2016 – A Look Ahead in the Middle Market (Third of a Series)

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One of the largest dinosaurs ever found debuted last week at the American Museum of Natural History in New York. At 120 feet, *Titanosaur* is so long that its head sticks out of the exhibit hall. The paleontologist who uncovered the bones knew he was on to something unusual. "Everything was extremely large," Dr. Diego Pal remarked.

The same may not be said of transactions in the leveraged loan market today. Volatility that kicked up last August has persisted into the new year giving pause to big deal arrangers. Cash departing from retail loan funds has sapped vigor out of the buy-side, making it challenging for syndicators to judge investor appetite.

While well-liked, moderately sized credits such as *1-800-Contacts* and *Pinnacle Foods* saw pricing tighten, *Petco*'s $2.5 billion term loan spread widened 25 bps. This cautionary tone will persist for other jumbo financings slated to launch 1Q.

Middle market transactions, on the other hand, are increasingly club affairs among non-bank lenders less exposed to market volatility and bank regulation. That allows debt to ebitda to push past the six times total set by leveraged lending guidance above which loans are deemed to be criticized.

Thomson Reuters LPC reports 4Q middle market LBOs had 6.15x total debt to ebtida, with senior leverage of 4.73x. All mid-cap loans (*Chart of the Week*) showed leverage off a bit, but the number of over-6x deals outweighed those below 6x. Large caps were more leveraged for all last year (6.0x vs. 5.7x), but the difference is narrowing.

Nonbank lenders have also had an impact on the amount of senior debt being offered in structures. This reflects both an increasing use of unitranche financings as well as competitive dynamics among the top tier middle market arrangers.

For 2016 we expect to see this trend to continue, though total leverage will remain in the six times range for the better credits; less for also-rans.

On the pricing front, middle market loan spreads should maintain an upward bias as arrangers consider volatility in the broader markets. We expect the illiquidity premium between mid caps and large caps, currently 131 bps (per LPC), to stay in that range.

Today a plain-vanilla LBO for an issuer less than $50 million ebitda will come out around L+500, give or take. That's up from L+450-475 a few months ago. Spreads should stay at the higher level well into the 1Q; add 25-50 bps for story credits.

For unitranche financings, all-in spreads ended the year at 8% on average. Depending on size and credit quality, our expectation is that one-stop costs will move in tandem with blended first lien and second lien pricing.

Next week, we continue our series with a look at the outlook for BDCs and middle market CLOs.