MARKET INSIGHTS 1Q 2017

PNC

DEBT CAPITAL MARKETS

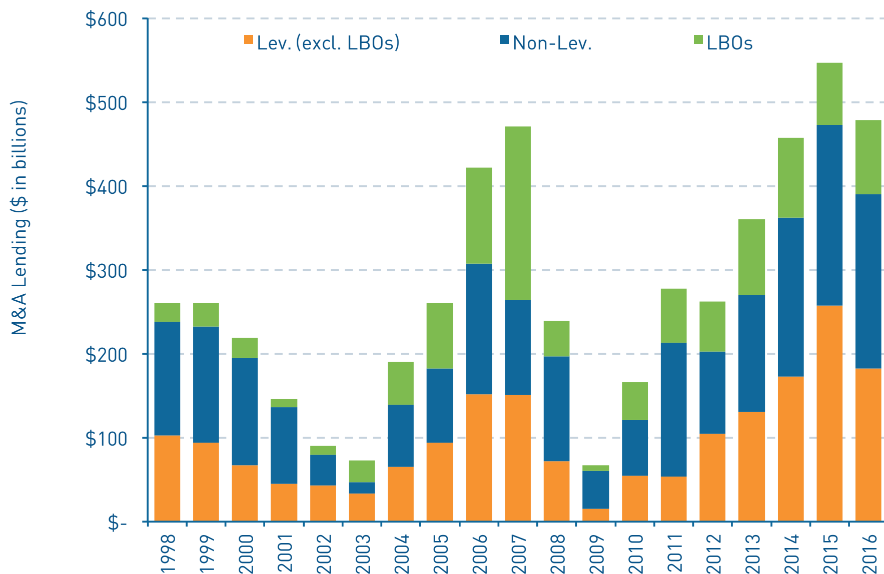
EXECUTIVE SUMMARY

- Despite the prospect of a higher interest rate environment, access and availability in the debt capital markets remain open and attractive in both floating and fixed-rate segments.
- Loan demand related to M&A should continue, and we're cautiously optimistic this demand will be accompanied by a resurgence in traditional loan demand for core organic growth and investment.
- Banks maintain a solid appetite for new loans as we enter 2017; however, it remains to be seen if banks begin to become more selective in their investment decisions in the overall context of a rising rate environment coupled (potentially) with a less rigid regulatory environment.
- The institutional leveraged loan market is currently experiencing strong technical-driven appetite that is decidedly issuer-friendly.

OVERALL LOAN MARKET

M&A volume reached the second-highest annual total on record in 2016 (2015 was the record) as companies used a combination of balance sheet cash and relatively low-cost debt financing to drive strategic growth.

2016 M&A VOLUME SECOND-HIGHEST ON RECORD



Source: PNC Capital Markets LLC, Thomson Reuters LPC, Federal Reserve Board Senior Loan Officer Survey

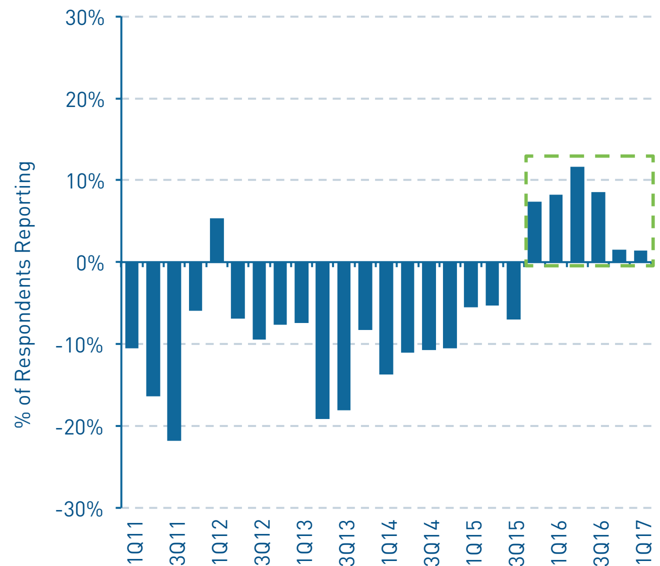
The robust year for M&A lending coincided with a “net tightening” in bank lending standards through the first three quarters of the year.

