



MIDDLE MARKET DIGEST QUARTERLY UPDATE FOURTH QUARTER 2017

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**MIDDLE MARKET DIGEST
QUARTERLY UPDATE
FOURTH QUARTER 2017**

TABLE OF CONTENTS

FROM THE MIDDLE.....	03
RELATIVE VALUE.....	04
NEW ISSUE YTM BY DEAL SIZE.....	05
SYNDICATED MARKET INDICATORS.....	06
INSTITUTIONAL INVESTOR INFLOWS.....	07



MIDDLE MARKET DIGEST QUARTERLY UPDATE FOURTH QUARTER 2017

From The Middle

February 2018

To the friends and clients of Interpeak Consulting:

I am pleased to offer the first edition of “From the Middle” a quarterly digest of key lending trends affecting small and medium sized business, or what is commonly referred to as the middle market.

Lending standards continued to be under pressure in the fourth quarter of 2017.

In the January 2018 Senior Loan Officer Opinion Survey on Bank Lending conducted by the Federal Reserve, respondents indicated a moderate easing of lending standards to large and middle-market companies as 15.7% of the respondents indicated lending standards “eased somewhat.” The vast majority, or 78.6% of the respondents, stated lending standards “remained basically unchanged.” Importantly, lending standards did not tighten.

In respect to loan spreads, 63.8% of respondents stated they remained unchanged for large and middle-market firms, with 26.1% of respondents indicating spreads were narrower. Small firms experienced less easing of loan spreads during the quarter, with 79.1% of the respondents indicating spreads remained basically unchanged and 11.9% indicated spreads eased. Not surprising, competition from other banks and non-banks were often cited for the cause of the lower lending standards and loan spreads.

According to Debtwire/Piper Jaffray private credit fundraising for middle market lending will reach new highs in 2018 with approximately \$70 billion to be raised vs. the \$60 billion raised in 2017. About two-thirds of the fundraise is from direct lending with the remaining third from CLOs and other credit funds.

Please provide any comments, they are always welcomed and hopefully you will find this report useful to you and your organization.

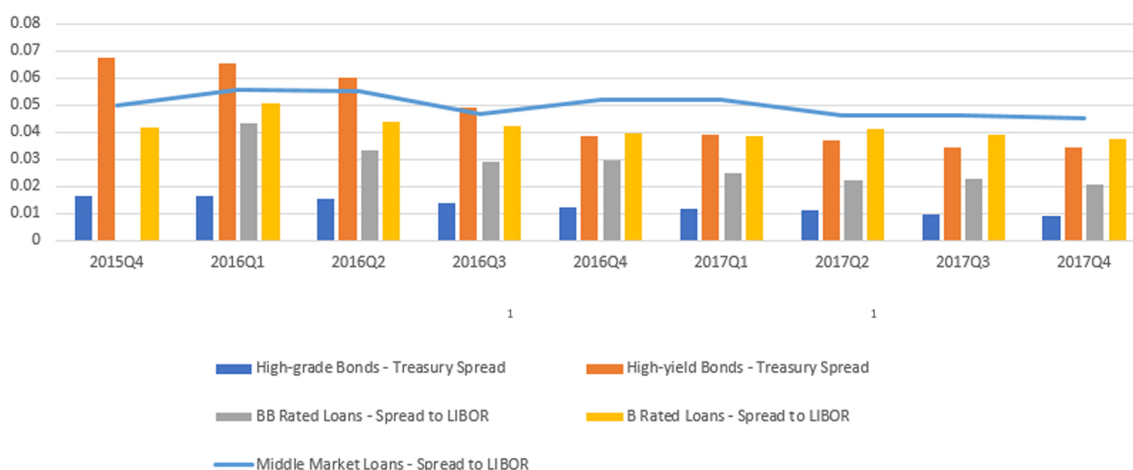
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MIDDLE MARKET DIGEST QUARTERLY UPDATE FOURTH QUARTER 2017

Relative Value

Comparative Rates



¹ Option Adjusted Spread

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

As the chart indicates, the tightening of spreads over the last eight quarters occurred largely in the high-yield bond and the broadly syndicated non-investment grade loan categories. The syndicated middle market spreads of 4.53% at the end of the fourth quarter, vs. a peak of 5.58% in the second quarter of 2016, experienced less change. Important to watch going forward with rising LIBOR and treasury yields is the return to a more normalized risk/return paradigm by investors.

