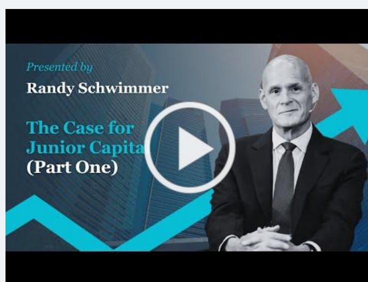
THE Lead Left
Your Tour Guide to the Middle Market®

PDF | Research | Week of July 17, 2023

Quote of the Week

"The environment for M&A transactions continues to be very challenging."
– Frank Aquila, senior M&A partner, Sullivan & Cromwell.



Lead Left Vodcast

The Case for Junior Capital (Part One)

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The Case for Junior Capital (Part Two)

We continue our discussion this week on why private mezzanine is going from strength to strength amid current economic and market conditions.

"We did zero mezzanine deals last year," one junior capital provider told us. "This year we've already done half-a-dozen. We're getting calls from sponsors that don't typically use mezz. Deal flow is up significantly, particularly for PIK deals given what's going on in the senior market. We're trying to pick our spots. If the use is just to pay senior cash interest, that's an easy no."

"Our high-water mark for investment activity occurred during the peak of aggressive senior debt market conditions, and we have experienced an uninterrupted growth trajectory in junior capital activity since 2011," our Head of Private Equity and Junior

Capital, Jason Strife, told us. “Middle market deal flow was soft versus the same period last year. However, our closed deals were up over 20%. Despite decline in buyout activity and broader M&A activity, we had many unique opportunities to capitalize on the market’s dislocation, with high quality businesses.”

What’s behind those unique opportunities? “The mix skewed towards add-on acquisitions for our portfolio companies,” he said. “Our sponsors are looking to avoid triggering MFN [most-favored nation] provisions. These are designed to protect existing lenders for some period against borrowers raising incremental capital in the same tranche at higher pricing.

“Given senior debt market spreads have widened out by about 200 bps over the past few months, it’s more cost efficient for sponsors to layer in a piece of junior capital or structured capital rather than re-price the entire senior facility.”

The MFN issue is helping a Chicago-based lender deploy junior capital. “We’re in one deal across the capital structure – senior, junior, and equity co-investment,” they reported. “The sponsor needed incremental financing for an acquisition. The agent wouldn’t waive the MFN so the sponsor used incremental mezzanine and equity. We priced the new mezz 1% higher and waived the MFN on the existing mezz, avoiding a reset of pricing across the board.”

The same market dynamics favoring terms for senior debt investors are helping buyers of junior debt and structured capital. “We’re getting 100 – 200 bps higher all-in spreads with a half to full turn of lower leverage with higher equity cushions. And that’s improving quarter-over-quarter.”

A more opportunistic junior capital lender also weighed in on today’s opportunity set. “Due to our high return hurdles we focus on hairier stuff, more non-sponsored transactions. But now we can achieve those returns with sponsor-backed businesses. Honestly, we’re trying to soak up as much second-lien, mezz, and PIK preferred as we can.”

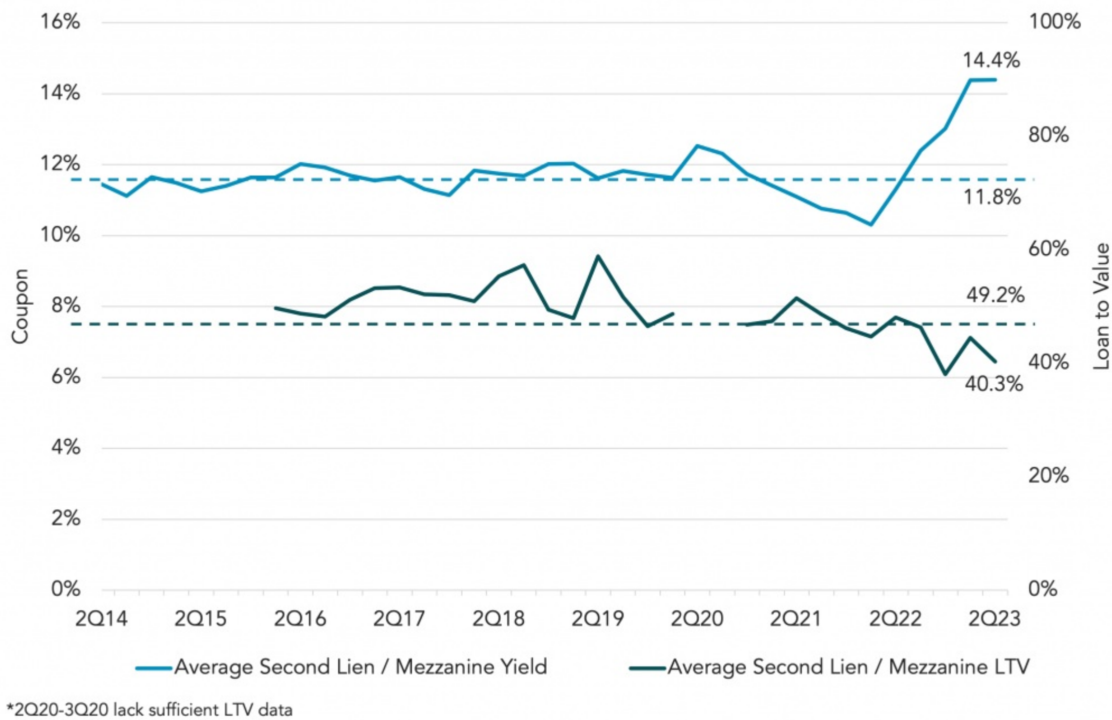
“It’s an incredible time to get mid-teens returns at 5x leverage or less. There’s a lot of demand for junior capital to preserve the senior credit facilities that are attractively priced. It’s like rewinding the clock 20 years for the junior capital market.”

Visit our Website

Chart of the Week

Yield of Dreams

Consistent with senior debt trends, junior debt yields are up, leverage down.