Banks tightened standards during this time as they rationalized their capital in light of new regulatory requirements, specifically around Basel III reform measures developed by the Basel Committee on Banking Supervision.

By the fourth quarter, however, the number of banks tightening or loosening lending standards was fairly evenly matched as more banks looked to grow loans as the year wore on.

As we move through the first quarter, banks’ renewed interest in lending money remains intact as evidenced by our investor experience as well as the most recent Senior Loan Officer Survey released by the Federal Reserve Board on February 6.

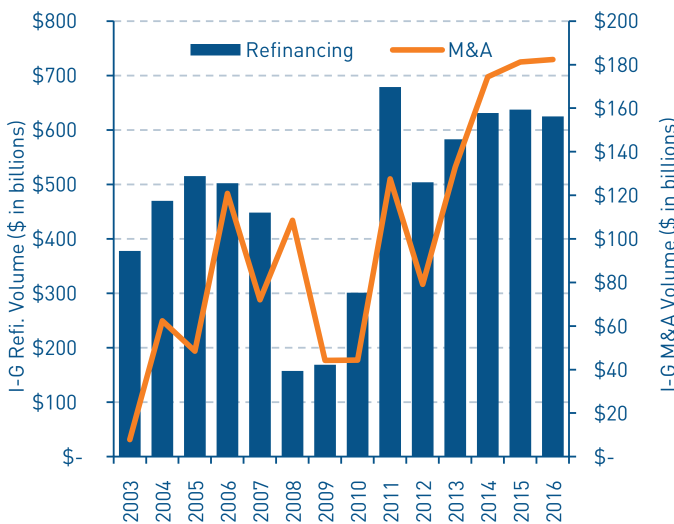
% OF BANKS TIGHTENING LENDING STANDARDS



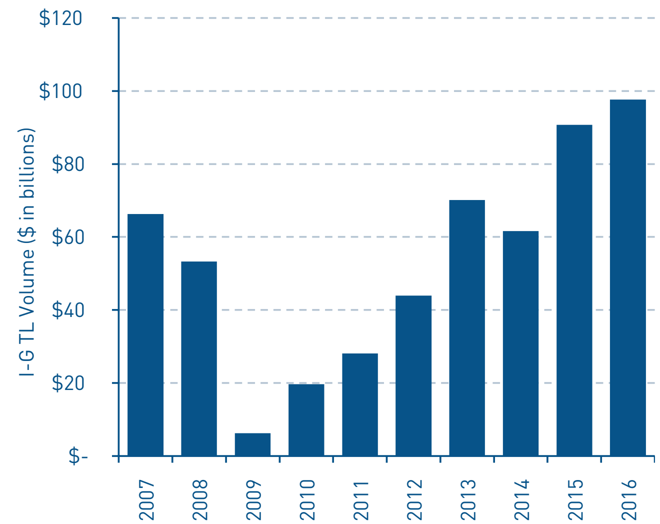
A. INVESTMENT-GRADE

Investment-grade loan volume in 2016 was on par with 2015’s record issuance. M&A financings propelled the volume, reaching a record in 2016, and Q4 was the third-highest quarterly total of the past 10 years.

RECORD M&A FINANCING – $182 BILLION



RECORD I-GRADE TERM LOAN ISSUANCE



Source: PNC Capital Markets LLC, Thomson Reuters LPC, Federal Reserve Board Senior Loan Officer Survey

Despite banks more closely evaluating the profitability of their relationships, banks still sought funded assets, sending I-G term loans to a record year at $98 billion. More than 60% of these Term Loans were used to back M&A deals.

Historically, spreads tighten significantly through the cycle. But thanks to the post-financial crisis regulatory environment, BBB spreads have been relatively sticky at 125 bps, compared to the sub-50 bps levels of the last two cycles.

