S&P Global
Market Intelligence

LCD Middle Market Review

Direct lending continues to take market share in 3Q

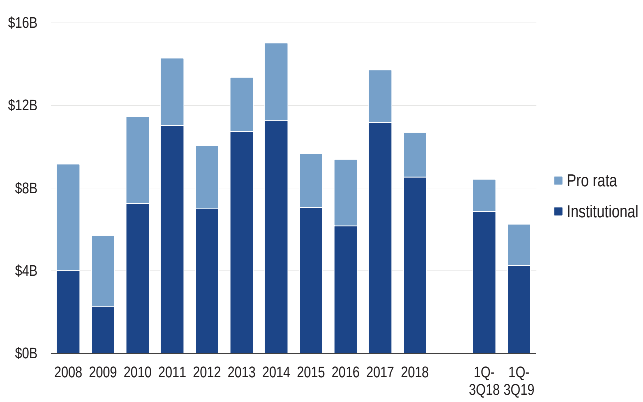
As the U.S. and global economies show signs of slowing, and U.S.-China trade turbulence continues, it's safe to say investors worldwide are treading lightly, wary of a recession. That cautiousness is particularly clear in the credit markets. In the broadly syndicated leveraged loan segment, for example, the recent flight to quality has created a yawning gap between better-rated (double-B) and lower-rated (single-B) spreads.

The increasingly high-profile private credit space, which often caters to smaller and unrated borrowers, has felt an impact as well.

"Smaller credits, as well as issuers in more cyclical sectors, are beginning to feel the pinch of credit tightening," says Stefan Shaffer, founder and managing partner of SPP Capital Partners.

Indeed, so far in 2019, middle market syndicated loan volume, excluding pro rata deals, has been underwhelming. Total volume year-to-date is $4.25 billion, less than the $6.86 billion at this time last year (in this instance we're using EBITDA of less than $50 million to define syndicated middle market). Total issuance in this segment during 2018 was $8.53 billion, more than double the amount for 2019 to date.

MM syndicated issuance (issuer EBITDA ≤ $50M)



Source: LCD, an offering of S&P Global Market Intelligence

"Syndicated issuance is down pretty significantly," Tim Lyne, co-head of sponsor coverage at Antares Capital, confirms. "It was down in the third quarter over the previous quarter, and it's also down year-over-year. The actual deal counts are holding up better, but you're seeing volume down 25–30%."

Deal counts are relatively stable due to specific activity by private equity sponsors.

"Add-on acquisition activity is up pretty significantly in 2019," Lyne says. "There are not as many platform buyouts being completed as 2018. More of the volume in 2019 is add-on volume versus new platform volume."

When looking more closely at middle market issuance this year versus last, refinancings (and repricings) tell an even bigger story. In 2018 there were considerably more refinancings, helping drive the overall volume numbers. Middle market all-in spreads at the end of 2016 were 581.5 bps. At the end of 1Q18, spreads had contracted to 457.3 bps, so naturally borrowers reduced their costs.

"There's very little refinancing and repricing activity in the 2019 numbers," Lyne says. "In 2018, you had significant repricing and refinancing, because spreads were decreasing and sponsors were taking the opportunity to reprice and refinance."

We'll note here that LCD does not count traditional repricings toward new-issue volume (though they are included in all-in spread calculations). But the decline in that activity is a good indication of overall market direction.

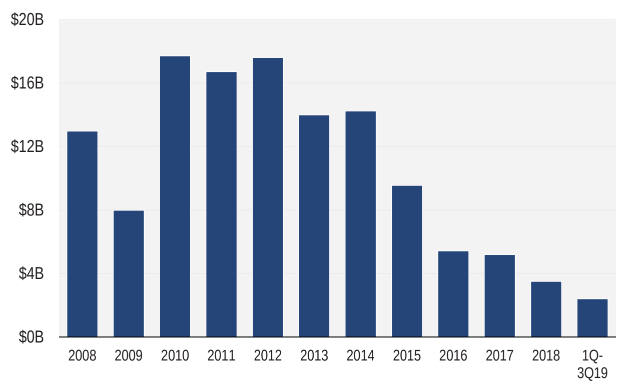
Direct lending vs. syndication

The other factor driving the relative lack of activity in the syndicated middle market is that private equity sponsors these days seem less willing to undertake a traditional syndication process.