Source: Refinitiv LPC

Lead with Your Left

Stat of the Week

	Retirement plan assets like a 401(k)	Personal savings	Investments outside retirement	Social Security
Where Will Your Retirement Financing Come From?*	74%	61%	50%	42%

*Source: The TIAA Institute and Business for Impact's AgingWell Hub at Georgetown University. *Income of $100K and up*

Loan Stats at a Glance

PitchBook | LCD

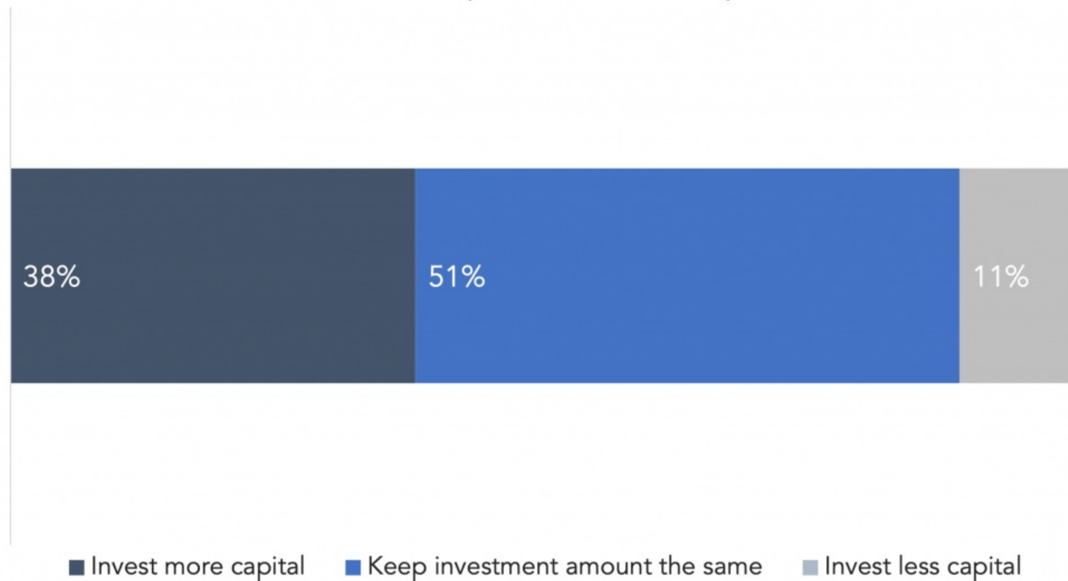
	This Week	Last Week	6MO Ago	YR Ago
New-Issue Clearing Yields				
$200M or less	NA	NA	NA	NA
$201M - $350M	NA	NA	NA	7.65%
$351M - $500M	10.27%	10.27%	10.54%	10.50%
$501M+	10.31%	10.23%	10.10%	8.26%
Middle market (≤ $50M)	NA	NA	NA	NA
Large corporate (> $50M)	10.31%	10.21%	10.16%	8.39%
Large corporate single-B (> $50M)	10.74%	10.63%	10.85%	8.49%
Middle Market Credit Stats				
Sr/EBITDA	N/A	N/A	NA	NA
Debt/EBITDA	N/A	N/A	NA	NA
Middle Market Index Data				
Monthly Returns	0.93%	0.41%	0.83%	0.15%
Average Bid	91.32	91.03	93.30	93.37
Source: PitchBook LCD				

Contact: **Marina Lukatsky** / S&P Global Market Intelligence

PDI Picks

Private Debt Investor

Are the storm clouds receding?



Private debt may be in the process of demonstrating its resilience in the face of the latest challenges.

One thing that studies consistently show – including our own *Perspectives* survey, see chart above – is that investors are still scrambling to access private debt. Tough times we may be living through, but nearly 90 percent of LPs appear keen to either increase their private debt exposure or keep it at the same level.

Perhaps this investor confidence is down to emerging evidence that the asset class can successfully weather the storms. A recent study from Kroll Bond Rating Agency determined that a distressed wave was unlikely to be building since it would by now have already appeared, washing over those companies that had failed to hedge themselves against interest rate rises.

The lack of interest rate hedging is acknowledged to be widespread, likely driven by the complacency that arose from operating in what seemed like a permanent ultra-low interest rate environment. When rates went up, they went up very quickly and caught some companies by surprise.

But the demands of higher interest rates 4.5 percent from 4.2 percent in the previous quarter. This is certainly above the long-term private debt default rate – which is closer to 2 percent – but well below the 8 percent rate recorded in the aftermath of the economic stasis that followed the initial covid outbreaks.

Given the fact that interest rate pressures have now existed for well over a year – the US Federal Reserve's first rate hike in more than three years took place in March 2022 – market sources tend to agree with Kroll's assessment that many of the worst outcomes have probably already been seen.

There is a view that capital has been used more efficiently and innovatively than in previous cycles, for example through increased use of payment in kind rather than cash, while cost-cutting measures of various kinds have been deployed to maintain margins in the face of wage inflation. Managers also appear to have done a good job – on the whole – of identifying sectors more resilient to downturns, even if that's meant going the extra yard on multiples and leverage.

