Markets at the Midpoint (Second of a Series)

THE LEAD | July 19, 2016

Luis Polonia, the former outfielder for nine major league baseball teams in the 1990's, once observed of the late Yankees owner, George Steinbrenner: "He's only interested in one thing. And I don't know what that one thing is."

We recalled Mr. Polonia's pronouncement last week as we surveyed lenders on the state of the middle market. Whether an arranger competing to win lead business, or an asset manager looking for new financings, each struggled to capture one theme to describe market conditions going into the second half of the year.

For those underwriting or arranging deals, there was a palpable frustration at the lack of deal flow. "There's not a lot of paper out there," the capital markets head of one middle market shop told us. "And the quality is not great."

His counterpart at another mid cap shop agreed. "We're certainly busier than we were in the first quarter. And the second quarter started slow as well. But things have picked up in the last few weeks. Unfortunately what we're seeing isn't the highest quality."

There was also a clear overhang of worry regarding from the string of troubling global events of the past month. "It's really hard to see future shocks," the managing director of a middle market bank admitted. "We're trying to keep from committing too far into future. Today's flex might not be enough to clear tomorrow's market."

On the buy-side, there was general agreement that the impact of regulation has decidedly slowed activity being from the bank community. "The non-banks are definitely busier than the banks," one non-banker said. "Sponsors are going the club route more than ever. It's much easier than dealing with a syndicated process."

Pricing has also settled into a range. According to the non-banker, that's also a by-product of banks being less competitive. "The non-banks are quoting Libor plus 500 bps with a 1% floor," he said. "That looks like it's sticking, although if things slow down much more, that level will be tested. Especially for the top-tier sponsors."

One structural feature showing upwards signs of movement is leverage. Sponsors are reporting purchase price multiples remain stubbornly high for select companies. And while contributed equity-to-capital ratios remain close to 50%, senior debt-to-ebitda is edging over the four times mark for larger credits – with the total over six times.

"The problem is that there's no differentiation in leverage," a managing director at a finance company lamented. "We're seeing both great and not-so-great businesses being quoted similar leverage multiples from arrangers. That's an indicator of how competitive it is right now. And how relatively few deals there are to choose from."

At the moment, however, this supply/demand imbalance is not driving more dividend recap activity. As our *Chart of the Week* depicts, both the number and share of middle market deals devoted to dividends is at a near-term low. It will be interesting to see if this trend continues for the balance of 2016.