Late Breaking News

# (NY) Middle market sees flurry of dealflow in face of wider volatility

October 12, 2011 - Since late September, at least a half dozen middle market LBO loans have launched, along with a mix of refinancings, acquisition loans and a dividend recap deal. In contrast, in the broadly syndicated loan market, only two LBOs have launched, Kinetic Concepts and Emdeon, underscoring the dearth of new supply from large corporate borrowers.

Though new issuance declined markedly from 2Q11 to 3Q11, the middle market is open for business-anchored by a buy-and-hold investor base in the traditional middle market space-and has remained largely insulated from the volatility rattling the broadly syndicated loan market. Regional banks, hungry to finance both sponsored and non-sponsored transactions, are also driving middle market lending activity.

"Demand for middle market paper has been stable relative to broadly syndicated loans, as a result middle market lenders have been able to execute deals at better pricing, with better structures," said one middle market institutional investor. Because of the stable investor base, when pricing does goes out, it won't go out as far, and there is a lot more visibility as to where a deal can get done," he noted.

On the whole, smaller deal size, non-sponsored loans and refinancings were the main drivers of activity in the middle market in the third quarter, helping to buoy the market as global risk aversion recast a shadow over the credit space in recent months.

Even if the pace of deal flow slowed and volumes dropped off, middle market participants cite stable funding and a committed capital among the traditional middle market investor base, as well as smaller lender groups, club deals and robust demand from pro-rata lenders as prime reasons for the middle market's relative stability.

Lenders are also looking to the unitranche structure, a structure that combines senior and subordinated debt in one tranche at a blended rate, to minimize risk.

"We are primarily doing unitranche deals due to the ease of execution, and the certainty of close. The unitranche execution provides more security and control with less risk," said Ted Koenig, President and CEO of Monroe Capital, a private investment firm and middle market lender.

Monroe Capital has been focused on refinancings and growth capital, which is where Koenig expects to see continued activity into year-end. There is a tremendous amount of demand from borrowers in the lower middle market to refinance existing debt as well as demand for additional growth capital, Koenig said.

Another segment, the non-sponsored lending space, which is largely made up of pro-rata loans from regional and commercial banks, proved a bright spot, lending further stability to the middle market overall. Issuance only fell to $27 billion in 3Q11 from $30.7 billion in 2Q11. Refinancings led the bulk of non-sponsored volume in 3Q, while new money M&A deals declined.

In contrast, activity in the broadly syndicated market is heavily tied to fund flows and the health of the capital markets. As a result, given the global sell-off of risk in response to macroeconomic concerns, including the deepening Eurozone debt crisis and regulatory uncertainty, the pricing of risk has been reactive in response to highly volatile capital flows.

"In the middle market pricing does not react as quickly to the capital markets, where as in the broadly syndicated market, the primary deals are priced to compete in the secondary market," said one leveraged loan investor.

Though spreads have increased on middle market deals, previously spreads had not tightened as much as in the broadly syndicated market, noted one investor. Since June, the average yield on broadly syndicated loans has moved up to 8.21 percent in October from 5.38 percent in June. Over the same period, the average middle market yield has increased to 8.91 percent, compared to 6.71 percent in June.

In fact, juicy yields on offer in some of the broadly syndicated new issue deals, which in some cases offer richer pricing than in the middle market, is attracting middle market investors to buy into deals from a purely relative value standpoint, but only where the price, structure and leverage are right, they said. In September, for example, middle market loans were yielding 8.06 percent, a slight discount to broadly syndicated loans at 8.34 percent.

However, though some broadly syndicated deals are clearing at a premium to middle market loans, the middle market in the long-term traditionally provides investors with greater yield. The demand from middle market borrowers for debt financing and the relative stability of middle market lending in contrast to the more liquid, but also more volatile large corporate market, could draw new investors to the middle market.

"In today's market, investors are more focused on yield than on multiples, which represents a cosmic change. This is good for the middle market from a return standpoint and in terms of attracting new middle market institutional investors," said Koenig.

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