PNC

DEBT CAPITAL MARKETS

EXECUTIVE SUMMARY

- Last year was a strong year for the corporate loan markets, including middle market and ABL, leveraged loans, and investment grade. Strong issuance and stable to lower pricing highlighted most of the year, and the markets were open and available.
- Volatility in the last 2 months of the year put a damper on an otherwise spectacular annum, especially in the leveraged loan market, and lower share prices placed a question mark around the amount of large M&A-backed debt issuance to come.
- Despite recent broader market volatility, the lending environment for traditional corporate middle market borrowers is relatively stable in early 2019, giving borrowers access to capital at relatively favorable pricing and terms.
- While the institutional loan market ended the year with the market selling off and pricing widening, early 2019 indications show the market opening back up with bid prices improving, inflows coming back into the asset class, and new-issue deals launching.
- Investment grade borrowers are able to refinance or borrow new capital at relatively stable spreads, indicating banks' continued desire to lend.

MIDDLE MARKET LOANS

Despite volatility in the broader capital markets, traditional bank middle market corporate borrowers are seeing relatively stable pricing and terms in the early stages of 2019.

Throughout 2018, middle market corporate borrowers exhibited increased demand for credit versus prior years. The increased demand, paired with lenders' desire to grow loans, led to 2018 posting the highest annual loan volume number since 2014. Further, every quarter in 2018 saw increased volume compared to the corresponding quarter in 2017.

Banks are continuing to increase their relative hold sizes for the right borrowers to protect ancillary business and maintain loan growth. A reported 38% of lenders responding to a Thomson Reuters survey reported not lending as much as they wanted in 2018, and 62% reported not lending as much as they wanted in 4Q 2018.

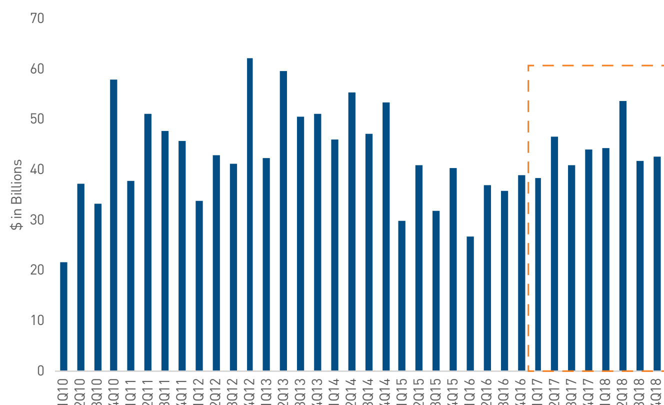
New capital into the direct lending space, which generally supports private equity sponsored transactions and the higher levered transactions, remains another competitive dynamic.

The number of direct lenders acting as financing arrangers doubled from 23 to 47 over the past 5 years, indicating that non-bank lenders (who often pair their own funds with additional leverage) are active in deploying capital. While competition for investment pushed terms to be significantly borrower-friendly, the current market volatility may be forcing lenders to take a step back and re-evaluate the landscape.

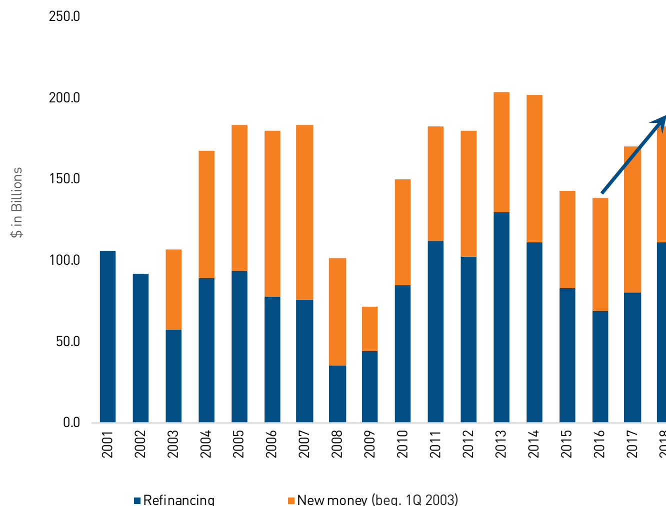
On the pricing side, the best corporate borrowers are generally still seeing pricing in the L+100-175 range, with lower pricing available for 364-day facilities versus 5-year deals. Some lenders responding to a Thomson Reuters survey reported spread requirements going as high as L+275-300, potentially indicating an evolving late cycle view that may be anticipating a weaker credit environment ahead.

