Peering into 2017: A Survey of the Private Credit Markets

Proskauer

Welcome to *Peering into 2017: A Survey of the Private Credit Markets*.

This survey is part of our ongoing effort to help our clients understand the latest trends in the private credit markets.

We commissioned market-leading researcher Acritas to conduct this survey on our behalf. Acritas is an esteemed professional services market research firm with whom we have partnered on many projects.

Top lending institutions responded to our benchmarking survey with their predictions for the next 12 months. The results, in conjunction with the market data we have collected from over 180 transactions in the last 12 months, provide us and our clients with a keen insight into market conditions and forecasts for the remainder of the year.

Thank you to everyone that participated in this survey. If you have any questions or comments about the survey or our report, we would greatly appreciate hearing from you.

Executive Summary

We are delighted to share with you the results from our inaugural survey.

Respondents shared their expectations for the Private Credit markets over the next 12 months, covering topics such as:

- Drivers of deal activity
- Challenges for dealmakers
- Interest rates
- Pricing
- Credit quality
- Defaults

We also captured feedback on respondents' investment strategies, including:

- The most commonly utilized lending vehicles
- The markets and industries firms are targeting for investment
- Their plans to fundraise and to purchase loan portfolios, and
- The controls governing their investments, in terms of equity required for transactions and the maximum leverage their organization is prepared to underwrite.

KEY FINDINGS

- On balance, **45% predicted increased deal activity** over the next 12 months
- **Dry powder levels are expected to be the primary driver** of deal activity for the next 12 months, with optimistic economic forecasts post-election and less restraint in deploying capital also influential factors
- Almost half of respondents felt **competition will be the biggest challenge** for dealmakers in the year ahead, and competition will drive lower pricing and higher leverage
- When respondents were asked for their predictions for the next 12 months:
  - A rise in interest rates was widely expected
  - Lower pricing is expected
  - Credit quality is anticipated to hold
  - A majority think defaults will stay the same
- 2/3 of respondents are currently raising a debt fund and **79% plan to fundraise** over the next 12 months
- The priority markets for investment by respondents are the **US and Canada**, with 1/3 respondents considering the UK and Mainland Europe
- Business Services, Health Care, Manufacturing, Consumer Goods and Retail, and Technology are being targeted for investment by a majority of respondents. Despite all of the uncertainty in the health care market, **the health care industry remains favored as a target for investment** by 87% of respondents
- When investing, most respondents will underwrite a maximum total leverage of **6.00x or more**
- Half of respondents require at least **35% equity** for their transactions

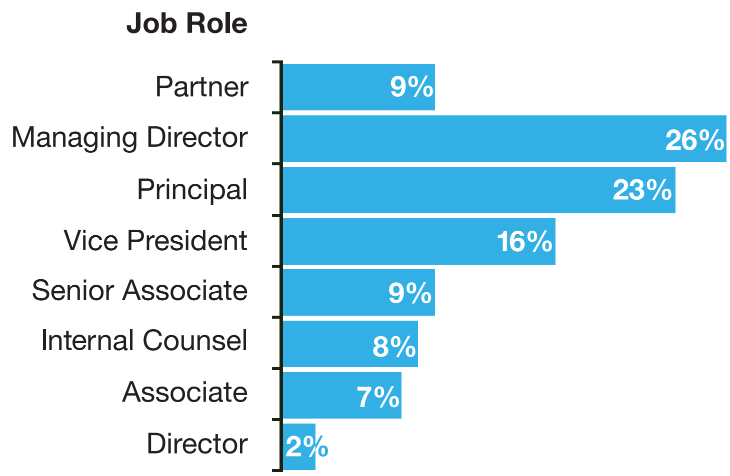
Demographics of Respondents

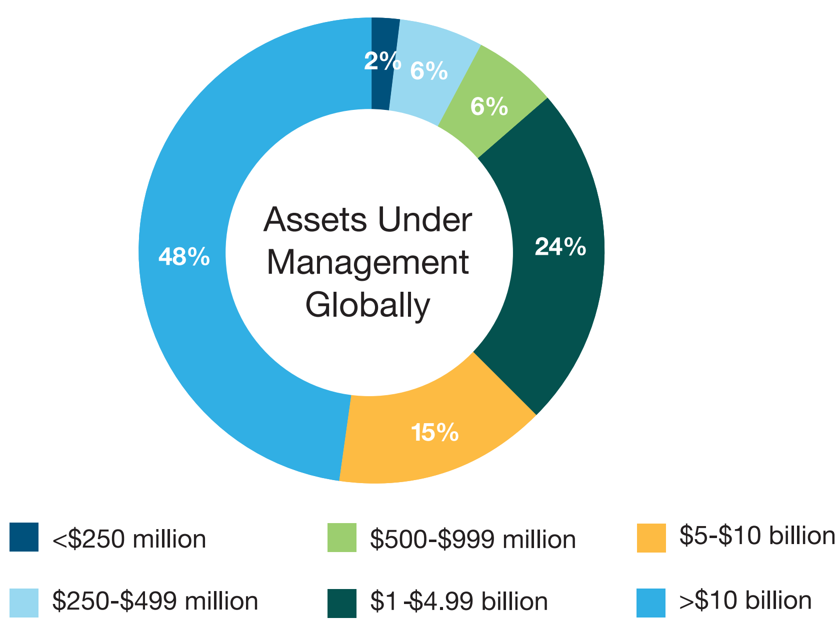
Demographics

We captured feedback from 88 respondents, the majority holding senior roles (Partner, Managing Director, Director and Principal) and managing substantial funds — just under 2/3 of survey respondents have responsibility for over $5 billion assets under management.