"We've been seeing this throughout 2019, but it's more pronounced over the last three to four months," says Lyne. "More and more U.S. sponsored middle market loan volume went from syndicated to direct lending. The direct lending market is continuing to take share from the syndicated market and, in particular, unitranche is becoming more and more prevalent."

This trend is most striking in the lower reaches of the syndicated middle market. In 2014, total syndicated middle market loan volume with a facility size of $200 million or less was $14.24 billion, according to LCD. So far in 2019, total syndicated middle market loan volume of deals less than $200 million is only $2.41 billion.

Volume deals ≤ $200M in size



Source: LCD, an offering of S&P Global Market Intelligence

And in the past year, even larger deals ($900 million-plus) have been getting done via direct lenders. For instance:

- At the beginning of August, Apollo committed to providing a $1.792 billion senior secured term loan to support the acquisition of **Gannett** by **New Media Investment Group**. Gannett is a public company (NYSE: GCI). Closing is expected by the end of 2019.

- In July, Golub Capital was sole lead arranger and administrative agent on a $950 million credit backing the acquisition of Amber Road by **E2open**. The loan is a GOLD (Golub One-Loan Debt) facility composed of a $920 million unitranche term loan and a $30 million revolver.

- And back in June, HPS and Goldman Sachs Private Credit provided a $1.25 billion unitranche loan to support **ION Investment Group**'s acquisition of a controlling stake in **Acuris**. UBS had been mandated to underwrite the debt financing to support the acquisition.

The incidence of near-jumbo loans done via the private market illustrates the continued impact of the segment recently. Indeed, global dry powder for private debt funds remains close to all-time highs, according to Preqin. As of June 2019, total private debt dry powder totaled $269 billion, off slightly from $287 billion as of December 2018. Furthermore, direct lending funds hold $103 billion of the $269 billion.

The move to private deals is more than a function of direct lender capacity. There are tangible deterrents to executing loans in the syndicated market. For ION, the decision to turn to direct lenders follows ION's troubles in the broadly syndicated market. The company withdrew a $1.96 billion cross-border term loan refinancing from syndication in May, bringing to an end a deal that launched in April as a $2.21 billion-equivalent TLB, to refinance debt at four entities, to create ION Corporates, and to pay a $250 million dividend.

The loan went through several iterations in syndication before being shelved, including the removal of the dividend element, the carve-out of a four-year tranche, at least two sets of doc amendments, timetable extensions, and pricing revisions.

Another potential deterrent in today's syndicated market is ratings.

"The ratings agencies have had a higher level of scrutiny on EBITDA adjustments in the past few months, and there are more deals that have had a risk of being downgraded to CCC," says Andy Steuerman, head of middle market lending at Golub Capital. "The ratings agencies have gotten tougher, so some borrowers are opting to come back to the private market, where ratings are certainly less critical to the execution of the deal."

"It's not uncommon to see a private deal grow to a billion, which was unheard of five years ago," Steuerman continues. "We've done that a handful of times. Nowadays, you don't have to have a syndicated deal to get a billion-dollar facility."

Simply put, syndicated executions for middle market loans, from a private equity sponsor's perspective, can be a headache.

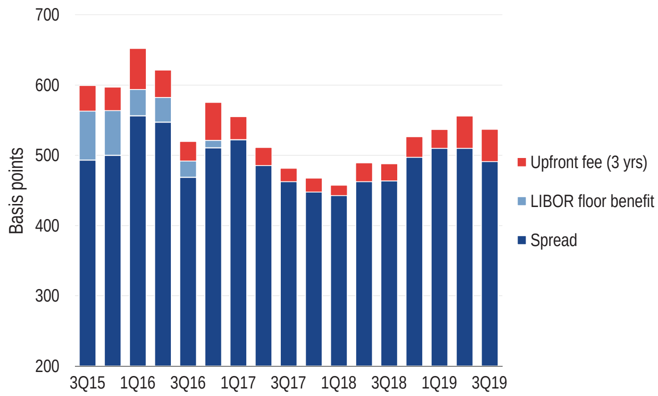
"A lot of sponsors say [the private route] is easier," Lyne says. "For sponsors, what's pushing them to a directly originated unitranche deal versus a syndicated deal is simplicity, speed, and certainty of execution. That's what's driving this huge surge in 2019."

