

# DEBT CAPITAL MARKETS

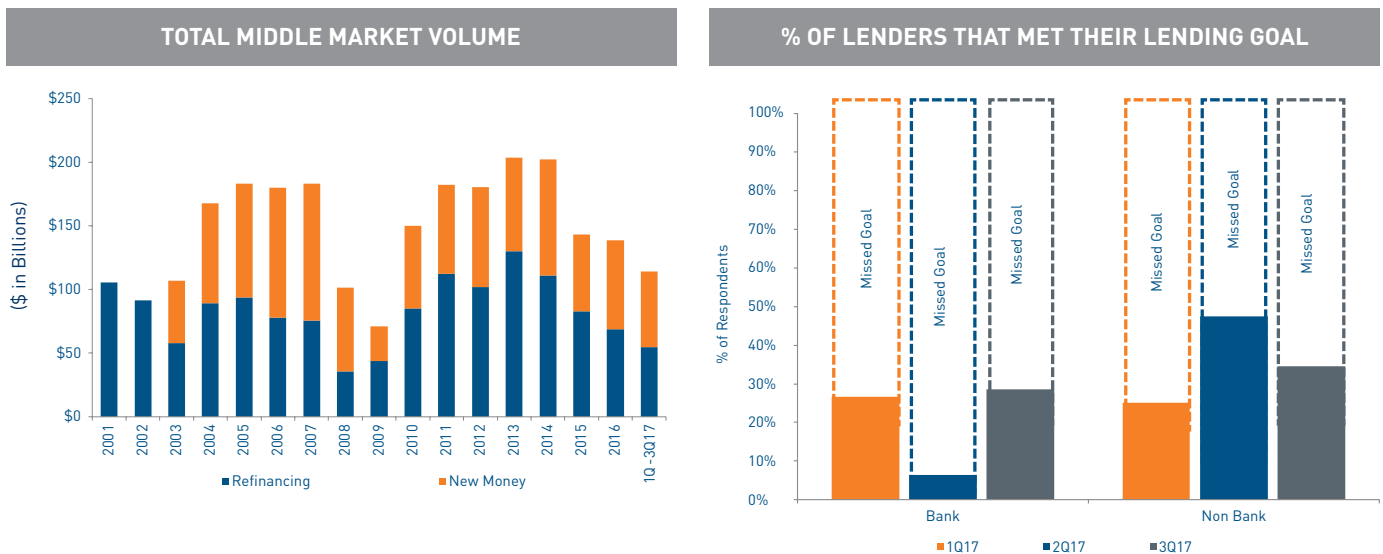
## EXECUTIVE SUMMARY

- In the middle market, bank loan capital is available at attractive levels. For leveraged middle market companies, non-bank lenders are driving down borrowing costs as they quickly deploy excess funds.
- In the broadly syndicated leveraged loan market, investors are accepting spreads as low as L+200 and demanding fewer structural protections in an effort to invest new money. The high yield bond market is open to issuers, and spreads over treasuries sit at the lowest levels since 2014.
- Investment grade lending increased on the back of higher M&A, and banks are still seeking to book funded loans to high-grade companies. Investors are oversubscribing investment grade bond transactions 3.1x year-to-date, and spreads over treasuries are the lowest dating back three years.

## MIDDLE MARKET

We're seeing significant competition in the syndicated bank loan market. With a lack of new-issue volume, banks are competing to win deals, making it an attractive time for borrowers to raise bank capital.

Further illustrating the point, seven out of every 10 bank respondents to a Thomson Reuters survey indicated missing their lending goals in 3Q 2017. While this is down from 95% missing in the prior quarter, it underscores the idea that banks have appetite to lend in the middle market but aren't able to find enough deals.