88 Respondents in total

Survey respondents are typically in senior roles with high market value assets



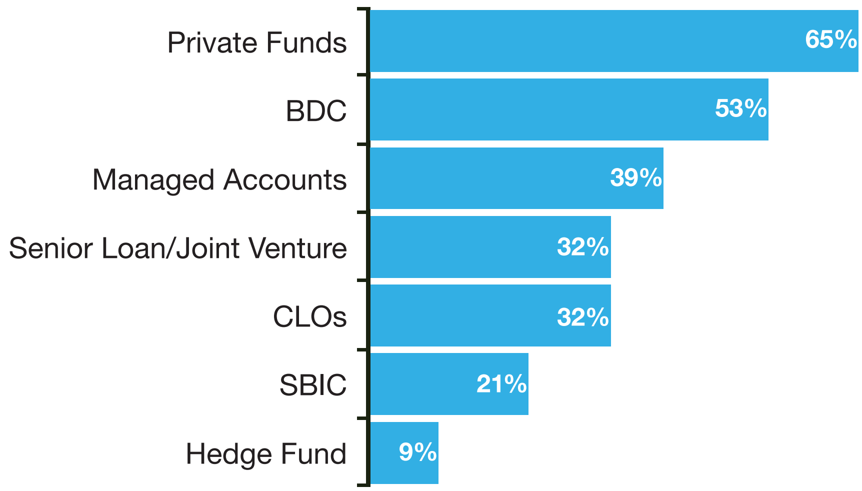


Detailed Findings

Investment vehicles

- **Almost 2/3 of respondents utilize Private Funds** for their investments, and over half use Business Development Companies.
- **81% of those responsible** for $10 billion or more AUM utilize Private Funds, which is significantly higher than those managing lower value assets.
- **Only 9% utilize Hedge Funds**; those using hedge funds are organizations with over $10 billion AUM.

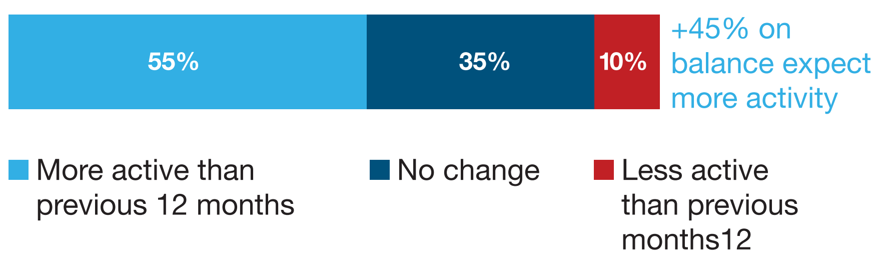
What vehicles do you utilize for your lending activities?



Deal activity

Respondents were optimistic about deal activity for the year ahead; on balance, 45% more respondents expected deal activity to increase.

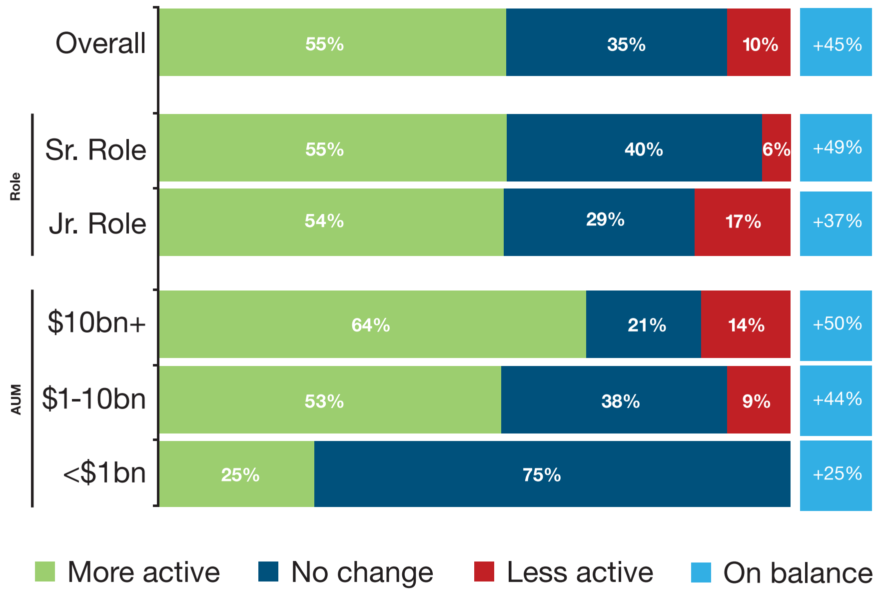
What are your expectations for deal activity in the market over the next 12 months?



Respondents with AUM over $10 billion were the most optimistic, with 64% predicting an increase in deal activity. This group was also significantly more likely to predict an increase in deal activity.