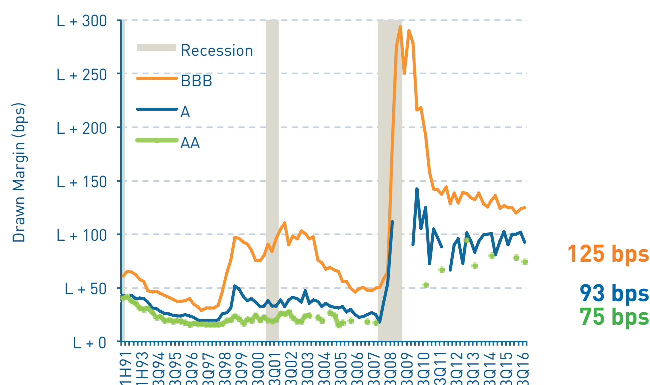
OUTLOOK

We expect economic growth and a continued interest in M&A fueled by open debt markets to drive another solid year.

Assuming no change to the bank regulatory landscape, we expect stable pricing to maintain current levels. Regulatory relief may result in renewed spread tightening; however, it is likely to be offset by rising short-term rates.

Last, we expect clients to continue rationalizing the number of relationships based on the depth of available bank ancillary business.

I-G PRICING



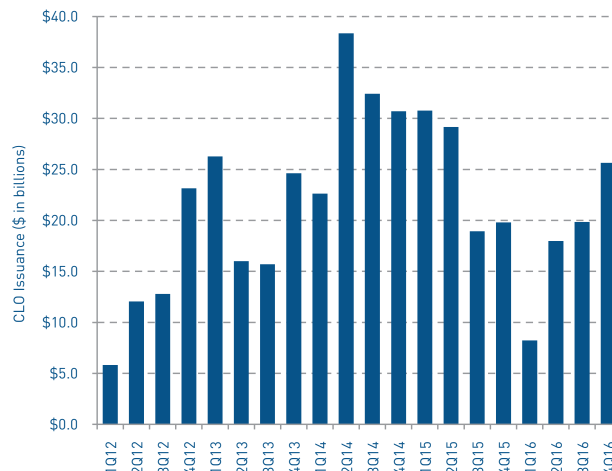
B. LEVERAGED/NON-INVESTMENT GRADE

Demand for leveraged loans surged in the fourth quarter and is accelerating in the first quarter as Libor is rising and technical factors make this an issuer-friendly market.

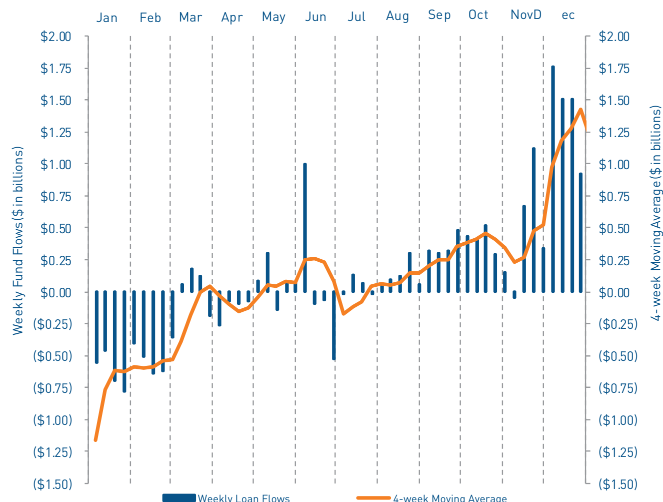
Collateralized loan obligations (CLOs), structured vehicles that purchase leveraged loans, ramped up new issuance late into the year as managers sought to issue new vehicles ahead of new “risk-retention” rules that took place on Christmas Eve. Further, investors are moving money to floating rate loan funds at a torrid pace, injecting new capital into the market that must be invested.

As a result, CLOs, retail loan funds and also cross-over investors are creating substantial demand for leveraged loans that’s currently outstripping supply.

