S&P Global Market Intelligence

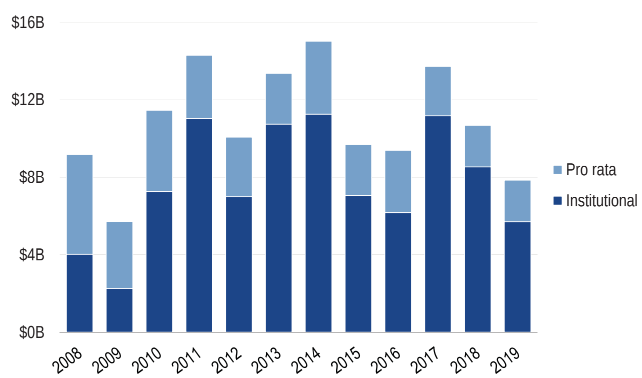
LCD Middle Market Review

Syndicated MM lending gives way to direct lending

The new-issue slowdown in the broadly syndicated loan market in 2019 was felt in the smaller end of the market as well, as a mere $5.7 billion of institutional middle market loans were issued last year, a 33% drop from 2018. Syndicated middle market loan volume has been plummeting since 2017.

This coincides, of course, with the rapid rise in direct lending fundraising and new-issue activity, as that segment continues to gain prominence in the capital markets.

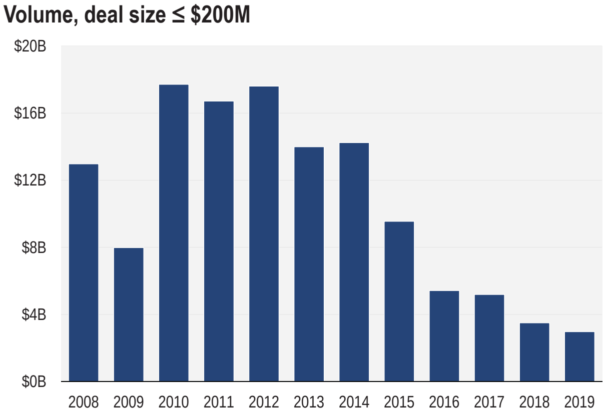
MM syndicated issuance (issuer EBITDA ≤ $50M)



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

Tellingly, the volume of syndicated deals under $200 million has evaporated over the past five years. In 2014, volume for these deals topped $14 billion. In 2019, volume of syndicated loans at $200 million or less in deal size shrank to under $3 billion. These deals are now getting done by direct lending funds, sources say.

Volume, deal size ≤ $200M



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

But it's not just the small deals. Direct lenders completed many transactions in 2019 that topped $500 million.

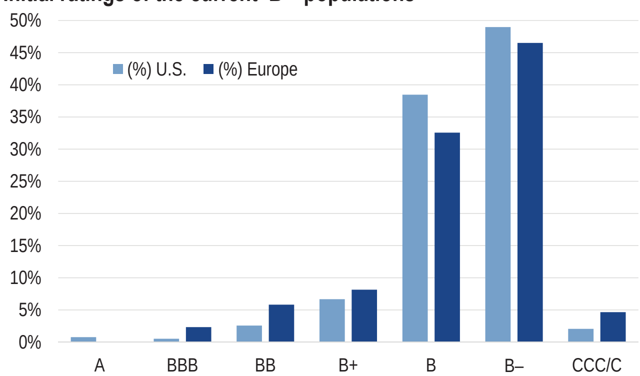
"We've noticed [more] upper middle market lenders migrating to higher deal sizes than they ever have done before," says Michael Ewald, head of private credit at Bain Capital Credit.

However, an oversupply of capital in direct lending funds isn't the only thing hindering syndicated middle market loan issuance. The demand side is driving this dynamic, too.

"If the CLO market is strong, it incentivizes banks to do syndicated deals because they have a number of constituents to serve," Ewald says. "The middle market CLO market has been relatively quiet, and as a result there's not an obvious type of investor to sell to, which has allowed direct lenders to be more active."