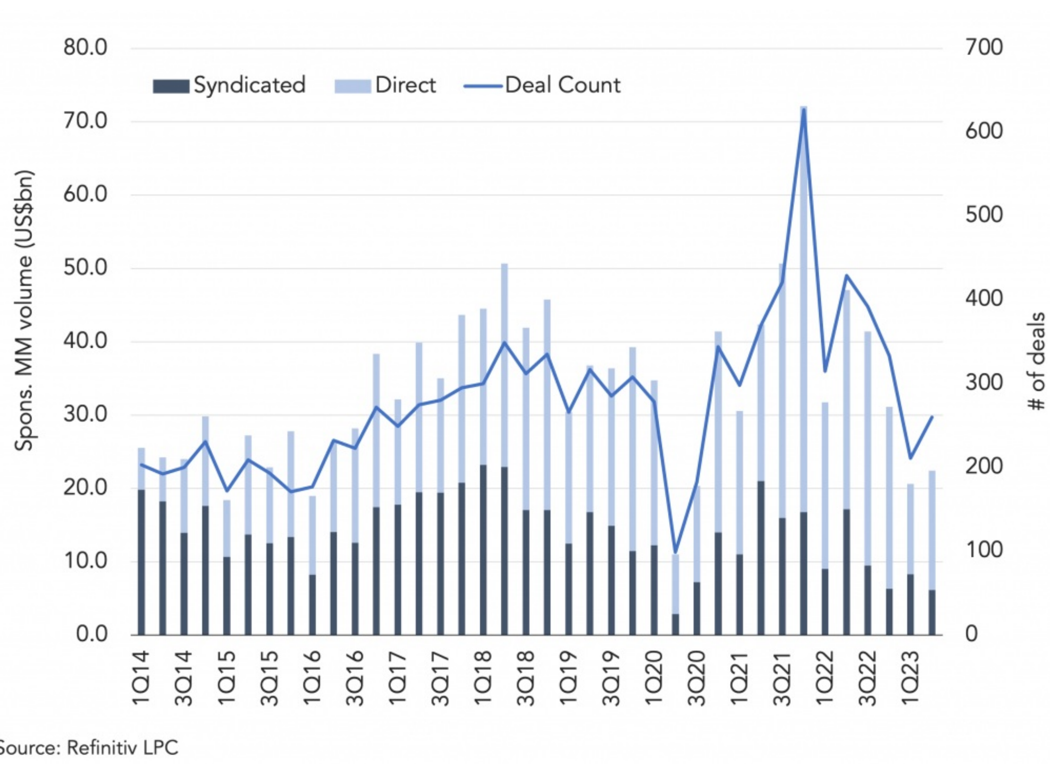
appear not to have taken a particularly heavy toll on borrowers. It's striking that there are no predictions of default Armageddon. Lincoln International's Senior Debt Index for the first quarter of this year showed the default rate rising to

For private credit as a whole, riding the latest storm would be seen as welcome evidence of its durability by investors who up to now have yet to see how it performs under a sustained period of pressure.

Contact: **Andy Thomson** / Private Debt Investor

Leveraged Loan Insight & Analysis

US sponsored middle market direct lending volume increased in 2Q23



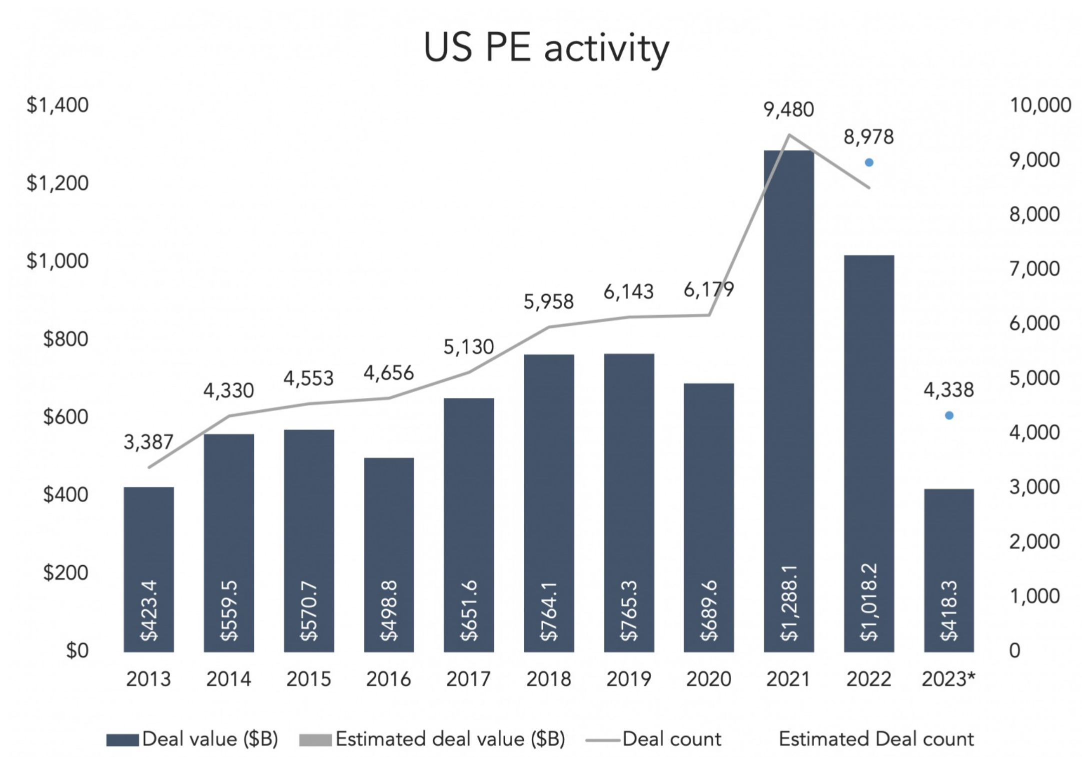
Activity picked up in the US middle market direct lending space in 2Q23 but remained at lower levels. At US$16.3bn, sponsored middle market direct lending volume was up 32% from 1Q23 but was down 46% year-over-year. In contrast, the syndicated sponsored market slowed down relative to 1Q23, with issuance dropping 26% quarter-over-quarter and a whopping 64% from 2Q22. In turn, the ratio of direct lending to syndicated loan volume climbed to 2.6 times after dropping to 1.5 times in 1Q23. Finding quality deals, low M&A activity and more selectivity continue to be the main factors hindering activity in the sponsored market.

Contact: **Diana Diquez** / Refinitiv LPC

The Pulse of Private Equity

PitchBook

Another mixed quarter



US PE activity brought in mixed results in Q2, with deal volume up slightly and value down almost 16%, according to PitchBook's US PE Breakdown. Dealmaking has declined in four of the past six quarters, making it difficult to ascertain any trends in a recovery. That said, deal volume is now above pre-Covid levels, while deal value is around the same level.