Those in senior roles were also more positive about deal activity in the year ahead.

What are your expectations for deal activity in the market over the next 12 months?



Increase in deal flow

When respondents shared the reasons behind their predictions for deal activity, over 1/3 talked about post-election optimism driving economic growth.

> *"More optimistic business environment post-election."*
>
> *"Trump, Trump, Trump."*
>
> *"Incoming administration will drive economic growth and increased confidence."*

With the new administration, investors anticipate policy change and a relaxation in some of the regulatory controls governing Private Credit.15% of respondents talked specifically about changes in regulation:

> *"I believe we will see a relaxing of some regulatory burdens; companies will seek to take advantage of this, which will lead to short-term growth."*
>
> *"Less regulation with the new administration and less uncertainty now that the new president has been sworn in."*
>
> *"Favorable changes implemented by the current administration."*

In addition to political change driving optimism for deal flow, respondents also talked about favorable market conditions that they believe will lead to an increase in deal activity:

"Markets are hot. Don't think they'll fall off for another year or so."

"Lots of money flowing into the debt markets and a rising interest rate environment."

20% of respondents mentioned they have capital to deploy, and 18% said there will be a release in pent-up demand created by uncertainty during the election cycle.

"Excess capital must be invested. Investors (equity and debt) will only be patient/disciplined for so long."

"Favorable financing market conditions; lots of capital that has been sitting on the side-lines that must be put to work."

"2015 and 2016 deal volume was depressed. I believe the economy is strengthening and this should help the financial performance of sponsor portfolio companies. If performance improves, this will provide the incentive for sponsors to sell some companies that have been in the portfolio for a long time."

Post-election optimism is also evident in the broader market; our research partner Acritas asked over 250 General Counsel and Chief Legal Officers from organizations with annual revenues of $50 million and above about the Trump administration's impact on their business operations as part of its annual Sharplegal survey:

- **72% of Sharplegal respondents**, across all industries, believe the new administration will impact their business operations
- **56% believe the impact will be positive**, citing increased investment, lower taxes and decreased regulation as key reasons for the change.

Decrease in deal flow

Of the 10% of respondents predicting a decrease in deal activity, the reasons they gave were also a combination of political or market conditions.

Market conditions

"Middle-market Private Equity volume will be lower."

"Competitive marketplace, bank/syndicated market more open/active."

"De-regulation of banks, increased competition in the lending space and equity valuations so high as to make deals impossible to finance."

"Spreads will tighten."

"Low interest rates; uncertainty over economy."

Political environment

"Uncertain political environment."

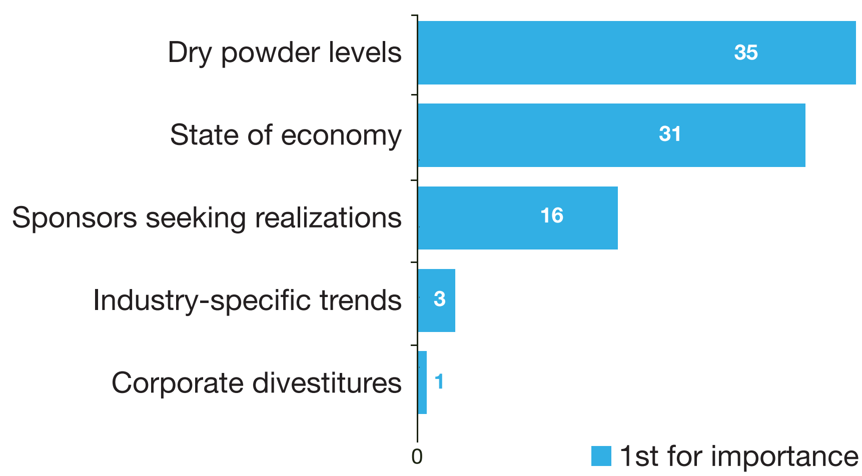
"Concerns about current Administration and potential tax reform."

Drivers of deal flow

When we asked respondents to select and prioritize the most important drivers of deal activity, respondents chose dry powder levels as the primary driver, followed by the state of the economy and sponsors seeking realizations.

Please rank your nominations for the most important driver of deal flow in the next twelve months in order of importance.

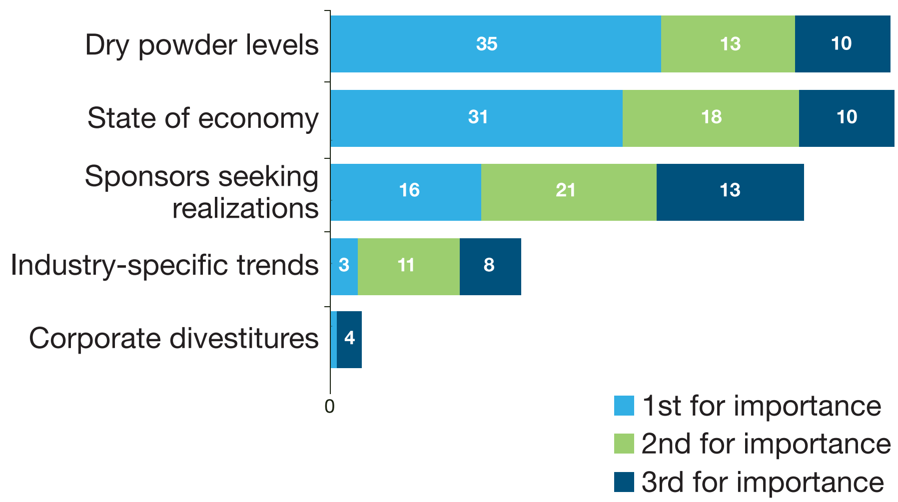
Select top 3 and rank



However, when we add in respondents' second-and third-choice drivers of deal flow, the state of the economy becomes just as important as dry powder levels. Sponsors seeking realizations may not be considered by most as the primary driver, but it is still an important factor.

