Capstone Headwaters

MIDDLE MARKET LEVERAGED FINANCE
CURRENT MARKET CONDITIONS | MARCH 2021
www.capstoneheadwaters.com

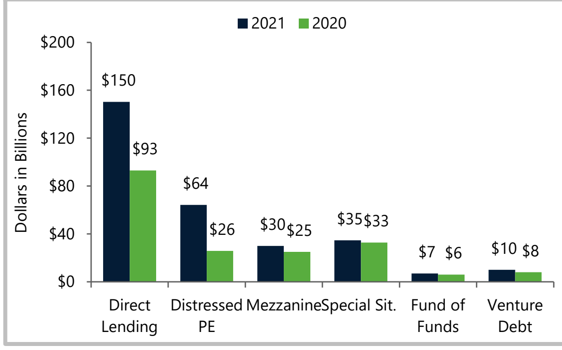
Key Market Stats[1,2]

- **Volume –** While Middle Market (MM) loan issuance saw a modest recovery in Q3, lending volume greatly accelerated throughout Q4 and into 2021 as lenders rushed to meet aggressive loan origination goals. Our team continues to witness heightened deal volume within the middle market, and we expect this surge to continue well into 2021.
- **Pricing –** Driven by a supply/demand imbalance (more debt capital available than good deals to invest in), LIBOR spreads have continued to tighten in the marketplace. In fact, the results from several of our recent mandates suggest that lending rates are now at (or better) than pre-COVID levels. Many lenders have highlighted that competition runs high and their better credits are being refinanced out more often these days by lower-cost lenders.
- **Leverage –** Leverage levels have varied based on industry sector, company size and performance throughout the pandemic. Market feedback indicates leverage levels for new loans have increased 0.25x-0.50x from last summer with more highly sought-after borrowers closer to or matching pre-COVID levels.
- **Default Rates –** After rising for months during mid/late 2020, default rates have seemed to peak. Full-bore bankruptcies and liquidations have been fewer than originally predicted.

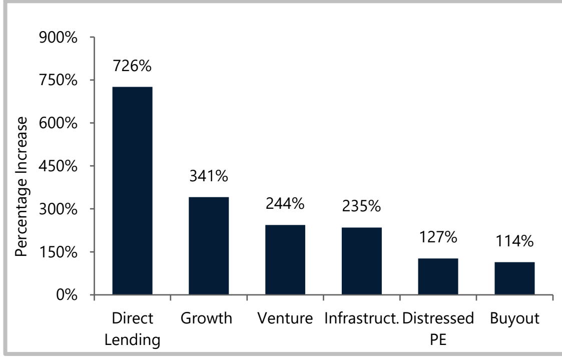
Quarterly Market Observations[3,4,5,6]

- **Credit Funds Increase Fundraising for Distressed Credit.** Throughout 2019 and 2020, a significant number of large new credit funds were raised in anticipation of a recession and, later, the expected fallout from the pandemic. However, generous government stimulus, low interest rates and the quick rebound for many businesses helped reduce the number of true "credit opportunities" available in the market. Regular-way MM credit started to come off the sidelines (at scale) during the Fall, allowing most fundamentally-strong companies in good sectors to secure debt on favorable terms over the past five months.
- **A Race to the Finish Line.** Deal flow increased in Q4, due to a strong push from sponsor leveraged buyouts (LBOs), add-ons at attractive multiples, and recaps initiated during the pandemic. The market is increasingly returning to more traditional dynamics with broad auctions and new platform activity leading the charge. Sponsored middle market volume of $14.0 billion in Q4 2020 ($10.0 billion new money, $4.0 billion refinancing) is nearly double Q3 2020 levels of $7.2 billion and up ~23% year-over-year. Competition for deals has led to modestly higher leverage and lower spreads, as credit funds remain saddled with a significant amount of dry powder that needs to be deployed and reluctantly offer tight LIBOR spreads in order to win and close deals. Barring another unforeseen event impacting the market, we believe the MM credit markets will remain decidedly "borrower friendly" well into 2021.
- **Continued Shift Toward Unitranche Debt Facilities.** Despite a chain of unfavorable events (recession, COVID, oil shock, civil unrest, and an "eventful" election cycle), the Leveraged Finance market kept bouncing back, ultimately ending the year in a similar situation to the way it began. Unitranche loans continue to build significant market share in the middle market, a trend likely to continue. Lenders increasingly want to be in the senior-most (dollar-one) position rather than in a bifurcated 1L/2L structure since it improves their position in a downside scenario while providing benefits to borrowers (one agreement, one lender, no intercreditor, etc.).
- **Middle Market Weathered the Storm.** As a surprise to many, private middle market companies are faring better than their own forecasts, beating their early COVID-19 pandemic expectations. In fact, in Q2 2020, overall EBITDA levels were expected to decline by 23% in 2020. However, by Q3 2020, the forecasts improved to an average decline of only 13%, a significant improvement. Additionally, enterprise valuation multiples for many transactions are trading at or above pre-pandemic levels, hitting a record of 10.4x last twelve months (LTM) EBITDA. These higher enterprise value (EV) multiples provide debt investors greater downside cushion and better recoveries in cases of default.
- **The Takeaway.** Thanks to recent developments in the COVID-19 vaccine, improving financial forecasts and growing investor confidence, MM lending volume is expected to continue to grow during the year. As a result, both bank and non-bank lenders are deploying capital at historically low rates and continue their bullish outlook on the future of middle market companies.
- Capstone's Debt Advisory Group maintains close relationships with most every institutional lender active in the middle market and is available to help clients secure favorably priced and structured debt capital for their businesses.