CLO ISSUANCE RISES IN 4Q16



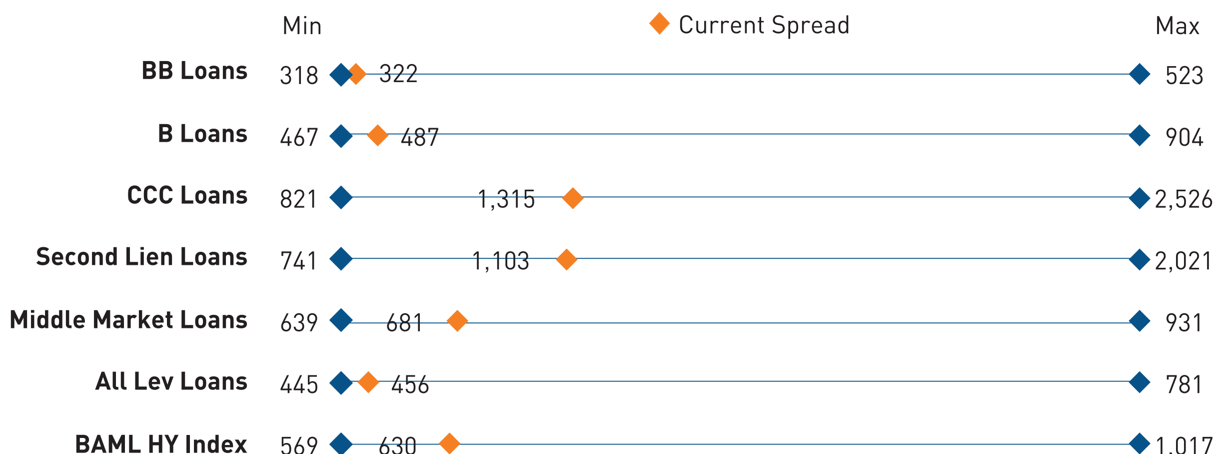
Source: PNC Capital Markets LLC, Thomson Reuters LPC, Federal Reserve Board, S&P Capital IQ LCD; BAML HY Index represents yield



With limited new-issue deals relative to demand, these investors are significantly oversubscribing double-B and even single-B new-issue Term Loan Bs. The result is tighter pricing and higher secured and total leverage.

Note that double-B, single-B, middle-market leveraged and all leveraged loans are on top of their tightest levels in more than four years.

Because of these technicals, we're seeing loans bid well above par and even 101, prompting issuers to reprice their loans at the highest level in the last three years. We're also seeing loan spreads as tight as L+200 with no Libor floor for a number of double-B–rated Term Loan Bs.



Loan spreads assume a three-year life

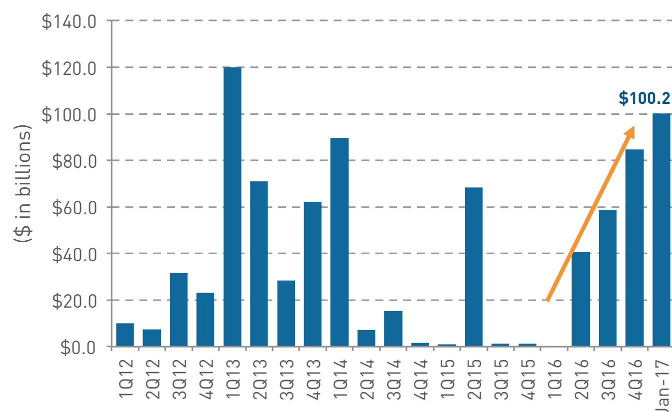
OUTLOOK

We expect new-issue and secondary institutional loan spreads to tighten as rates rise and investors allocate more money to floating rate loans.

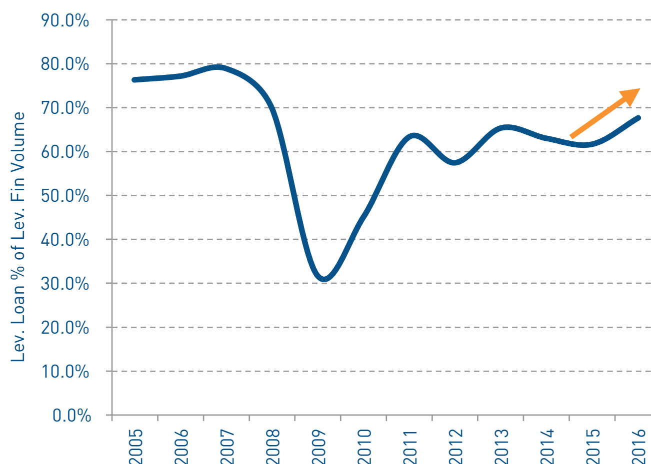
Source: PNC Capital Markets LLC, S&P Capital IQ LCD; BAML HY Index represents yield