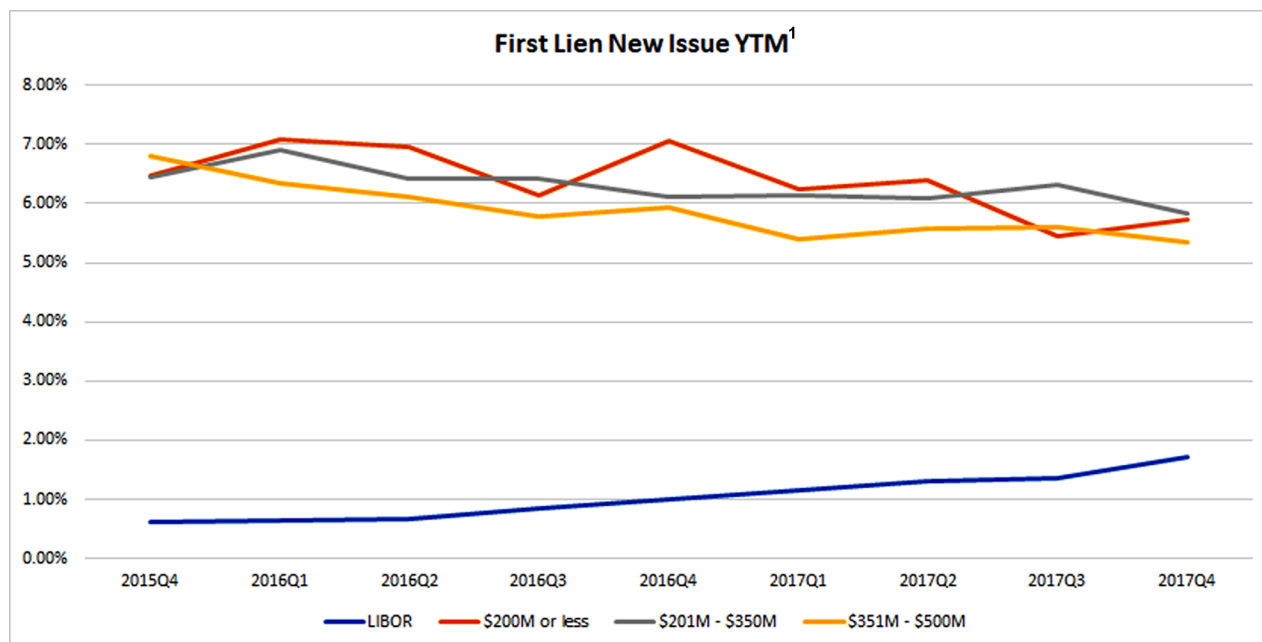
From a relative value perspective, the spread differential between high-grade bonds and middle market credits for the period from 4Q-2015 to 4Q-2017 widened from 3.33% to 3.64%, largely driven by the spread on high grade bonds reaching lows of 0.89% at the end of 2017.

All-in rates for middle market credits according to Piper Jaffray & Co. ended 2017 at 6.23%, compared to 6.53% at the end of 1Q-2017.



MIDDLE MARKET DIGEST QUARTERLY UPDATE FOURTH QUARTER 2017

New Issue YTM by Deal Size



¹YTM – Assumes loan repayment/refinancing in three years

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

Transactions in the above chart are segmented into three categories: \$200 million or less, between \$201 million and \$350 million, and between \$351 million to \$500 million. The loans represent syndicated middle market credits, all with EBITDA of \$50 million or less.

Interestingly, the yield difference between the smallest transaction size to the largest varied from 1.11% to -0.34%. A better proxy of risk pricing due to deal size is reviewing the average YTM during the eight-quarter period.

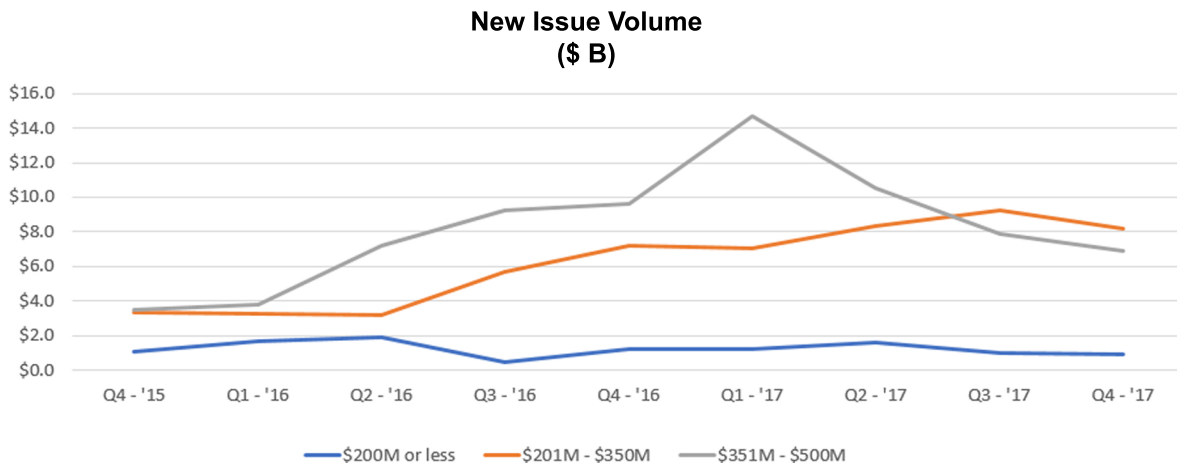
The average YTM over the eight-quarter for transaction size of \$200 million or less is 6.39%, 6.30% for transactions between \$201 million and \$350 million, and 5.88% for transaction between \$301 million and \$500 million. Hence, the implied risk premium for the smaller transactions/smaller companies is 51 basis points.