Pricing

Middle market spreads have generally been higher than last year. For syndicated middle market loans, the all-in LIBOR spread (spread plus upfront fee) has hovered in the 520–560 bps range since 2018's fourth quarter.

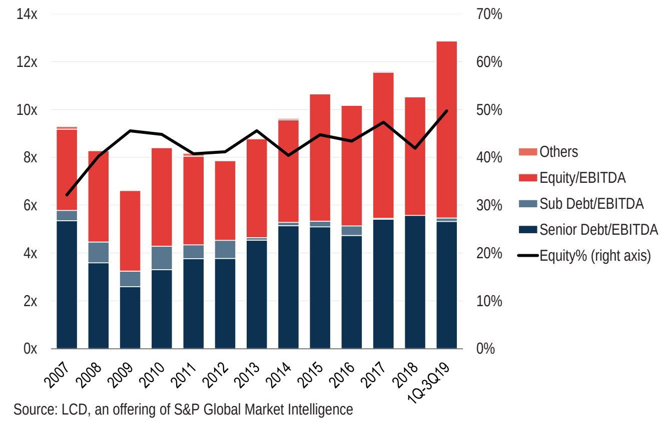
"We have certainly not seen any decrease in spreads in 2019, regardless of the size of the company or ratings," Lyne says. This is consistent with the fact that there has been less refinancing and repricing activity this year.

All-in spreads, MM deals (issuer EBITDA ≤ $50M)



Source: LCD, an offering of S&P Global Market Intelligence

Purchase price multiples for MM deals (issuer EBITDA ≤ $50M)



Source: LCD, an offering of S&P Global Market Intelligence

Primary market for MM loans (issuer EBITDA ≤ $50M)

	2014	2015	2016	2017	2018	1Q-3Q19
Domestic bank	4.4%	6.8%	6.2%	1.0%	12.1%	8.4%
Finance co.	11.7%	15.9%	20.0%	15.6%	11.1%	9.0%
Foreign bank	9.1%	11.4%	13.1%	7.5%	10.1%	10.9%
Institutional investor	73.7%	63.8%	59.4%	72.8%	66.4%	71.1%
Securities firm	1.0%	2.0%	1.3%	3.0%	0.3%	0.5%

Source: LCD, an offering of S&P Global Market Intelligence

In the direct lending market, traditional commercial banks are now losing market share due to pricing. Domestic banks are making up a smaller share of all middle market lenders, while institutional investors are taking a larger share.

"The market is getting more and more competitive every day," a bank lender says. "Direct lenders used to stop at a certain price point, but now they're starting to come down in price. Banks are competing and winning deals for sure, but pricing out there is shocking, in terms of how low it is. Private debt funds are providing cheaper loans. And banks used to be able to compete a lot on price, while being stricter on terms. But a lot of borrowers are putting emphasis on flexibility versus price now."

According to SPP Capital, pricing in the lower middle market (non-syndicated) has tightened significantly since last year. For banks, senior cash flow pricing tightened from 4% (the center of the pricing range) in September 2018 to 3.5% by the end of September 2019. Unitranche pricing in September 2018 for lenders with more than $20 million in EBITDA was 6.75%. At the end of September 2019, that had contracted to 5.75%.

Valuations

Valuations in middle market buyout deals have continued to increase from 2018, amid increased competition among middle market private equity sponsors. In 2018, total valuation multiples were at 10.56x EBITDA, according to LCD. So far in 2019, the average multiple is 12.86x.

"We're seeing valuations continue to increase, and it is super competitive right now in terms of sponsors trying to win deals," Lyne says.