Please rank your nominations for the most important driver of deal flow in the next twelve months in order of importance.

Select top 3 and rank

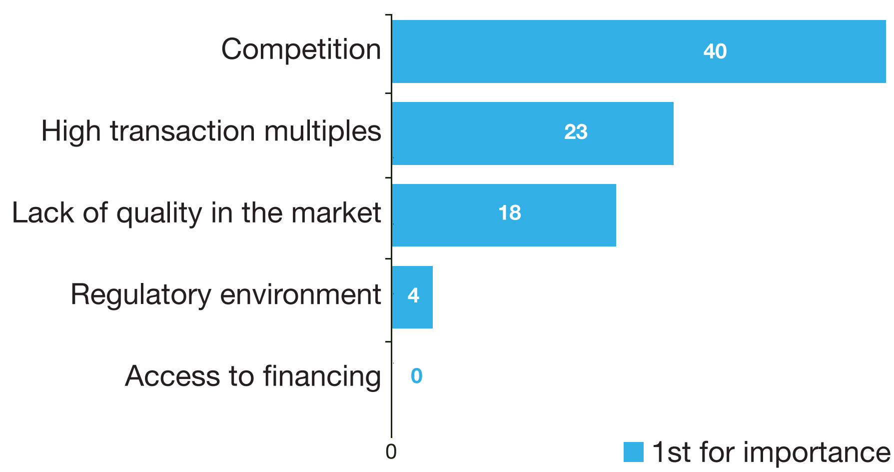


Challenges for dealmakers

Competition is the number one challenge for dealmakers as they plan for the year ahead.

Please rank your nominations for the biggest challenge for dealmakers in the next twelve months in order of importance.

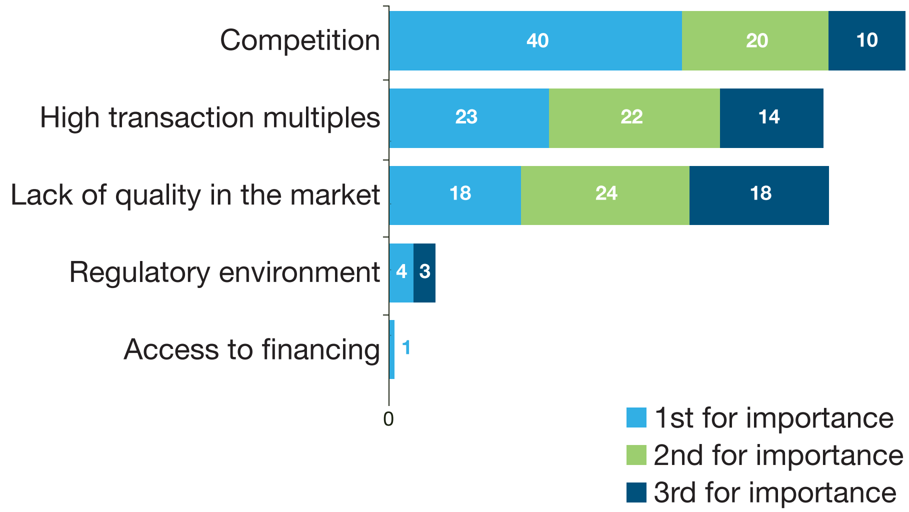
Select top 3 and rank



High transaction multiples and a lack of quality assets in the market also provide significant challenges for dealmakers, but are not considered as big of a challenge to dealmaking as competition.

Please rank your nominations for the biggest challenge for dealmakers in the next twelve months in order of importance.

Select top 3 and rank



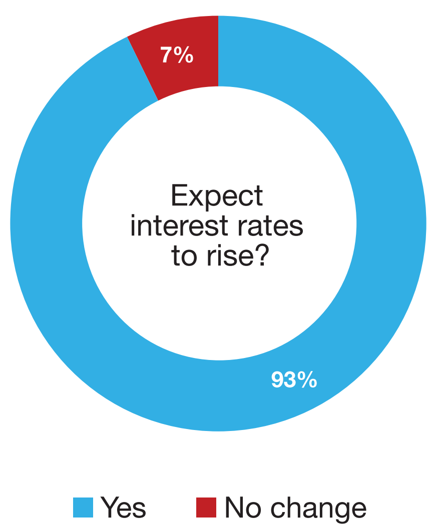
Market predictions

Respondents were asked to share their predictions for the market over the next 12 months, in terms of interest rates, pricing, credit quality and likelihood of defaults.

A rise in interest rates is widely expected.