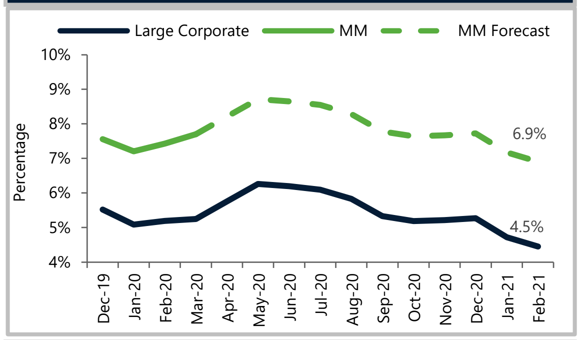
Private Debt Fundraising from 2020 to 2021[1]



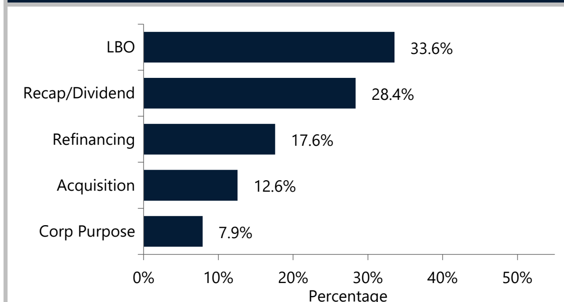
Growth in Dry Powder, 2020 vs. 2010 by Fund[2]



New Issue Yields[3]



U.S. 2020 Middle Market Volume by Purpose[4]



Required Reading

- In the Cision PR Newswire, the Mitsubishi UFJ Financial Group discusses how 2021 is shaping up to be a strong and supportive year for the Leveraged Finance markets – *MUFG, "M&A and Refinancing to Lead Strong Leveraged Finance Activity in 2021, MUFG Predicts"*

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Capstone Headwaters

BUILT FOR THE MIDDLE MARKET

Capstone Headwaters' **Debt Advisory Group** specializes in providing debt placement services to middle-market companies in connection with senior credit facilities, second-lien loans, unitranche facilities, and mezzanine debt across a range of industry sectors. The firm is one of the few national investment banks that maintains a debt-only placement (non-lending) practice staffed by leveraged finance veterans focused solely on the debt funding needs of mid-sized companies and the sponsors that invest in them. The majority of our engagements involve raising debt for acquisitions, recapitalizations, refinancings, and growth/expansion financings with a particular focus on special situations where non-traditional debt capital is required.

Notes & Citations

1. S&P Global Market Intelligence, "Fundraising targeting direct lenders soars 62% on YOY basis – Preqin," www.lcdcomps.com, accessed March 9, 2021
2. Bain & Company, "Global Private Equity Report," www.bain.com, accessed March 9, 2021
3. S&P Global Market Intelligence, "LLI Default Rates – DD," www.lcdcomps.com, accessed February 26, 2021
4. S&P Global Market Intelligence, "MM_Quarterly_4Q20 WEB MM," www.lcdcomps.com, accessed February 26, 2021
5. The Lead Left, "State of Capital Markets – Fourth Quarter 2020 Review and First Quarter 2021 Outlook," www.theleadleft.com, accessed February 26, 2021
6. S&P Global Market Intelligence, "In surprise, middle market companies fare better than expected during COVID-19" www.lcdcomps.com, accessed February 26, 2021