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2017 – A Look Ahead (Second of a Series)

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Last week we ventured some thoughts on where this year would take us on middle market deal terms – pricing, leverage, structures, and covenants [link]. This week we examine the supply and demand technicals we expect will drive those terms.

First, let's dispel the persistent myth of too much cash chasing too few deals. Last year Thomson Reuters LPC reported $52 billion in middle market sponsored loans. The vast majority of this was traditional senior debt. If you use the year-end average leverage of 4.1x senior/4.6x total, that translates to over $45 billion senior loans and less than $5 billion junior debt.

Compare that to the demand side. According to Preqin, over $92.5 billion was raised by private debt funds in 2016. But only $20.9 billion was designated as "senior debt." This is consistent with reports from fundraisers and institutional investors that many of these new funds target 9% or more yields. That's junior or higher risk senior debt.

What commentators also miss about new entrants is that many have limited middle market experience. They are either large cap shops dipping down into smaller deals or "credit op" funds seeking issuers who can't get "regular way" financings. This may be because the companies lack creditworthiness to attract traditional senior debt, or because they are non-sponsored, or because they are in non-favored sectors.

These opportunities carry a significant execution component. "Story" deals demand much higher yield than the private senior secured debt club market. Opportunistic financings have 10-12% coupons, vs. the 6-7% all-in spreads for borrowers that are market leaders and demonstrated good performance through business cycles.

Besides, if there's too much cash out there chasing too few deals, why haven't we seen a greater contraction in loan spreads? According to Thomson Reuters LPC, all-in middle market spreads were 6.33% at the end of January 2016 (based on a three-year life) and ended last year at 6.60%.

This spread stability is in part due to the continued disintermediation of the lowest-cost lenders (banks) by direct lenders offering flexibility in favor of spread. It is also masking what that flexibility often entails; namely, higher leverage. That leverage is increasingly comprised, as we've previously noted, of aggressive ebitda adjustments.

On the supply side, there's actually more middle market deal flow than is being captured by most reporting firms. One exception is LPC. Their data show private club market deal volume building steadily for the past four quarters (see our *Chart of the Week*). We expect that to continue well into 2017.

Finally, the strengthening economy should give a modest lift to M&A activity this year. Some sectors will give investors more pause than others, but overall the promise of a more business-friendly climate should keep the "supply" part of supply/demand full.

Next week we examine the outlook for credit quality during 2017.