Do you expect interest rates to rise in the next 12 months?

How do you expect a rise in interest rates to impact deal flow?



- **93%** expect interest rates to rise in the next 12 months

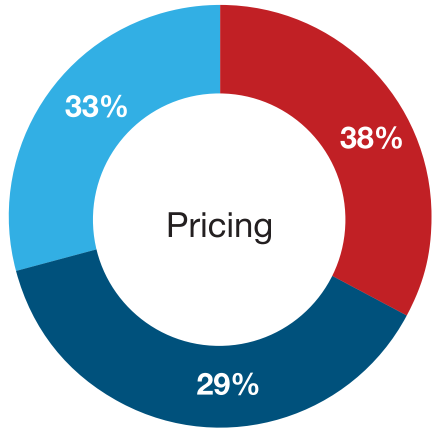
Of this group:

- **12%** believe rising interest rates will positively impact deal flow
- **15%** believe it will have a negative impact
- **73%** forsee no impact on deal flow

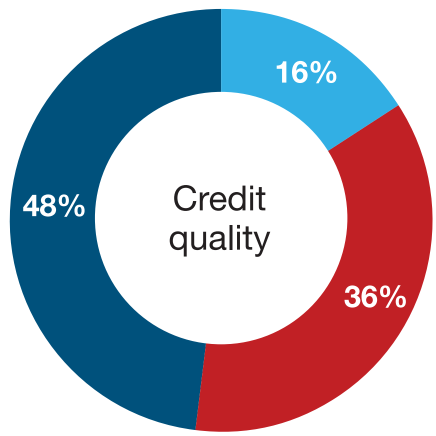
Respondents also predicted lower pricing, with credit quality anticipated to hold.

What are your expectations over the next 12 months?

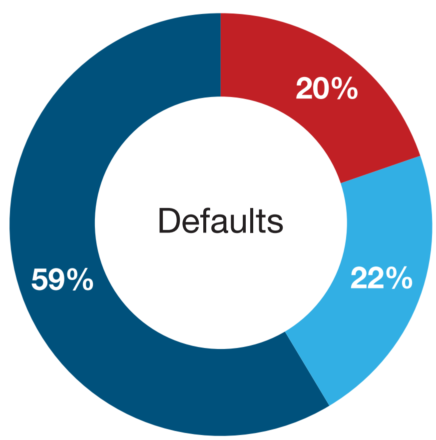
- Higher pricing than previous 12 months
- Lower pricing than previous 12 months
- No change



- Better than previous 12 months
- Worse than previous 12 months
- No change



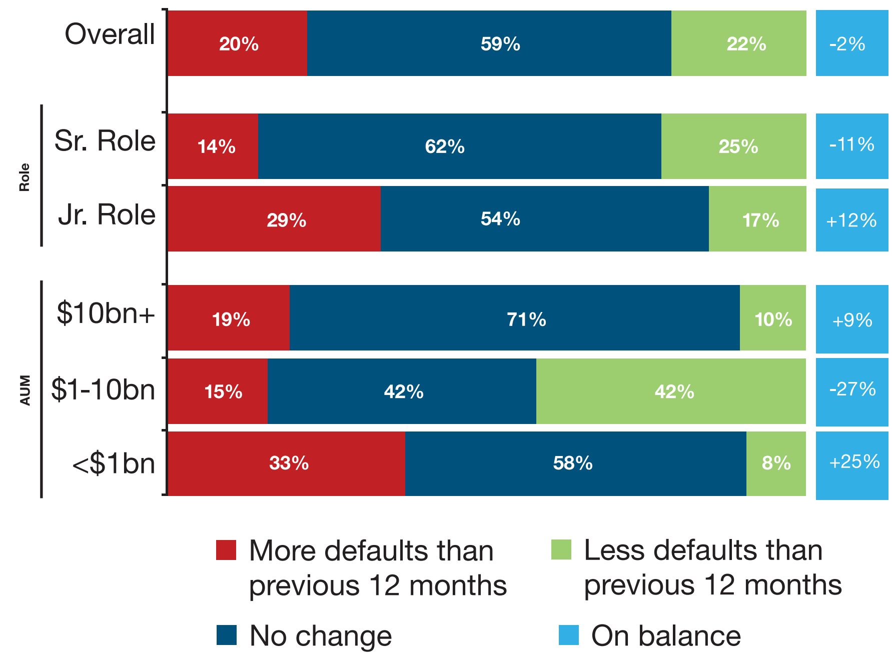
- More defaults than previous 12 months
- Less defaults than previous 12 months
- No change



The majority of respondents (59%) believe the level of defaults will stay the same. However, there were some significant differences in expectations when we look at different respondent groups:

- Those in junior roles were significantly less likely to predict no change in defaults
- Those with AUM of $1-10 billion were significantly more likely to predict less defaults; whereas
- Those with AUM $10 billion and above were more likely to predict no change in defaults and significantly less likely to predict less defaults

What are your expectations for your portfolio over the next 12 months?



Investment strategy

In addition to understanding respondents' views on expected deal flows and their predictions for the market overall, we captured more specific data on organizations' investment strategies and gauged respondents' appetite and plans to invest.

