Proskauer» The Private Credit Group

Tr€nd$ in Priv£te Credit

Predictions and expectations for 2018

Contents

88%

expect deal activity to stay the same or increase

90%

predict deal flow will increase or stay the same as a result of tax reform

70%

believe tax reform will lead companies to make greater investments

2/3

of respondents are currently raising a debt fund

70%

of respondents will underwrite a maximum total leverage of 6.00x or more

2/3

of respondents require at least 35% equity for their transactions

We are delighted to share with you the results from our second annual Trends in Private Credit survey. This year's survey was conducted via web from January 9th to February 9th 2018.

In this report, we will share respondents' views on deal flow for the year ahead, drivers of deal volume and the challenges facing dealmakers. Respondents also gave us their market predictions for 2018, and expectations for pricing, defaults and interest rates.

Looking more broadly at economic and political factors affecting the market, we captured respondents' thoughts on GDP growth and the impact of US Tax Reform and the European Leveraged Lending Guidelines on deal flow, financing and appetite for investment.

Taking those market predictions into consideration, we then looked at respondents' investment strategies, including:

- Hot markets for investment
- Most commonly used lending vehicles
- Plans to fundraise and plans to purchase a loan portfolio

Finally, we will present respondents' feedback on the conditions and controls which govern investments, such as:

- The equity required on transactions
- Use of financial covenants
- The maximum leverage underwritten
- The most important risks to lenders

Respondents are generally optimistic about the year ahead; 88% expect deal activity to stay the same or increase

A buoyant economy and the availability of capital are driving this optimism

Dry powder levels are considered the most important driver of deal flow overall

The impact of US tax reform, Brexit, the Eurozone economy and geopolitical instability are not considered primary drivers of deal flow

Most respondents anticipate a positive impact from US tax reform: 90% predict deal flow will increase or stay the same and 70% believe tax reform will lead companies to make greater investments

Over a third expect European Leverage Lending Guidelines to have a positive impact on private debt deal flow and 48% predict no change in deal flow as a result

Competition is the greatest challenge for dealmakers overall, with high transaction multiples slightly more concerning for respondents from the UK and Europe

When respondents were asked their predictions for the next 12 months:

UK and US interest rates are widely expected to increase, though there is less certainty around the Eurozone

The majority think defaults will stay the same

Lower pricing is expected overall

Most respondents are expecting US GDP growth between 2-3%, UK GDP growth below 2% and Eurozone growth between 2-2.49%

The US, UK Western Europe and Canada are the key markets for investment

Business Services, Healthcare, Software and Technology, Manufacturing and Transport and logistics are being targeted for investment by ¾ of respondents, with Software and Technology experiencing significant year-on-year growth in the US

2/3 of respondents are currently raising a debt fund and 78% plan to fundraise over the next 12 months

When investing:

70% of respondents will underwrite a maximum total leverage of 6.00x or more

2/3 require at least 35% equity for their transactions

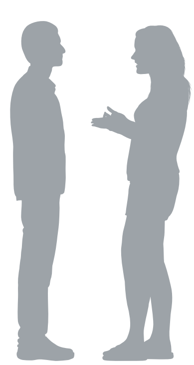
Virtually all respondents require a financial covenant for deals with <$/€40m EBITDA

The greatest risks to lenders are covenant-lite or springing covenants and allowance of add backs to EBITDA calculations

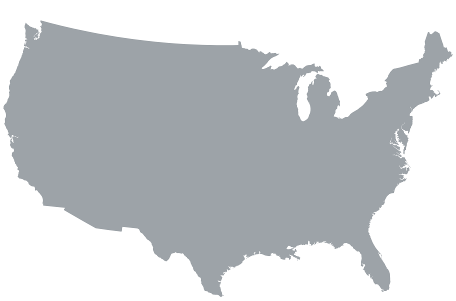
Demographics of Respondents

We captured feedback from 209 respondents (149 based in the US and 60 from the UK and Europe). The majority of respondents hold senior roles (Managing Director, Partner, Principal or VP) and manage substantial funds: just under 2/3 of US respondents have responsibility for over $5 billion assets under management and over 3/4 of UK and European respondents have responsibility for over €5 billion.

Managing Director	**33%**
Partner	**21%**
Principal	**16%**
Vice President	**14%**
Associate	**8%**
Senior Associate	**3%**
Internal Counsel	**3%**



71%

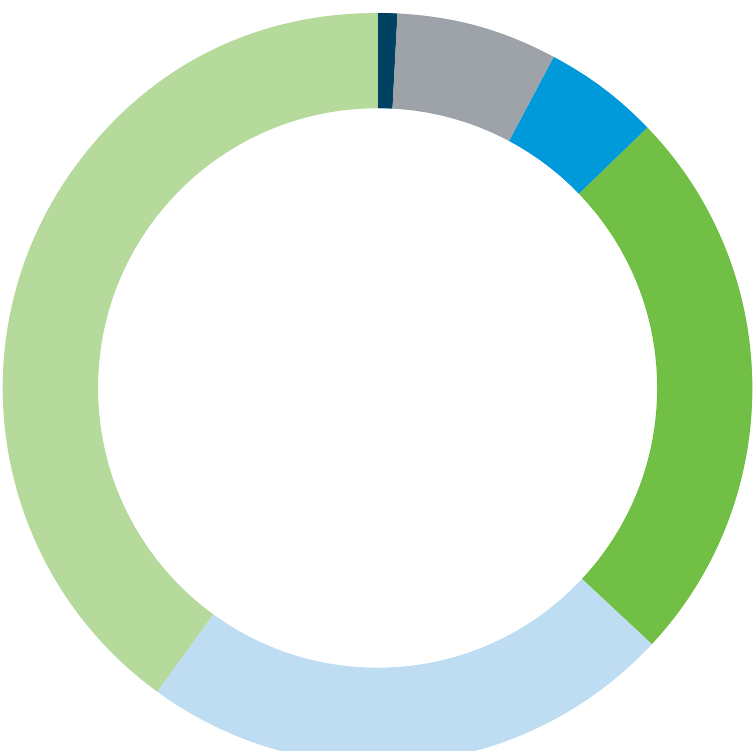


United States

29%

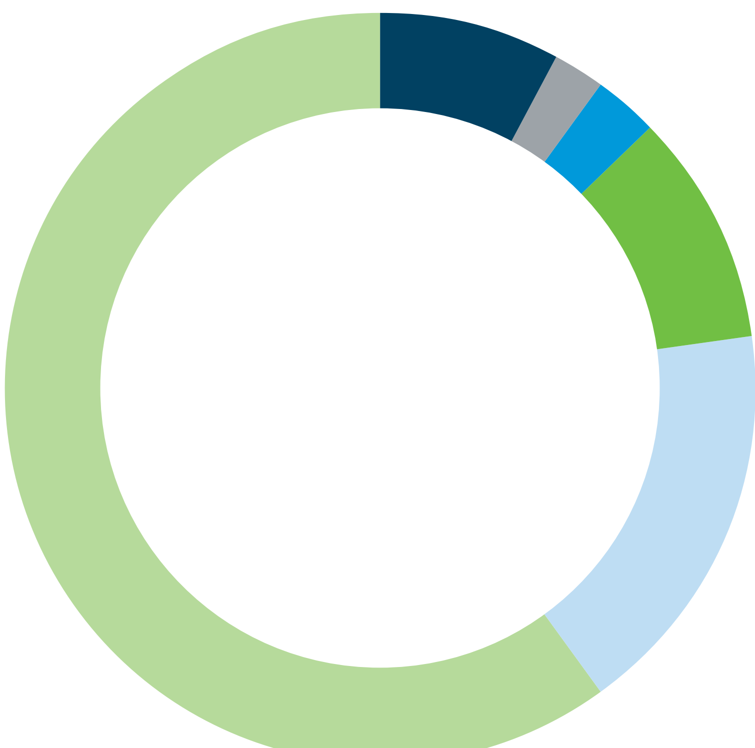
UK & Europe

Demographics of Respondents



US AUM

- <$250 million - 1%
- $250–$499 million - 7%
- $500–$999 million - 5%
- $1–$4.99 billion - 24%
- $5–$10 billion - 23%
- >$10 billion - 40%



UK/EU AUM

- <€250 million - 8%
- €250–€499 million - 2%
- €500–€999 million - 3%
- €1–€4.99 billion - 10%
- €5–€10 billion - 17%
- >€10 billion - 60%

Detailed Findings

Deal activity

88% of respondents were optimistic about deal activity for the year ahead; 41% expect deal activity to increase and 47% predict it will stay the same.