More specifically, the issue concerns lower-rated B– loans, typically for smaller issuers. By the second quarter of 2019 the proportion of speculative-grade debt issuers rated B– hit an all-time high of 20.5% in the U.S., according to research by S&P Global Ratings. Downgrades have added to the B– stack.

Initial ratings of the current 'B–' populations



Sources: S&P Global Ratings Research and S&P Global Market Intelligence's CreditPro®
Published in: *Credit Trends: The Expansion Of The 'B-' Segment Is Feeding Growing Vulnerabilities*, Sept. 26, 2019

Randy Schwimmer, head of origination and capital markets at Churchill Asset Management, explains how this affects middle market loan issuance:

"The demand side of the broadly syndicated loan equation comes mostly from CLOs and retail funds. CLO managers spent a good part of last year worried about downgrade risk for weaker single-B credits and the impact on triple-C baskets.

That pushed yields up for all but the best issuers. And until recently, cash was exiting from loan funds. Those factors created headwinds for the larger middle market syndicated deals. Private equity sponsors, accordingly, turned to direct lenders, whose capacity to hold larger commitments has expanded dramatically. At a time when financing itself has become weaponized, the direct route offers quicker and surer execution."

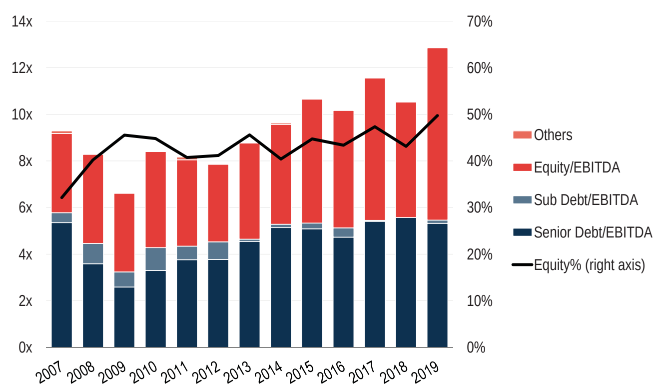
"Yields are widening out in the lower end of the BSL market, which is justification for sponsors going the direct lending route," adds Garrett Ryan, partner and head of capital markets at Twin Brook Capital Partners.

Leverage & Purchase Price Multiples

Purchase price multiples for middle market companies have skyrocketed over the past decade, from roughly 6.6x in 2009 to 12.9x in 2019, according to LCD.

"In some of these upper middle market software-related businesses, purchase price multiples are north of 20 times," Dave Brackett, CEO of Antares says.

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



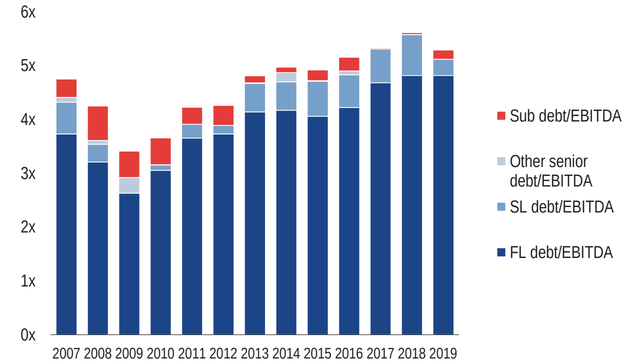
Source: LCD, an offering of S&P Global Market Intelligence

One reason for this: Private equity firms are sitting on hundreds of billions of dollars in dry powder, and they are bidding up the valuations of middle market companies. As good deals become scarce, larger private equity firms have come down into the middle market to buy companies, increasing upward pressure on valuations.

However, leverage levels aren't rising at the same pace as purchase price multiples.

First-lien debt/EBITDA ratios held stable from 2018 to 2019. Even in the lower middle market, leverage levels haven't risen significantly.

Debt/EBITDA for deals ≤ $50M EBITDA



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

We haven't really seen sponsors push leverage much more," says John Brignola, managing partner and co-founder of LBC Credit. "I think it's because of this cautionary perspective concerning a potential recession."

Philadelphia-based LBC's typical borrower has $5–25 million in EBITDA.

