THE Lead Left
The Premier Middle Market Newsletter

Churchill Asset Management
A TIAA Company

What Brexit Means for Loans

"Thank God for the Electoral College." Thus the co-head of a major credit trading desk put a brave face on the US political outlook after last week's stunning Brexit vote.

And while the wisdom of our Founding Fathers may shield us from a similar upheaval in the direct popular vote for President, there's no guarantee that past party precedence in the electoral vote won't end up with the same surprising turnabout.

Beyond trading and currency turmoil, there was little certainty of what other immediate financial fall-out would accompany the "Leave" outcome. Equities have taken a hit, though most selling was due to dealers reluctant to hold positions over last weekend.

High-yield bond prices, the most sensitive of credit instruments to bad economic news, traded off a few points, but otherwise shrugged off events in Europe. Same with broadly syndicated loans; prices were generally "quoted lower" as buyers searched for bargains. Sellers sought clarity amid uncertainty.

What was clear was that whatever lies ahead for the UK and EU will not be resolved soon. Debt arrangers had kept pipelines light in expectation of the vote. If pending deals clear without tears, issuers will be emboldened to venture forth, albeit at a cost.

What impact will Brexit have on loans, and in particular, middle market loans? For one thing, volatility has returned to the market. That's good for investors. As we saw last August, this means higher spreads, lower secondary prices, and tighter structures. For another, as Thomson Reuters has noted, the syndicated loan market is a dollar or euro market, so is naturally cushioned against pound sterling shocks.

For issuers, it's a mixed bag. As one sales pro told us, "Volatility clouds visibility." Repricings are off the table for the present. So are the tougher credits. But the buy-side is still flush with cash. That means there's room for good deals to get done.

And the Fed is likely done with rate hikes this year; indeed, its next move may be *down* (see *Chart of the Week*), creating continued appetite for yield. As one loan manager suggested, "Brexit gives accounts a second chance to take advantage of the market."

Economists are issuing downward GDP revisions for the UK (drastic) and EU (less so). Adjustments to the US have been minimal. That points to a strength of middle market credit. Those issuers have largely domestic revenues with less European exposure.

Another Brexit upside for private credit investors is that larger banks are likely to back away from the middle market syndicate game. Gone with them are cov-lite for below $50 million Ebitda issuers and more aggressive debt baskets.

Not long ago we published a series on the challenges of direct lending in Europe. One

QUOTE OF THE WEEK

"I think credit could be one of the sweet spots in the current environment."

- Anastasia Amoroso, global market strategist, J.P. Morgan Asset Management.

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experienced manager noted the hurdles created by jurisdictional differences. "Europe is not a market," he told us. That certainly resonates even more today.

Next week we will conclude our two-part series on covenants.

THE LEAD LEFT SPOTLIGHT

This week we continue our conversation with Jessica Reiss and Justin Forlenza, attorneys with Covenant Review. Begun in 2006, Covenant Review is the world's first boutique research firm focused on bond and loan covenants.

Second of two parts - View part one

The Lead Left: MFN [most favored nation] is triggered if the company raises debt priced 50 bps from the existing debt.

Justin Forlenza: That's correct. Lenders are always asking if prospective financings are subject to MFN.

Jessica Reiss: Another example of term erosion is something called "re-classification." For covenants and incremental debt facilities it's common on bond documents to have a ratio, for example, 2.0x interest coverage, above which the borrower can issue any debt. However, if the company has *dollar-based* baskets, they can go up those levels even if the interest coverage is less than 2.0x.

JF: The catch is even if the company has no access to the ratio basket, they can retroactively apply it later after they use it, and still have the dollar-based baskets free and clear.

