust distribution capabilities providing a 360° view of the market; relationships with over 400 lenders and significant transaction experience with alternative credit providers
- Real-time, proprietary view of the leveraged finance market from William Blair's global M&A and debt advisory practices
- Senior banker attention and unbiased, objective advice; senior bankers average more than 20 years of experience
- Thoughtful, customized financing processes that produce outstanding outcomes

Our expanded high-yield team complements our established leveraged loan arrangement capabilities with a team of bankers who have deep experience executing high-yield transactions for middle-market issuers.

- $5 billion+ of lead-managed high-yield financings across 30+ transactions since 2011
- Unique expertise in crafting middle-market structures and indentures
- Significant expertise relating "storied" credits to the market
- Extensive experience completing transactions for first-time issuers

With more than 150 senior bankers around the world, William Blair has completed more than 2,000 advisory and financing transactions totaling more than $200 billion in value for our clients*

Leveraged Finance

Kelly Martin
Managing Director
+1 312 364 8832
kmartin@williamblair.com

Michael Ward
Managing Director
+1 312 364 8529
mward@williamblair.com

Jeff Zolkin
Managing Director
+1 310 734 5809
jzolkin@williamblair.com

Travis Black
Director
+1 312 364 8761
tblack@williamblair.com

Jonathan Lee
Director
+1 310 734 5810
jlee@williamblair.com

Heather Mosbacher Reiner
Director
+1 212 237 2781
hreiner@williamblair.com

* In the past five years as of January 31, 2016

Disclosure

About William Blair Investment Banking

William Blair's investment banking group enables corporations, financial sponsors, and owner/entrepreneurs around the world to achieve their growth, liquidity, and financing objectives.

Drawing on the collective intellectual capital and deep sector expertise of a global team that reaches across more than 15 cities on four continents, the investment banking group brings a rigorous and innovative approach to corporate board advisory projects, mergers and acquisitions, and equity and debt financing. From 2012 to 2016, the team advised on more than $230 billion in completed transaction volume.