The headline numbers camouflage some trends that are evident. Deals have gotten smaller, as LBO financing has become trickier. Smaller deals are easier to finance, which has also aided more add-on deals to be done in the current environment. The add-on-to-LBO ratio is now at 78%, its highest reading ever. Growth equity deals are also comparatively strong, as they don't require leverage components. Its share of PE activity is now at 22%, up from 19% last year and withing earshot of its all-time high. So even as overall dealmaking sputters along with mixed readings, the undercurrents of those readings—smaller deals, more add-ons and growth investments—are more solidified than the headline readings suggest.

Download Data & Report

Contact: **Alex Lykken** / PitchBook

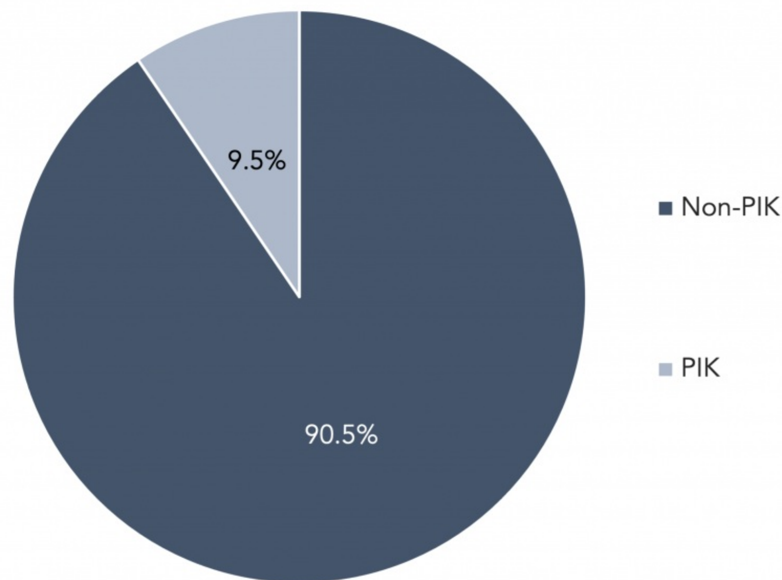
DL Deals: News & Analysis

Direct Lending Deals
A KBRA ANALYTICS PRODUCT FOR PRIVATE CREDIT

KBRA DLD Default Index:
2023 forecast is 2.5% for sponsored deals

KBRA DLD Default Index

	All	Sponsored	Non-Sponsored
YTD	0.9%	1.2%	0.8%
2023 Forecast	2.5%	2.5%	2.3%



Source: Solve; as of March 31, 2023, cost basis; Senior debt includes 1L, 2L, Unitranche

KBRA DLD's 2023 default forecast is 2.5% for sponsor-backed direct lending loans, equating to roughly 30 defaults against the roughly 1,200 sponsored borrowers in the KBRA *DLD* Default Index.

Table 1

The year-to-date (YTD) sponsored rate is 1.2%, which includes 14 defaults—mainly bankruptcies. Searchlight Capital Partners-backed MediaMath marked the most recent default at the end of June.

For non-sponsored direct lending, *DLD* projects a 2023 default rate of 2.25%. This segment has experienced 11 defaults so far this year against more than 1,400 non-sponsored issuers in the Index, translating

The pressure of higher borrowing costs can also be seen in the form of PIK payments as borrowers flip to this option or some combination of PIK/Cash-Pay, as seen during the early days of the pandemic.

According to *Solve*, 9.5% of outstanding senior debt investments (1L, 2L, Unitranche) was PIKing across nearly $230 billion of senior assets across BDC portfolios in the first quarter on a cost basis. The likelihood of more companies emerging with PIK pricing in the quarters ahead is strong as base rates remain elevated. Unlike the relatively short-lived financial crunch during the pandemic, higher borrowing costs are here to stay for some time.

to a 0.8% rate YTD.

For the overall Index, the 2023 forecast is 2.5% and stands at 0.9% YTD. The Index is curated by *DLD* and comprises private loans to more than 2,600 companies.

Interest threat

Swift and steep interest rate hikes over the last year have created the biggest danger to cash flows. Many issuers are now grappling with borrowing costs of roughly 12%, up from about 8% a year ago in the private market.

DLD's ratings parent, KBRA, published separate research last month highlighting movement across interest coverage ratios. In the rating agency's cohort of middle market corporate credit assessments, last October's 12% stress test pushed the percent of borrowers with coverage ratios <1.0x to 38% from 23%, according to the research.

Against an updated 13% stress test, the percent of borrowers with <1.0x ratios ticked up to 39%, while a 13.5% stress test increased the <1.0x group to 40% of the cohort. (Note that about 15-20% of the group comprises recurring revenue loans.) The message: The damage is already done.

Chart 1

Private equity-backed companies typically have more aggressive capital structures and loan terms than non-sponsored borrowers, however PE firms have more resources in terms of access to capital, expertise and relationships to drive portfolio companies through rough patches.

During the Covid-era, direct lenders reined in terms, making the 2020-2023 class of sponsored loans one of the most conservative since the Global Financial Crisis. Leverage, a key measure of appetite for risk, has generally trended downward over the past 24 months, by roughly 1x, according to *DLD*. Moreover, vintages pre-dating 2020 were structured more conservatively relative to the aggressively arranged deals in the syndicated loan (where about 80% of volume is covenant-lite) and high yield markets.