Source: Thomson Reuters LPC

QUARTERLY LOAN MIDDLE MARKET VOLUME



ANNUAL MIDDLE MARKET LOAN VOLUME



In summary, strong traditional bank middle market corporate borrowers are still able to receive relatively advantageous pricing and structure into 1Q 2019 on the back of lenders pursuing loan growth.

Asset Based Lending

Despite market volatility, pricing on ABL deals is near record low levels with L+125 bps now the market benchmark for high-quality ABL credits.

We continue to see many borrower-friendly enhancements in financial covenants, advance rates, voting rights and liquidity triggers. In addition, sponsors continue to assert more control over the documentation process leading to more favorable borrower-friendly provisions. We see the ABL market remaining relatively issuer-friendly, as arrangers continue to take larger hold positions alongside more club-type syndications.

A consistent theme throughout 2018 was the broad acceptance of First-in, Last-out (FILO) tranches, which provide borrowers incremental liquidity at the cost of premium pricing over the traditional revolver. This concept was incorporated into 2018 deals as issuers pushed for additional capital. The FILO continues to gain momentum.

LEVERAGED / HIGH YIELD

There is an old adage that says "It's not how you start, it's how you finish," and the leveraged loan market finished 2018 in historically poor fashion. Underperformance and broader market volatility in 4Q 2018 provided the proverbial black eye to an otherwise strong 2018. Amid massive fund outflows and secondary price softness, investors took the opportunity to push back on primary loan structure, specifically on permissive covenant packages, incremental capacity, MFN protection and EBITDA adjustments.

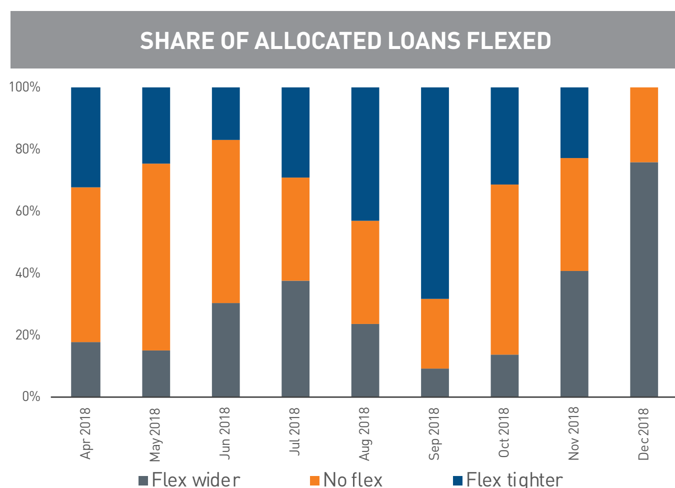
Loan funds in particular, which can be used as a proxy for overall demand in the leveraged loan market, saw massive outflows in 4Q 2018 to the tune of ~$14 billion, reversing inflows for the first three quarters of the year, causing 2018 to limp to the finish line with over $3 billion of net outflows.

Pressure in the secondary market dropped the share of performing loans priced at par or higher to less than 1% by the end of December, which is a low since April 2009, and down from 36% in October and ~75% in early 2018. In fact, the Leveraged Loan Index dropped to 93.81 on the bid in late December, the lowest level since July 2016.

