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A Year in Review (Last of a Series)

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2016 was the Chinese Year of the Monkey. We're not sure what this meant, or how it applied to the middle market, but in looking at how loans spreads behaved throughout the year, there might have been some relationship.

For one thing, all-in spreads swung around wildly month to month. February, according to LPC, was the highpoint, with almost a 8% yield. The lowpoint arrived only three months later, in May (5.6%).

We're familiar enough with the non-correlated nature of middle market loans to know their prices don't rhyme exactly with those of liquid loans. But they do resonate. As fund flows and CLO formation create volatility in the broadly syndicated markets, mid-cap spreads will move in concert with their larger cousins to maintain the same relative illiquidity premium.

That was indeed the case for 2016 middle market first-lien spreads, which averaged around 6.6%. That was slightly better than 2015's performance of 6.5%, and about 125 bps higher than all-in yields for broadly syndicated loans at the end of the year.

Looking a bit closer at the distinction between traditional middle market loan spreads and those of larger loans, we observe they've traded back and forth over the past four quarters (see *Chart of the Week*). The year ended with smaller, probably clubbier, loans up close to L+500 while larger mostly syndicated ones contracted to L+450.

The real takeaway, though, is that yields really don't stray historically much from the L+450-500 range.

Loans also proved to be adaptable and resourceful, depending on market conditions. When necessary, arrangers filled out order books by tweaking spreads or OID, or in some cases expanding and contracting first and second lien tranches.

The story on second lien last year was to some extent tied to unitranche. As the popularity of the one-stop has grown, seconds have waned. Why pay L+1000 for a second-lien when spreads for unitranches have contracted down from L+700 to 600 for the larger, better credits? That's close to what some issuers were paying for *first-lien* loans not long ago.

No surprise, then, that LPC reported second lien volume shrunk to around $1.75 billion, half of 2015's $3.5 billion number. (S&P LCD reported only $270 million in second liens for middle market issuers for all of last year.)

For 2017 – the Year of the Rooster – we expect the month-to-month spread swings to continue, along with a general tightening trend within a band. So if deal flow continues its relatively strong showing from the second half of last year, both investors and issuers will have something to crow about this year.

Next week we begin a new series on trends for 2017.