Middle Market Leveraged Finance

Current Market Conditions | June 2021

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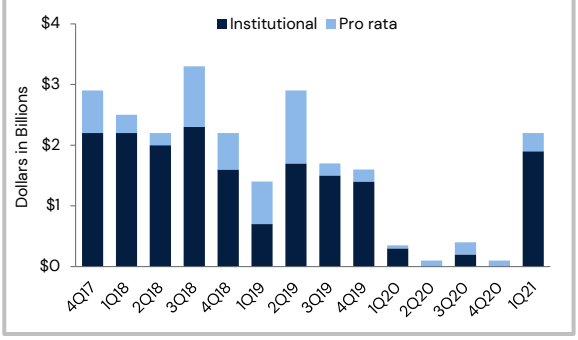
Key Market Stats[1,2]

- ***Volume surged in the first quarter to $2.2 billion.*** This was the highest quarterly total since Q3 2019 as pent-up demand was buttressed by the sense that a return to normalcy was on the horizon. Healthcare led the way, accounting for 30% of volume; interestingly, Retail and Gaming & Hotel, two sectors that were all but banished by lenders throughout the pandemic, combined to represent ~36%. Refinancings and leveraged buyouts (LBOs) represented nearly 70% of volume with dividends (17.6%) and mergers (12.6%) accounting for the remaining balance.
- ***Leverage reached levels reminiscent of the halcyon days of 2007.*** Senior and total leverage for middle market (MM) LBOs hit 5.7x and 6.1x, respectively. In particular, the senior multiple is the highest reading since 2018. This isn't entirely surprising, given the lofty valuation multiples being seen in the (M&A) market. As such, loan-to-value has taken front-and-center in lenders' underwriting decisions and equity contributions of 35-50% remain the norm.
- ***Pricing remained stable relative to Q4***. Average spreads held in the 500-515 context, with a 99 original issue discount (OID) and 6.26% average yields. With limited market data in Q2 and Q3 of 2020, it's challenging to draw a longer-term trend, however, we expect to see yield compression in the months ahead. Since the end of Q1, pricing and yields have held firm.
- ***Default rates declined precipitously.*** After peaking at 4.64% in September, Q1 default rates declined 42% to 2.67%, in yet another sign of the market's recovery and the positive outlook for 2021. That said, excluding the 2020 spike, the default rate remains at its highest level since 2016.
- As further discussed below, many factors contributed to the frothy market including red-hot lender demand combined with a shortage of attractive new-issue opportunities leading to a technical imbalance.

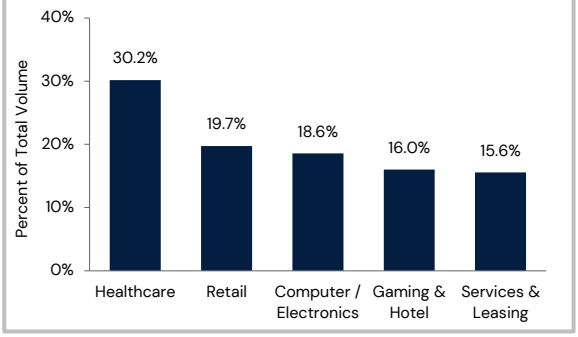
Quarterly Market Observations[1,2,3]

- ***Direct Lending continues to dominate***. The Private Credit market has grown exponentially over the past decade and that trajectory is certain to continue. As of mid-January, there were 266 direct lending funds in market seeking to raise $150 billion of capital commitments. Comparatively, the previous high-water mark was in 2017 when 100 funds with a direct lending mandate were fundraising. The driver of this spike is clear - in a world where monetary stimulus has pushed global interest rates ever lower, direct lending provides investors with significantly more attractive risk-adjusted returns than other fixed-income alternatives.
- ***Repayments…they are a coming.*** Direct lenders are witnessing the early stages of a repayment wave which will serve to further enhance market conditions for borrowers. Beyond the traditional reasons – opportunistic refinancings, bond-for-loan take-outs, syndicated deals, etc. – the scale and velocity of special purpose acquisition company (SPAC) formation has presented another competitive challenge for fund managers looking to deploy capital. **It took slightly more than two months this year to break the annual record for new SPAC listings – 227 – which was set last year.**
- ***So, what does this all mean?*** Extremely borrower-friendly market conditions for the foreseeable future. In our view, the combination of the technical imbalance as depicted to the right, continued gains in the number of vaccinated Americans and concomitant economic recovery across sectors points to a very strong 2021 for leveraged finance participants.
- ***It's a great time to be a borrower.*** We strongly recommend that companies and sponsors with financing needs in the next 24 months take advantage of the current environment and address those needs now.

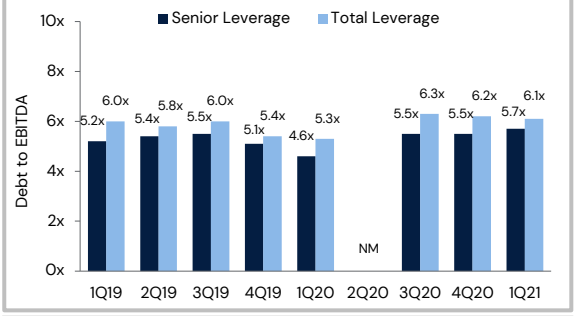
Volume by Quarter[1]



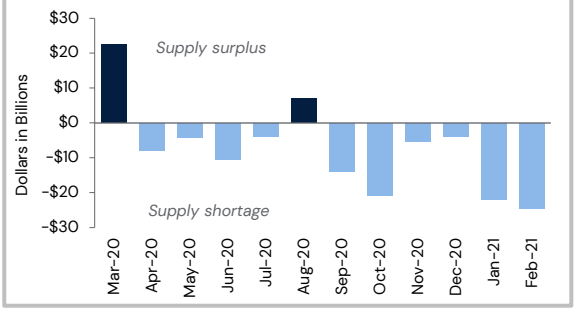
Volume by Industry[1]



LBO Leverage Multiples[2]



Supply vs Investor Demand[3]



Required Reading

- Oaktree's Insights "Performing Credit Quarterly, Q1 2021" discusses the credit trends throughout Q1 activity and provides an outlook for the remainder of 2021 - Oaktree Q1 Quarterly Update

Built for the Middle Market

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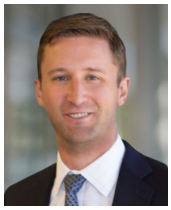

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ENDNOTES

1. S&P Global Market Intelligence, "LCD Middle Market Review 1Q 202," www.lcdcomps.com, accessed May 21, 2021.
2. William Blair and Company, "William Blair Leveraged Lending Index," www.williamblair.com accessed May 21, 2021.
3. S&P Global Market Intelligence, "LCD Research SPACs," www.lcdcomps.com, accessed May 21, 2021.

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