As a result, we expect more oversubscribed deals, a continued shift of fixed to floating as borrowers choose institutional loan issuance (see adjoining chart), and institutional investors eyeing certain Term Loan A tranches to fill their loan portfolios (we co-led First Data's $1.3 billion, L+200, 3.4yr Term Loan A that closed in January, and institutional investors snapped up hundreds of millions of dollars at par in the secondary). In short, the leveraged loan market is open and available in 1Q17.

REPRICING ACTIVITY INCREASES



LEVFIN VOLUME SHIFTS TO LOANS



C. MIDDLE MARKET

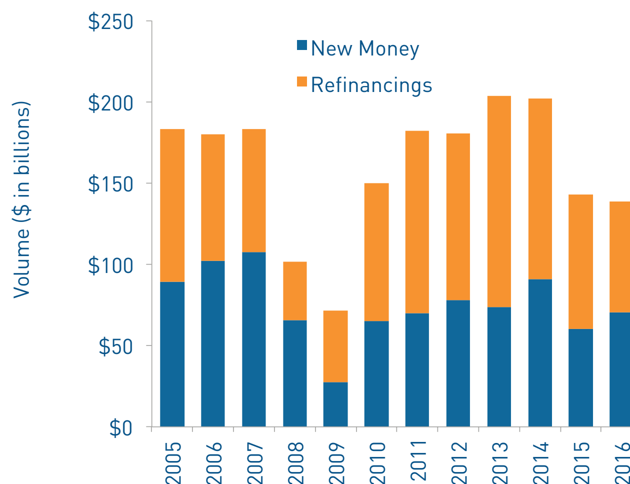
Middle market syndicated loan volume was down slightly from a weak 2015, hitting the lowest level since 2009.

All-in borrowing costs increased throughout the year along with Libor, and loan spreads for general corporate purposes in both the large corporate and traditional middle market spaces ticked upwards.

New-money issuance was up and on par with recent years; however, volume was down due to reduced refinancing activity.

In particular, there were far fewer refinancings in the non-sponsored space, as borrowers had little incentive to open up their deals.

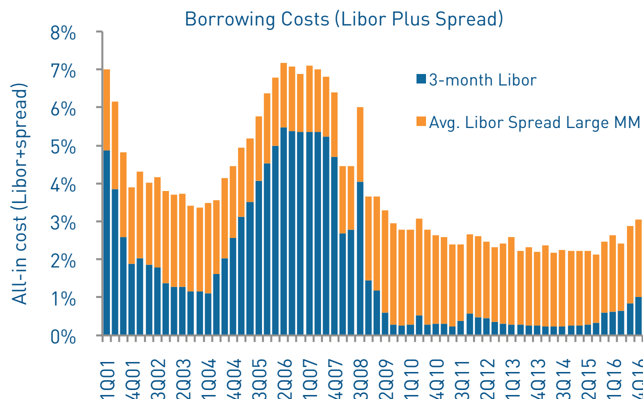
TOTAL MIDDLE MARKET VOLUME



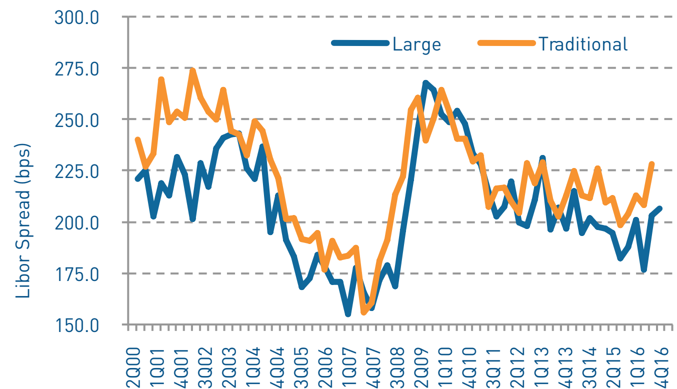
Furthermore, slow growth and a lack of clarity around the direction of the economy and the election saw borrowers hold off on debt for M&A or upsizing working capital and capex facilities.