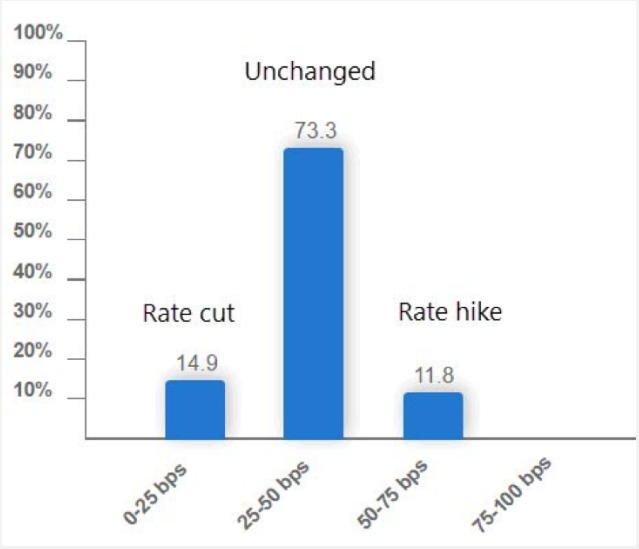
JR: In the past two weeks, we've seen three deals where this has made its way into accordion baskets. Incremental debt under the credit agreement is ok, but if the company incurs side-car debt, you'll often have a different set of lenders. You don't know if they'll be on the same page with you. Incentives may not be aligned.

"MFN protection has gotten a lot of attention. Not just for

CHART OF THE WEEK

EU-Turn

Thanks to Brexit, market watchers now think the probability of a Fed rate cut this year outweighs that of a rate hike.



Sources: The Daily Shot, CME Group

STAT OF THE WEEK

	June 2016	Jan 2015	Mar 2011	June 2007
UK 10-Year Bond Yield	0.933	1.341	3.691	5.462

Source: Investing.com

LOAN STATS AT A GLANCE

Provided by: S&P CAPITAL IQ

	This Week	Last Week	6MO Ago	YR Ago
New-Issue Clearing Yields				
$200M or less	6.85%	6.85%	6.47%	6.38%
$201M - $350M	6.03%	6.07%	6.06%	5.86%
$351M - $500M	6.21%	6.30%	6.81%	5.64%
$501M+	5.22%	5.22%	5.49%	4.69%
Middle market (≤ $50M)	6.79%	6.72%	6.35%	6.29%
Large corporate (> $50M)	5.39%	5.40%	5.70%	4.98%
Large corporate single-B (> $50M)	5.66%	5.67%	6.12%	5.17%
Middle Market Credit Stats				
Sr/EBITDA	N/A	N/A	5.7	3.9
Debt/EBITDA	N/A	N/A	5.7	4.4
Middle Market Index Data				
Monthly Returns	0.00%	0.12%	-0.89%	0.10%
Average Bid	92.99	93.22	93.91	97.10

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MIDDLE MARKET DEAL TERMS AT A GLANCE

the accordion, but also other incremental debt. "

TLL: What's your perspective on covenant-lite loans?

JR: It's a continuum. At one end is when both the RC and TL have maintenance covenants. Then the TL can have a springing covenant, in which the RC has a maintenance test, but it's subject to the RC being 35% drawn. If there's an ABL in the capital structure, the TL may not have a maintenance covenant.
If you're in the institutional tranche with a maintenance covenant, you get a quarterly test, but only for the RC. The TL gets some derivative protection, but TLs can waive a breach or call a breach on their own. You can't charge a fee, etc.

JF: If you have a maintenance covenant, there may be an indirect benefit to the company meeting their ratio, but you get dragged along with no rights. Of course, the borrower still has to deliver its financial statements and other obligations.

JR: Lack of maintenance covenants is not the worst thing. There are other flexibilities that go along with covenant-lite. For example, debt incurrence tests where they get more room. There are things under the company's control, such as incurring debt vs. having a covenant triggered because your cash flow falls below a certain level.

JF: It's a fact of aggressive markets that for broadly syndicated loans, those with covenants are suspect. It would be interesting to run recovery rates on covenant vs. cov-lite deals.

TLL: What are the hidden traps lenders should look for?

JF: MFN protection has gotten a lot of attention. Not just for the accordion, but also other incremental debt. For example, permitted debt for acquisitions allows for additional *pari passu* first lien debt. The existing lenders did not get the benefit even though pricing was over the 50 bps test. If it's under the ratio basket, the MFN usually applies. Debt incurred under a sidecar applies. But under