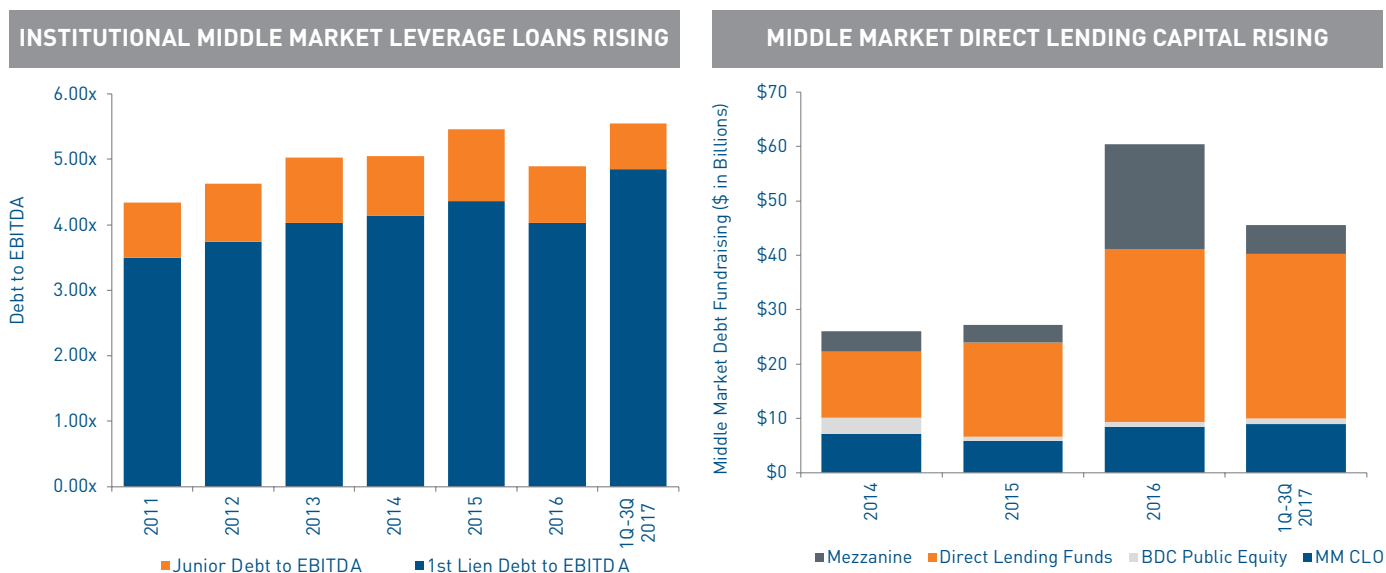


Sources: Thomson Reuters LPC, PNC Capital Markets LLC

To win business, banks are doing any or all of the following: taking larger hold sizes, lowering their yield targets, loosening structure and leveraging strong relationships with private equity firms. Based on our conversations with investors, banks are also hard-pressed to end a client relationship unless there are unacceptably low returns or little opportunity for additional ancillary business.

In the leveraged middle market segment, private debt funds are raising a staggering amount of capital. Direct lenders, those who originate deals directly and often support private equity backed deals, are raising the bulk of that capital.

Investors are competing more fiercely to invest those new dollars, driving down spreads over LIBOR to the lowest level post-recession (439 bps). One effect of the competitive environment is that Debt / EBITDA levels are approaching 6x. In fact, Senior Debt / EBITDA is approximately equal to 2016's total debt level.



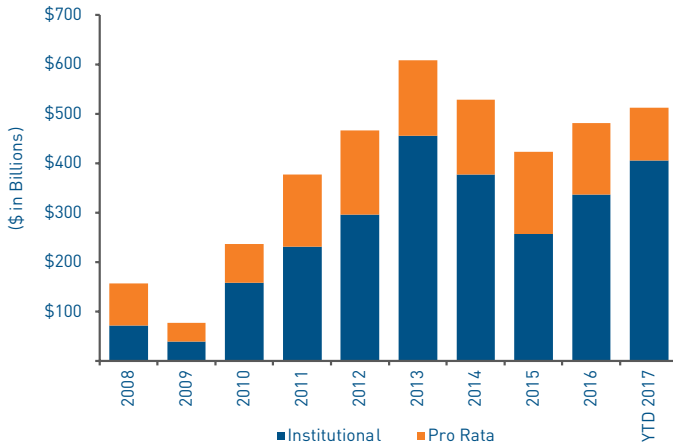
## ASSET-BASED LENDING

In asset-based lending (ABL), we're seeing a continuing trend in structural flexibility. The market is issuer-friendly, and both sponsors and borrowers are finding creative ways to maximize borrowing base availability. For example, in syndicated ABL deals, we are frequently seeing the inclusion of First-In, Last-Out (FILO) tranches, which provide incremental liquidity at the cost of premium pricing over the traditional revolver. The FILO was most typically utilized in the retail industry, but has recently been accepted in the broader ABL market.