Sources: Thomson Reuters LPC, S&P Capital IQ LCD

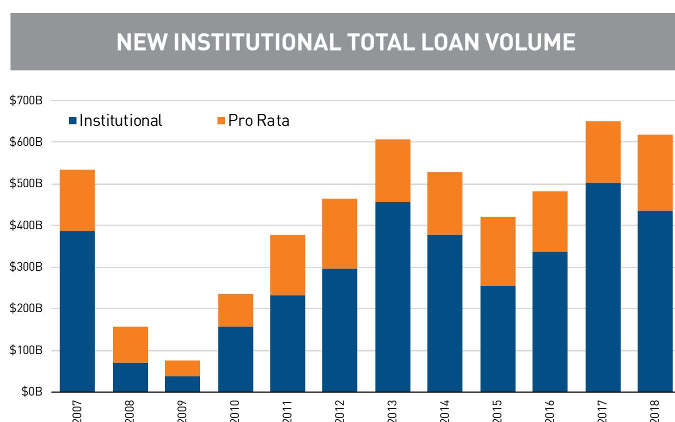
Outflows in concert with secondary pressure weighed heavily on primary loan execution. Of the deals that were allocated in December (and some were postponed due to market conditions), 76% were revised wider, the largest share since October 2015. Conversely, pricing didn't tighten on a single deal for the first time since September 2009.

SHARE OF ALLOCATED LOANS FLEXED



Despite a rough 4Q, it should be noted that 2018 as a whole proved to be another strong year for primary issuance in the institutional loan market. Volume of $436 billion was down ~13% from the chart-topping $503 billion logged in 2017, but was the third-largest annual total on record. When including pro rata, total leveraged loan volume in 2018 was $619 billion, the second-most ever, behind 2017's $650 billion.

NEW INSTITUTIONAL TOTAL LOAN VOLUME

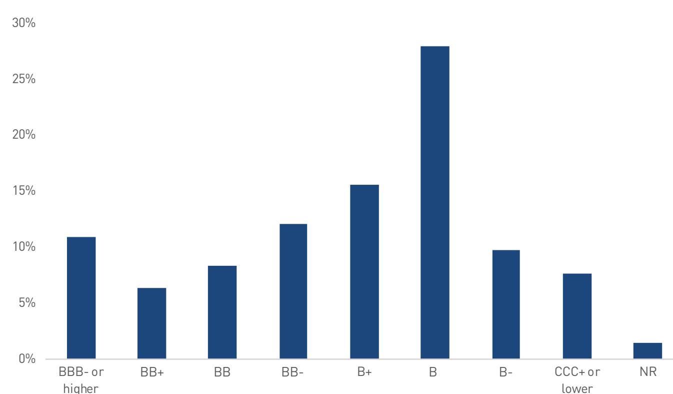


M&A was the primary driver, shooting to record highs and helping propel U.S. leveraged loan outstandings north of the $1 trillion threshold. The 2019 new-issue CLO volume projections of $90–$140 billion follow ~$128 billion in 2018, which was a new-issue record.

We expect the leveraged loan market to be open in 2019, although it will most likely continue to operate at a cautious pace in the early stages of 2019. Secondary prices have started to firm during the first weeks of January thanks to buyers stepping back in and funds holding ground or returning to the asset class. Uncertainty will persist with respect to CLO demand, which has been expected to be strong, and the general appetite for the floating rate high yield asset class given growing uncertainty regarding Fed Policy moves.

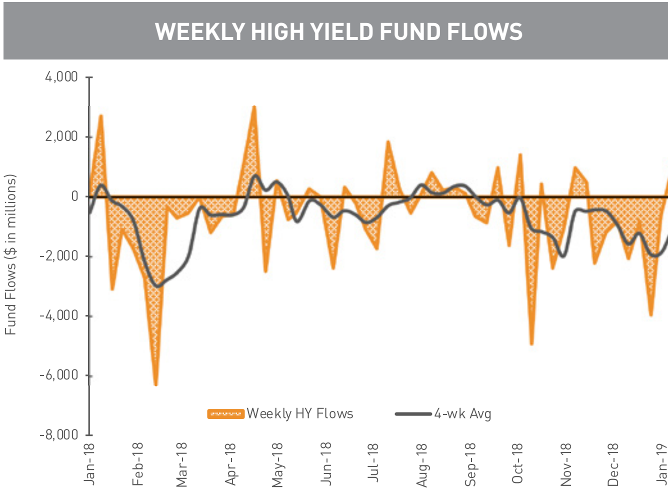
One thing to watch will be the unprecedented amount of single B paper as a percentage of outstanding market share. Even if defaults remain low, any migration to CCC will be impactful across the broader leveraged loan market. Firming secondary prices, a long-term softening of outflows, or a reversal to inflows into the leveraged loan asset class could be catalysts for stronger primary execution in early 2019.

