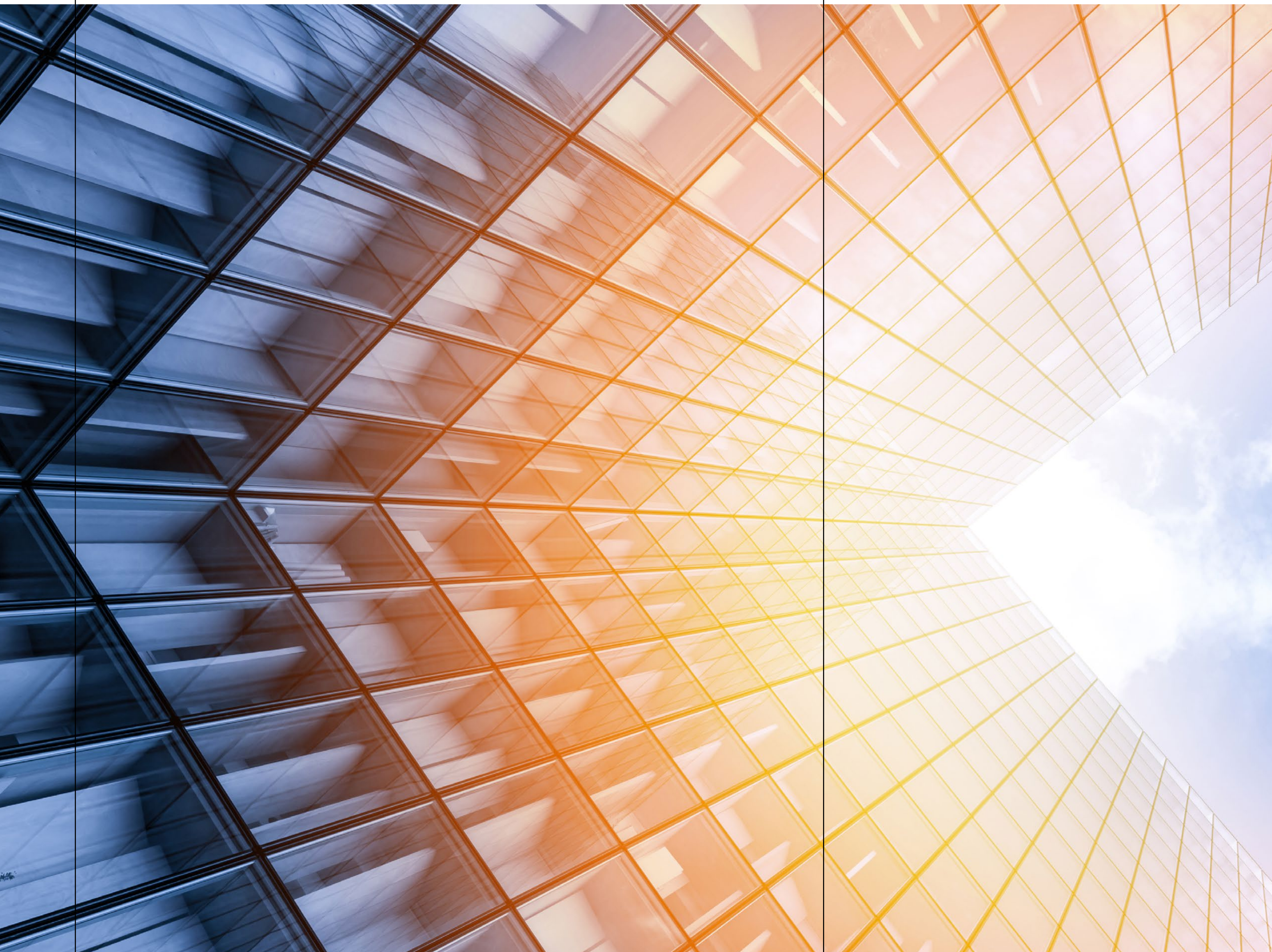
William Blair

Leveraged Finance

Q4 2019

Investors Narrow Their Focus on Higher-Quality Borrowers

In This Report



Investors Narrow Their Focus on Higher-Quality Borrowers

Bifurcation in the leveraged finance market became more pronounced during the fourth quarter, as investors continued their flight to quality.