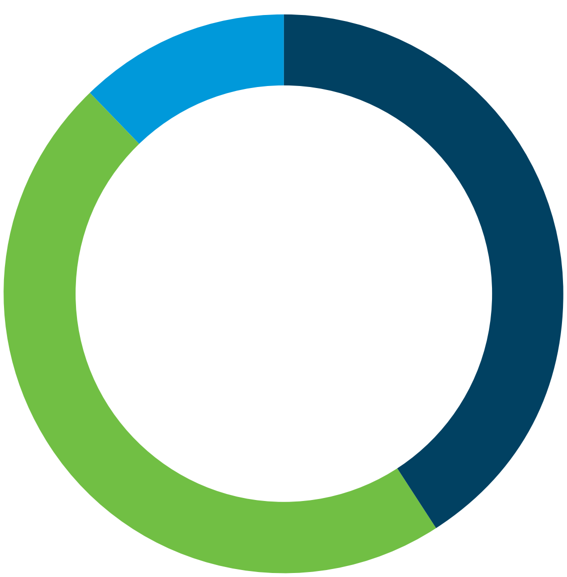
Respondents in the US were slightly more positive in their predictions for deal activity than those in the UK/EU: 42% in the US foresee more deal activity, compared to 39% in the UK/EU. However, when we look at predictions year-on-year, among US respondents the percentage predicting an increase in deal activity has fallen significantly (from 55% in 2017 to 42% in 2018).

88%

respondents were optimistic about deal activity for the year ahead

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

Why do you think deal activity will increase/stay the same/decrease?

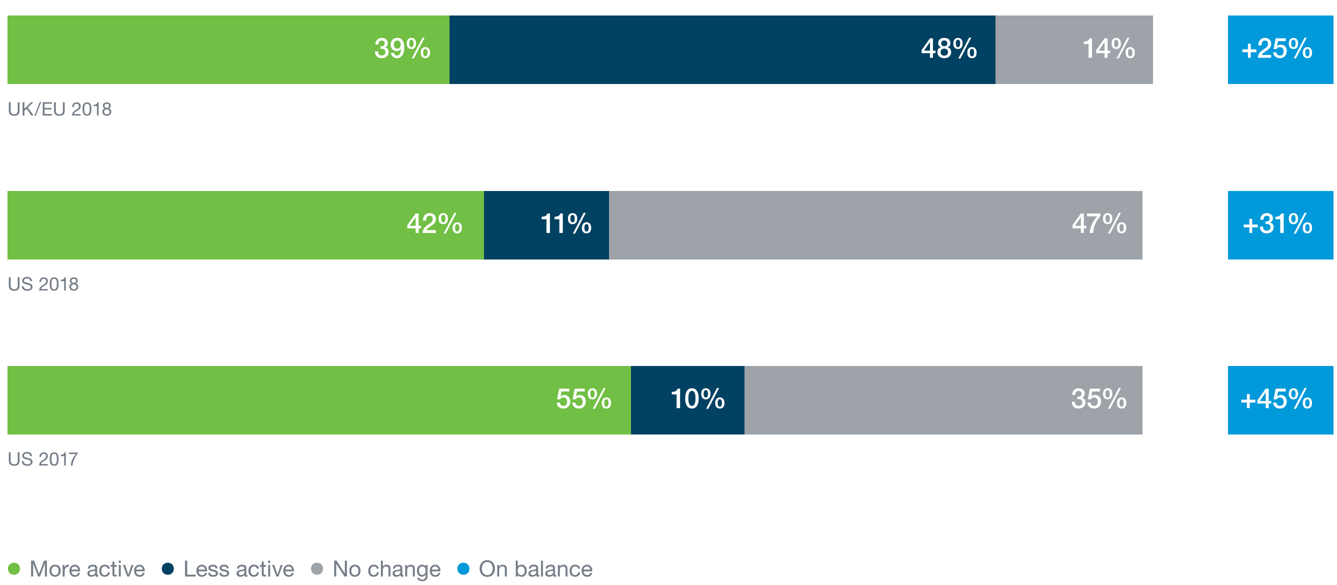


41% More active – top drivers
31% Improved economic outlook/market
23% Availability of capital
20% Dry powder levels

47% No change – top drivers
61% Stable/strong market
23% High levels of capital
11% Competitive environment

12% Less active – top driver
100% Less deal activity anticipated

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



Detailed Findings

Respondents expecting deal activity to increase mostly attribute it to improved economic conditions; more available capital in the market and dry powder levels are also important factors.

"More M&A, with tax cuts freeing up cash."

"The markets remain extremely frothy, with a lot of capital that needs to be put to work and valuations are being pushed higher. Tax cuts will likely help continue that trend."

"Strong economy and outlook, low interest rates and available capital."

"Banks continuing to decrease their market share due to regulatory pressures. Record amounts of private equity dry powder will drive deal flow."

"Increasing penetration of direct lenders continuing to take share away from banks."

Those predicting deal activity levels to remain constant expect the market will remain stable and strong.

"Positive economic outlook and high private equity dry powder could keep sponsor-driven M&A levels to current levels."

"No obvious factors to slow M&A."

"We are getting more cautious."

"Limited number of reasonably attractive and available M&A assets and fierce competition from strategic buyers."

"Overall continued positive economic sentiment and growth outlook, robust financing market, and sufficient Private Equity dry powder; offset by headwinds in certain industries and competition from strategic buyers."

"The economy has received a boost from Trump de-regulation and thus business optimism coupled with lower corporate taxes and large amounts of capital (debt and equity) that need to be employed."

"Extreme competition makes deal activity hard to come by."

The minority which predicted lower deal volumes felt that after such a strong 2017 a reduction in deals was inevitable.

The reasons respondents gave for their predictions for deal activity were largely consistent globally. However, 1/5 of US respondents expect tax reform/change to drive an increase in deal activity over the next 12 months.

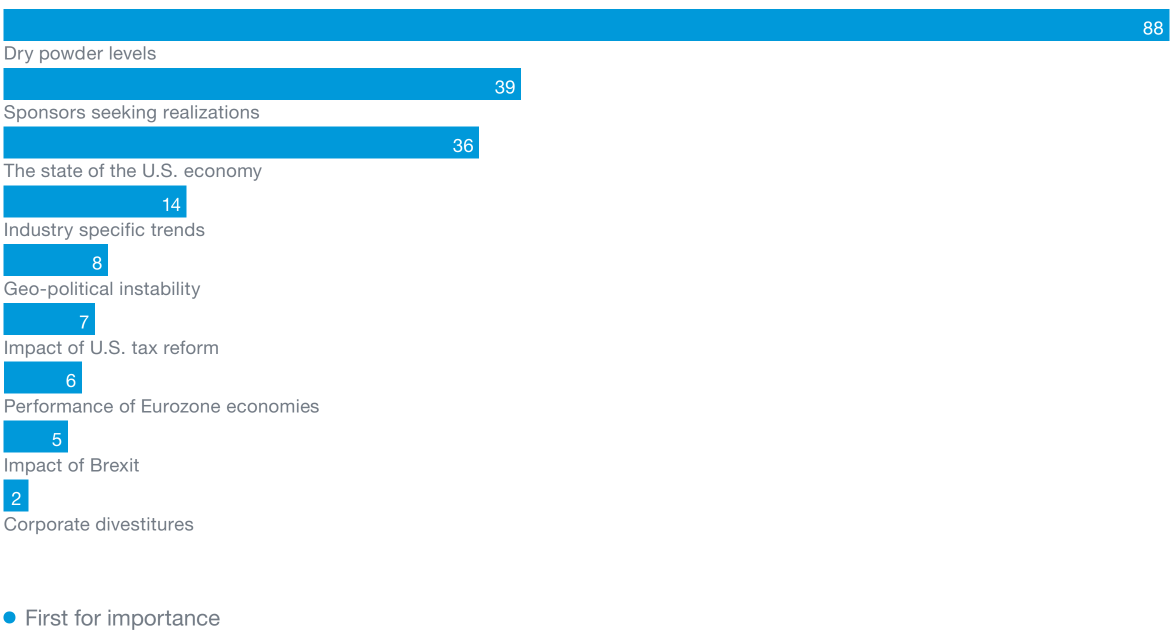
1/5

of US respondents expect tax reform/change to drive an increase in deal activity over the next 12 months.

