Leveraged Finance

Q4 2018

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Economic and Political Uncertainty Take a Toll on Leveraged Finance Market

Markets pulled back in the fourth quarter as wide-ranging uncertainty forced lenders to rethink their risk tolerance.

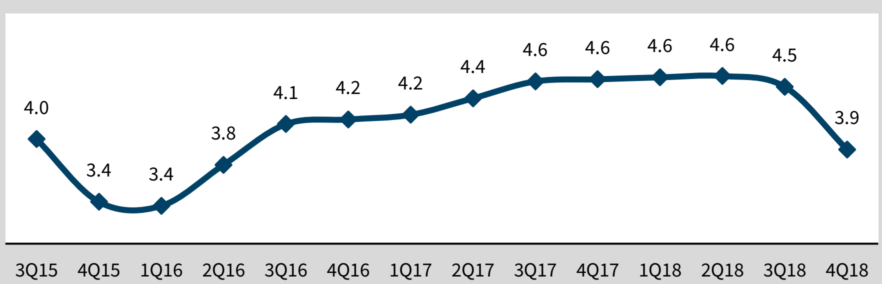
The leveraged finance market roared out of the gates in the fourth quarter, with October recording the second-highest monthly volume of 2018. But the momentum fell victim to the volatile conditions that roiled equity markets in the last three months of 2018. Uncertainty around issues such as economic growth, trade policies, interest rates, and the overall political landscape pushed lenders to focus on credit quality, chased away retail investors, and largely eliminated opportunistic issuances. Total leveraged loan volume fell from $67 billion in October to $33 billion in November before closing out the year with a mere $13 billion in December, the lowest monthly total in three years. During the quarter, the percentage of total volume from opportunistic transactions fell from 53% in October to only 6% in December.

From a pricing and terms standpoint, on the surface it appears that the fourth quarter remained relatively stable. According to William Blair's proprietary Mid-Market LBO Financing Database, the average spreads on senior and second-lien pricing in LBOs were L+455 and L+825, respectively, both unchanged from the third quarter. Average unitranche pricing in LBOs even fell 30bps to L+580. Leverage trends followed suit, as average senior leverage increased slightly from 4.7x in the third quarter to 4.9x in the fourth quarter, while average total leverage was unchanged at 5.6x. These averages, however, mask the rapidly changing middle-market dynamics that played out over the course of the fourth quarter. The majority of the transaction volume came during a red-hot October, and by December only the best credits were coming to market. In the broader loan market, spreads for new-issue B term loans rose to L+508, the highest level since 2012 and more than 150 basis points higher than where averages stood at the end of October, according to LCD/S&P.

Lender respondents to William Blair's Leveraged Finance Survey in December largely echoed these sentiments, with 71% of respondents indicating that pricing for their primary debt offering either increased or stayed the same during the fourth quarter, and 66% responding that terms and leverage tightened or remained the same. This is in stark contrast to a year ago, when 70% of lenders responded that pricing decreased and 57% said terms and leverage loosened in the fourth quarter of 2017. The late-2018 market dynamics caused William Blair's Leveraged Lending Index to drop below 4.0 for the first time since the second quarter of 2016.

William Blair Leveraged Lending Index Falls to Lowest Level in Two and a Half Years

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. After nine consecutive quarters without a decline, the index has now dropped over the last two quarters and has gone below 4.0 for the first time since 2Q16.



Middle-Market High-Yield: Primary Issuance Slows Amid Turbulent Secondary Trading Performance

After option-adjusted spreads (OASs) reached a post-crisis low of 303bps in early October, yields and spreads across the high-yield market moved meaningfully higher in the fourth quarter. OASs rose 210bps during the quarter (228bps peak to trough) while yields rose 171bps (195bps peak to trough) to end the year at 7.95%. A confluence of factors, including trade and recession concerns and a precipitous drop in oil prices (WTI crude dropped 38% in the fourth quarter), led the high-yield market to fall in the quarter—along with nearly all other financial markets. In terms of total return, the high-yield market fell 4.53% in the fourth quarter of 2018, compared with a gain of 0.47% in the fourth quarter of 2017. For full-year 2018, total return in the high-yield market fell 2.18%.