In the final months of 2019, lenders expanded on a year-long trend that has made life difficult for less creditworthy borrowers looking to raise debt capital. Despite public equity markets flirting with all-time highs and available capital piling up on the sidelines, many lenders believe that the end of the current cycle is fast approaching. Thus, lenders continue to shift their focus to credit quality, creating a bifurcation in the market between higher- and lower-quality credits, a trend that intensified in the fourth quarter. In November, for example, the gap between double-B and single-B clearing spreads in the institutional loan market peaked at 233 basis points, up from 67 basis points at the beginning of 2019.

Loan volume was muted during the fourth quarter as lenders became increasingly discerning. Lenders, however, weren't the only investors shying away from the riskier corners of the market. M&A-related institutional loan volume fell 40% from both the previous quarter and the prior year; the $29.2 billion of volume in the fourth quarter was the lowest quarterly figure since 2013. While declining rates helped revive the opportunistic market, it wasn't enough to offset the M&A-related decline. Overall, total leveraged loan volume fell to $103 billion, down 23% from the previous quarter and down 15% year-over-year.

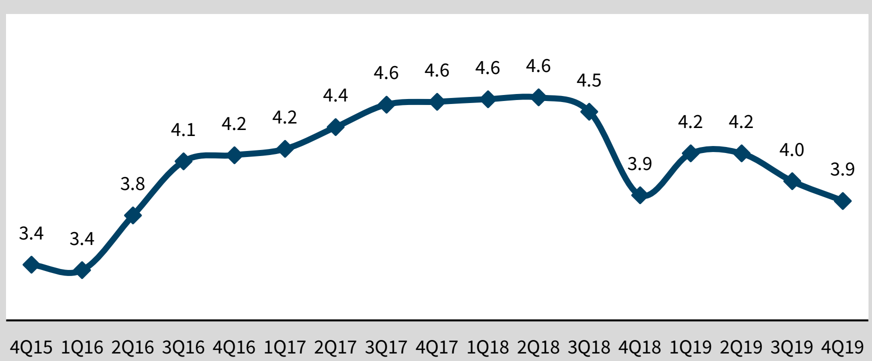
As was the case throughout much of 2019, the lack of high-quality deal volume relative to the abundance of available capital continued to pressure lenders to provide aggressive terms for attractive credits. With the borrower distribution skewed toward the lower-quality end of the spectrum, however, overall conditions in the leveraged finance market are undoubtedly trending in lenders' favor. William Blair's Leveraged Lending Index reflects this trend; the index fell below 4.0 for only the second time in the past 14 quarters.

Leverage levels also seemed to follow suit during the quarter. According to William Blair's proprietary Mid-Market LBO Financing Database, average senior leverage in LBOs fell from 5.5x in the third quarter to 5.1x in the fourth quarter. During the same period, average total leverage fell from 6.0x to 5.4x.

Without having to reach on leverage, lenders were able to keep pricing relatively flat. During the fourth quarter, average spreads on senior and second-lien pricing in LBOs were L+460 and L+840, respectively; both figures were within 10 basis points of their third-quarter averages. Similarly, average unitranche pricing came in at L+560, up only 10 basis points on the quarter.

William Blair Leveraged Lending Index Continues Downward Trend

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 a full year at its peak of 4.6, the trend over the past six quarters continues to move in lenders' favor.



2020 Vision: Expectations for the Leveraged Loan Market

When asked about factors that will have the greatest impact on the leveraged loan market in 2020, lenders primarily identified issues that have lingered for more than a year. Political uncertainty was at the top of the list, followed closely by trade policy, interest rates, and the timing of the next economic cycle. The good news for investors is that 2020 will likely provide additional clarity regarding many of the complicating factors that continue to be top of mind.

