Debt Markets in 2013

U.S. credit markets continued to rally into the first half of 2013. By May, the U.S. high yield spread to Treasuries had fallen below 430 basis points, its lowest level since October 2007. At the same time, the average price of U.S. high yield debt reached a record high of $107. This rally reversed suddenly and sharply at the end of May, driven by fears about the Federal Reserve’s plans to “taper” its latest bond buying program. Although a surprise to no one, the increased attention to the eventual end to quantitative easing, combined with an unexpectedly strong May jobs report, sparked a substantial sell-off in the credit market. The average price of high yield debt fell almost 5% to end the second quarter below $102 and the yield spread spiked to 490 basis points, while the 10-year Treasury yield itself increased nearly 100 basis points to end the quarter above 2.5%.

European credit markets experienced much less volatility during the period as the continent continued to work through its de-leveraging process. European leveraged loans rallied in the first quarter alongside the U.S. market, with a narrowing spread versus U.S. leveraged loans. The second quarter in Europe was largely flat and for the first half overall, those markets avoided any flare-ups of the sovereign debt crises that have dominated headlines for the past two years. Though Europe is still lagging the U.S. in solving its problems, its relatively orderly de-leveraging continues. European banks are less capital starved, and thus can be more selective sellers of assets, than was originally feared.

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1 Source: Barclays Capital
Distressed & Opportunistic Debt

Distressed debt managers continued to face relatively few near term attractive debt buying opportunities during the first half of 2013, even when prices fell towards the end of the period. As a result, those managers continued to focus largely on investment opportunities outside of traditional corporate debt. These have included direct asset investments, in areas such as shipping, aviation, and credit receivables, as well as real estate-related debt and non-performing loan (“NPL”) pools. NPLs have been a particular area of increased focus in Europe, as one of the few areas where banks are consistent sellers of assets and are relatively less price sensitive. As reported in prior periods, fundraising for directly-originated middle market lending strategies remained high, matched with increasing investor demand. As capital supply increases for middle market loans, pricing already has and may continue to be pressured downward. However, most managers believe that, despite these signs of an increasingly efficient market, there remains a supply/demand imbalance that is likely to persist for several years.

Mezzanine Debt

Mezzanine debt managers reported a slow first half of 2013 in terms of completed deal volume. Competition from second lien/unitranche debt providers and BDCs was high and had a meaningful impact on pricing and total leverage multiples. Coupon rates fell below 12% on higher quality transactions and total leverage reached an average multiple of 5.5x, the second highest level behind only 2007 in the past decade. At the same time, overall purchase price multiples remained mostly flat at 8.5x and well below the 2007 peak of almost 10x, indicating lower equity contribution rates as buyout managers sought to take advantage of cheap leverage while it remained available. Mezzanine providers at the lower end of the middle market fared somewhat better, both in terms of pricing pressure and deal volume, but faced largely the same competitive dynamics.

Economic Update

The first half of 2013 saw a continuation of the weak economic growth in the global economy that started in 2011. The U.S. GDP grew at a rate of less than 2% for the first half of 2013 and was affected by the automatic government sequester that went in effect during the period. The Euro Area continued to generate negative growth but showed some signs of break-even activity in the coming 12 months. Emerging Markets also continued to post lower GDP growth than in years past due to lower demand for goods and services from the U.S. and Europe and internal monetary policies targeted towards addressing high inflation. Towards the end of Q2 2013, some emerging markets counties including India, Turkey, Indonesia, and Brazil, experienced currency volatility as investors pulled money out of these counties in anticipation of higher yields in the U.S. as the Federal Reserve began discussing its tapering plans. On the positive side, Japan, third largest economy in the world, had 4.1% GDP growth in Q1 2013 and 3.8% in Q2 2013. This improvement was largely attributable to a new round of monetary, fiscal, and regulatory reform, dubbed Abenomics, initiated under the leadership of Prime Minister Abe.

1 Source: US Bureau of Economic Analysis

2 Source: WSJ