Quarterly high-yield fund withdrawals created an environment of net sellers, with investors pulling nearly $20 billion from funds. December was the first month with no new issuances in at least 12 years.

The year's total volume of new high-yield issuances was $169 billion, the lowest full-year volume since 2009 and a 39% decrease from 2017. Supportive of the recently diminished high-yield market—and despite the large fund outflows—coupon payments and redemptions exceeded issuance for the first time since 2009.

Where Do We Go From Here? Expectations for the Leveraged Finance Market in 2019

When asked about factors that will have the greatest impact on the leveraged loan market in 2019, the health of the economy was top of mind for nearly every lender. Although default rates are well below historical averages, recession fears and recent outflows of investor capital have increased the focus on credit quality and terms, both of which have eroded over the past few years. In fact, 47% of respondents to William Blair's Leveraged Finance Survey indicated that they expect transaction terms and leverage to tighten in 2019, with another 50% expecting them to remain the same. Only 3% of lenders believe that terms and leverage will loosen during the next 12 months. Pricing expectations fell along the same lines, with 93% of lenders expecting pricing to increase or remain the same.

In the minds of lenders, running a close second to economic health is the continued rising interest rate environment. If the Federal Reserve continues to raise rates in 2019, lenders will be forced to dial back leverage to compensate for reduced fixed-charge coverage. According to analysis by Nomura, holding all else equal, a 100bps increase in the 3-month LIBOR would reduce interest coverage for a typical loan issuer by approximately 0.5x. In 2018 the 3-month LIBOR increased by roughly 110bps yet leverage ratios continued to rise, so lenders likely will be sensitive in this area if rates continue to rise. Some lenders may even bring back the floating-rate hedge requirements that had largely disappeared in recent years.

As for the high-yield market, analysts are predicting that volatility in secondary trading and decreased primary activity will continue into early 2019, with full-year new issuance volume generally projected to be in line with 2018 levels. In terms of expected returns for the asset class in 2019, there is less of a consensus. As underlying projections about the federal funds rate, Treasurys, energy prices, and default and recovery rates vary widely across the industry, projected 2019 returns are relatively divergent for a market where small differences are meaningful. Estimates for high-yield market returns in 2019 range from 0% to 9.9%, with the average near 6%.

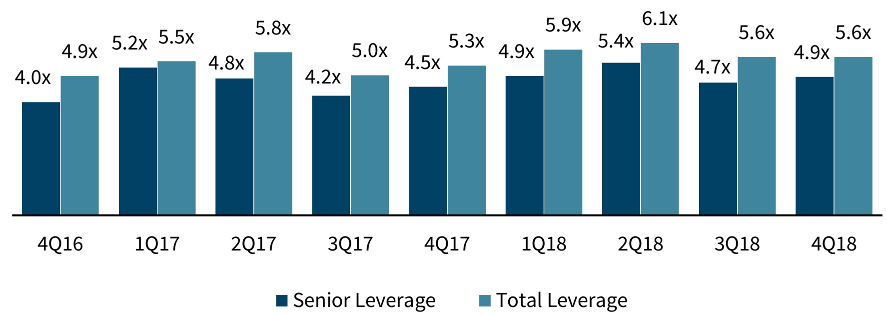
Regardless of asset class, the key to 2019 will be eliminating some of the uncertainty that has spooked the markets over the last couple of months.