With the presidential election less than 10 months away, investors will keep a close eye on the polls and the results of the Democratic primaries. The coming months should also provide some clarity around the impeachment process, as formal hearings began in January.

Regarding trade policy, as of this writing, the United States and China had already agreed to phase one of a trade deal between the two nations. While there are still questions about how it will be implemented, phase one provided investors with the first real insight into what trade policy will look like over the course of 2020.

As was explained in last quarter's newsletter, expected timing of the next credit cycle significantly influences lender decision-making. Even with intense scrutiny of economic indicators, uncertainty will persist and bifurcation in the market will only become more pronounced until the looming market correction actually occurs. Until then, the syndicated market's lack of appetite for lower-quality transactions should open the door for more private deals. Look for direct lenders to continue taking share in 2020 as they capitalize on their steadily increasing hold sizes and mountains of available capital.

Interest Rate Expectations: Negative Thoughts About Negative Rates

After eight rate hikes by the U.S. Federal Reserve between December 2016 and December 2018, and then three decreases in 2019, this year is shaping up to be refreshingly stable. With the economy on solid footing, a strong consumer sector, and inflation sitting just below the Fed's target of 2.0%, it appears that the U.S. central bank will likely leave rates unchanged for the near future, despite significant pressure from the White House. During the past few months, President Trump has publicly lobbied for the Fed to reduce rates further, suggesting on multiple occasions that the Fed introduce negative rates to help the United States be more competitive in the global market. Federal Reserve Chair Jerome Powell, however, has repeatedly pushed back on the idea. In a November congressional hearing, Mr. Powell told the Joint Economic Committee: "Negative interest rates would certainly not be appropriate in the current environment. You tend to see negative rates in the larger economies at times when growth is quite low and inflation is quite low. That's just not the case here." It is also not yet clear whether the Fed even has the legal authority to charge banks interest on excess reserves.

Despite the recent chatter in Washington, the lender universe doesn't seem to believe that the subject merits much consideration. When asked about the likelihood of negative rates in the United States over the next 24 months, 77% of respondents to William Blair's Leveraged Finance Survey indicated that they believe it is either "somewhat unlikely" or "extremely unlikely," with another 16% responding that they are neutral on the topic. The overwhelming majority of respondents also believe that a shift to negative rates would have a net negative impact on the market. But as one lender pointed out, in that scenario the bigger impact would come from the underlying economic issues that made the Fed believe such a move was necessary.

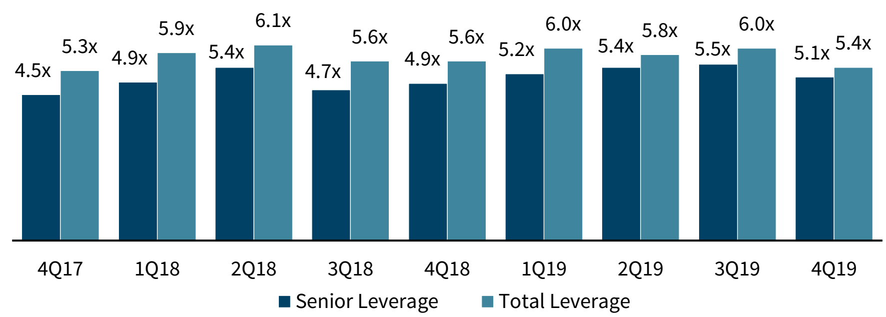
To learn more about these and other trends shaping the leveraged finance market, please don't hesitate to contact us.

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 fell during the fourth quarter. Average senior leverage decreased to 5.1x, while average total leverage fell to 5.4x, its lowest level since the fourth quarter of 2017.