U.S. OUTSTANDING LOANS BREAKDOWN BY RATING



In high yield, while no new issues priced in December, January saw the market open back up. High yield mutual funds and ETFs saw outflows late in 4Q 2018 as investors parked cash on the sidelines, aiding in the high yield sell-off. A reversal of fund flows into high yield early in 2019 would be bullish for the asset class.

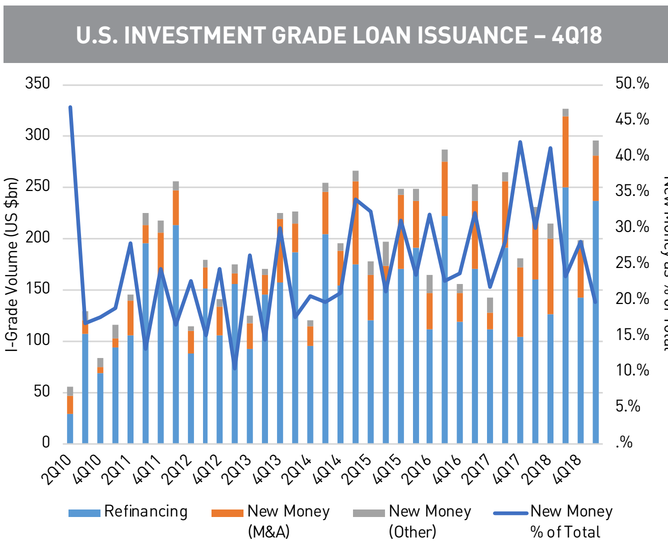
Sources: S&P Capital IQ LCD



INVESTMENT GRADE LOANS

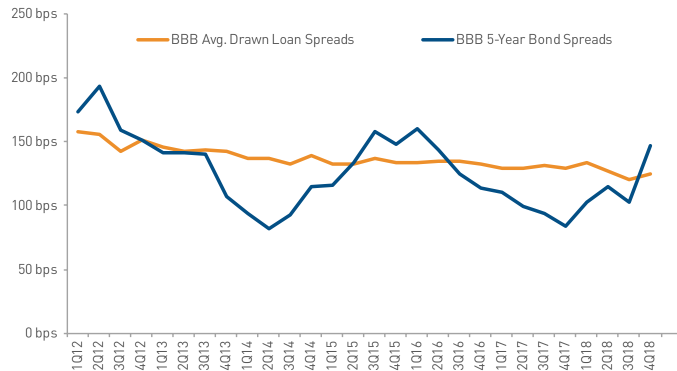
Last year was a strong year for the investment grade loan market as market conditions were favorable for borrowers and bank demand was healthy.

Overall investment grade loan issuance climbed to over $1 trillion in 2018, the average deal size increased to $2.2 billion from $1.9 billion, funded term loans became more widespread, jumbo refinances were prevalent, and four of the largest bridge loans on record took place in 2018.



In 2018, refinances jumped 33% year over year. In the fourth quarter we saw BBB 5-year bond spreads surpass 5-year drawn loan spreads. Issuers were able to take advantage of the favorable loan market conditions, and high grade issuers pushed out their loan maturities. In 2018, 31 high grade issuers refinanced loans greater than $5 billion in size, more than double the prior year.

