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2017 – A Look Ahead (First of a Series)

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If we learned one thing in 2016, it was that predictions of many sorts went awry. From national departures from economic unions, to presidential elections, to World Series champions, the unlikely became reality.

With that in mind, we will offer in this series some thoughts on what's to come this year in middle market lending, with a healthy awareness that anything can happen.

Let's start with issues that concern many middle market debt investors about the year ahead: deal terms, supply/demand, credit quality, and exogenous factors.

Deal terms are the most visible consequences of market conditions. Obvious examples include pricing, leverage, structures, and covenants. All are interwoven, of course, but let's examine each and see where trends may be headed.

Pricing – Because the middle market is a "closed" system, relative to the broadly syndicated market where investor cash comes and goes, spreads tend to be more stable. Also, as we've said many times, direct lenders are "buy-and-holders," so there's no secondary market to push prices – thus spreads – around.

This year, our sense is that bank capacity will continue to shrink and non-bank lender capacity will grow, creating sufficient cash to absorb loan supply (more on this dynamic next week). That balance will mean loan spreads will continue to be range-bound. We predict first-lien spreads will be L+475-525 on average, with second-lien spreads roughly 4% higher. Unitranche will remain in the L+600-650 range.

Leverage – As our *Chart of the Week* depicts, the more "clubby" the loan characteristics, the higher equity contribution we're seeing from private equity sponsors. So for new buyout transactions, we expect debt/capital to remain significantly below historic levels. Debt/ebitda, while still high in terms of senior debt, will continue – for total debt – to be below the pre-Leverage Lending Guidance era.

Structures – Direct lenders are increasingly able to offer a wider variety of loan structures across the spectrum from senior/mezz, first lien/second lien, senior stretch, and unitranche. All are firmly established in the sponsor's mind, and all play important roles in leveraged finance.

Unitranche will continue to be the structure of choice this year for sponsors looking for one-lender solutions. However, as BDC valuations improve, so will second-lien availability. That's especially the case for issuers looking to stretch leverage, and who are willing to pay up to get it, particularly for dividend recaps and acquisition financings.

Covenants – Last year saw covenant-lite volume drop over 2015 for middle market issuers, ending 2016 was only 4% of midcap activity. Still a province of larger midcap borrowers, cov-lite will remain an exception rather than the rule.

Next week we examine the factors influencing loan supply/demand for 2017.