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

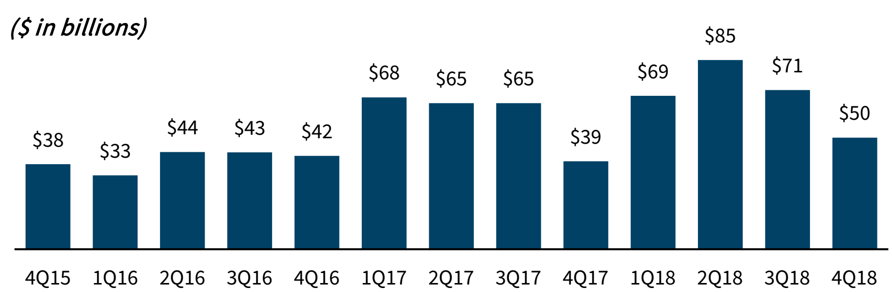
Total leverage multiples for middle-market LBOs remained relatively flat in the fourth quarter, but the three-month average was buoyed by significantly higher volume during an aggressive October.



Source: William Blair Proprietary Mid-Market LBO Financing Database

Institutional M&A Volume

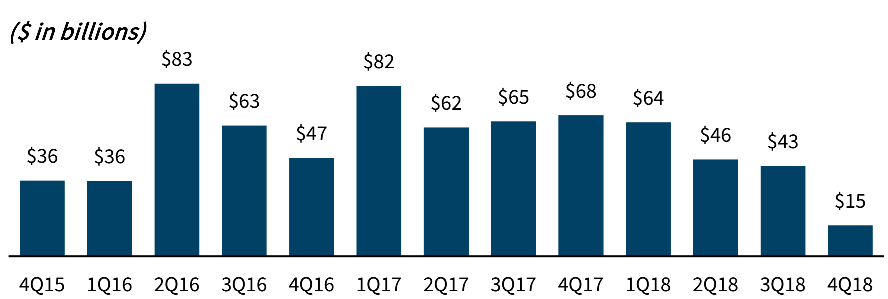
M&A activity represented 66% of all institutional loan volume in the fourth quarter, although volume was down roughly 30% from the third quarter and more than 40% from the second-quarter high. Overall institutional loan volume in the fourth quarter fell to $76 billion, down from $140 billion and $89 billion in the second and third quarters, respectively.



Sources: S&P LCD

High-Yield Bond Volume

New-issuance high-yield volume declined significantly in 2018, as leveraged loans continued to capture an increasing share of the market. The $169 billion of high-yield volume in 2018 is the lowest full-year volume since 2009.



Sources: S&P LCD

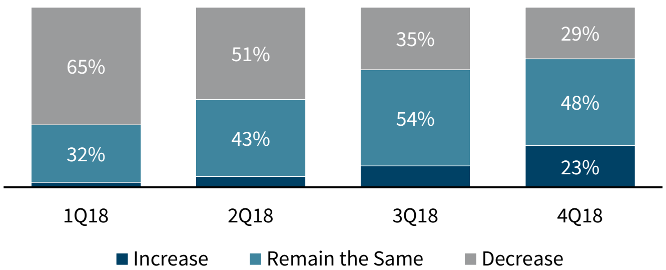
Highlights From William Blair's Fourth Quarter 2018 Leveraged Finance Survey

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 77 leveraged finance professionals who participated in the survey this quarter.

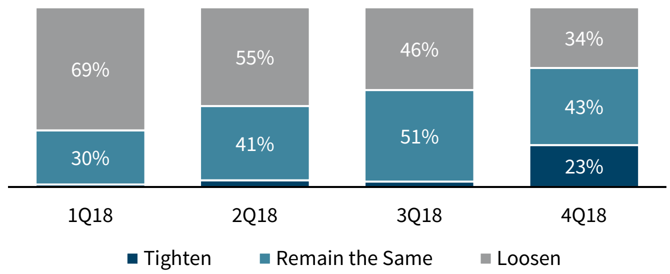
Middle-Market Leveraged Lending Environment Begins to Tighten

The fourth quarter saw a significant shift in market sentiment, particularly in November and December, as economic and political uncertainty forced lenders to re-evaluate their risk appetite and underwriting guidelines. The growing percentage of lenders who expect pricing to increase and leverage and terms to tighten reflect this dynamic.

