Middle Market Leveraged Finance

Current Market Conditions | June 2022

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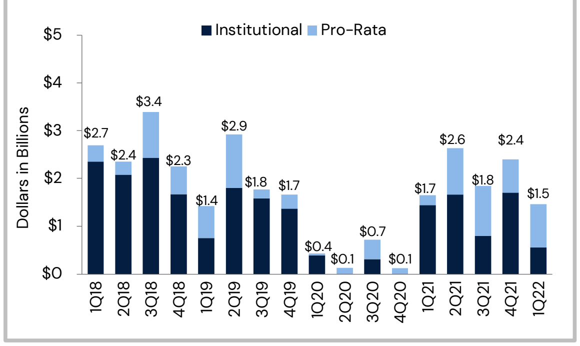
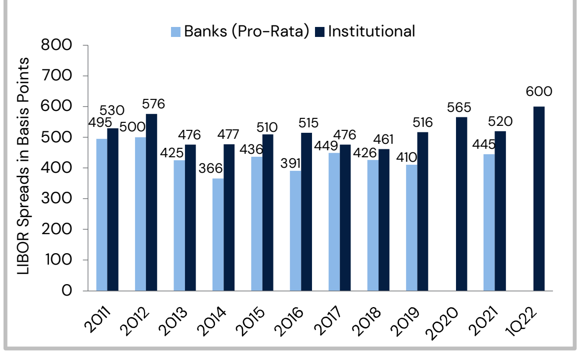
Key Market Stats[1,3,4]

- ***Significant pullback in loan volumes.*** Q1 2022 middle market (MM) loan volume decreased substantially compared to Q4 2021 as the feverish M&A pace of 2021 subsided. M&A drove ~31% of overall loan volume in Q4 2021 compared to ~5% in Q1 2022. Leveraged buyout (~40% of overall volume) activity led the way in Q1 2022, supported by elevated private equity dry powder, followed by strong refinancing activity (~35%) as rates remained relatively low, particularly toward the beginning of the quarter. We expect this trend to continue reversing in the second half of the year as the Fed tightens monetary policy and raises rates. The remaining loan volume for the quarter consisted of various other corporate purposes (~25%).
- ***Increased loan pricing***. Average LIBOR spreads widened to 600 basis points (bps), their highest level in the past decade, as increasing Fed benchmark rates and general economic uncertainty led to a recalibration of perceived credit risk in the broader market. Capstone expects additional rate hikes to lead to continued yield expansion in the second half of 2022 before settling at heightened levels in early 2023.
- ***Sustained leverage multiples.*** Middle market leverage multiples remained elevated for the quarter. While rates increased somewhat, significant dry powder among fund managers resulting from unprecedented fundraising in recent years continued to support high leverage multiples in the market.
- ***Decreased inflows of debt capital.*** The vast amounts of dry powder combined with general economic uncertainty led to decreased fund inflows through March of 2022. Approximately $2.5 billion was raised in Q1 2022 compared to $4.1 billion for the same period in 2021 and down from $9.5 billion raised in Q4 2021. With that said, the perceived hedge that private credit provides in a rising interest rate environment, coupled with a search for yield among institutional investors, should continue to support a relatively healthy fundraising environment moving forward.

Leverage Loan Volume per Quarter[1]



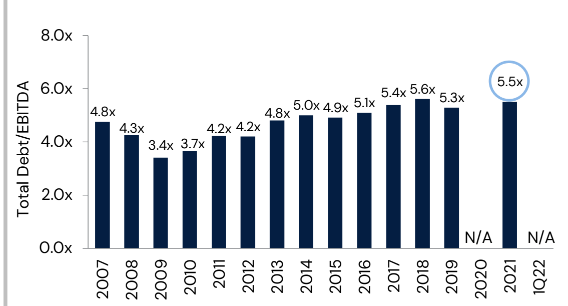
LIBOR Spreads (bps) – MM Loans[1]



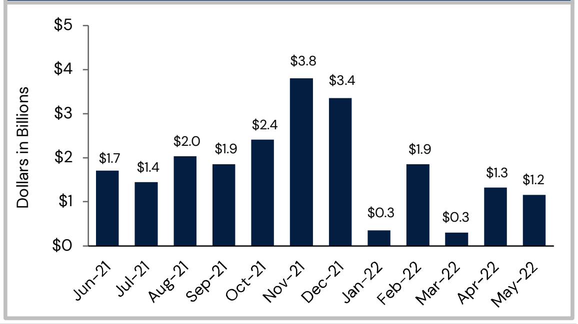
Quarterly Market Observations[1,3,4]

- ***More of the same…for now.*** Despite recent trends in the public markets, borrower-friendly conditions persist within the Direct Lending market due to a continued supply and demand imbalance and a lack of quality deal flow in the first half of 2022. While increased competition among lenders has sustained market strength, recent data points to the potential of a recession as soon as the end of 2022 as continued inflation, a historically tight labor market, and supply chain challenges permeate the overall economy and require continued action from the Fed in response.
- ***Private credit continues to gain share.*** Private credit continues to gain market share at the expense of the Broadly Syndicated Loan (BSL) and High Yield Bond (HYB) markets. Increasingly large direct lending funds with growing hold positions and an appetite for higher leverage and looser credit agreement terms have made direct lending competitive with more liquid credit sources. Additionally, spreads have widened more rapidly within the BSL and HYB markets, eliminating the cost of capital advantage those offerings have historically enjoyed. However, the advantage could be short-lived. Direct lending has historically lagged the more liquid markets and recent trends indicate the likelihood of choppiness in the second half of 2022.
- ***Credit Agreement terms revert to the mean***. Further supporting the shift toward direct lending is the convergence of terms between direct and syndicated loans. Historically less flexible on terms (EBITDA addbacks, financial covenants, etc.), direct lenders have become more accepting of terms formerly reserved only for the BSL and HYB markets. Despite expected market volatility, these conditions will likely continue in the near-term as competition for quality deals remains elevated.

Total Debt/EBITDA Multiples – MM Loans[1]



Monthly Inflows to the MM Loan Asset Class[2]



Required Reading

- Oaktree's Insights, "Performing Credit Quarterly 1Q 2022" discusses current credit market trends through the end of 2021 and early 2022 and provides an outlook through year-end based on current market conditions - Oaktree 1Q Quarterly Update

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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ENDNOTES

1. S&P Global Market Intelligence, "MM_Quarterly_1Q22 WEB MM," www.lcdcomps.com, accessed June 20, 2022.
2. S&P Global Market Intelligence, "CLO Global Databank," www.lcdcomps.com, accessed June 20, 2022.
3. S&P Global Market Intelligence, "LCD Middle Market Weekly," www.lcdcomps.com, accessed June 20, 2022.
4. GF Data, "GF Data Leverage Report – May 2022," www.gfdata.com, accessed June 20, 2022.