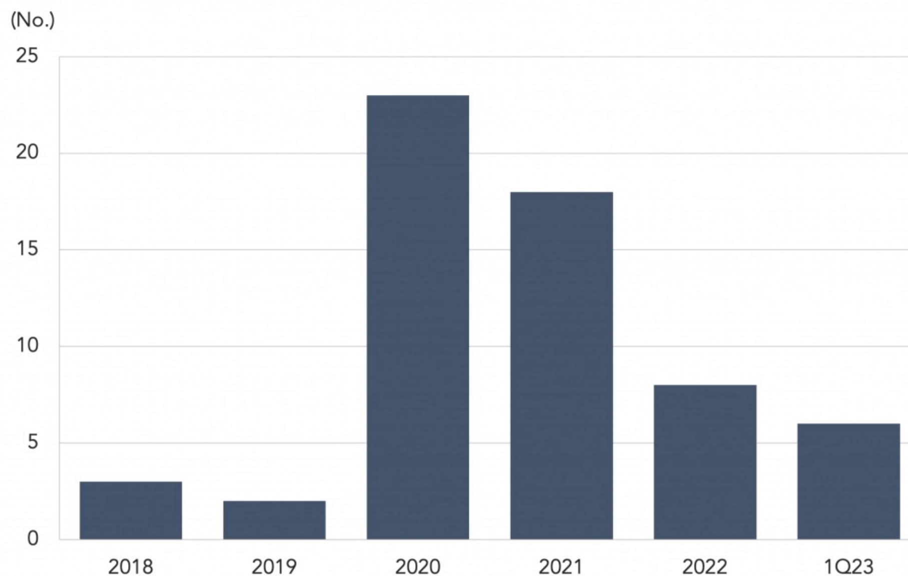
One of the main tenets of the private market is the close-knit relationship sponsors enjoy with a smaller group of lending partners. The next several quarters will certainly test those bonds.

Contact: **Kelly Thompson** / KBRA DLD

Middle Market & Private Credit

FitchRatings

Default Outlook for Middle Market



Fitch recorded eight defaults in our Private Monitored Rating (PMR) portfolio in 2022, down from the pandemic-affected years of 2020 and 2021 when we recorded 23 and 18 respectively. YTD defaults through June 2023 total seven, one short of the total in 2022 and ahead of full-year 2018 and 2019 totals.

Fitch expects defaults in our PMR portfolio to remain elevated through 2023 and into 2024 as companies with compromised business models buckle under the weight of high interest rates and weakening demand. Elevated interest expense could result in otherwise healthy companies seeking concessions from lenders on cash payments, which could further pressure defaults.

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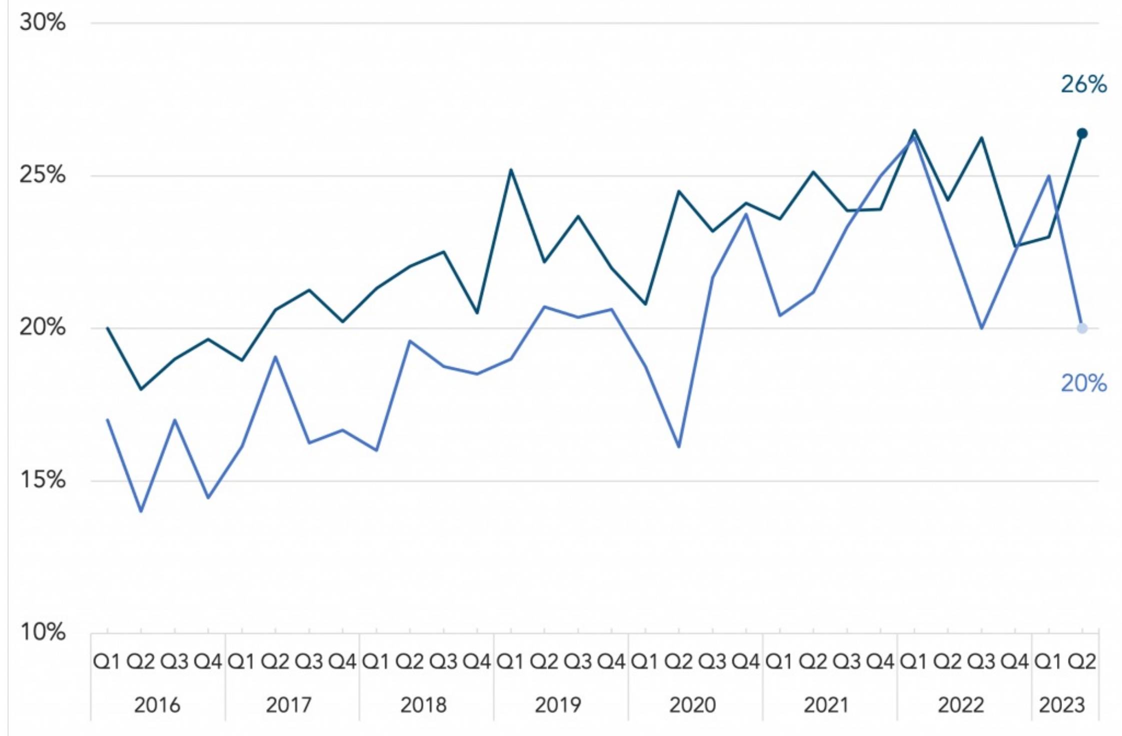
Contact: **Brad Hamner** / FitchRatings