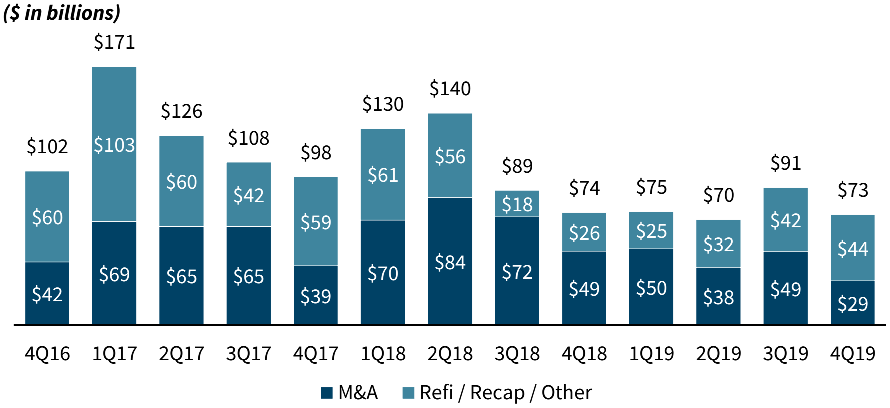


Source: William Blair Proprietary Mid-Market LBO Financing Database

Institutional Loan Volume

Institutional loan volume struggled to close out the year, decreasing by 20%, primarily because of a large drop-off in M&A-related volume, which was down 40% from both the previous quarter and year-ago period.

($ in billions)

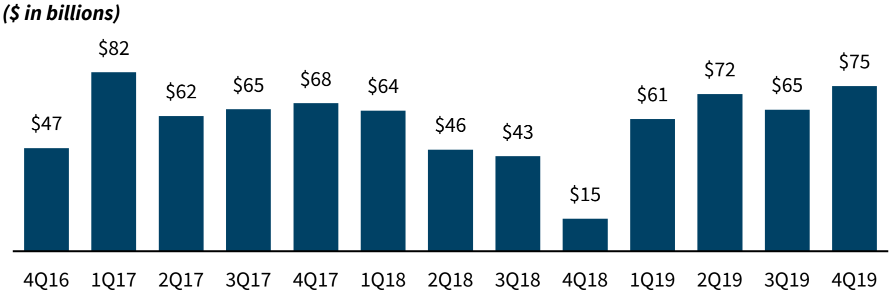


Sources: LCD, an offering of SPGMI

High-Yield Bond Volume

The high-yield market continued its positive momentum and finished 2019 with its strongest quarter since the first quarter of 2017.

($ in billions)



Sources: LCD, an offering of SPGMI

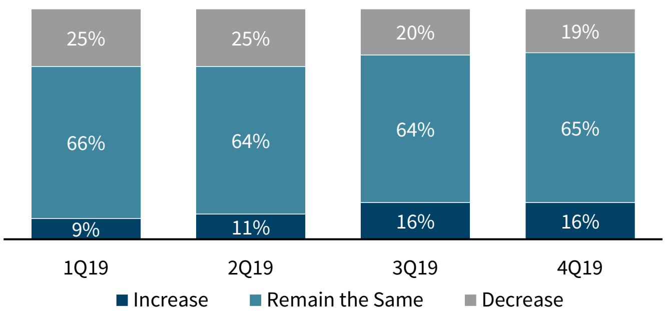
Highlights From William Blair's 4Q 2019 Leveraged Finance Survey

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.