Detailed Findings

Drivers of deal activity

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



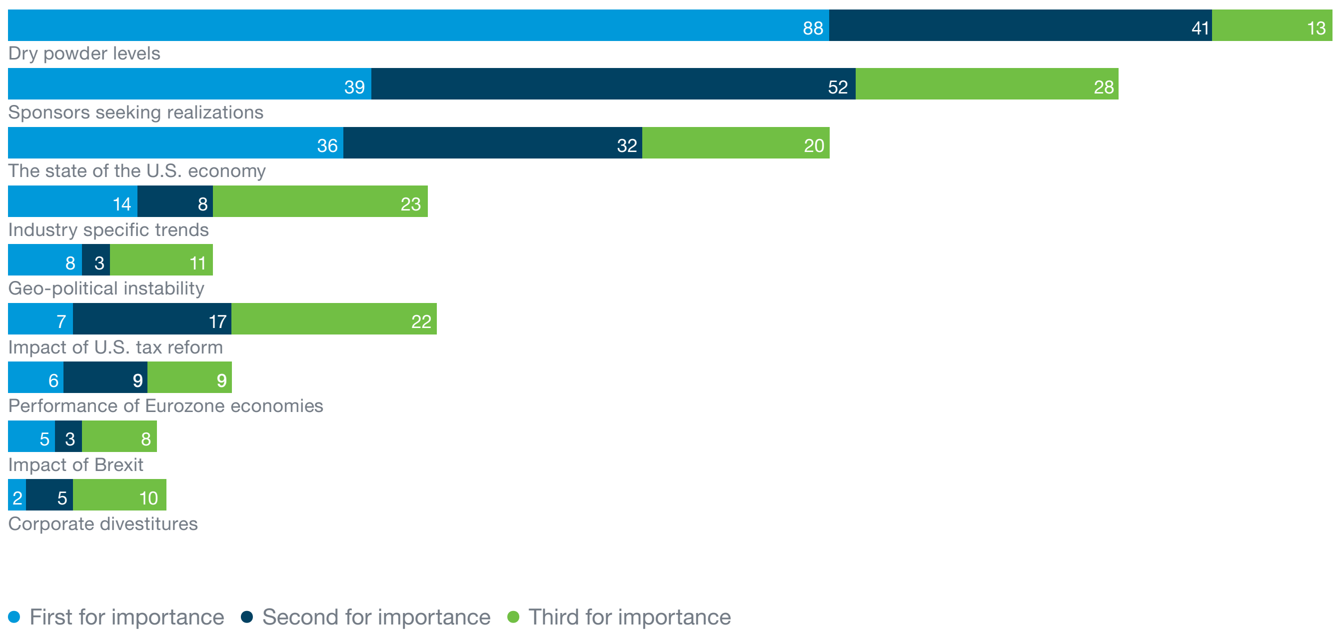
Interestingly, despite all the talk in the market about the impact of Brexit, respondents did not view Brexit as a primary driver that will impact deal flow in the next 12 months. Only five respondents considered it to be a primary driver of deal flow and 16 respondents included Brexit in their top three drivers. Closer to the Brexit deadline of March 2019, we would anticipate some reduction in deal activity, but the outlook for the next 12 months is positive.

When we add in respondents' second and third choice drivers of deal flow, the top three drivers remain the same. Most respondents consider dry powder levels to be in the top three drivers.

Respondents did not view Brexit as a primary driver that will impact deal flow in the next 12 months.

Although only seven respondents felt US tax reform was a primary driver, 46 included it in their top three drivers. As a result, when all the responses are taken into consideration, US tax reform is the 4th most important driver overall.

Performance of Eurozone economies was only mentioned as a primary driver by six respondents overall but was the third most selected driver overall for those in the UK/EU.

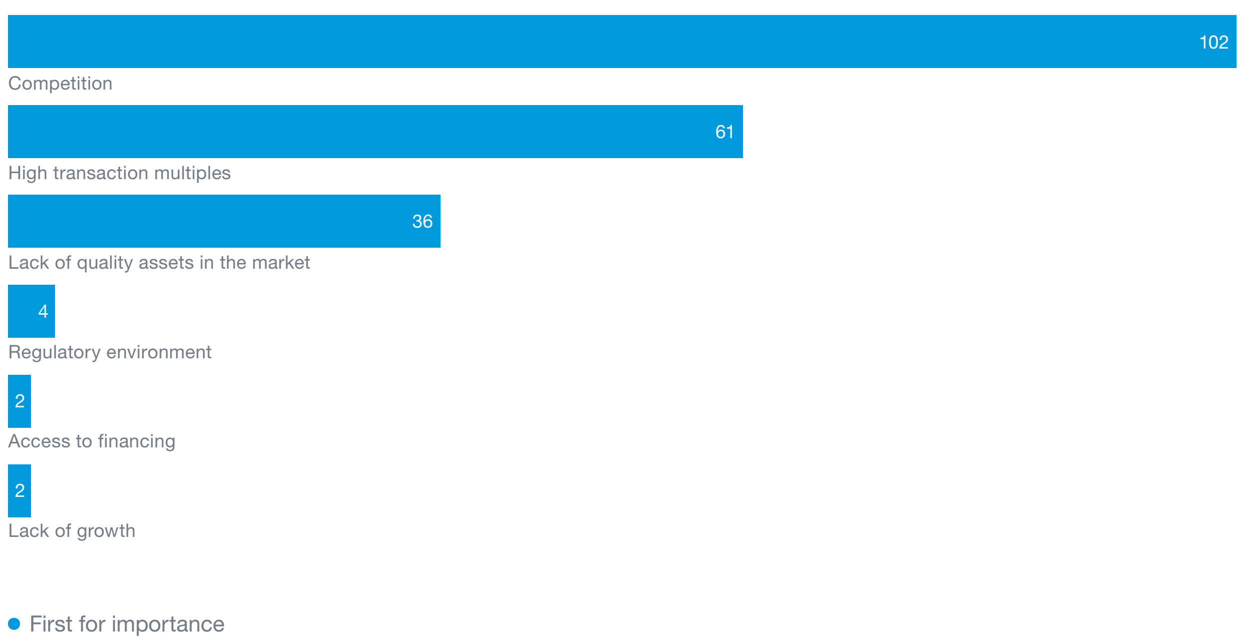


Detailed Findings

Challenges for dealmakers

As expected, in this robust finance market, competition is the number one challenge for dealmakers as they plan for the year ahead (102 out of 208 respondents felt this was the greatest challenge), followed by high transaction multiples (61 respondents) and a lack of quality assets in the market (36 respondents).

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

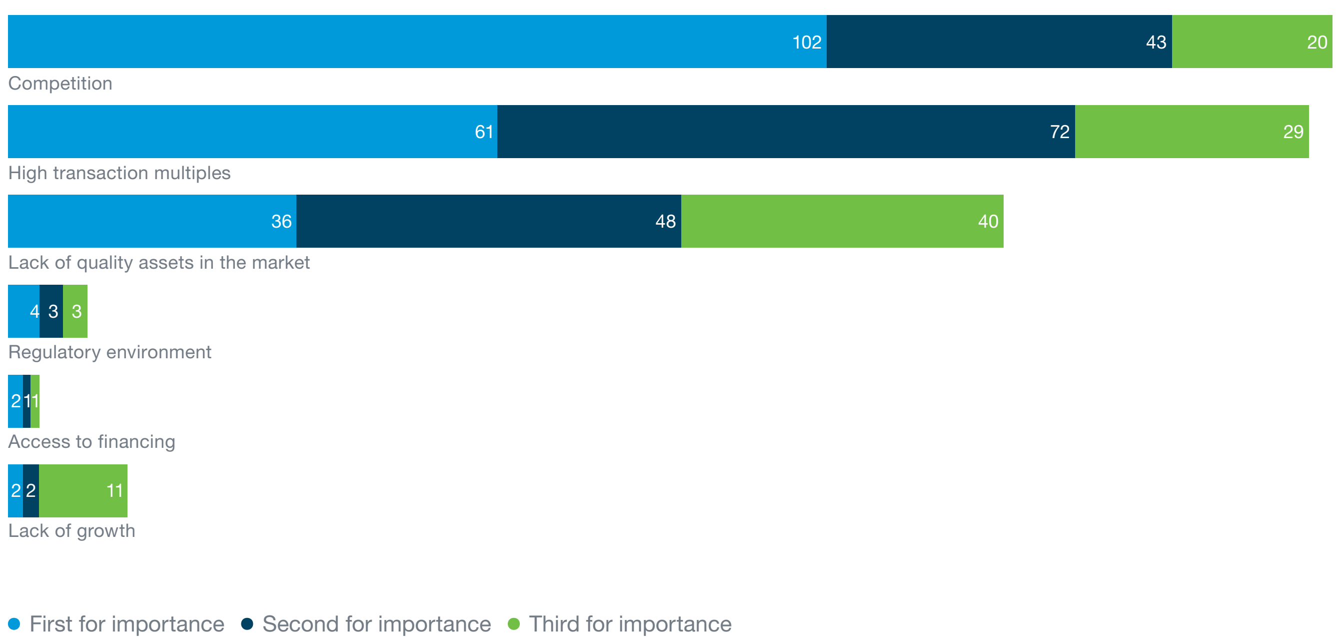


When we consider the US results from 2017, we see the same top three challenges, but the lack of quality assets was seen to be a greater challenge than high transaction multiples last year.

In contrast, lack of growth was selected by only two respondents as the most important challenge for dealmakers, and received just 15 nominations overall, when taking into consideration the 2nd and 3rd biggest challenges. This is surprising, particularly for the US market where just 6 months ago we heard concerns about slow growth (1-2% growth) impacting opportunities for deals.

When we add in respondents' views on the 2nd and 3rd greatest challenges, the top three remain the same for both US and UK/EU respondents.