Source: PNC Capital Markets LLC, S&P Capital IQ LCD; BAML HY Index represents yield, Thomson Reuters LPC

MIDDLE MARKET SPREADS OVER 3-MONTH LIBOR



NON-SPONSORED NON-M&A MM SPREADS



Also, regulations and tightening credit standards forced some middle market borrowers to seek more expensive capital outside the bank market.

However, we saw sponsored middle market issuance rise modestly, and direct lenders/alternative capital providers took a greater share of the market, and some deal flow was "self-syndicated." Aiding deal flow were private equity shops that had dry powder to put to work.

OUTLOOK

We are cautiously optimistic for 2017 volume, as we expect more companies will amend facilities to extend maturities and borrow to fund organic growth. In general, we expect fairly stable spreads, although, due to rising short-term rates, an overall increase in all-in borrowing cost.

D. ASSET-BASED LENDING

At just over $75.0 billion, syndicated ABL volume in 2016 trailed year-ago totals of roughly $85.0 billion. At the outset, we saw more unreported sole-lender deals and underreported clubbed deals for 1) traditional issuers in the middle market and 2) larger issuers that historically would have relied on retail syndication.

The supply/demand imbalance continued to be the theme within the ABL market in 4Q16. At just under $5.0 billion, new money ABL made up roughly one-third of total issuance in 4Q16. Of this total, financing to corporate lenders represented more than 60% of new-money issuance. Investors continued to shy away from new-issue "criticized" credit profiles.

Sponsored middle market activity ended the year on a strong note as issuers and investors worked hard to deploy capital. Sponsors benefited from higher hold levels from lead arrangers and relationship lenders. As more evidence, the "club" market has stolen market share from traditional retail syndications.

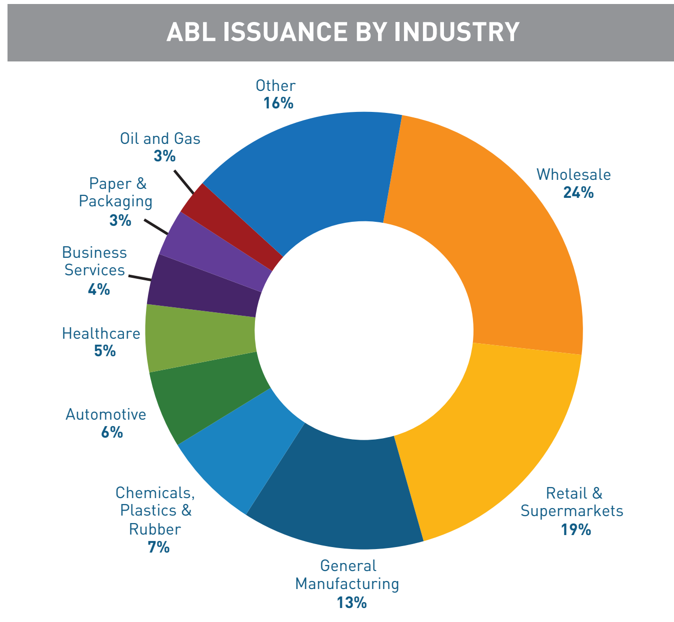
Source: PNC Capital Markets LLC, Thomson Reuters LPC

