William Blair

Leveraged Finance

Q3 2019

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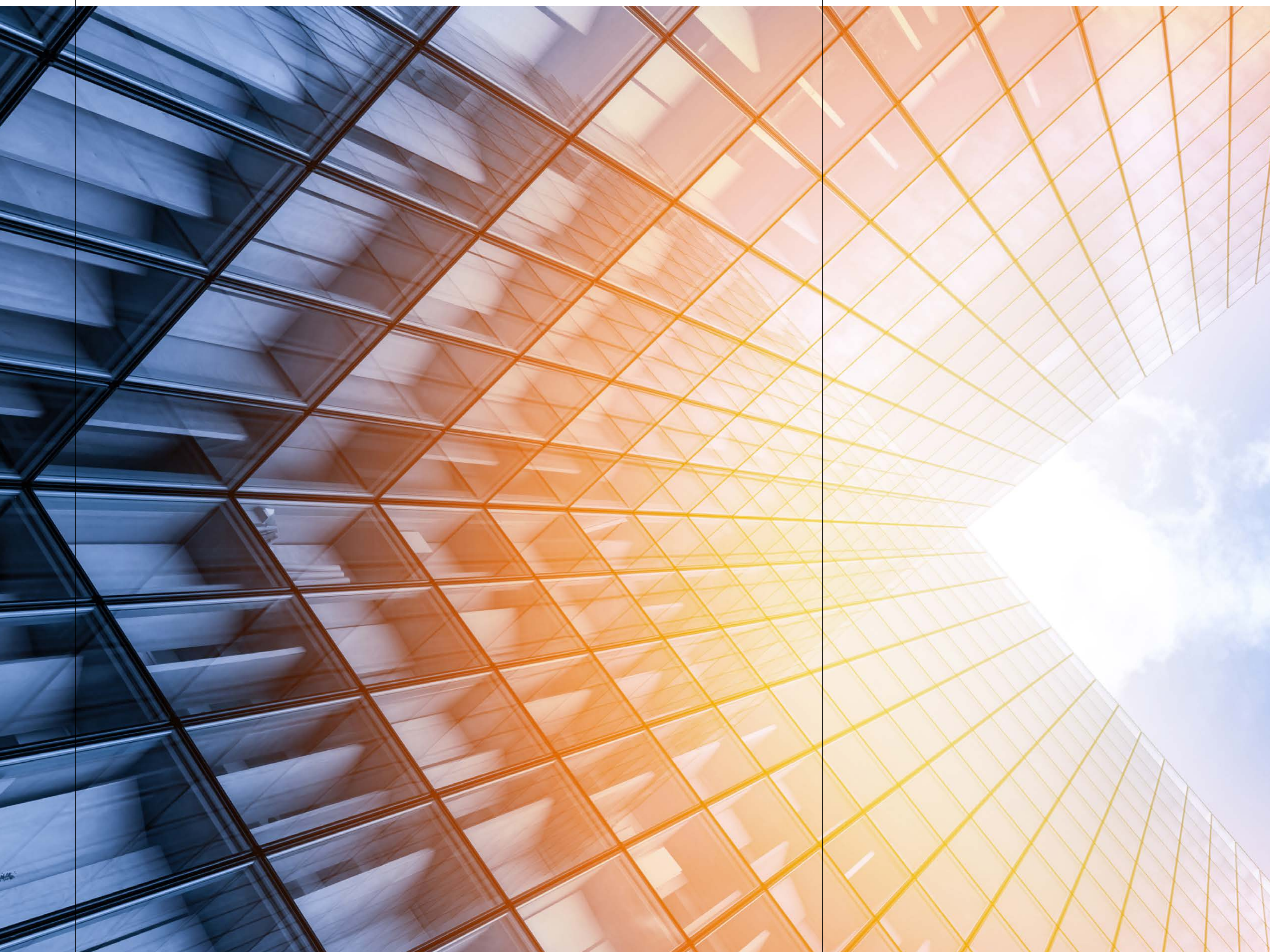


Resilient Leveraged Finance Market Becomes Increasingly Discerning in Q3

Against a challenging global backdrop, the leveraged finance market turned in a solid third quarter, as both borrowers and lenders found ways to be aggressive.