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

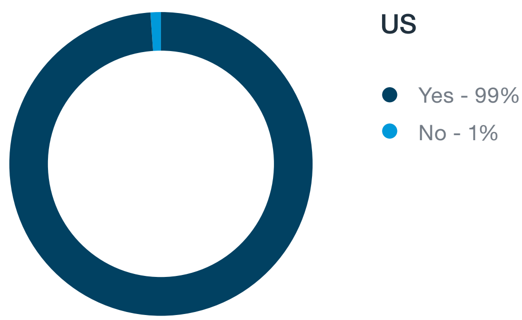


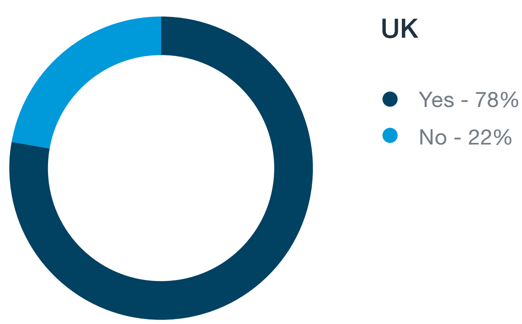
Market Predictions

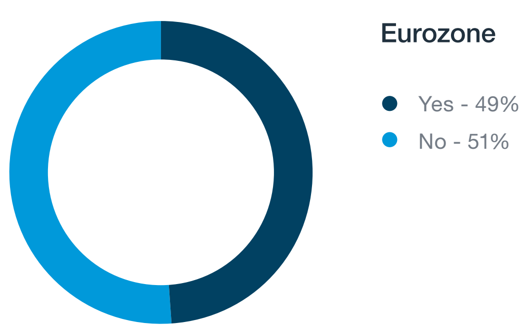
Pricing and Interest Rates

Respondents were asked to share their predictions for interest rates, pricing and deal flow over the next 12 months.

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







	United States	12% Increase	13% Decrease	75% No Change
	United Kingdom	9% Increase	18% Decrease	73% No Change
	UK & Europe	24% Increase	10% Decrease	66% No Change

A rise in US federal borrowing rates was widely expected in the year ahead, with 99% of US respondents predicting a rise in interest rates. Despite the increased cost of borrowing, most US respondents (75%) anticipate no impact on deal flow; 12% think increasing interest rates will positively impact deal flow and 13% predict a negative impact. With interest rates rising, 91% expect pricing to fall or remain static. Compared to last year, there has been a significant drop in the number of US respondents predicting price increases (in 2017, 33% expected pricing to increase; in 2018, this fell to just 9%).

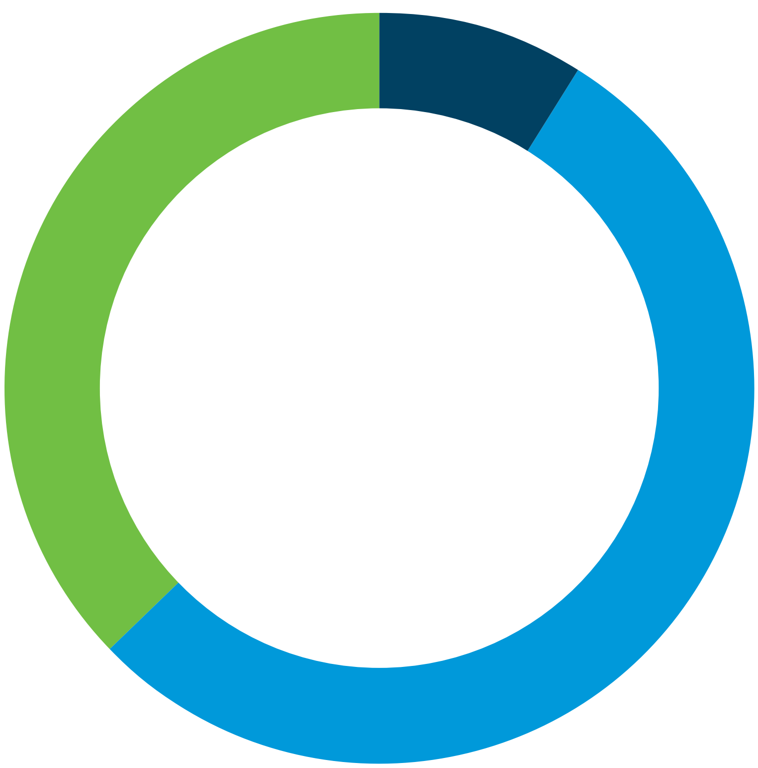
Turning to the UK, interest rates are also expected to rise but respondents tend to be less certain than their US counterparts – just over ¾ respondents predict an increase in UK interest rates. Similar to the US, with interest rates rising, the outlook remains relatively stable with 73% expecting no change in deal flow, 9% predicting a positive impact and 18% a negative impact on deal flow. At the same time, 88% of UK/EU respondents expect no increase in pricing.

Market Predictions

Pricing and Interest Rates

Respondents were asked to share their predictions for interest rates, pricing and deal flow over the next 12 months.

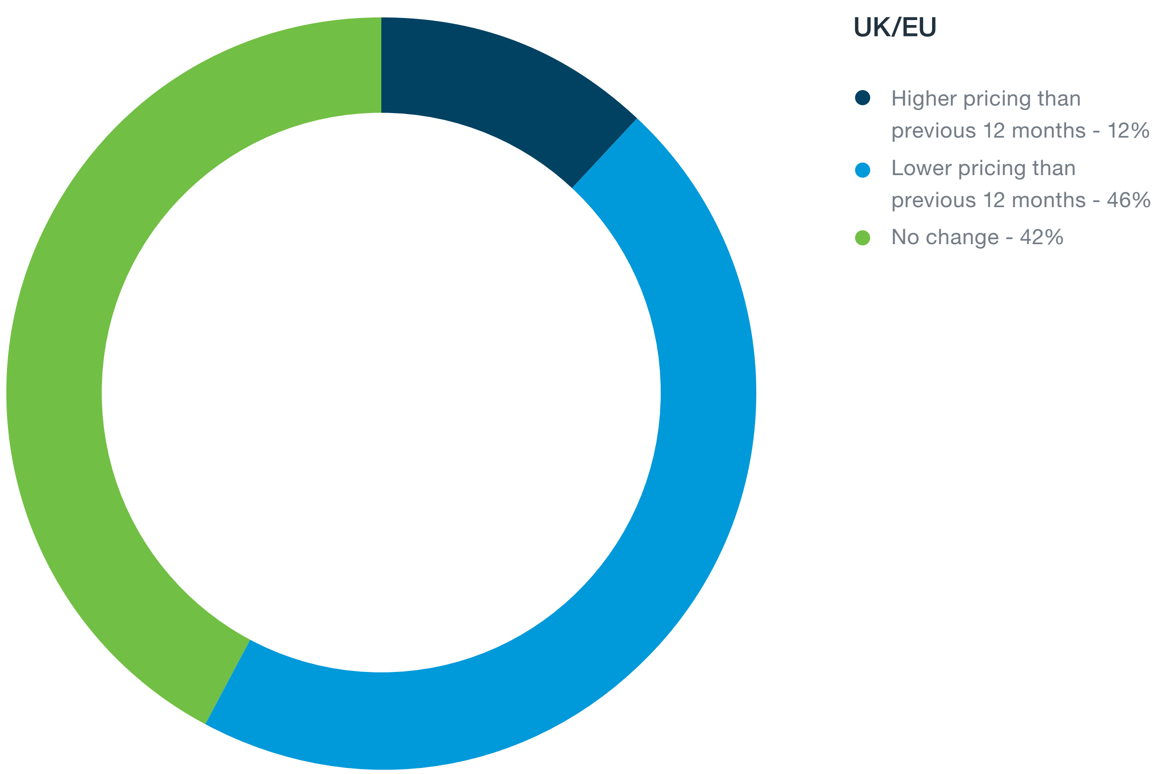
What are your expectations for pricing over the next 12 months?



US

- Higher pricing than previous 12 months - 9%
- Lower pricing than previous 12 months - 54%
- No change - 37%

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



Market Predictions

Default Risk

We also asked respondents for their predictions for their portfolio in the upcoming year and the likelihood of default.

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

US 2018

- More defaults than previous 12 months - 28%
- Less defaults than previous 12 months - 10%
- No change - 62%

US 2017

- More defaults than previous 12 months - 22%
- Less defaults than previous 12 months - 19%
- No change - 59%

EU/UK 2018

- More defaults - 27%
- Less defaults - 7%
- No change - 66%

2/3
of respondents expecting the likelihood of defaults to be stable

The majority of US respondents expect the level of defaults to remain steady in 2018; 62% foresee no change. In 2017, a similar proportion of US respondents (59%) predicted that defaults would remain the same. Where we see a significant difference in results year-on-year is in the proportion of respondents predicting less defaults. In 2017, 19% felt there would be less defaults whereas in 2018 only 10% of respondents expected a reduction.

In the UK and Europe, we see a similar outlook with 2/3 of respondents expecting the likelihood of defaults to be stable.

Economic and political factors

Other factors influencing deal flow that we analyzed as part of the study include:

GDP Growth

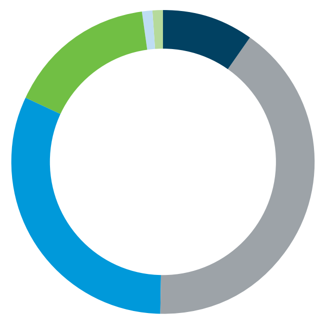
US Tax Reform

Changes to the European Leveraged Lending Guidelines

Market Predictions

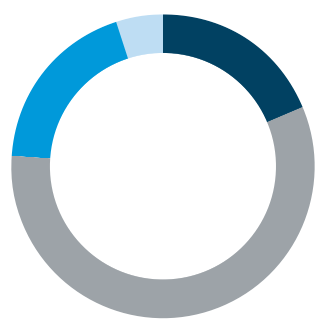
GDP Growth

What are your expectations for GDP growth this year?