BBB LOAN VS. BOND SPREADS



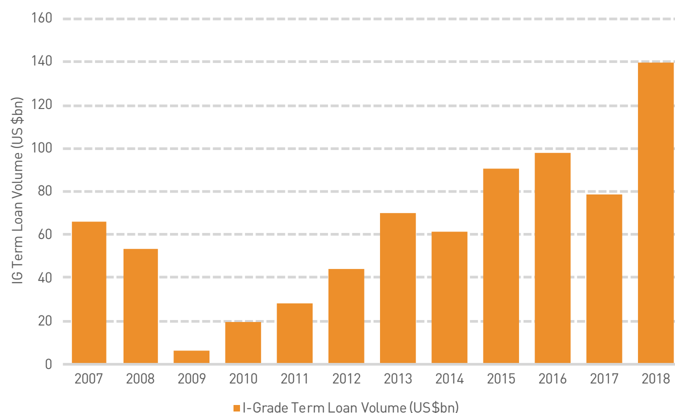
Investment grade M&A lending activity was robust in 2018 reaching a record $235 billion, which included major acquisitions by Cigna and Comcast. Prior to recent widespread market volatility, equities were hitting record highs. However, heightened market volatility and dampened valuations have created uncertainty around the amount of acquisition-related loan issuance to come in 2019, though 2019 appears to be off to a good start.

For now, the markets still remain open to loans backing M&A activity, and the Bristol-Myers Squibb acquisition financing, which is currently in market, starts 2019 with the sixth-largest bridge loan on record ($25.5 billion).

In the last newsletter we discussed the trend of shorter-dated, lower-priced term loan issuance within the utilities industry. Term loans grew in interest across the investment grade market as well, with volume soaring to $140 billion. Some banks are being aggressive on term loan pricing citing banks' current low cost of funds, competitive market conditions and appetite for loan growth.

Sources: Lipper, Thomson Rueters LPC, Bloomberg

Note: BBB includes BBB+, BBB and BBB-



Forward View

The overall investment grade loan volume outlook for 2019 remains unclear. Despite banks' capacity to lend, lenders don't expect the market to top 2018's record-breaking loan issuance. One factor in particular remains uncertain: Despite banks' appetite, with strong refinancing volume behind us, the potential for rate hikes ahead, a choppy market, and an increase in cash from the tax overhaul, what can we expect from borrower demand?

On the pricing side, we do expect investment grade loan spreads to stay consistent, with drawn BBB spreads hovering around L+125 and drawn A spreads around L+87.5.

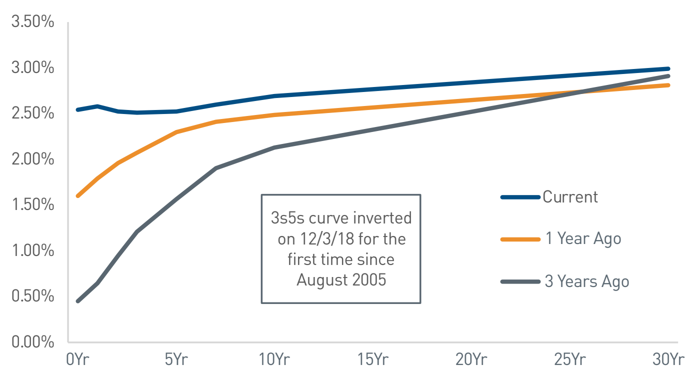
SOFR, the Secured Overnight Financing Rate, has continued to move forward as a replacement to LIBOR in 2021. SOFR gained popularity in 2018 across a number of debt issuances, and banks are incorporating LIBOR replacement language as a standard in new credit agreements.

Investment Grade Bonds

2018 produced a healthy $1.2 trillion of new-issue investment grade bond volume, though down ~12% from the prior year. Volumes were stymied by heightened volatility in the U.S. equity markets in the second half of the year and lower refinance needs overall. While total volume fell, M&A bond volume jumped almost 25%.

This year, new-issue supply is expected to be healthy with January expectations coming in as high as $110 billion, though total issuance for the year is expected to be down slightly from 2018 (~8% lower).

Factors that may affect the market in 2019 are spreads pushing higher, the new-issue market being less receptive, slowed M&A activity after a heavy 2018, and issuers focusing on deleveraging rather than refinancing upcoming maturities.