New deal flow is limited, and as a result lead arrangers are utilizing their balance sheets to support clients with larger commitment levels. This creates "club" executions with small lender groups, meaning there's more ancillary business to spread across fewer lenders (who in turn must accept larger hold sizes).

In addition, because the market is so competitive, large cap sponsor provisions (that are very "borrower-friendly") are trickling down to the middle market. In turn, lenders are relaxing their risk tolerance to compete.

OVERALL LEVERAGED LOAN VOLUME



Capital raising efforts continue to be robust by direct lenders, which creates the opportunity for these lenders to play a bigger role across unitranche, Term Loan B, second lien and mezzanine tranches. While we expect to see more ABL lenders partnering with direct lenders to provide one-stop shop financing solutions, we're also seeing lead arrangers/bookrunners pursue larger deals to help offset the direct lender origination model.

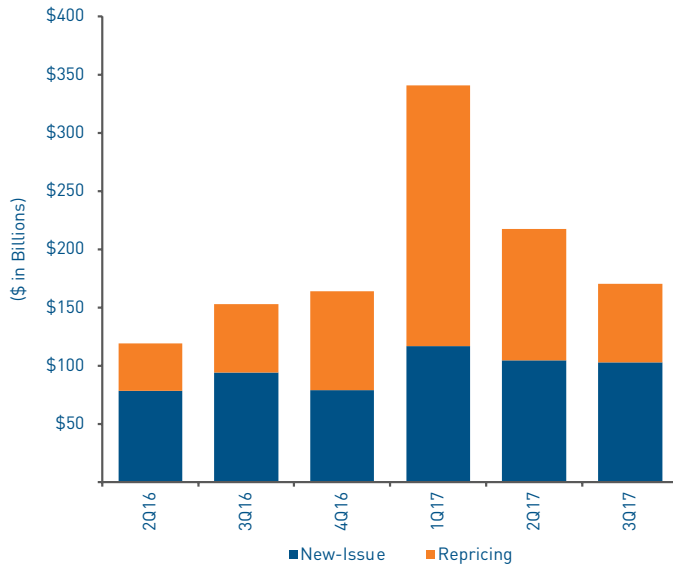
LEVERAGED / HIGH YIELD

2017 will likely be a record volume year and an all-time high for the leveraged loan market. At more than \$540 billion so far, and on the back of significant institutional refinancing and re-pricing volume, pro rata and institutional leveraged loan volume looks like it will eclipse 2007's \$535 billion and 2013's all-time high of \$607 billion.

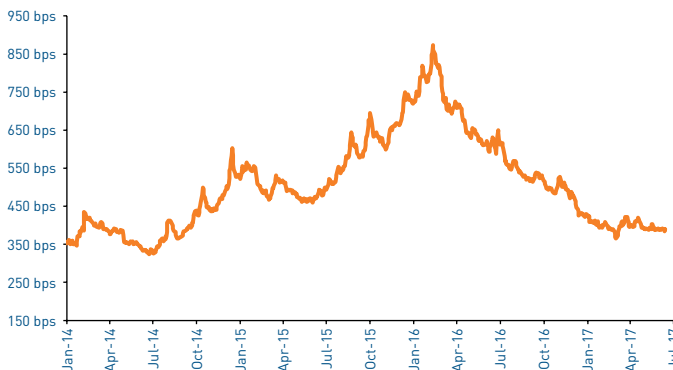
Pricing is also coming in significantly. For pro rata, price tightening is less pronounced as the best mid to high BB names see pricing in the range of L+150.

For Term Loan Bs, however, our analysis of tranches over \$200 million denominated in U.S. dollars finds that more than 50 borrowers either have spreads of L+200 or are in-market with price talk of L+200-225. For reference, zero loans re-priced to L+200 in 2016 according to S&P Capital IQ data. One client, for example, is looking to reduce spread on a large Term Loan B from L+275 to L+200-225. Price tightening is a trend we expect to continue throughout the fourth quarter.

