CAPSTONE PARTNERS

Middle Market Leveraged Finance
Current Market Conditions | September 2021
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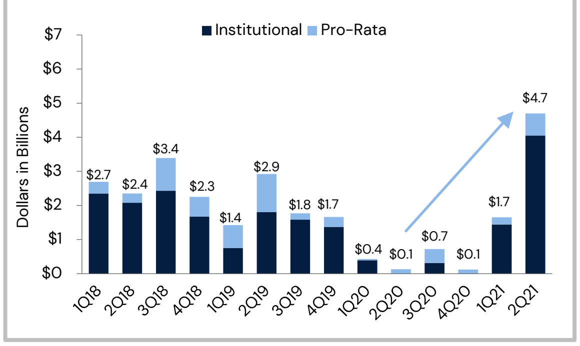
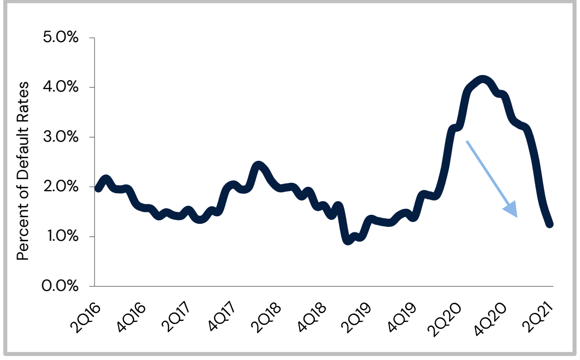
Key Market Stats[1,2]

- ***Near record volumes.*** Q2 2021 loan volume reached its highest quarterly total since Q3 2017 as record merger and acquisition (M&A) activity and a low interest rate environment led issuers to take advantage of the continued strength in the credit markets. Refinancing activity (35% of total volume) picked up significantly as low rates and borrower-friendly terms remained the norm and private equity (PE) portfolio companies continued to recover from the pandemic. Leveraged buyout (26%) and acquisition (22%) transactions comprised nearly half of overall volume in the quarter while dividends, corporate purposes, and mergers accounting for the remainder of deals (18%).
- ***Leverage remains elevated.*** Total debt/EBITDA multiples crept up to 5.7x in Q2 2021, the highest level recorded since 2005. A robust M&A environment and a continued supply/demand imbalance for middle market transactions caused lenders to increase leverage to win deals. While ~50% equity contributions are still required in most cases, elevated purchase multiples and excess dry powder with both lenders and PE sponsors led to increased leverage multiples.
- ***Pricing remained stable relative to Q1.*** Average spreads remained near 500 basis points with total expected yields of ~6.0%. We expect yields to hold in this range or moderately decrease as competition for deals remains robust.
- ***Default rates continue to decline.*** Q2 default rates continued to decline, benefiting from a combination of prior lender concessions and a strengthening economy. The Q2 2021 default rate of 1.25% was down from a pandemic high of 4.17% and is the lowest monthly default rate since May 2019.

Volume by Quarter[1]



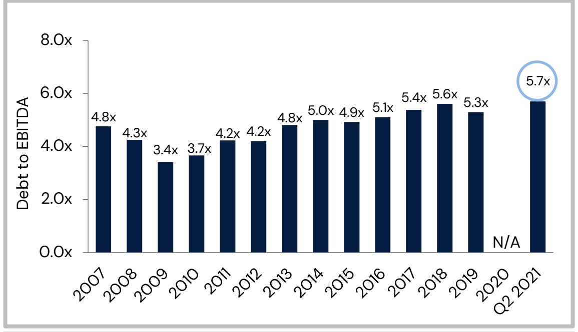
Percentage of Default Rates[1]



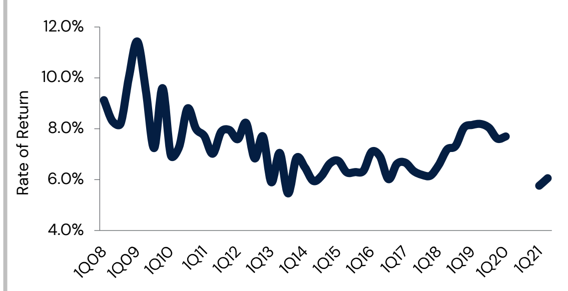
Quarterly Market Observations[1,2]

- ***COVID addbacks.*** Direct lenders continue to scrutinize the definition of Adjusted EBITDA in credit agreements, particularly as it relates to COVID-related EBITDA addbacks. Expense addbacks were more commonly accepted, particularly in cases where data could be used to validate the temporary nature of the increases. Lenders continue to push back on revenue-related addbacks and seek to cap both timing and amount, if not altogether disallowed.
- ***Middle Market M&A activity remains robust.*** Supported by improving economic conditions, relatively cheap debt, ample PE dry powder and the possibility of a capital gains tax hike, Middle Market M&A activity approached its highest levels on record. Significant fundraising activity coupled with a dearth of M&A transactions during COVID-19 should provide ample runway for this trend to continue.
- ***Direct lending thrives.*** The pre-pandemic shift toward direct lending at the expense of the broadly syndicated market continued in Q2 2021. 2020's combination of increased fundraising and depressed volume added to the supply/demand imbalance, ensuring that pricing, leverage, and terms remain competitive in the near-term.
- ***Return of the dividend recap?*** Dividend recapitalization activity reached its highest level since 2013 for the broader market and its highest level since late 2018 in the Middle Market. Primarily available within the sponsored market, PE groups are increasingly using dividend recaps to achieve partial liquidity on existing holdings while retaining the expected upside from a future sale once portfolio companies fully recover from the pandemic.
- ***Fundraising strength continues.*** An all-time high of 5,248 PE and venture capital (VC) funds were in the market at the beginning of July targeting a combined $900 billion of total capital. Despite the strength within PE fundraising, direct lending funds raised a total of $20.6 billion in first half 2021, outpacing Middle Market PE funds by $1.6 billion year-to-date. Strong fundraising trends should help support borrower-friendly market conditions for the foreseeable future.

Total Debt/EBITDA Multiples (MM)[1]



Middle Market First-Lien Yield-to-Maturity[1]



Note: No rate of return for 2020 due to lack of data

Required Reading

- Oaktree's Insights, "Performing Credit Quarterly 2Q 2021" discusses key credit trends through the second quarter of 2021, providing an outlook through year-end based on current market conditions – Oaktree Q2 Quarterly Update

CAPSTONE PARTNERS

Built for the Middle Market

Capstone Partners' **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.

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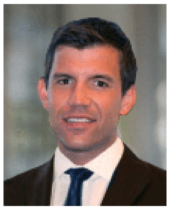

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ENDNOTES

1. S&P Global Market Intelligence, "MM_Quarterly_2Q21 WEB MM Archives," www.lcdcomps.com, accessed July 28, 2021.
2. PitchBook, "US PE Breakdown Q2 2021," www.pitchbook.com, accessed July 28, 2021.

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