During the third quarter, participants in the leveraged finance market were forced to navigate a multitude of complicating factors, including escalating trade tensions, a violent shock to oil markets, an inverted yield curve, two Fed rate cuts, a formal impeachment inquiry, and broad concerns about both global and domestic growth. With that in mind, a pullback in leveraged lending activity wouldn't have been surprising.

However, despite the conditions, leveraged loan volume in the third quarter was $128 billion, up 15% from the previous quarter and up 7% year-over-year. Growth during the quarter was supported by institutional loan volume of $92 billion, up 31% from the prior quarter thanks to July and September being the two strongest months of 2019. While M&A-related volume increased 27% to $48 billion, the biggest contribution came from refinancing activity, which generated $35 billion of total volume, up 103% from the prior quarter and up 141% year-over-year. With higher-quality paper in demand and plenty of dry powder on the sideline, borrowers seized the opportunity to refinance existing debt, optimizing pricing and terms while pushing out maturities.

Although volume remained strong, overall market sentiment is beginning to trend in lenders' favor. The market has shown more discipline of late, with lenders particularly focused on structure and protecting value as we approach the end of the cycle, as opposed to searching for the best pricing opportunities.

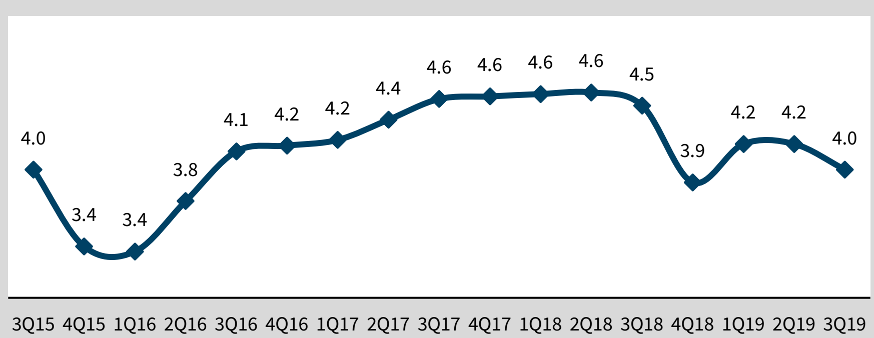
According to William Blair's proprietary Mid-Market LBO Financing Database, the average spread on unitranche pricing in LBOs during the third quarter fell by 25 basis points to L+550. Additionally, average senior pricing fell slightly from L+455 to L+450, while average second-lien spreads came down 15 basis points to L+850.

Leverage levels for the quarter also were slightly more aggressive, with average senior leverage in LBOs moving from 5.4x to 5.5x, while average total leverage increased from 5.8x to 6.0x. However, as was detailed in last quarter's newsletter, it is important to note that the market has become significantly bifurcated. While lenders remained aggressive, their focus on higher-quality borrowers likely contributed to this quarter's increase in average leverage levels.

Lenders' responses to William Blair's Leveraged Finance Survey in September confirmed these market dynamics. Although 20% of lenders still report decreasing their pricing, and another 20% reported loosening

William Blair Leveraged Lending Index Trending in Lenders' Favor

Each quarter we ask 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. After reaching and maintaining its peak of 4.6 for a full year, the last five quarters have seen the index steadily trend in lenders' favor.



terms and leverage, both of those figures are the lowest they have been since the first quarter of 2016. William Blair's Leveraged Lending Index, which began to turn more lender-friendly in the third quarter of 2018, has mirrored that trend. The index, which measures conditions in leveraged lending markets on a scale of 1 (the most lender-friendly) to 5 (the most borrower-friendly) has continued to shift in the lenders' favor over the past five quarters and currently sits at 4.0 after peaking at 4.6 for much of 2017 and 2018.