Covenant Trends

Covenant
Review

Average EBITDA Adjustment Cap for Synergies & Cost Savings

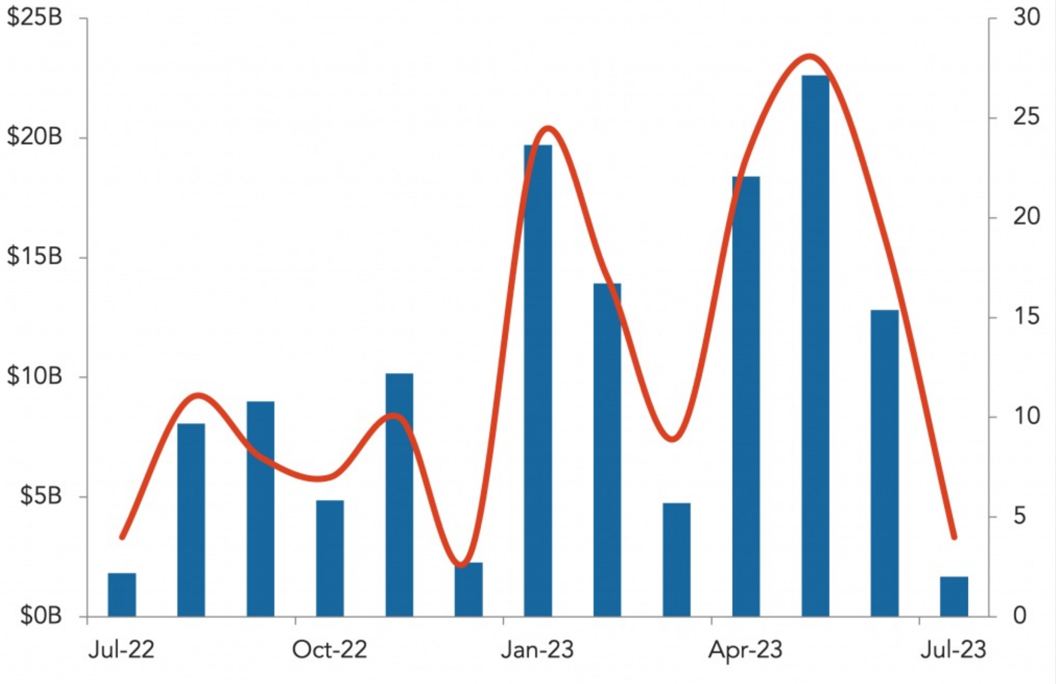


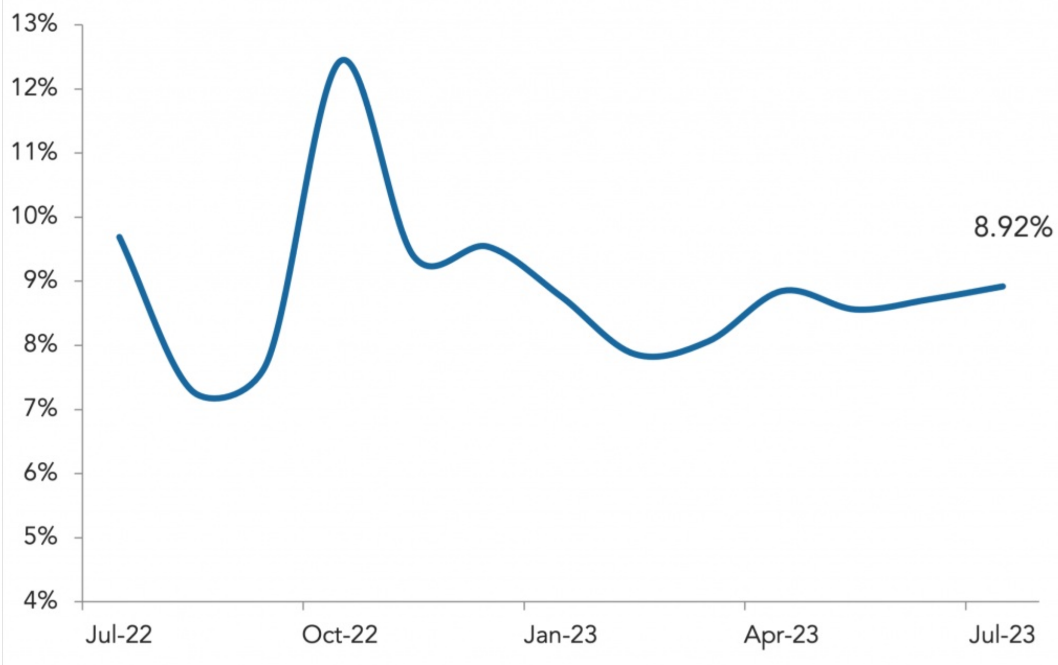
Download Data

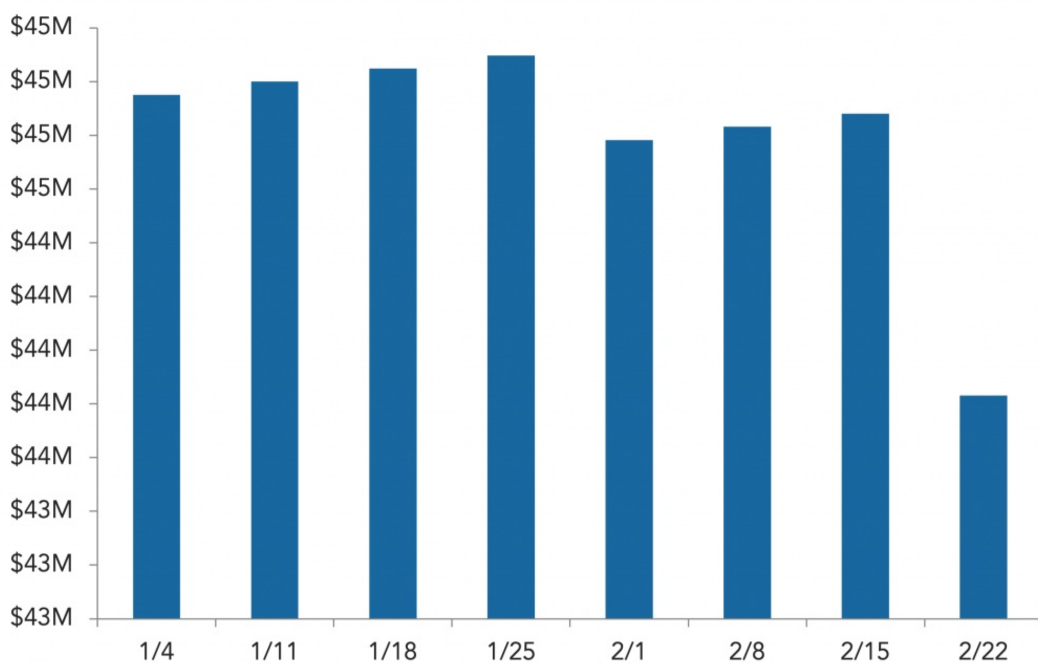
Contact: **[Steven Miller](#)** / [Covenant Review](#)