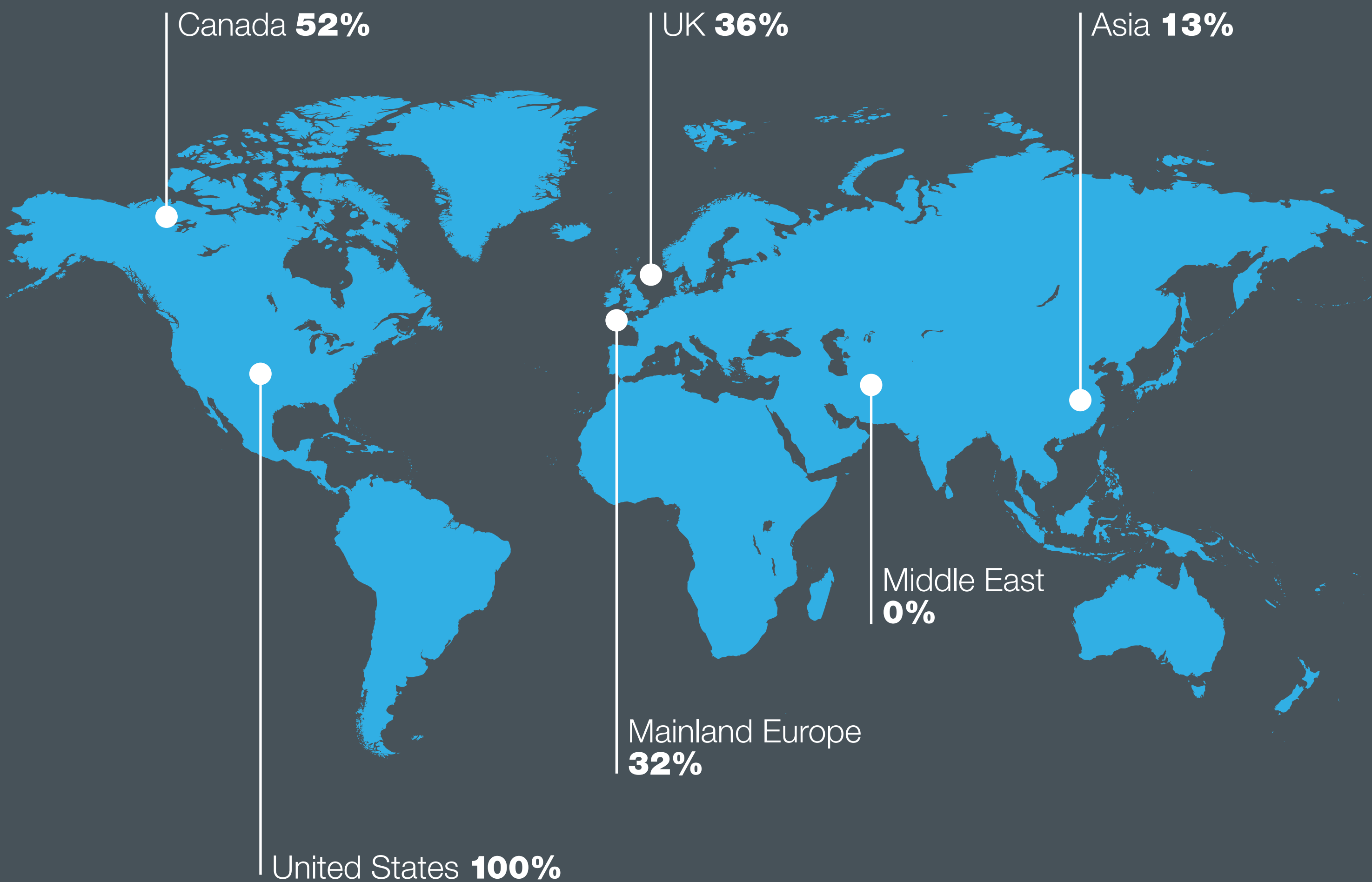
Key markets

As expected, all respondents are considering investing in the US market in the next 12 months, with just over 1/2 considering investing in Canada.

Mainland Europe and the UK are also viewed as opportunities for investment with 1/3 of respondents considering these markets.

Organizations managing a higher value of assets are more global in their investment strategy; those responsible for $10 billion or more AUM are significantly more likely to be investing in Canada, the UK, Mainland Europe and Asia.

Which locations is your organization considering investing in over the next 12 months?



Investment in key industries

Over 3/4 of respondents are considering investing in Business Services, Health Care and Manufacturing in the next 12 months.

Consumer Goods and Retail and Technology also will be important sectors in the year ahead.

In which industries is your organization interested in/considering investing in over the next 12 months?

Business Services 98%	Health Care 87%
Manufacturing 87%	Consumer Goods and Retail 74%
Technology 73%	Infrastructure 45%
Energy & Utilities 26%	Real Estate 18%

Investment plans

When we asked respondents about their investment plans in the next 12 months, we found that 2/3 of respondents are fundraising currently, and fundraising is more likely among organizations with $1-10 billion AUM.