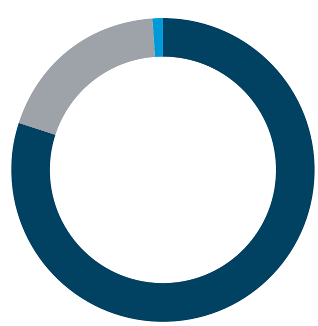
US

- <2.00% - 10%
- 2.00–2.49% - 41%
- 2.50–2.99% - 32%
- 3.00–3.49% - 16%
- 3.50–3.99% - 1%
- ≥4.00% - 1%



Eurozone

- <2.00% - 19%
- 2.00–2.49% - 58%
- 2.50–2.99% - 19%
- 3.00–3.49% - 0%
- 3.50–3.99% - 5%
- ≥4.00% - 0%



UK

- <2.00% - 80%
- 2.00–2.49% - 19%
- 2.50–2.99% - 1%
- 3.00–3.49% - 0%
- 3.50–3.99% - 0%
- ≥4.00% - 0%

Predictions for GDP growth were largely in line with broader economic research.

In the US, most respondents (73%) are expecting GDP growth between 2-3% in the year ahead. Only 2% think growth will be higher than 3.5%. Around a third of US respondents (32%) predict growth between 2.50-2.99%, which is in line with official estimates for accelerated pace of growth:

2.7%

IMF predicted 2.7% growth for 2018

2.5%

US Bureau of Economic Analysis (BEA) shows GDP increased at an annual rate of 2.5% in Q4 2017

A slightly higher proportion (41%) are a little more pessimistic, predicting slightly lower growth (2-2.49%)

For the UK, 99% expect growth levels up to 2.49%, though a large majority (80%) predict growth will not surpass 2%. No respondents from the UK expect growth to exceed 3%. Comparing these predictions with official forecasts, our survey respondents are more positive:

1.7%

Office of National Statistics reported UK GDP increased 1.7% between 2016 and 2017

1.5%

IMF predicted 1.5% growth

Turning our attention to the Eurozone, the majority (58%) expect growth between 2-2.49%. Around a fifth are predicting growth at less than 2% and another fifth predicting 2.50-2.99%. No respondents are expecting growth of 3.49% or above.

2.3%

The European Commission is predicting 2.3% growth in 2018

2.2%

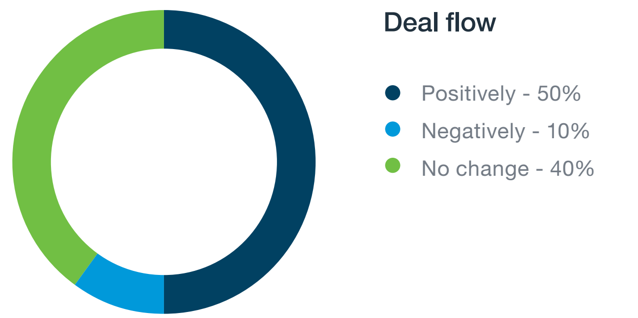
IMF is predicting 2.2% for the Euro area

Market Predictions

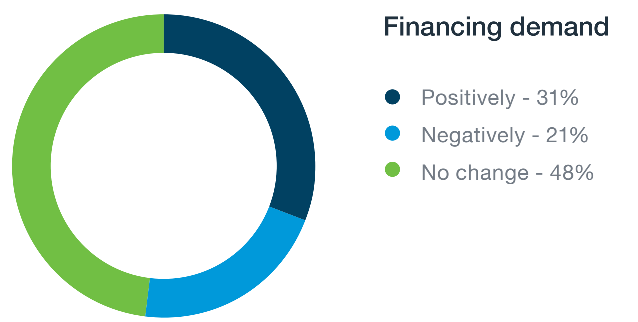
US Tax reform

US respondents were asked about the impact of tax reform; 90% think deal flow will be impacted positively or stay the same, reflecting robust deal flow in the market at the moment. A majority anticipate that companies will make greater investments in the US as a result of the reforms, as the changes will allow organizations to free up capital for investments.

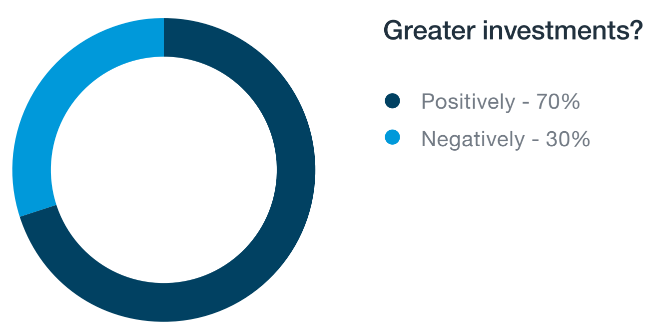
How do you expect US tax reform will affect deal flow?



How do you expect US tax reform will impact the demand for financing?



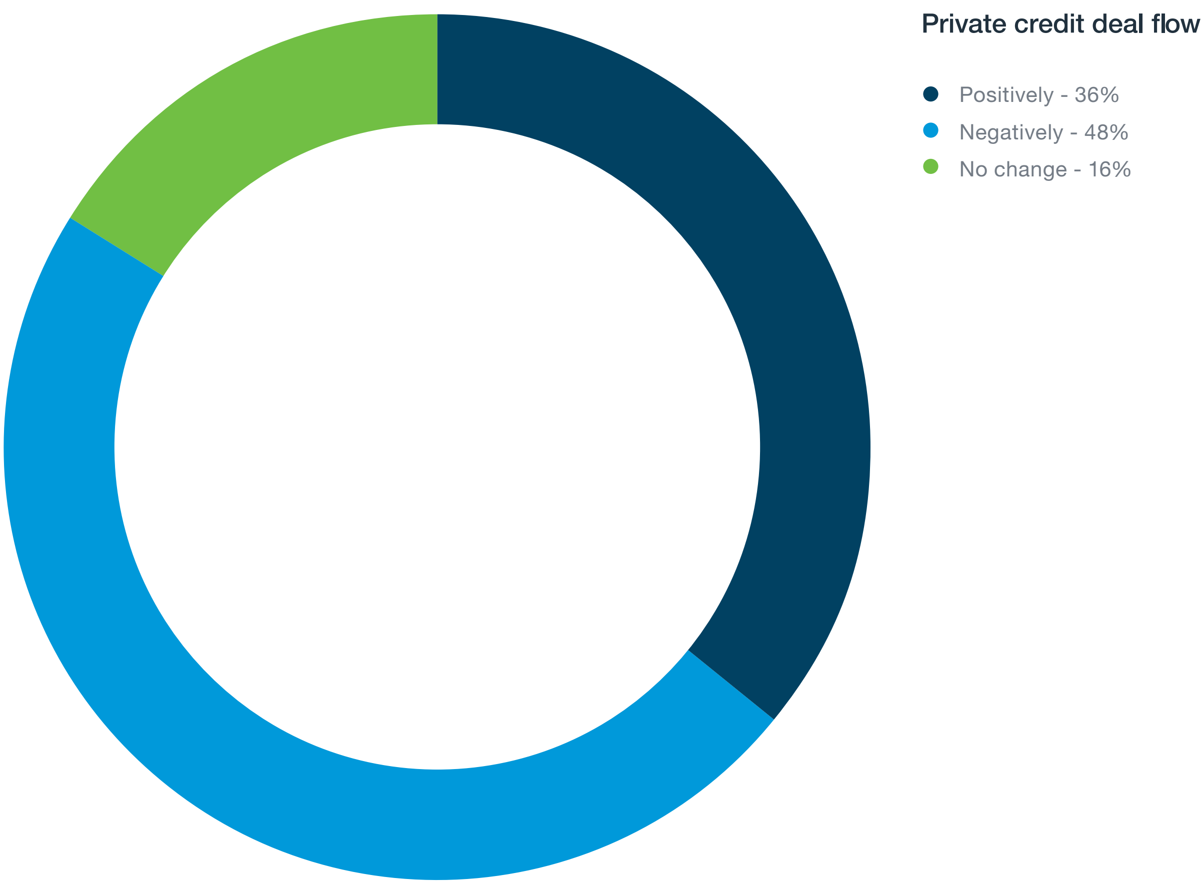
Do you anticipate that companies will make greater investments in the United States in light of US tax reform?



European Leveraged Lending Guidelines

84% of respondents think the European Leveraged Lending Guidelines will have a positive effect or no impact on private credit deal flow in the year ahead. This is a positive sign for organizations providing private credit, as restrictions on banks continue.

How do you expect European Leveraged Lending Guidelines to affect European private credit deal flow over the next 12 months?