Rising LIBOR as expected will have an effect on spreads and yields going forward.



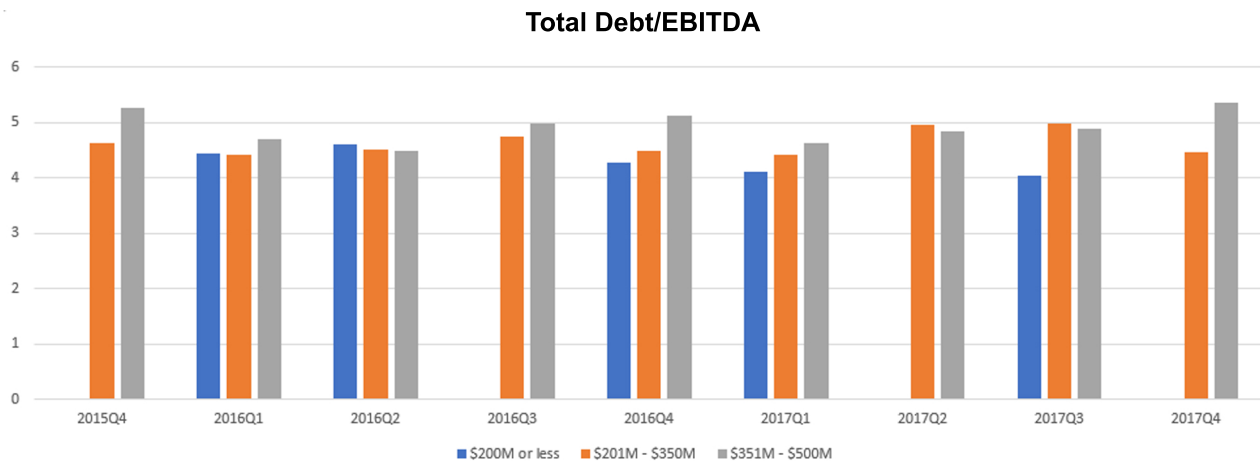
MIDDLE MARKET DIGEST QUARTERLY UPDATE FOURTH QUARTER 2017

Syndicated Market Indicators



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

The above slide breaks new issue by deal size, using the same categories as on page 5. All of the categories experienced higher volumes in the beginning of 2017 then they did at the end of 2017, with transactions between \$351 million and \$500 million experiencing the greater drop off.



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

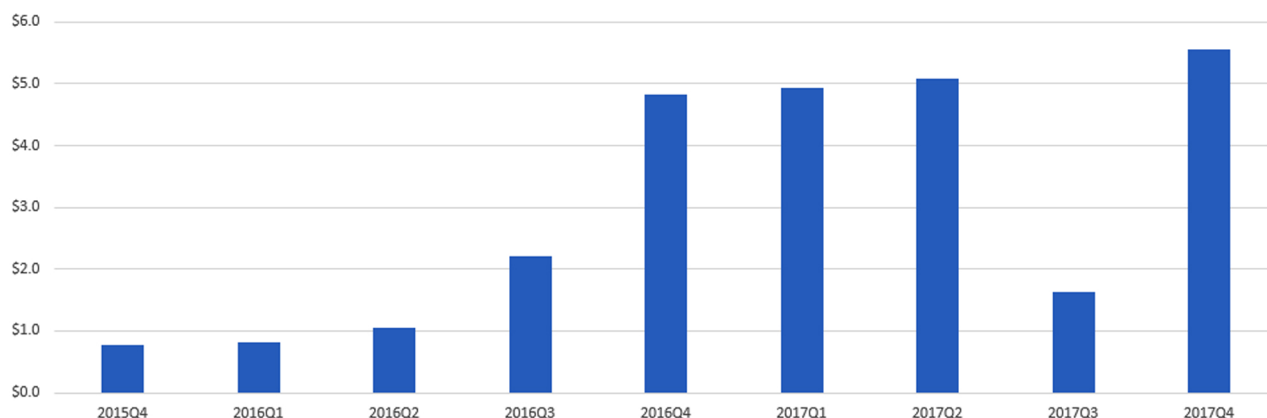
Reviewing opening leverage by deal size clearly shows the larger transactions are able to achieve a higher amount of opening leverage than the transactions of \$351 million or less. Average leverage ratio for the eight-quarter period for transactions between \$210-\$350 million and \$351-\$500 million was 4.62x and 4.92x respectively.



MIDDLE MARKET DIGEST QUARTERLY UPDATE FOURTH QUARTER 2017

Institutional Investor Inflows

BDCs and CLOs Middle Market Inflows



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

Over the past five quarters the number and amount of CLOs dedicated to investing in syndicated middle market loans has increased significantly. During the same period loan inflows from BDCs have declined or have not yet been fully reported.

Nearly all market participants expect the inflows from CLOs into the middle market space to continue into 2018 and 2019. These inflows are expected to put added pressure on lending standards and yields, including the increased adoption of covenant-lite (or incurrence only financial ratio tests) transactions. Middle-market covenant lite volume for syndicated loans up to \$350 million exceeded 80% of the total volume of new issue syndicated middle-market loans in October, 2017.

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