Private Equity Sponsors Increasingly Turn to Direct Lending Market

In response to post-financial crisis regulation, traditional banks significantly reduced their business lending activity, particularly within the middle market. This created a void that allowed for the rapid expansion of private debt funds. According to Preqin research, private debt fund raising has grown from $25 billion in 2009 to $110 billion in 2018. With more than 40% of the total tied to direct lending funds, the industry has grown from $275 billion in assets under management to nearly $770 billion during that same period. And with direct lenders continuing to fundraise at near-record levels, those figures should continue to climb.

Institutional investors looking to middle-market credit to achieve higher yields have fueled the decade-long growth of direct lending. However, with extremely high asset prices and piles of capital sitting on the sidelines, competition within the direct lending market has become intense in recent years. Over time, that competitive pressure brought down yields, loosened leverage and terms, and forced lenders to speak for larger hold sizes.

For private equity firms that face many of the same challenging dynamics, the direct lending market has become more attractive every year. Larger borrowers that previously looked to the traditional leveraged loan market are increasingly pursuing direct loans, as they are able to take advantage of similar terms and flexibility, maintain their privacy throughout the process, and avoid any syndication risk.

Looking ahead, the market should also continue to benefit from the easing of global monetary policies, with negative yields outside the United States creating additional demand for private credit markets.

Expected Timing of Credit Cycle Shapes Lender Decision-Making

As part of William Blair's third-quarter Leveraged Finance Survey, we asked lenders to share their view (or their firm's view if it has one) on timing in regard to the end of the current economic/credit cycle. While most lenders believe it will occur sometime in the next 12–18 months, the feedback ranged from "it started six months ago" to "not ending anytime soon." What really stood out, however, is how different timing expectations—and the conviction behind them—are influencing each lender's decision-making.

At this stage, it is generally understood that lenders are focusing on stronger credits and typically avoiding businesses with cyclicality concerns. That is especially true for lenders that have convinced themselves that the end is near. However, it was extremely common to hear lenders acknowledge how often their timing predictions have been wrong in the past, and how it prevented them from being competitive on previous opportunities. In today's market, understanding those expectations could very well be the difference between a quick decline and a constructive financing proposal.

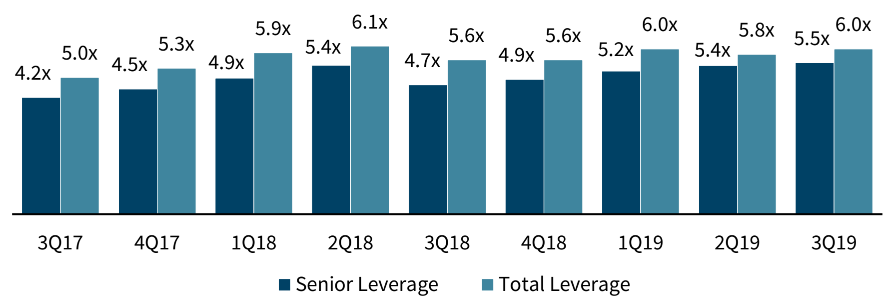
To learn more about these and other trends shaping the leveraged finance market, please don't hesitate to contact us.

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

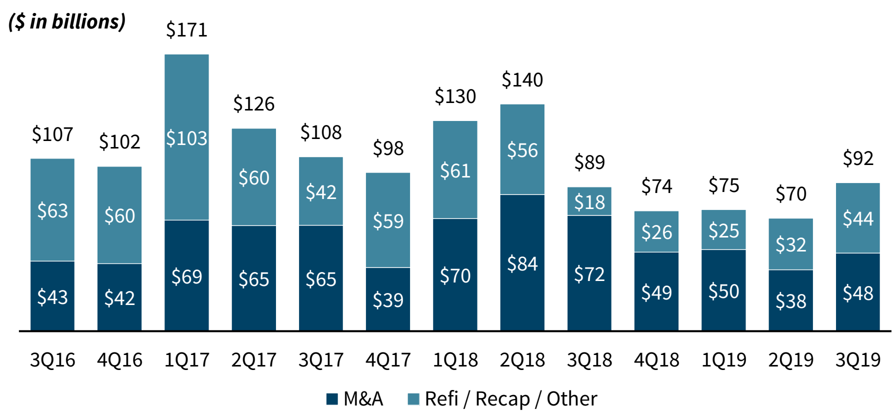
Leverage multiples for middle-market LBOs ticked up slightly during the third quarter. Average senior leverage increased to 5.5x, while average total leverage returned to the 6.0x mark after sitting at 5.8x the previous quarter.