According to SPP Capital, leverage levels for the lower middle market have been relatively stable over the last year. For companies between $10 million and $20 million of EBITDA, leverage was unchanged, staying within the range of 4–5.25x. For companies with over $20 million in EBITDA, the range expanded marginally, from 4.5–5.75x to 4.5–6x.

"A disproportionate amount of the increase in purchase price multiples has been borne by the private equity sponsors," Brackett says.

Indeed, according to LCD, middle market equity contributions have increased from 43% in 2018 to roughly 50% in 2019. This is not due to a lack of debt capital available to lever deals. This is mainly because private equity sponsors are achieving higher leverage levels in other ways.

"There are some borrowers who push very hard to get cov-lite loans," Stefanie Birkmann, co-head of Ropes & Gray's global finance practice group, says. "If the borrower can't get this, the fallback is covenant-loose. If you end up with covenant-loose, there's a lot of focus on providing sufficient covenant cushion and negotiating the EBITDA definition, including EBITDA adjustments and addbacks." While stated leverage levels haven't risen, EBITDA adjustments have increased, effectively increasing leverage.

"The subtle change is the unstated dynamic of EBITDA addbacks," Brackett says. "The flexibility around addbacks has become far more accommodative for sponsors, such that they are able to lend off of more heavily adjusted EBITDA."

According to Stefan Shaffer, managing partner of SPP Capital, "Between 2015 and 2019, adjustments to EBITDA have increased by another full turn; i.e.—in 2015, a total debt-to-adjusted EBITDA of 4.75x translated to total debt-to-unadjusted EBITDA of ~5.5x. Today, a ~5.5x total debt-to-adjusted EBITDA translates to ~6.75x total debt-to-unadjusted EBITDA."

Pricing and yields

First-lien middle market yields have fallen significantly over the past year. In 1Q19, the average yield was 8.15%. By the fourth quarter 2019, yields had fallen to 7.61%, marking a 0.54% decline. The fall in three-month LIBOR played a role.

YTM, MM deals (issuer EBITDA ≤ $50M)

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

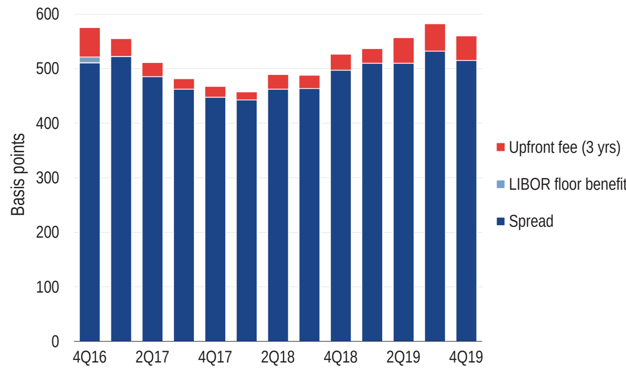
On Jan. 15, 2019, 3-month LIBOR was at 2.77%. As of Jan. 22, 2020, 3-month LIBOR was 1.81%, a 0.96% drop.

That said, the actual spreads on syndicated middle market loans have been stable.

Throughout 2019, spreads never fluctuated more than 18 bps. The average spread in 4Q19 was 515 bps. However, spreads have certainly widened from 2018 levels, when they were in a range of 443–497 bps.

In the lower middle market, Brignola comments that spreads stayed "very stable the last half of 2019."

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



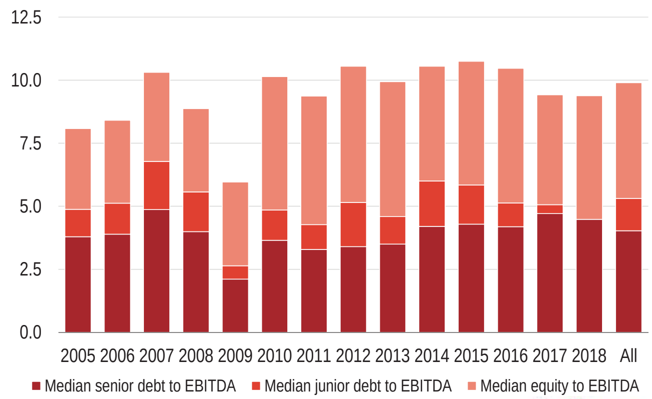
Source: LCD, an offering of S&P Global Market Intelligence