Large MM: Borrower sales above $500mm, deal size $100–$500mm

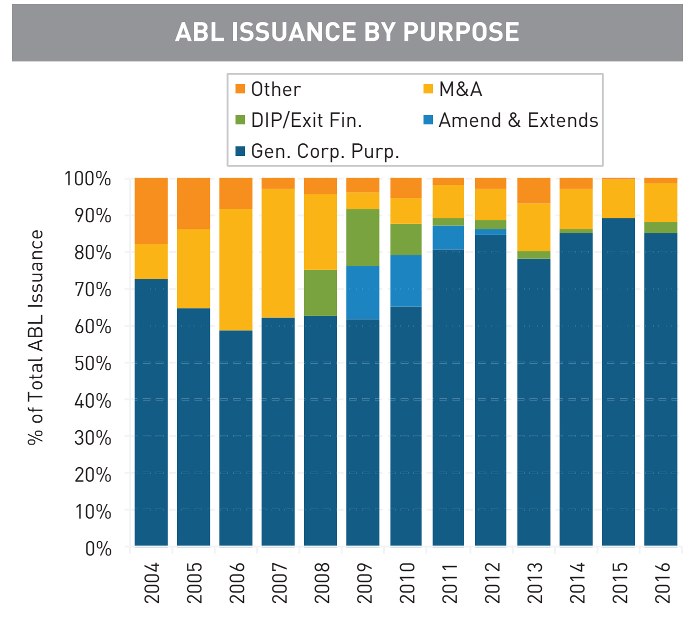
Traditional MM: Borrower sales above $500mm, deal size <$100mm

At the smaller end of the sponsored market, ABL arrangers are teaming up with direct lenders and alternative capital providers to deliver one-stop financing solutions. Some of these issuances are arranged as unitranche structures, a trend that continues to gain momentum with select lenders.

ABL ISSUANCE BY INDUSTRY



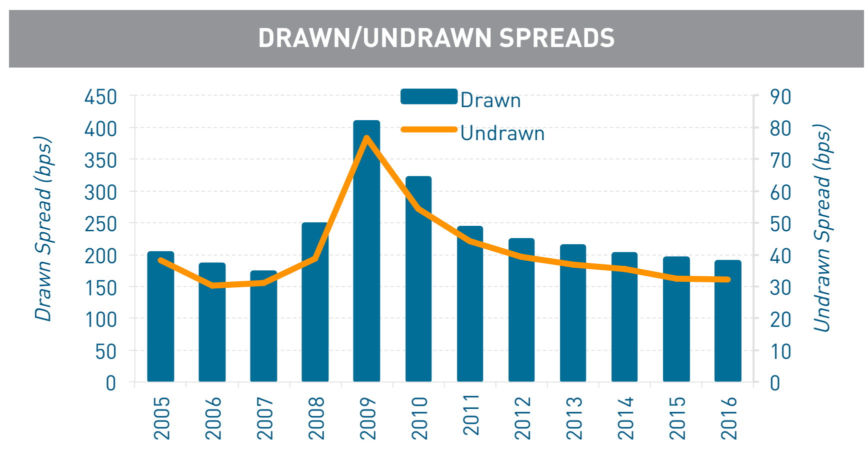
ABL ISSUANCE BY PURPOSE



OUTLOOK

Lenders will continue to be focused on overall return models and capturing the share of issuer wallets as drawn/undrawn spreads continue to remain competitive. The technical landscape looks relatively healthy given the lack of near-term loan maturities and relatively low issuer default rates.

DRAWN/UNDRAWN SPREADS



Thinner priced deals will remain a challenge for pure buy-side investors without cross-sell product offerings.