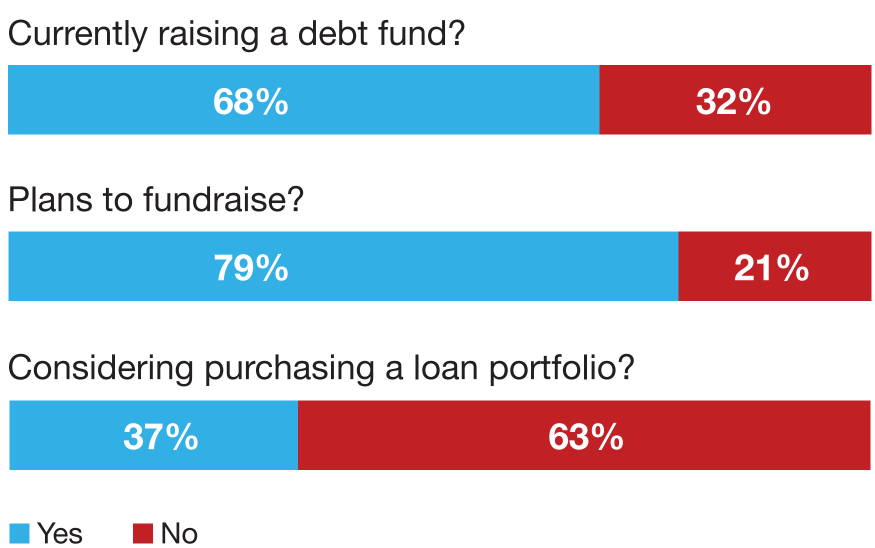
- 79% plan to fundraise in the next 12 months.
- Only 1/3 are considering purchasing a loan portfolio.

Is your organization currently raising a debt fund?

Does your firm have plans to fundraise in the next 12 months?

Is your organization considering purchasing a loan portfolio over the next 12 months?

Of the **32%** not currently raising a debt fund, **37%** plan to fundraise in the next 12 months.



Maximum leverage and equity required

As organizations plan to invest and take advantage of favorable market conditions, less regulation and post-election optimism, we looked at the conditions and controls governing those investments.

We found that **60% of organizations** were prepared to underwrite a maximum total leverage of **6.00x or more**.

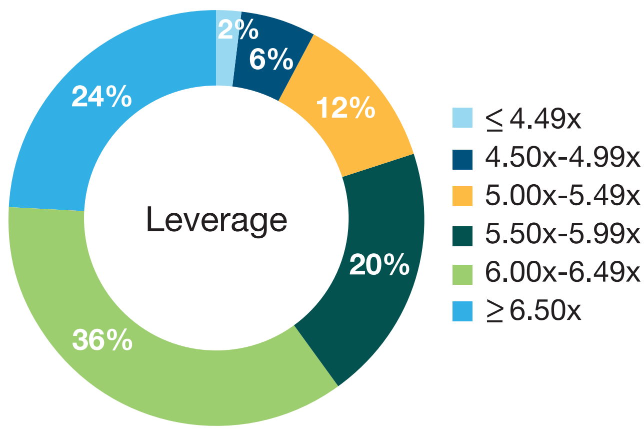
The equity required on transactions varies, **but 52% of respondents** require at least **35% equity** to support their transactions and 19% require at least 40% equity to support their transactions.

No organizations require more than 50% equity for their transactions.

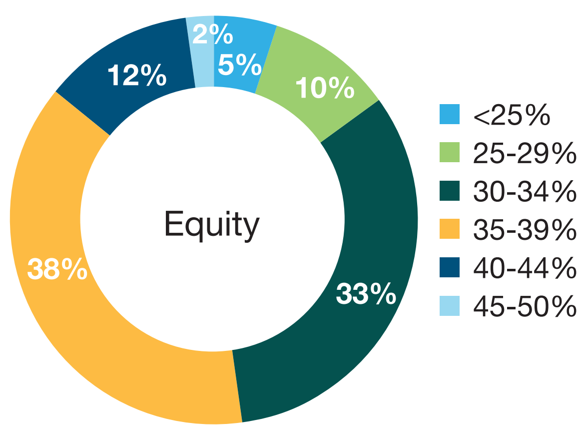
What is the maximum total leverage that you will underwrite today?

How much equity (on a % basis) does your organization require in your transactions?

Maximum leverage is 6.00x or greater for the majority of respondents



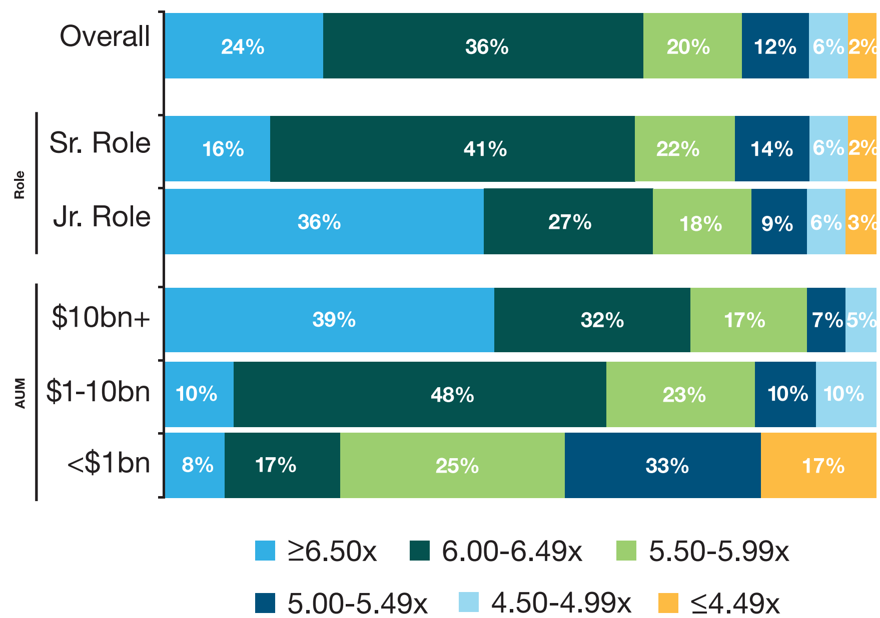
At least 35% equity is required in transactions half of respondents