Source: William Blair Proprietary Mid-Market LBO Financing Database

Institutional Loan Volume

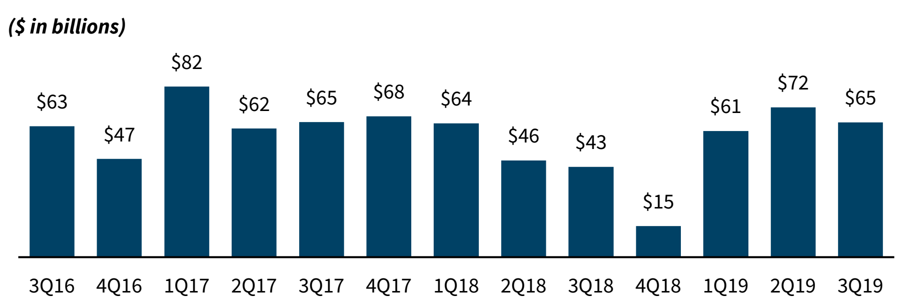
Institutional loan volume rebounded in the third quarter, increasing by 31%, thanks in part to an uptick in refinancing activity. M&A-related volume was also up 27% on the quarter, although it was still down significantly year-over-year.



Sources: LCD, an offering of SPGMI

High-Yield Bond Volume

Although new-issuance high-yield bond volume fell 10% from the previous quarter, the $65 billion was the second-largest total in the last seven quarters.



Sources: LCD, an offering of SPGMI

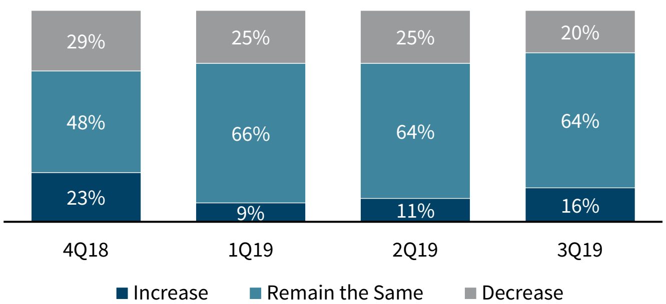
Highlights From William Blair's 3Q 2019 Leveraged Finance Survey

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 reflect responses from the 70 leveraged finance professionals who participated in the survey this quarter.

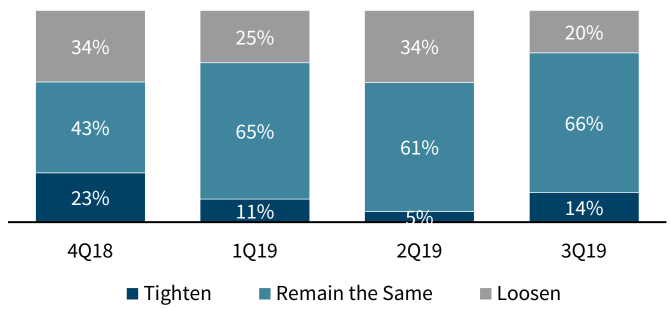
Leveraged Lending Market Conditions Slowly Beginning to Tighten

Although the majority of lenders report that pricing, leverage, and terms remain unchanged, a trend toward tighter market conditions can be seen on the margin. There are still more lenders decreasing pricing than increasing it, but the gap between the two postures continues to shrink; the decrease/loosen population is the smallest it has been in years.