This dynamic is another factor pushing sponsors to obtain directly originated loans to finance buyouts.

"As the M&A market remains very competitive, buyers are looking to differentiate themselves," Steuerman says. "One way of doing this is by securing speed and certainty through a private loan, versus a syndicated loan. And buyers are willing to pay a premium in a private deal for that speed and certainty. Part of what's driving the prevalence of these large private unitranche deals is the ease of execution. Especially if you're trying to win a public company, you have to show certainty and speed. You don't have to sit there and talk about syndication strategy and timing."

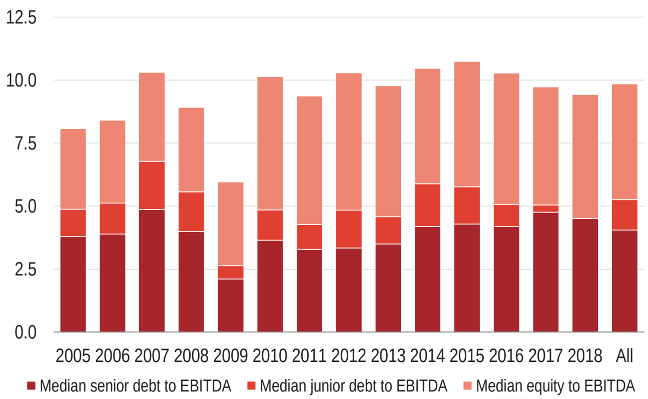
High purchase price multiples have another impact on private equity strategy—sponsors typically will try to buy down the purchase price through multiple add-on acquisitions.

"If you're trying to buy lots of businesses because your purchase price requires access to capital, the direct lending market is a lot more amenable to supporting that thesis," Steuerman explains.