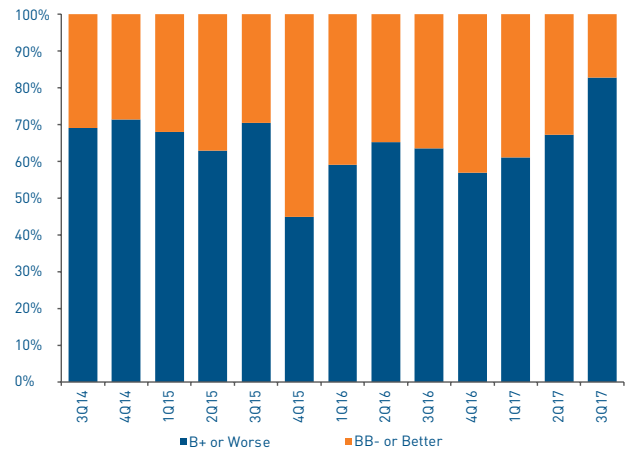
INSTITUTIONAL NEW ISSUE AND REPRICING VOLUME



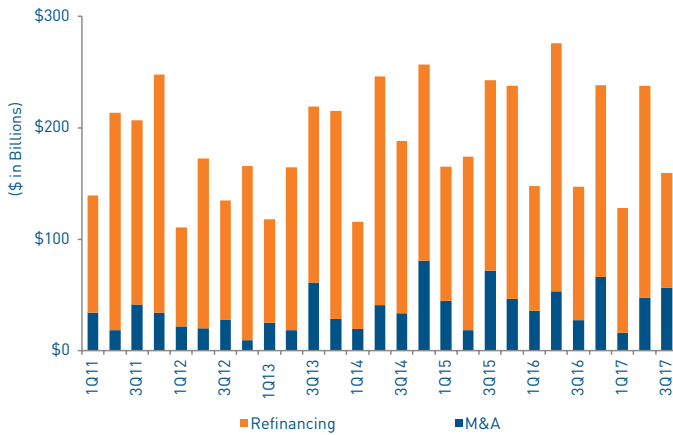
TIGHTER HY SPREADS ARE ATTRACTIVE FOR NEW ISSUERS



MORE DEALS HAVE B+ OR WORSE RATING



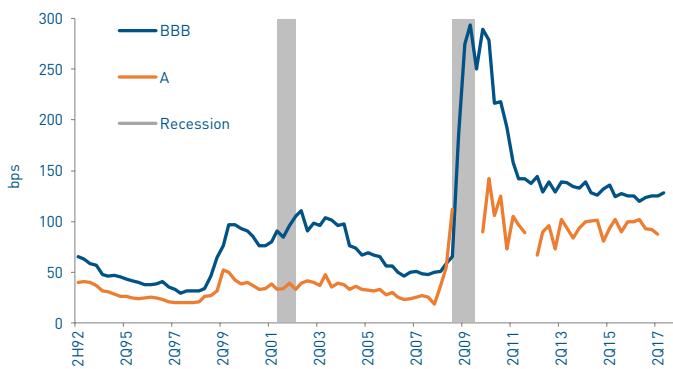
**M&A UPTICK, REFINANCING SUSTAIN U.S. I-GRADE LOAN MARKET**



We don't see demand for loans drying up anytime soon. Collateralized loan obligations, which purchase more than half of all institutional loans, raised \$12.1 billion in an unusually busy August and another \$8.9 billion in September, according to S&P Capital IQ data. Plus, the largest loan ETFs are still holding 5–10% of their assets in cash as they work to invest existing dollars from the massive investor inflows from earlier in the year.

One trend we're watching in 4Q 2017 is the credit quality of new-issue deals. Issuers rated B+ or worse accounted for a staggering approximately 85% of TLB volume last quarter, up substantially from approximately 60% at the beginning of the year.

**I-GRADE DRAWN SPREADS**

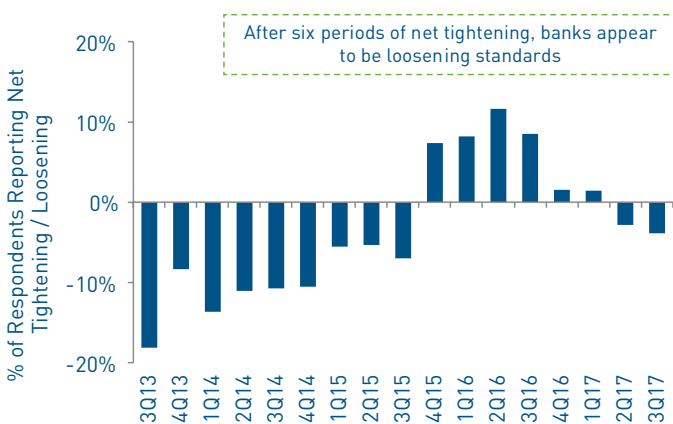


In the high yield bond market, spreads over treasuries, as measured by the Option Adjusted Spread, are among their lowest levels post-recession. And volume is robust.