Investment Strategies

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 appetite for investment.

Hot Markets

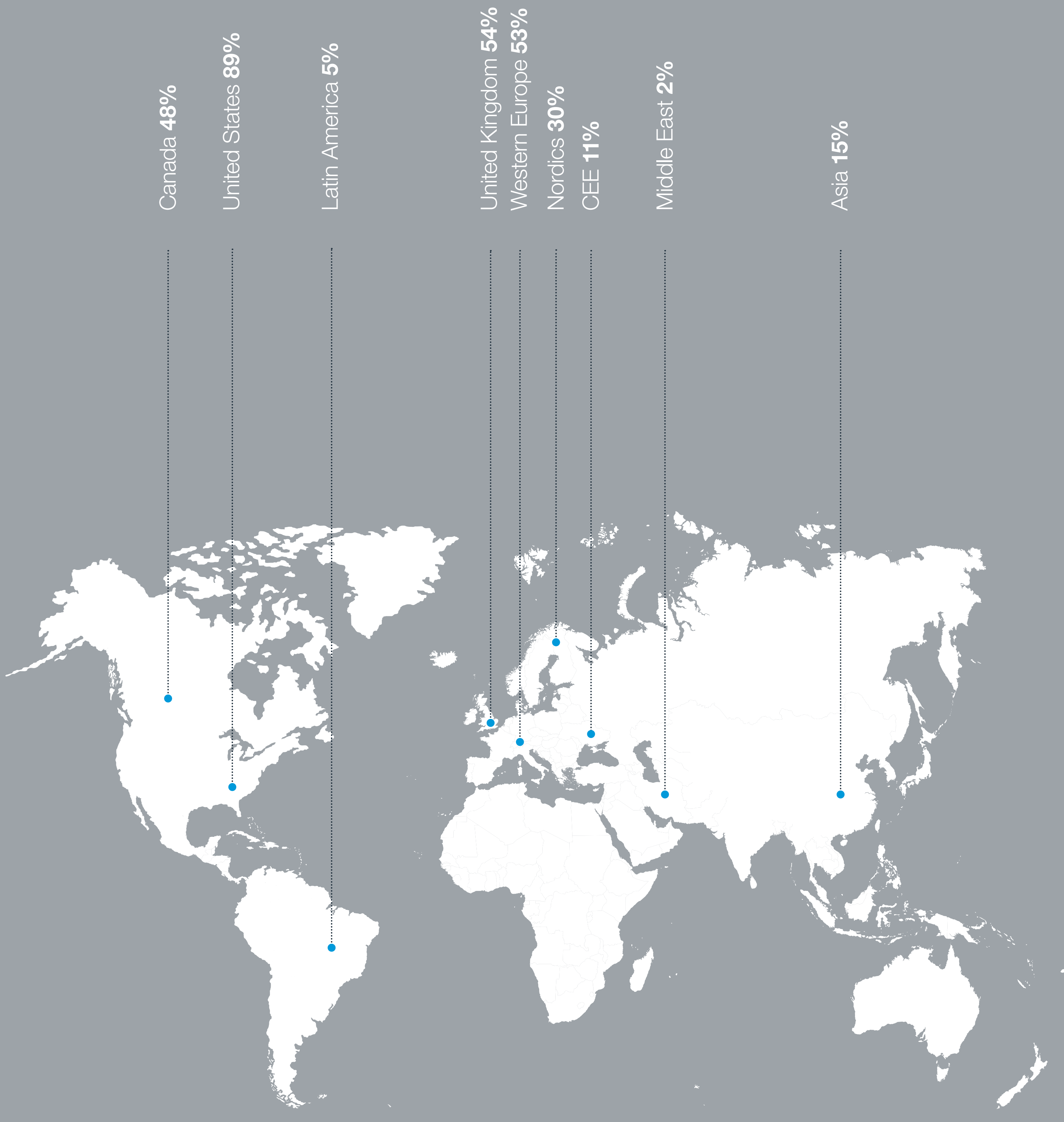
As you would expect, home markets are a priority for respondents when it comes to investments. Looking at the results overall, the hottest markets are the US, Canada, UK and Western Europe. Expected level of investment in Asia, Central and Eastern Europe, Latin America and the Middle East are much lower.

US respondents managing $10bn+ assets are planning investing in all regions, but significantly more likely to invest in the US and Canada than those with less AUM.

$10bn+ assets

are planning investing in all regions.

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



Investment Strategies

Key Industries

The key industries for investment are: Business Services; Healthcare; Software and Technology; Manufacturing and Transport and Logistics, with over ¾ of respondents planning to invest in these sectors.

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

95%
Business Services

89%
Healthcare

87%
Software & Technology

79%
Manufacturing

77%
Transport & Logistics

61%
Education

53%
Consumer & Retail

47%
Construction, Engineering & Infrastructure

33%
Energy & Utilities

26%
Real Estate

Investment Strategies

Key Industries

With mounting pressure on retailers and the growth of online suppliers such as Amazon, we have seen a drop in the proportion of US respondents that plan to invest in this sector (from 74% in 2017 to 55% in 2018).

> "E-commerce represents about 10% of all U.S. retail and Amazon is by far the largest player, with an estimated share of 43%. Last year, Amazon accounted for 53% of all the incremental growth of online shopping, which means they are only growing their dominance."
>
> *Source: Forbes June 19, 2017 Assessing the damage of 'The Amazon Effect.'*

However, 53% overall and over half in the US still see opportunities in Consumer and Retail organizations.

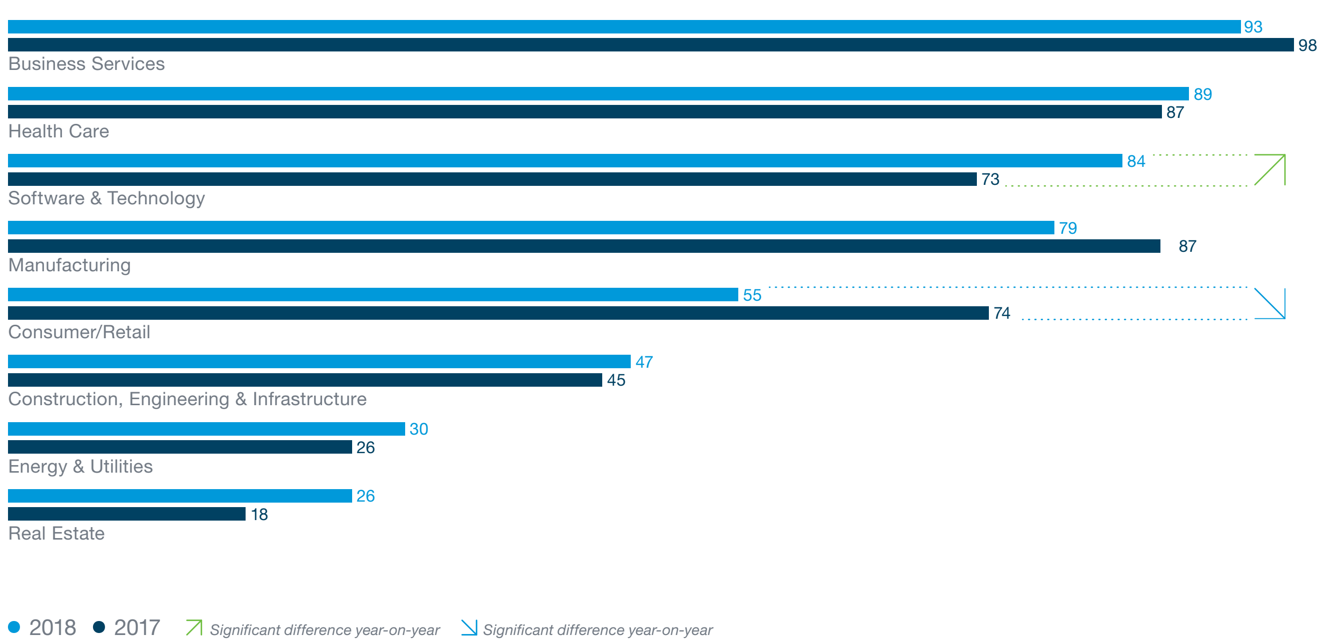
Software and Technology has become a significantly more attractive investment opportunity for US investors in the last 12 months, growing from 73% of respondents considering investment in this sector in 2017 to 84% in 2018.

Respondents in the UK and Europe are significantly more likely to consider investing in Software and Technology and Education than their US counterparts (95% include it among their target sectors) and are also significantly more likely to consider investing into Education (88% compared to 51% in the US).