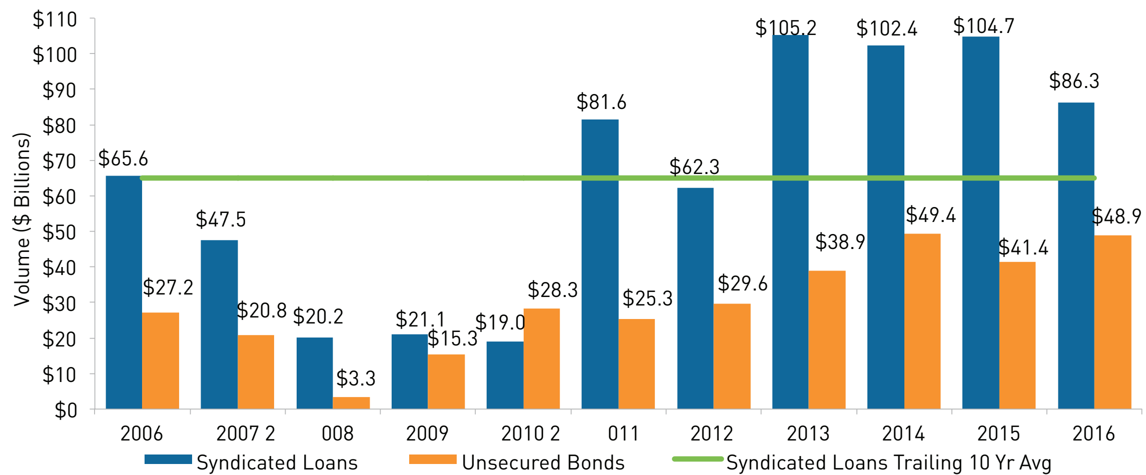
Also, banks' perceptions of the ABL regulatory guidance will continue to evolve as tougher-rated credits will have a limited syndication audience.

Finally, in the middle market, ABL lenders will continue to seek relationships with direct lenders and alternative capital providers in order to deliver one-stop solutions.

Source: PNC Capital Markets LLC, Thomson Reuters LPC

E. REAL ESTATE

ANNUAL REIT VOLUME



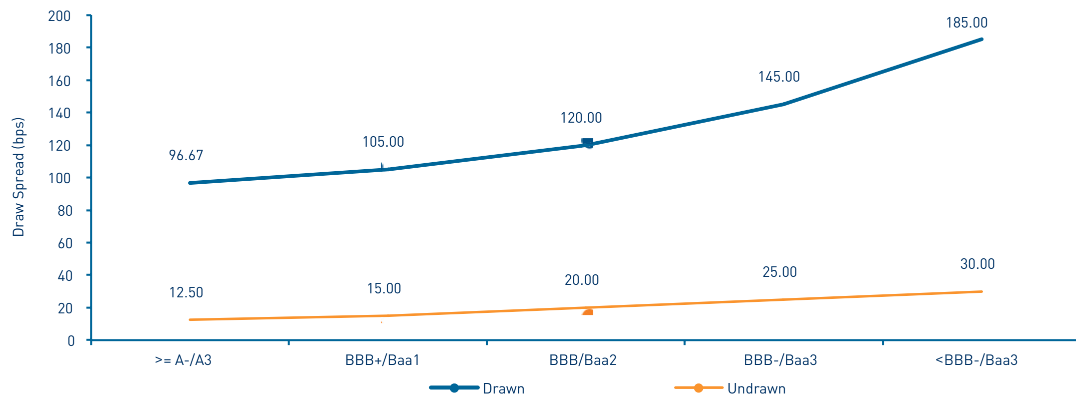
The secured bank market has settled into a relative equilibrium as pricing has plateaued across segments. Lenders continued to be circumspect about construction lending activities throughout 2016, saving their capital for the best relationships and the greatest returns. Multi-family projects, in particular, came under special scrutiny throughout the year. Fully funded term loans, backed by single assets and property pools, were the most desired asset class. Spreads within the REIT bank market appear to have bottomed; however, the market compensated with some increases in fees and wider participation in fee-earning roles within bank groups. Lender groups routinely shuffled as banks rationalized their positions relative to ancillary income opportunities.

Source: PNC Capital Markets, SEC filings, Federal Reserve Board, Loan Pricing Corporation, S&P Capital IQ LCD, Bloomberg

OUTLOOK

Having experienced heavy refinance and opportunistic term financing volume since 2013, the REIT market is poised for a bit of a breather. Borrowers are likely to continue the process of optimizing the match between bank group size, facility size and ancillary fee pools. Pressure on REIT spreads, in this case, will remain to the upside. Property markets should continue to operate at or near current spread levels given relative balance between loan supply (driven by high expected refinancing requests) and demand (driven by competitive bank loan alternatives).

4Q16 U.S. REITS AVERAGE SPREAD



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Source: PNC Capital Markets, SEC filings, Federal Reserve Board, Loan Pricing Corporation, S&P Capital IQ LCD, Bloomberg

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