Pricing



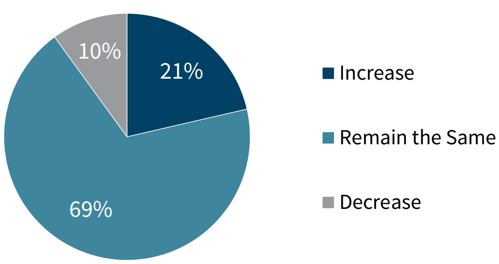
Leverage and Terms



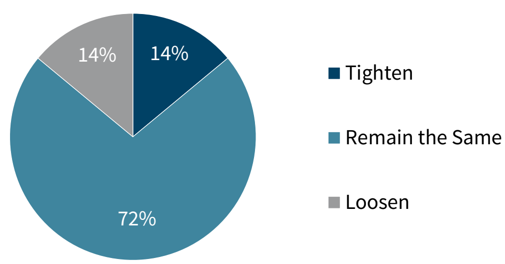
Lending Expectations for the Remainder of 2019

Respondents overwhelmingly expect pricing, leverage, and terms to remain the same over the remainder of 2019.

Pricing Expectations

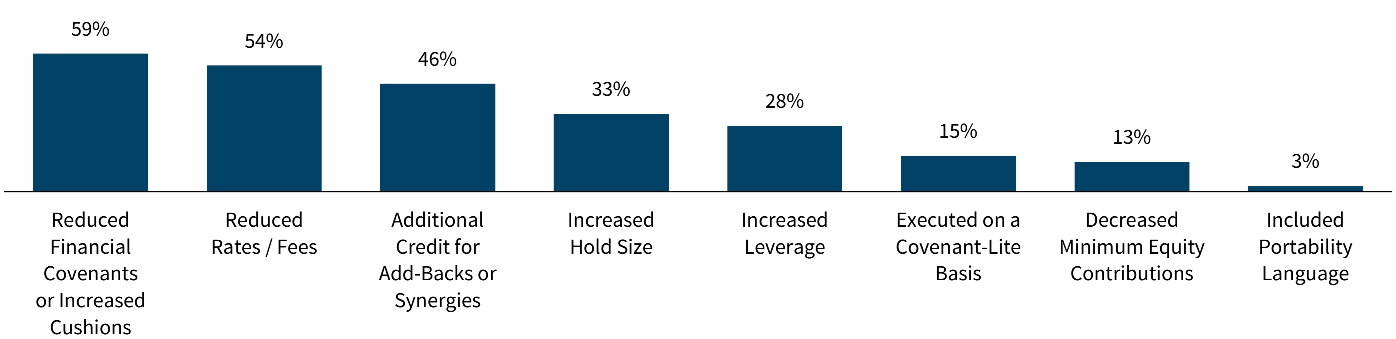


Leverage and Terms Expectations



Playing to Win

We surveyed lenders to see if they made any concessions this quarter that they historically wouldn't have made to win a deal. Fifty-four percent responded affirmatively, in line with the 53% recorded the previous quarter. Given where we are in the cycle, it isn't surprising to see that lenders have been pushed to reduce financial covenants/increase cushions.



William Blair by the Numbers

185+

completed leveraged finance transactions since 2012

$30+B

arranged financing since 2012

400+

lender and alternative credit provider relationships

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:

Not Disclosed Esterline Interface Technologies Split Lien Credit Facilities September 2019	Not Disclosed Sealforlife Industries Multi-Currency Credit Facilities July 2019	$70,300,000 Strauss Senior Secured Credit Facilities June 2019
$160,000,000 AEVEX Aerospace Unitranche Credit Facility May 2019	$410,000,000 CM Group First Lien and Second Lien Credit Facilities May 2019	Not Disclosed Lighthouse Senior Secured Credit Facilities April 2019

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.

- Over $30 billion of completed financing arranged since 2012
- 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 more than 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

With more than 160 senior bankers around the world, William Blair has completed more than 1,050 advisory and financing transactions totaling more than $335 billion in value for our clients.*

Leveraged Finance

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* In the past five years as of June 30, 2019

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 20 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 2014 to 2018, the team advised on more than $300 billion in completed transaction volume.