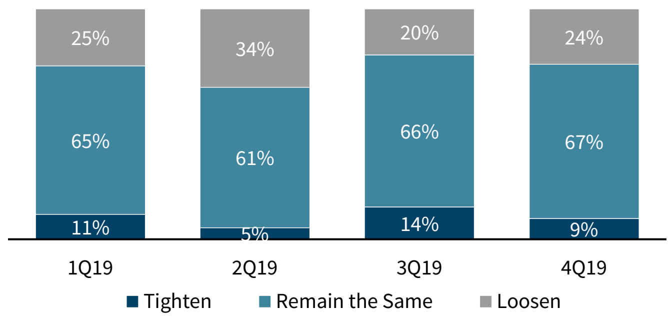
Leveraged Lending Market Conditions Remained Relatively Unchanged Throughout 2019

After adjusting to shifting market dynamics in the second half of 2018, lender behavior, as a whole, remained relatively steady throughout 2019. Individual lenders may have periodically adjusted pricing, leverage, and terms based on specific competitive dynamics or portfolio strategies, but overall behavior remained relatively constant during the past 12 months.

Pricing



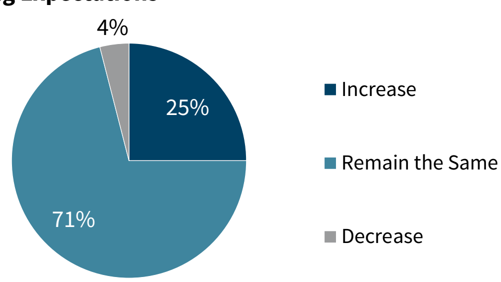
Leverage and Terms



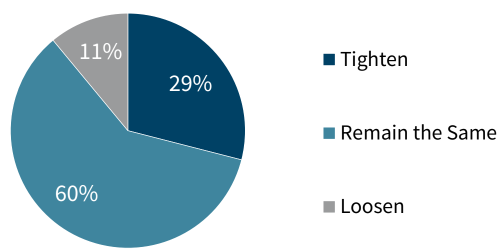
Lending Expectations for the Remainder of 2020

Respondents largely expect pricing, leverage, and terms to either remain the same or further shift in lenders' favor over the course of 2020.

Pricing Expectations

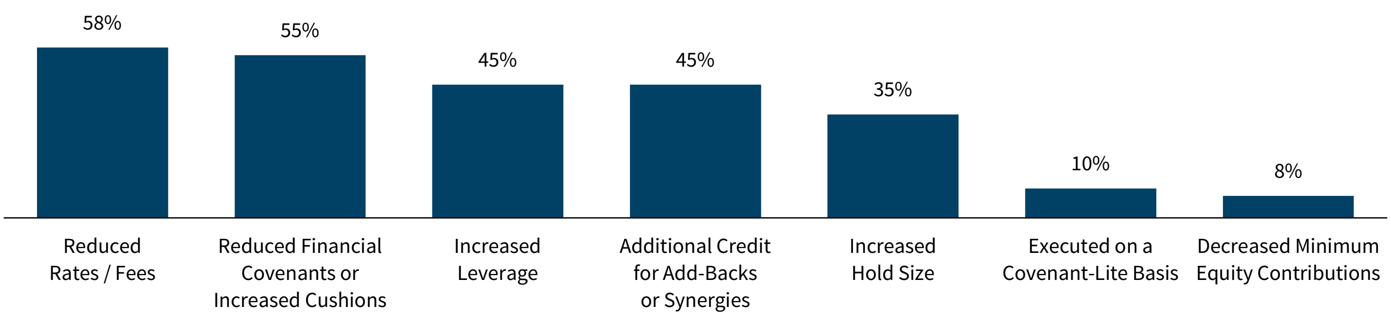


Leverage and Terms Expectations



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-seven percent responded affirmatively, compared with 54% the previous quarter. While most responses were in line with previous quarters, the 35% that reported increased hold sizes is the largest such figure since the survey began.



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 by the Numbers

185+

completed leveraged finance transactions since 2012

$30B+

arranged financing since 2012

425+

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.

- 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 170 senior bankers around the world, William Blair has completed more than 1,050 advisory and financing transactions totaling more than $365 billion in value for our clients.*

Leveraged Finance

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* In the past five years as of December, 31, 2019

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 2015 to 2019, the team advised on more than $365 billion in completed transaction volume.