High-Yield Bond Statistics

LevFin Insights







Weekly fund flows source: Lipper

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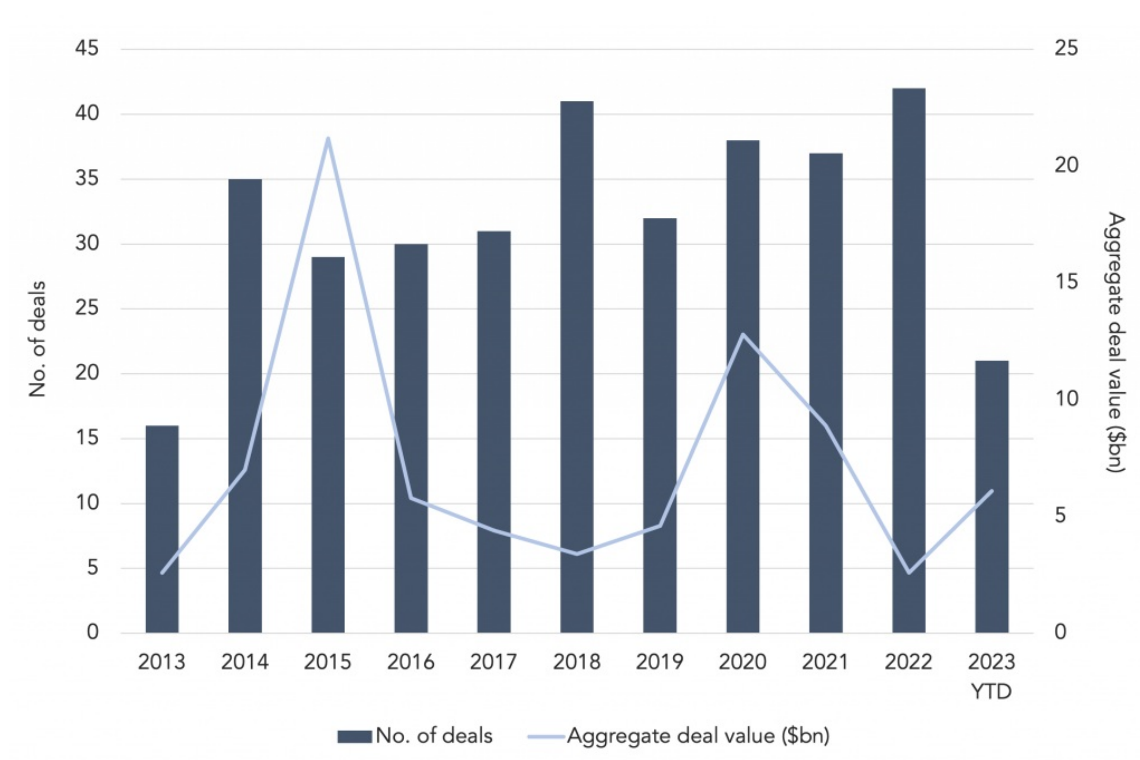
Contact: **Robert Polenberg** / LevFin Insights

Private Debt Intelligence

PREQIN

Emerging market private debt dealmaking remains steady

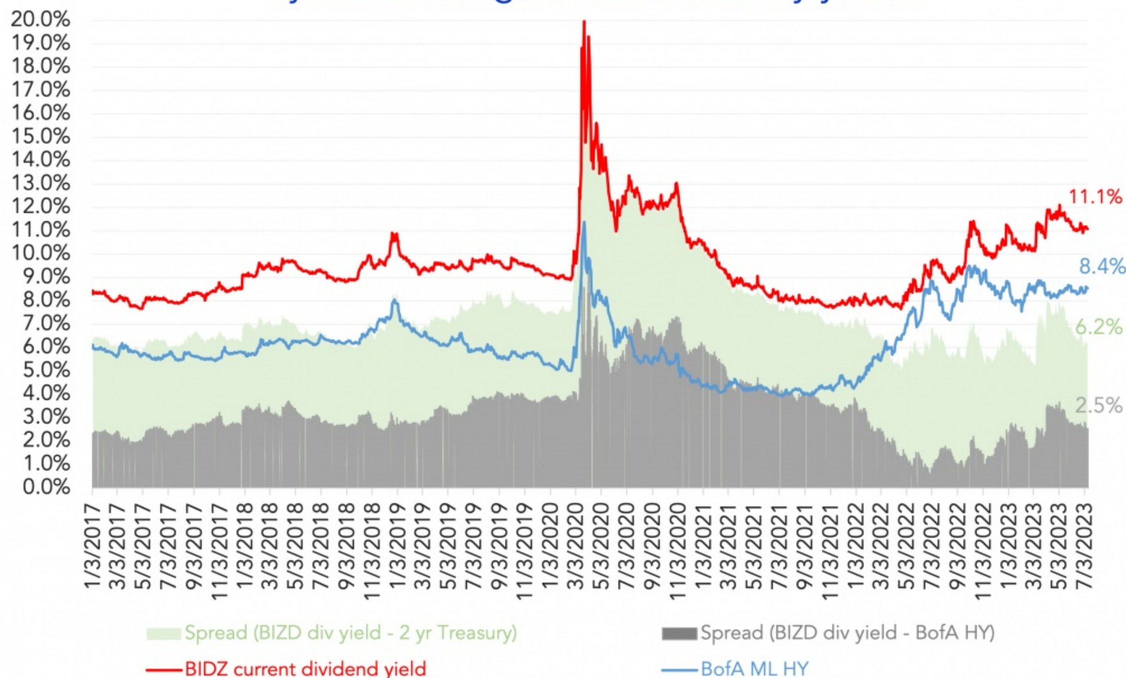


As emerging markets continue to develop their private debt markets, they present both opportunities and risks for investors looking to tap into their growth. With regions such as India, Southeast Asia, and the Middle East among those targeted by fund managers in 2023, there is a clear desire for dealmaking. According to Preqin Pro, there has been a steady rise in deal volume. Between 2019 and 2022, deal volume grew from 32 to 42, while deal value fluctuated between $4.6bn on average to $6.1bn in that same period, peaking at $12.8bn in 2020.