Looking at how maximum total leverage differs by an organization's AUM, we see, as expected, the greater the AUM the higher the maximum total leverage an organization will underwrite.

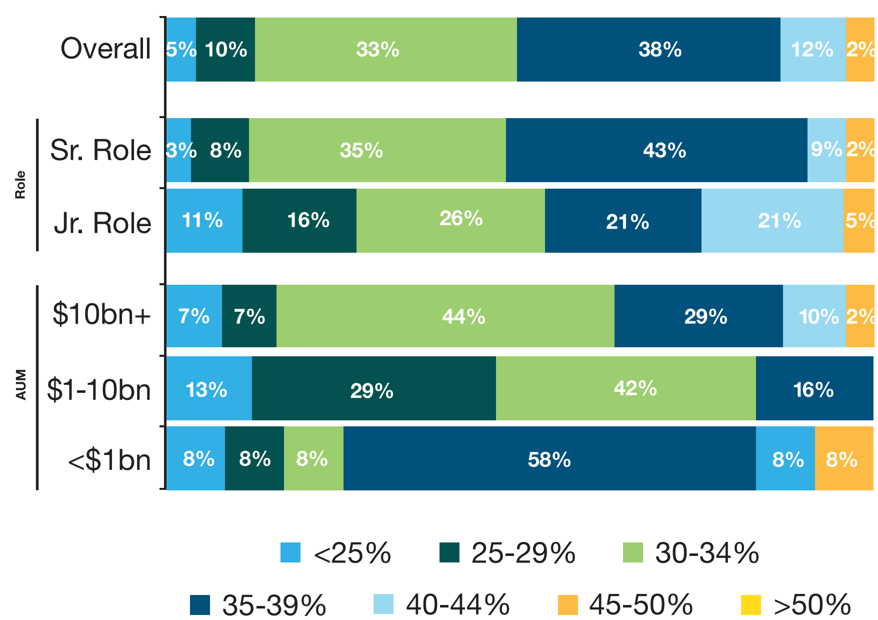
Respondents with $10 billion or more AUM are significantly more likely to underwrite a total leverage of 6.50x or above.

What's the maximum total leverage that you will underwrite today?



The equity required for transactions also varies by size of organization and AUM; 75% of organizations with less than $1 billion AUM require 35% or more equity on transactions.

How much equity (on a % basis) does your organization require in your transactions?



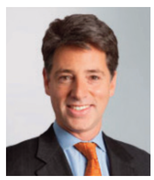
We hope you enjoyed our inaugural Private Credit Market Survey. For further information about this survey, our methodology, or to suggest additional questions or areas of interest for our next survey, please feel free to contact any of the partners in The Private Credit Group listed below.

Steven M. Ellis
Partner, Co-head
New York/Boston
t: +1.617.526.9660
t: +1.212.969.3557
sellis@proskauer.com

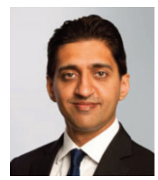
Stephen A. Boyko
Partner, Co-head
New York/Boston
t: +1.617.526.9770
t: +1.212.969.3451
sboyko@proskauer.com

Peter J. Antoszyk
Partner
New York/Boston
t: +1.617.526.9749
t: +1.212.969.3416
pantoszyk@proskauer.com

Kristen V. Campana
Partner
New York
t: +1.212.969.3066
kcampana@proskauer.com



Gary J. Creem
Partner
New York/Boston
t: +1.617.526.9637
t: +1.212.969.3062
gcreem@proskauer.com



Faisal Ramzan
Partner
London
t: +44.20.7280.2075
framzan@proskauer.com

Sandra Lee Montgomery
Partner
Los Angeles
t: +1.310.284.4573
smontgomery@proskauer.com

Alexander L. Griffith
Partner
London
t: +44.20.7280.2145
agriffith@proskauer.com

Vincenzo P. Lucibello
Partner
Boston
t: +1.617.526.9681
vlucibello@proskauer.com

Benjamin Davis
Partner
London
t: +44.20.7280.2169
bdavis@proskauer.com

The Private Credit Group is a unique middle market finance practice. The breadth and diversity of our practice is unmatched in the industry. The group was the first to dedicate its practice solely to representing providers of private credit. We represent over 50 clients, including private debt funds, business development companies, asset managers, finance companies and family offices. These lenders provide financings for transactions ranging from $10 million to more than $1 billion across a myriad of product types and industries.

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