"Over the last six months of 2019 there wasn't really any change in pricing," Twin Brook's Ryan says. "The other thing that emboldens direct lenders to maintain yield is that LIBOR has dropped significantly. I don't think the idea of increased LIBOR floors over 1% will gather momentum, but it would be interesting to see. Direct lenders are sensitive to what's happening with LIBOR, as it affects overall yields."

— Shivan Bhavnani

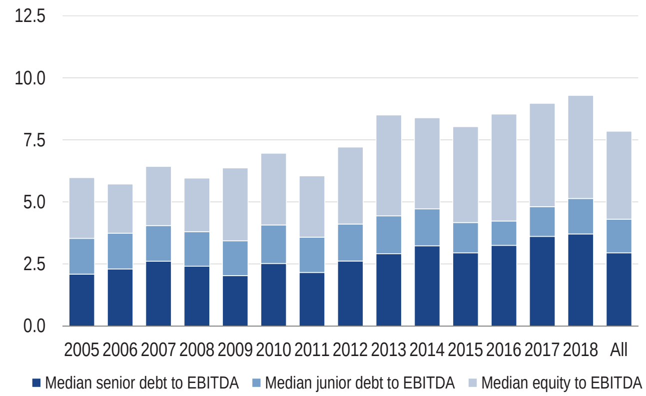
Direct lending stats from CEPRES

Private debt financing structure at entry: Europe



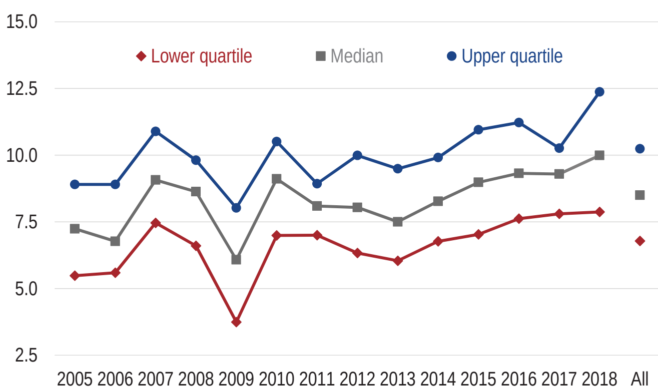
Source: CEPRES Platform

Private debt financing structure at entry: North America



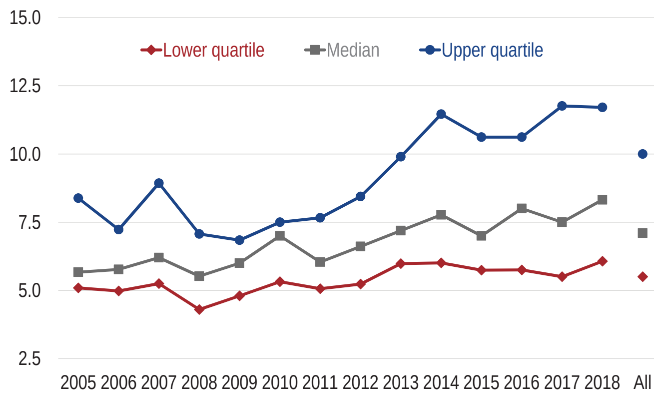
Source: CEPRES Platform

Private debt EV to EBITDA at entry: Europe



Source: CEPRES Platform

Private debt EV to EBITDA at entry: North America



Source: CEPRES Platform

CEPRES Platform: https://platform.cepres.com/register

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

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

Francesca Ficai (020) 7176-0659
francesca.ficai@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

Vincent Sireci (212) 438-6604
vincent.sirect@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

Hannah Wiltshire (212) 438-1018
hannah.wiltshire@spglobal.com