**INVESTMENT GRADE**

Based on our conversations with borrowers, banks are looking to book funded assets. As such, lenders welcomed last quarter, which saw another meaningful step-up in M&A loan volume, bridge loans backing M&A and a meaningful quarter for refinancing volume.

**BANKS LOOSEN STANDARDS FOR SECOND STRAIGHT QUARTER**



In fact, last quarter saw an 8% jump over the prior year period for a total of \$168.5 billion, according to Thomson Reuters data.

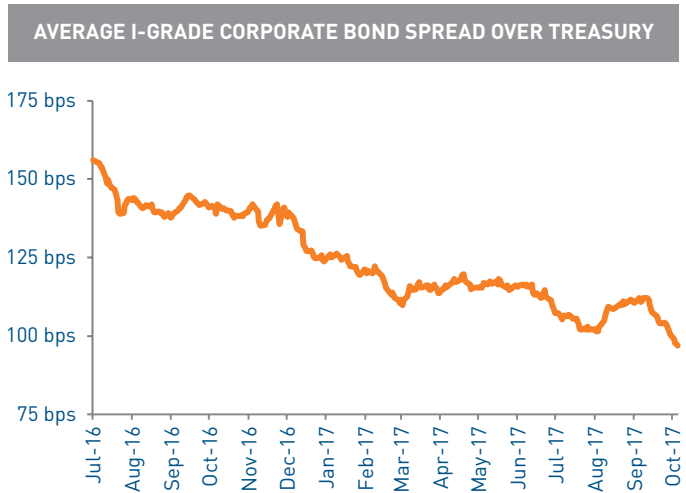
Also, the last two quarters both topped \$60 billion in "new-money" issuance, which is new loan supply to the market. This hasn't happened since 2Q–3Q 2007.

Loan pricing continues to stay relatively flat, with increasing regulatory costs making it difficult for banks to drastically reduce spreads as in past cycles.