Download Data

Contact: **Thomas Marrs** / Preqin

Debtwire Middle-Market



Source: VanEck BDC Income ETF, BofA Merrill Lynch US High Yield Effective Yield

The red line in the chart is the current dividend yield of the *VanEck BDC Income ETF that tracks the overall performance of publicly traded business development companies (BDCs, lenders to privately held middle-market businesses that tend to be below investment grade or not rated, with most lending comprising of senior secured loans). The blue line displays the BofA Merrill Lynch US High Yield (US HY index – currently at 8.54% as of 10 July), which tracks the performance of USD denominated below investment grade corporate debt publicly issued in the US.

Amid higher inflation and a rise in interest rates, we have seen a rise in the US HY index, from the lows of 4.5% in January 2022 to the current yield of 8.54%, with a peak of 9.5% in September 2022. The recent decline in HY from its peak has been a function of declines in CPI numbers (4% as of May 2023, from the peak of 9.1% in June 2022) and FED's recent pause on rate hikes.

The spread of BIZD dividend yield minus the US High Yield (*shaded area in gray*) shows the premium/discount of middle-market loans over traditional high yield. As of 10 July, BIZD dividend yield was at a premium of 255bps to the US High Yield Index, higher than the 1-year average of 208bps. The premium for middle market, to some extent, depicts illiquidity for private loans and the credit risk associated with middle market companies. The spread of BIZD dividend yield minus the 2-year treasury (*shaded area in green*) stood at 624bps as of 10 July, marginally below the 1-year average of 638bps.

** As of 30 June 2023, BIZD's weighted average market cap stands at USD 4.3bn, with PE ratio of 15.72 and PB of 0.93, with the entire portfolio holdings in publicly traded BDCs.Click here for top holdings.*

Download Data

Contact: **Suneet Chandvani** / Debtwire

Middle Market Deal Terms at a Glance

Deal Component	June 2023	June 2022
Cash Flow Senior Debt (x EBITDA)	Micro Cap1.50x-2.00x Small Cap2.00x-3.00x Midcap2.50x-4.50x	Micro Cap1.50x-2.50x Small Cap2.75x-3.25x Midcap3.50x-5.50x
Total Debt Limit (x EBITDA)	Micro Cap2.50x-3.50x Small Cap3.50x-4.50x Midcap4.00x-5.00x	Micro Cap3.75x-4.25x Small Cap4.00x-5.00x Midcap5.00x-7.00x
Senior Cash Flow Pricing	Bank: S+3.75%-5.00% Non-Bank: <$7.5MM EBITDA S+6.50%-8.50% Non-Bank: >$15.0MM EBITDA S+6.50%-8.00%	Bank: L+3.00%-4.50% Non-Bank: <$7.5MM EBITDA L+6.50%-8.50% Non-Bank: >$15.0MM EBITDA L+5.50%-6.50%
Unitranche and Second Lien Pricing	Micro CapS+8.50%-11.00% Small CapS+6.75%-8.50% Midcap S+6.50%-8.00%	Micro CapL+8.00%-10.50% floating Small CapL+7.50%-8.50% floating Midcap L+5.50%-8.00% floating
Subordinated Debt Pricing	Micro Cap13.00%-16.00% Small Cap12.50%-14.00% Midcap11.00%-14.00%	Micro Cap12.00%-14.00% Small Cap11.00%-13.00% Midcap9.50%-11.50%

*Micro Cap= <$7.5mm EBITDA / *Small Cap= >$10mm EBITDA / *Midcap= >$20mm EBITDA / *Changes from last month are in red

Contact: **Stefan Shaffer** / SPP Capital Partners

Select Deals in the Market

Deal	Arranger	Sponsor	Industry	Facility*	Spread	Floor	OID	Rating	CSA***
Golden West Packaging (CL)(1)	Citizens	Lindsay Goldberg	Forest Product	290.0	525	75	99	B-/B2	
Secretariat Advisors (1)	Key Bank	JLL Partners	Services & Leasing	190.0	475	75	99.5	NR/NR	
Emerald EMS (CL)(3)	UBS AG	Crestview Partners	Computers & Electronics	265.0	SOFR+625	100	98	B-/B3	10/15/25
AHF Products (3)	UBS AG	Paceline	Building Materials	215.0	SOFR+625	75	98	B/B2	10/15/25
East West Manufacturing (CL)(1)	Key Bank	MSD Capital	Automotive	275.0	SOFR+575	75	99	B-/B3	
Flow Control (1)	BNP	First Reserve Corp	Manufacturing & Machinery	75.0	SOFR+550	100	99	B-/B3	11/26/42
Advancing Eyecare (CL)(3)	UBS AG	Cornell Capital	Healthcare	250.0	SOFR+575	50	97.5	B-/B3	10/15/25
PowerGrid Services LLC (1)	BNP	Sterling Group	Building Materials	55.0	SOFR+525	100	97.5	NR/NR	
Sterling Site Access	TD Bank	Blue Wolf	Forest Product	150.0	NA	NA		NR/NR	
Instant Brands	BOA	Cornell Capital	Home Furnishings	132.5	SOFR+1000	100		NR/NR	
Averages				190	500		98		

* Senior only
** May be estimate based on leverage. Assumes unfunded revolver
NA Not Available
All dollar amounts in $MM
Corporate ratings unless otherwise noted
*** Credit Spread Adjustment

(1L) First Lien
(2L) Second Lien
(CL) Covenant Lite
(D) Dividend
(AO) Add-On

New Deal
Flex Up
Flex Down

Call Schedules
(1) 6 Month 101
(2) 12 Month 101
(3) 101
(4) 102/101
(5) 102
(6) 18 Month 101

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

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