Pricing



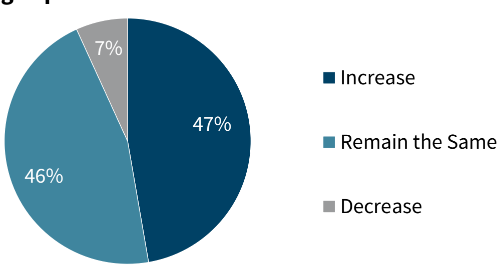
Leverage and Terms



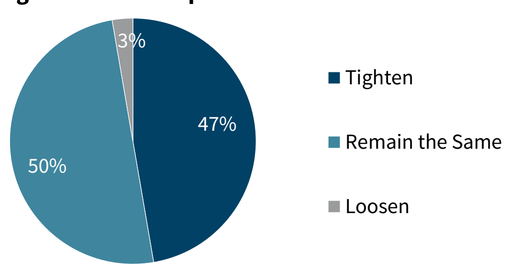
Lending Expectations for 2019

Respondents expect pricing, leverage, and terms to either remain the same or further shift in favor of lenders over the course of 2019.

Pricing Expectations

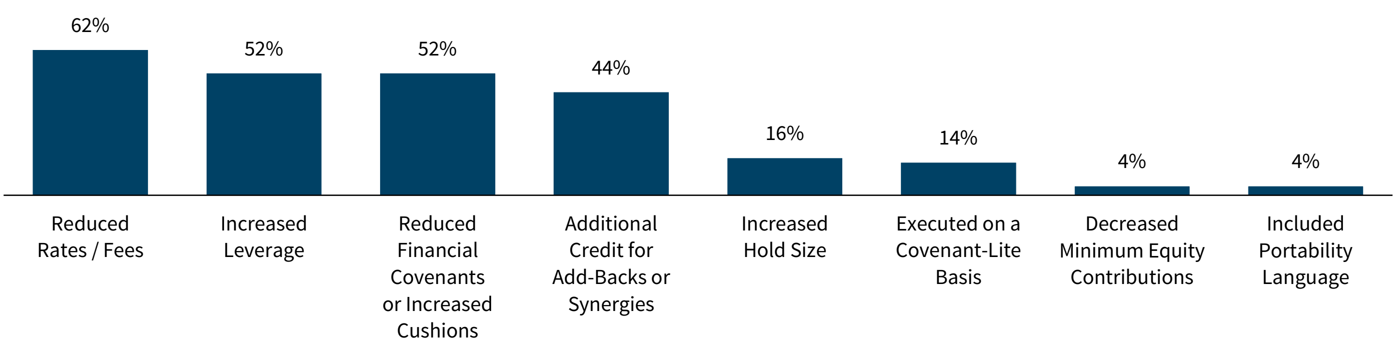


Leverage and Terms Expectations



Playing to Win

We surveyed lenders to see if they made any concessions that they historically would not have made to win a deal this quarter. 57% responded affirmatively, down from 70% in the third quarter. Not surprisingly, the most common concessions involved rates, leverage, and covenants.



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:

$80,000,000 Unitranche Credit Facility November 2018	Not Disclosed EDGE Industrial Technologies formerly doing business as Pearl Technologies, Inc. Unitranche Credit Facility September 2018	Not Disclosed uniFund Multi-Draw Credit Facility (Add-on) June 2018
$141,000,000 edsal Split Lien Credit Facilities June 2018	$135,000,000 mark andy Senior Secured Notes June 2018	$400,000,000 Compass Diversified Holdings Senior Notes April 2018

William Blair by the Numbers

110+

completed leveraged finance transactions since 2013

$21.2bn

arranged financing since 2013

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.

- $21.2 billion of completed financing arranged since 2013
- 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 300 bankers globally, William Blair has completed more than 1,000 advisory and financing transactions totaling more than $300 billion in value for our clients*

Leveraged Finance

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* As of January 1, 2014 through December 31, 2018

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