53%

overall and over half in the US still see opportunities in Consumer and Retail organizations

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



Investment Strategies

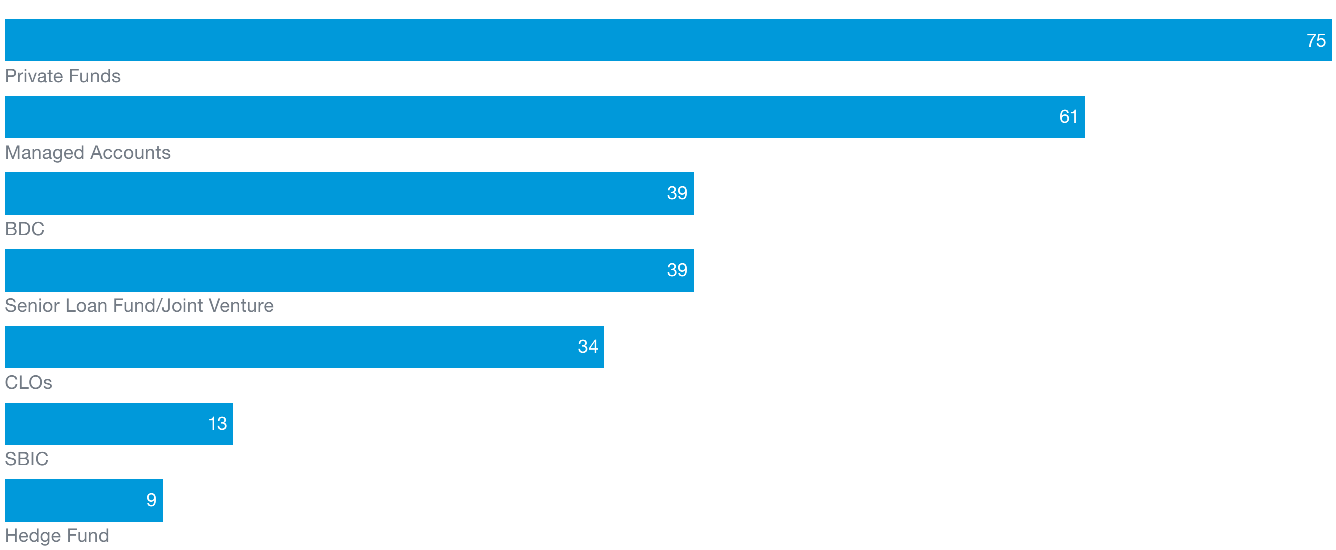
Investment vehicles

¾ of respondents use Private Funds for their investments, and almost 2/3 use Managed Accounts. Business Development Companies are the 3rd most used investment vehicle overall, driven by the US market.

The use of Managed Accounts has increased significantly in the US in the last 12 months. In our 2017 survey, we found that 39% of US respondents utilized Managed Accounts. This has increased to 63% in 2018 and stands at 61% for respondents overall. These results echo what our fund formation partners are seeing in the market – limited partners are looking for funds of one and separately managed accounts with custom fees and controls.

1/3 of respondents overall utilize Collateralized Loan Obligations (CLO) for lending activities, with higher usage in the US at 36%, compared to the UK/EU at 28%. In the US market, CLOs are more appealing to respondents with larger funds. Respondents with $10bn AUM or more are significantly more likely to utilize CLOs.

What vehicles do you utilize for your lending activities?



Investment plans

When asking respondents to share information about their investment plans for the next 12 months, we found that overall:

39%
are considering purchasing a loan portfolio

68%
are raising a debt fund

78%
plan to fundraise

Respondents with a higher value of assets under management are significantly more likely to be considering purchasing a loan portfolio (53% of respondents managing $10bn+ AUM are considering a loan portfolio purchase). We found that UK and European respondents are significantly less likely to be considering a loan portfolio purchase than those in the US (27% for UK/EU versus 43% of US respondents).

Investment Conditions and Considerations

As organizations plan to invest in growth markets, in this final section of the report we look at the conditions governing deals: the maximum leverage organizations are prepared to underwrite; the equity they require on transactions; views on financial covenant requirements and the risks organizations face.

Maximum total leverage

We found that the majority of organizations (70%) were prepared to underwrite a maximum total leverage of 6.00x or greater, and that 50% of respondents will underwrite a maximum total leverage of 6.5x or more.

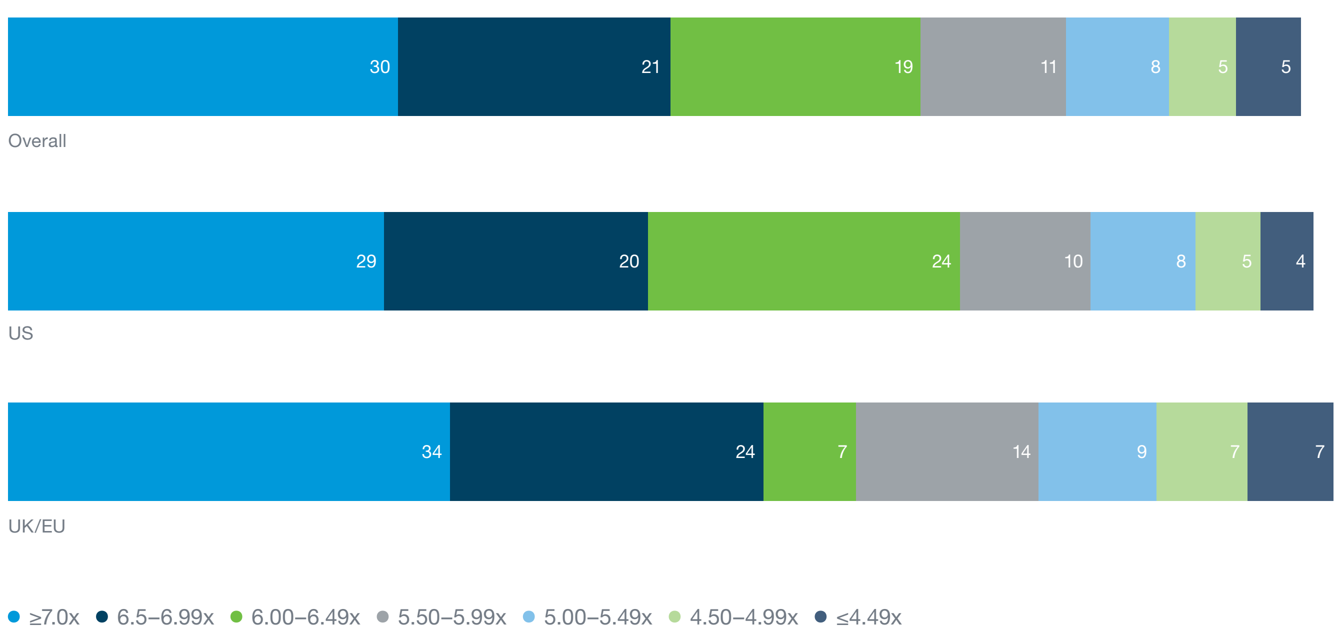
There are some variations by region, with the UK/EU respondents operating at the higher end of the scale:

70%
are prepared to underwrite a maximum total leverage of 6.00x or greater

50%
will underwrite a maximum total leverage of 6.5x or greater

US respondents are significantly more likely to underwrite 6.0-6.49x than respondents in the UK and Europe.

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

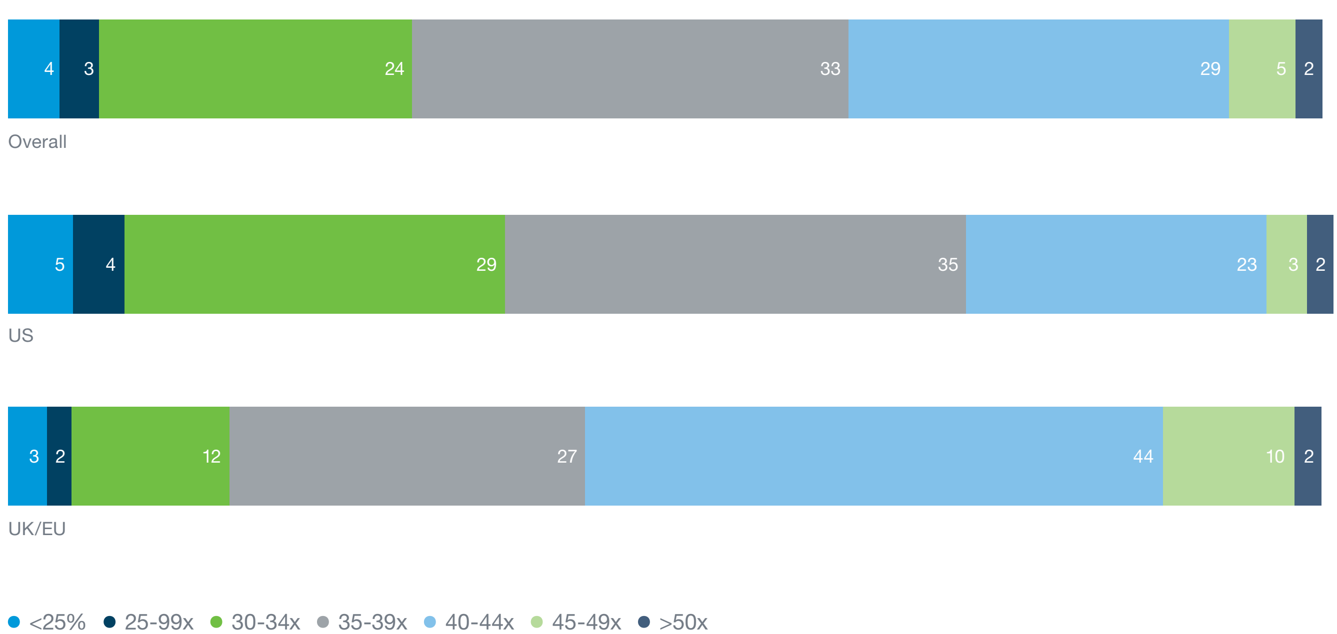


Investment Conditions and Considerations

Equity

When we look at the level of equity organizations require to support their transactions, overall, 1/3 of respondents require 40% or above and 2/3 require 35% or above. This is consistent with our findings in the 2017 Private Credit Insights report, in which the average equity contribution across over 200 deals was 40.6%.