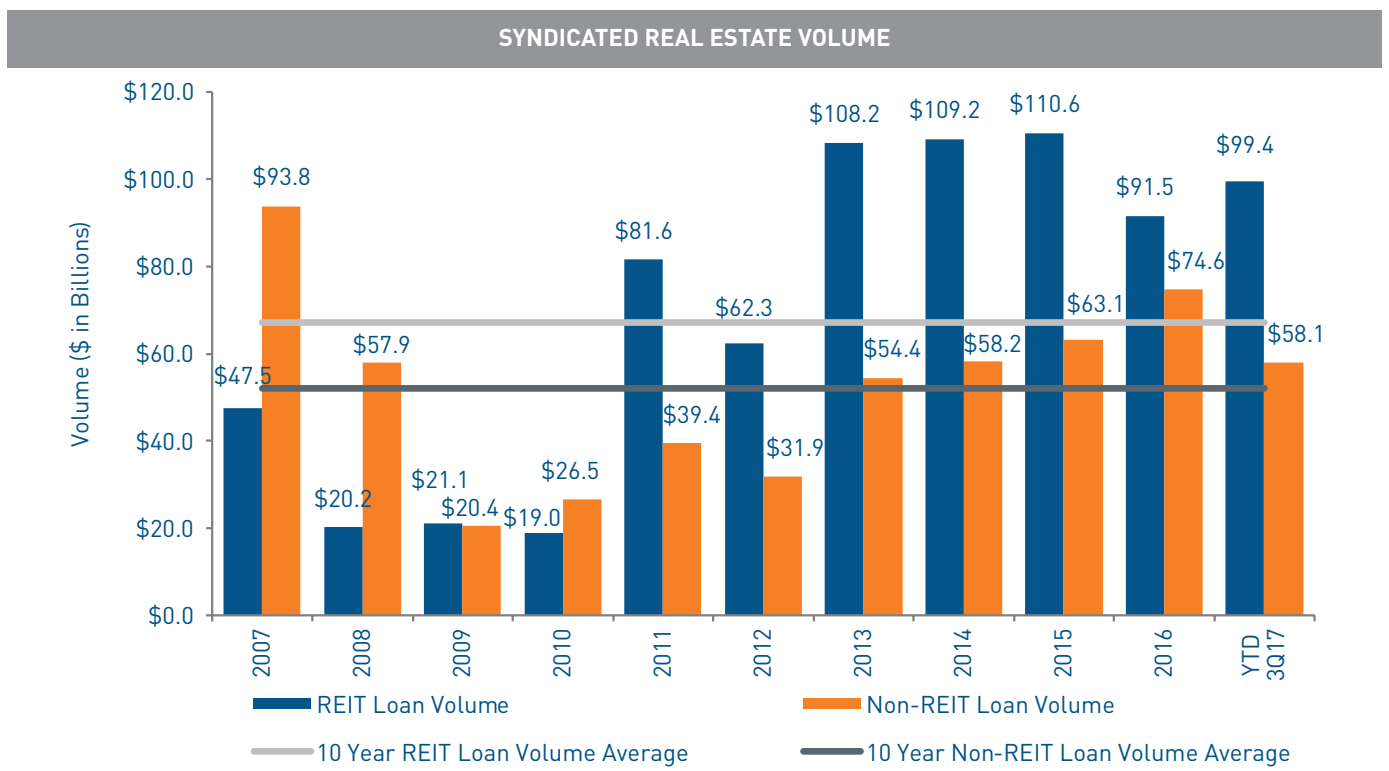
Banks are still looking to hit lending targets and are slightly loosening their lending standards to do so. The Federal Reserve's most recent Senior Loan Officer Opinion Survey echoes our own investor conversations, which show respondent banks on average loosening their lending standards.

Finally, in investment grade bonds, we're seeing a robust market where investors are piling in for new deals. Bond spreads over applicable treasury bonds are at significant period lows, and investors are oversubscribing deals a few times over.

Data from PNC Capital Markets' fixed-income syndicate desk show that on average investment grade bond deals are oversubscribed 3.1x year-to-date. In short, the market remains open and attractive for issuers to price new transactions.



## REAL ESTATE



Participants in the real estate loan markets are having quite different experiences depending upon the segment of the market in which they lend. REIT markets have outperformed volume expectations year-to-date, while the market for construction loans continues to be shaped by regulatory and portfolio balance (real estate as a percentage of total loan portfolio) considerations. Term lending markets have been strengthened by great interest on the part of multiple market participants and a relative lack of product.

The REIT markets are trending toward total volumes that would markedly exceed 2015's record levels. These levels were unexpected based on a lack of any material movement in pricing or structure and many borrowers having refinanced. Year-to-date volumes totaled \$99.4 billion as of September 30 versus \$66.2 billion in 2016. Meanwhile, pricing continues at virtually the same levels as in the past 18 months. REIT structural adjustments have been minimal, with most changes being to conform documents to existing market standards. The sole exception to this trend has been the re-examination of capitalization rates used for portfolio valuation, particularly in the case of retail-focused companies.

Project-related markets continue to be a tale of "haves" and "have nots" as lenders employ heavy scrutiny of construction lending opportunities. Large, institutional borrowers with strong banking relationships and strong projects attract the most capital and the tightest pricing. Others find that attracting a bid can be more difficult, and, in some cases, pricing for these borrowers has increased to compensate for the lack of market liquidity. The property types attracting the most construction loan dollars continue to be multifamily and well-leased office. Retail, given the transformational and disruptive forces at work in the industry, has become much more difficult to finance.

Finally, term lending saw the most aggressive lender behavior over the past quarter. Going against the trend, spreads actually have tightened for the best located, strongly leased, low leveraged deals. Life insurance companies have maintained strong appetite through the past quarter and, combined with CMBS and bank competition, helped drive demand for funded commitments. Into the fourth quarter, lenders will carefully watch developments in geopolitical relationships, regulatory and tax policy, interest rate movement and retail transformation as they refine their approach to lending in 2018 and through the late innings of an economic cycle.

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