— Shivan Bhavnani

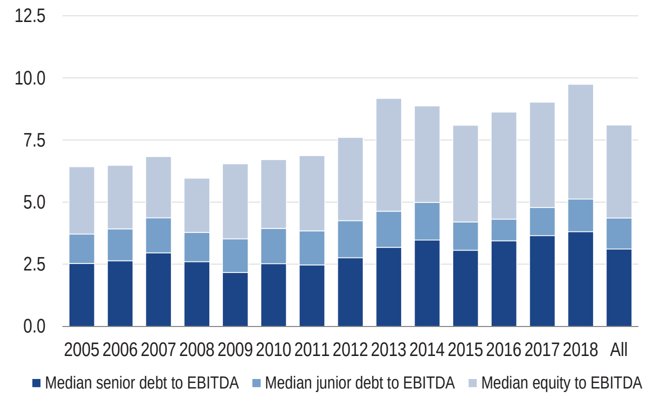
Direct lending stats from CEPRES

Private debt financing structure at entry: Europe



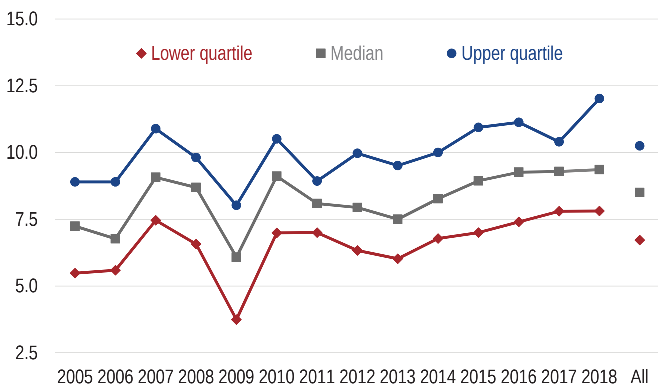
Source: CEPRES PE.Analyzer

Private debt financing structure at entry: North America



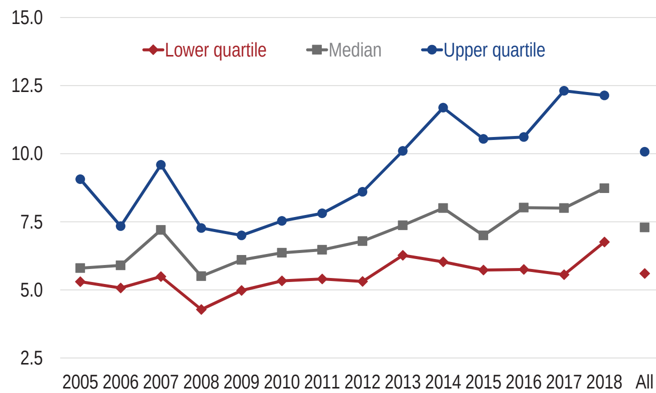
Source: CEPRES PE.Analyzer

Private debt EV to EBITDA at entry: Europe



Source: CEPRES PE.Analyzer

Private debt EV to EBITDA at entry: North America



Source: CEPRES PE.Analyzer

CEPRES Private Debt: https://www.cepres.com/private-equity-database

Leveraged Commentary & Data

LCD News – U.S.

Tim Cross (212) 438-2724
tim.cross@spglobal.com

John Atkins (212) 438-1961
john.atkins@spglobal.com

Jon Hemingway (212) 438-0192
jonathan.hemingway@spglobal.com

Gayatri Iyer (212) 438-2726
gayatri.iyer@spglobal.com

Alan Zimmerman (646) 415-8143
alan.zimmerman@spglobal.com

Rachelle Kakouris (212) 438-7258
rachelle.kakouris@spglobal.com

Richard Kellerhals (917) 622-4457
richard.kellerhals@spglobal.com

Andrew Park (212) 438-3256
andrew.park@spglobal.com

Shivan Bhavnani (212) 438-0335
shivan.bhavnani@spglobal.com

Mairin Burns (212) 438-0584
mairin.burns@spglobal.com

Jakema Lewis (212) 438-0537
jakema.lewis@spglobal.com

Tyler Udland (212) 438-0296
tyler.udland@spglobal.com

Alexander Saeedy (212) 438-0485
alexander.saeedy@spglobal.com

Copy Edit/Production

Brenn Jones (212) 438-2704
brenn.jones@spglobal.com

Bob Matthes (212) 438-3592
robert.matthes@spglobal.com

Michael Baron (212) 438-4816
michael.baron@spglobal.com

Jamie Tebaldi (212) 438-1462
jamie.tebaldi@spglobal.com

LCD News – Europe

Luke Millar (44-20) 7176-3926
luke.millar@spglobal.com

David Cox (44-20) 7176-7829
david.j.cox@spglobal.com

Nina Flitman (44-20) 7176-3995
nina.flitman@spglobal.com

Isabell Witt (49-173) 231-5018
isabell.witt@spglobal.com

Copy Edit/Production

Alex Poole (44-20) 7176-3933
alexander.poole@spglobal.com

LCD Global Research

Marina Lukatsky (212) 438-2709
marina.lukatsky@spglobal.com

Miyer Levy (212) 438-2714
miyer.levy@spglobal.com

Taron Wade (44-20) 7176-3661
taron.wade@spglobal.com

Cuong Huynh (212) 438-5202
cuong.huynh@spglobal.com

Sara Shehata (212) 438-4441
sara.shehata@spglobal.com

Nicholas Boekel (212) 438-3847
nicholas.boekel@spglobal.com

Leonie Dackham (44-20) 7176-6025
leonie.dackham@spglobal.com

Igor Silva (212) 438-5837
igor.silva@spglobal.com

Shaundra Edmonds (434) 951-7658
shaundra.edmonds@spglobal.com

Daniel Levine (212) 438-2213
daniel.levine@spglobal.com

Tim Mastracci (434) 951-4512
timothy.mastracci@spglobal.com

Carl Syverud (434) 529-2846
carl.syverud@spglobal.com

Brian Wright (212) 438-1683
brian.wright@spglobal.com

Eric Lehmann (212) 438-1689
eric.lehmann@spglobal.com

Marketing/Sales

Neslyn D'Souza (212) 438-2708
neslyn.dsouza@spglobal.com

Vanessa Greaves (212) 438-2292
vanessa.greaves@spglobal.com

Chris Polanco (212) 438-3231
christopher.polanco@spglobal.com