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



Greater equity is needed on UK and European deals:

83%

of UK/EU respondents require a minimum of 35% equity of transactions and 56% require a minimum of 40% equity

63%

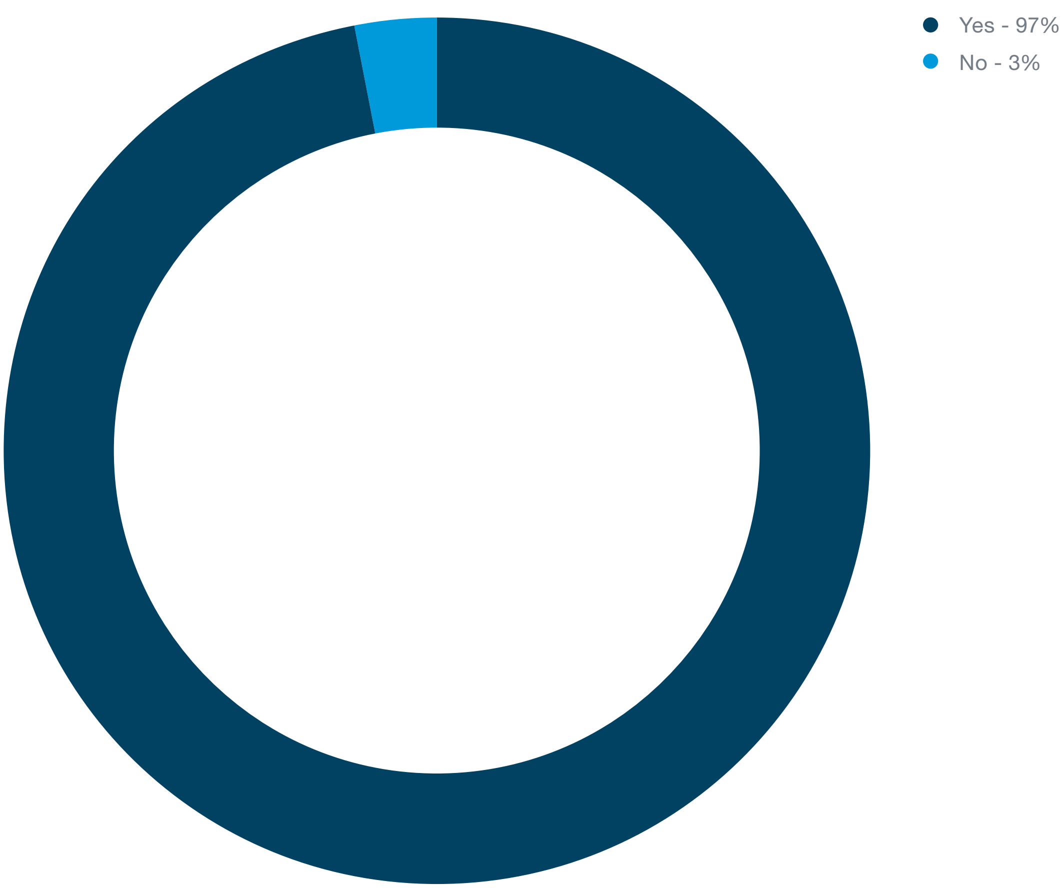
of US respondents require a minimum of 35% equity of transactions and 28% require a minimum of 40% equity

In the last 12 months, we have seen an increase in the proportion of US respondents requiring 35% or more equity for their transactions (from 52% in 2017, to 63% in 2018). We expect that the level of equity required will increase further over time, as transaction multiples continue to grow.

Investment Conditions and Considerations

Financial Covenants

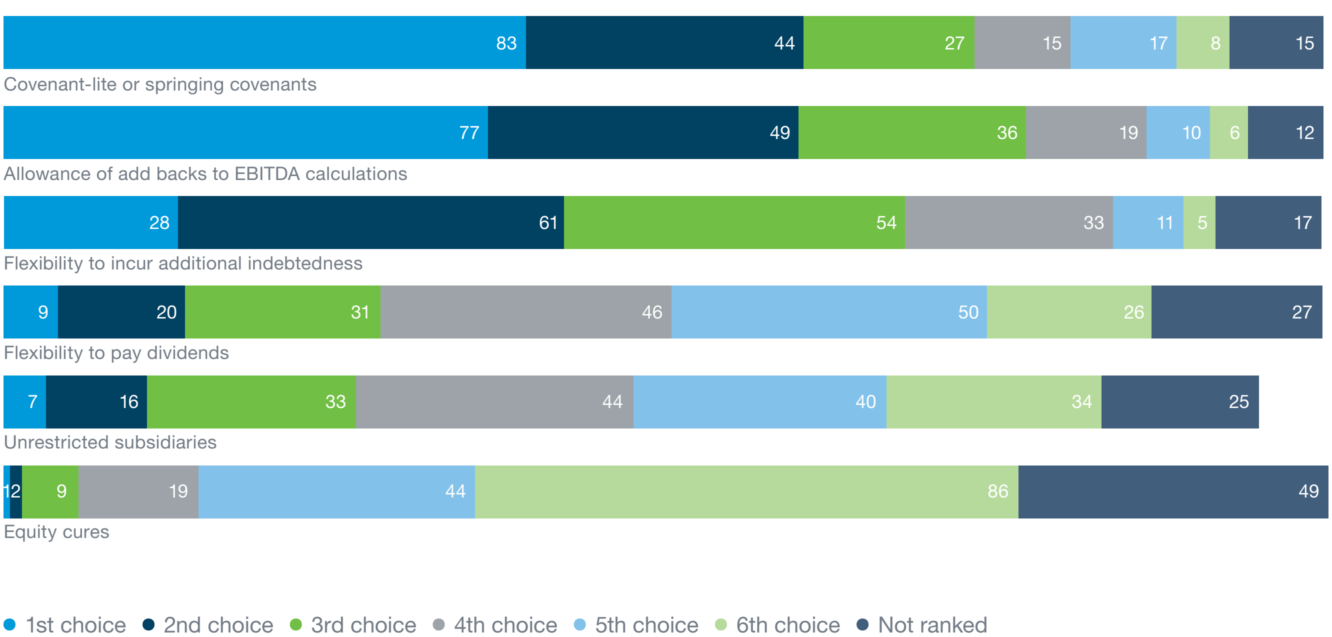
When we asked about the use of financial covenants we found that almost all respondents when originating deals with less than $/€40m of EBITDA will require a financial covenant to govern the deal. This is also consistent with the findings of our 2017 Private Credit Insights report, in which 94% of deals with less than $40mm of EBITDA had at least one financial covenant.



Risks

We asked respondents to rank the risks facing lenders and found that covenant-lite or springing covenants and allowance of add backs to EBITDA calculations are the most concerning risks. While, flexibility to incur additional indebtedness was not viewed by many as the most important risk, it received a far higher number of nominations as the second or third most important risk.

Which of the following concessions by lenders do you believe present the greatest risk to lenders? (Rank 1-6, 1 being most concerning)



EBITDA calculations

"The divergence between actual performance and pro forma / run rate EBITDA is increasing the inherent leverage in transactions and limiting the future benefit of financial covenants and other documentary controls."

"Definition of EBITDA has been severely watered down and there are so many allowable addbacks that are market standard."

"Even if there is a covenant in the deal, a weak EBITDA definition can render it useless and give the borrower too much flexibility to incur debt or divert cashflow away from debt repayment."

"Overly aggressive EBITDA adjustments are likely to result in under-performance of borrowers in 18-24 months once closing adjustments have largely rolled off and actuals may not have materialized."

"The allowance of add-backs is not on its own particularly risky or harmful — it has long been standard to include normalizing add-backs for one-time or non-cash charges — it is aggressive EBITDA definitions with the ability to include (occasionally uncapped) prospective, pro forma synergies that pose the problem."

Covenant-lite / springing covenants

"Loose documentation on covenants and the embedded inability to monitor the company and intervene on a timely basis in case of under-performance is a major risk because it could prevent the lender to act before the situation deteriorates."

"We continue to believe that giving up control in under-performing investments (covenant-lite structures) represents the greatest risk to lenders over the medium-to-long term."

Principal Contacts

We hope you enjoyed reviewing the results of our second annual Trends in Private Credit survey. Thank you to everyone that participated—we greatly appreciate your feedback.

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.

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