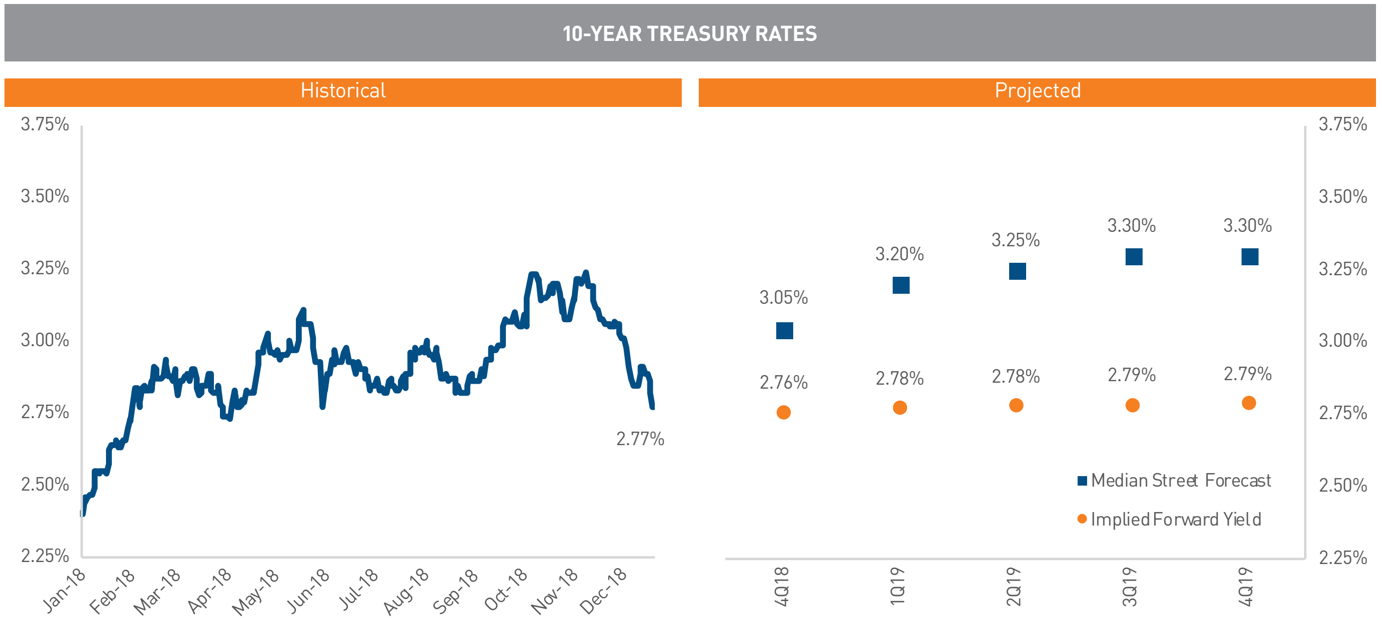
Over the last 12 months, the UST yield curve flattened with short-term rates rising faster than long-term rates, alongside four Fed rate increases.

The 3s5s curve inverted in early December 2018 for the first time since August 2005. Inversions have historically been an early predictor of a looming recession.

However, it took 28 months from the point of inversion in 2005 before the ensuing recession began. The more closely watched 2s10s curve has not inverted, but is trading near its tightest level (17 bps) since 2007.

Amidst volatile equity markets and growing concerns of slowing global growth, expectations for rate hikes have ratcheted back, with traders now pricing in less than one interest rate hike in 2019. The Federal Reserve has recently signaled that it will likely slow the pace of rate hikes in 2019, which could provide positive momentum for equity and debt investors.

Sources: Thomson Reuters LPC, Bloomberg



Source: Bloomberg

FOR MORE INFORMATION

Visit **pnc.com/dcm**.

Services such as public finance investment banking, securities underwriting, loan syndication, and securities sales and trading are provided by PNC Capital Markets LLC ("PNCCM"). PNCCM, member FINRA and SIPC, is a wholly-owned subsidiary of The PNC Financial Services Group, Inc. ("PNC") and affiliate of PNC Bank, National Association ("PNC Bank").

©2019 The PNC Financial Services Group, Inc. All rights reserved. CIB ENT PDF 0119-084-1079402

PNC