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June Update

Deal Component	June 2016	June 2015
Cash Flow Senior Debt (x EBITDA)	Micro Cap 1.50x-2.50x Small Cap 2.50x-3.50x Midcap 3.00x-4.00x	Micro Cap 1.50x-2.00x Small Cap 2.00x-3.50x Midcap 3.00-4.25x
Total Debt Limit (x EBITDA)	Micro Cap 3.00x-4.00x Small Cap 3.75x-4.50x Midcap 4.00x-5.50x	Micro Cap 3.00x-4.00x Small Cap 3.75x 4.50x Midcap 4.00x-5.00x
Senior Cash Flow Pricing	Bank: L+3.50%-4.50% Non-Bank: <$10.0MM EBITDA L+6.00%-8.00% Non-Bank: >$15.0MM EBITDA L+4.50%-6.50% (potential for a 0.50%-1.00% floor)	Bank: L+1.75%-3.50% Non-Bank: L+4.00%-6.00%
Second Lien Pricing (Avg)	Micro Cap L+9.00%-12.00% floating (0.50%-1.00% fl) Small Cap L+7.50%-9.00% floating (0.50%-1.00% fl) Midcap L+5.50%-7.50% floating (0.50%-1.00% fl)	Micro Cap L+8.00%-11.00% floating (1.00% fl) Small Cap L+6.00%-9.00% floating (1.00% fl) Midcap L+5.50%-7.50% floating (1.00% fl)
Subordinated Debt Pricing	Micro Cap 12.0%-14.0% Small Cap 11.0%-13.0% Midcap 10.0%-12.0% Warrants in special situations; Second lien may buy down to ~9.0%. Equity co-invests readily available.	Micro Cap 12.0%-14.0% Small Cap 11.0%-13.0% Midcap 10.0%-12.0% Warrants in special situations; Second lien may buy down to ~9.0%.
Unitranche Pricing *Micro Cap= <$7.5mm EBITDA *Small Cap= >$10mm EBITDA *Midcap= >$20mm EBITDA *Changes from last month are in red	Micro Cap L+8.00%-11.00% (0.50%-1.00% fl) Small Cap L+7.00%-8.50% (0.50%-1.00% fl) Midcap L+6.00%-7.50% (0.50%-1.00%-1.50% fl) Potential for fixed rate with BDC or mezz lender. Equity co-invests readily available.	Micro Cap L+8.00%-11.00% (1.00% fl) Small Cap L+6.50%-8.50% (1.00% fl) Midcap L+6.00%-7.50% (1.00% fl) Potential for fixed rate with BDC or mezz lender.Most Unitranche lenders allow a small ABL facility outside of the loan.

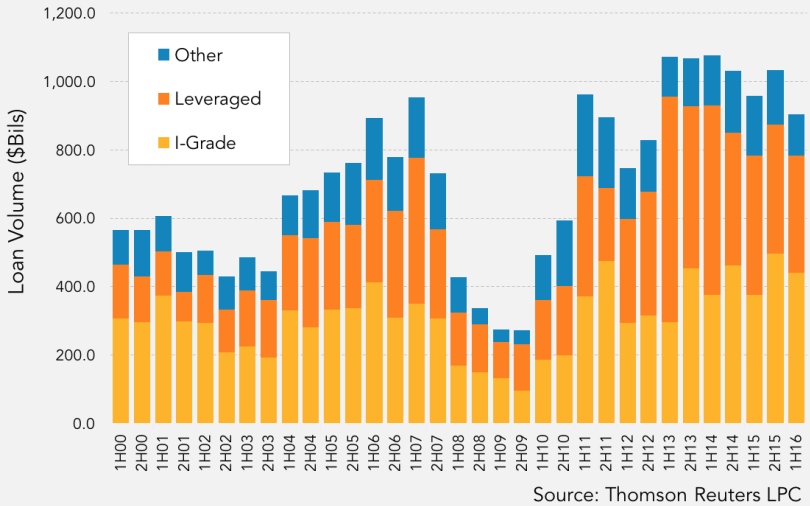
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LEVERAGE LOAN INSIGHT & ANALYSIS

Provided by:

THOMSON REUTERS

2Q16 Loan volume up 55% compared to 1Q16; 1H16 down over 5.5% y-o-y



Source: Thomson Reuters LPC

Supported by solid technicals and a steady - if uninspired - pipeline of deals, the US loan market got a substantial boost in 2Q16 to push over US$550 billion in loan volume through the market and logging nearly US$905 billion of total issuance during the first six months of the year. Coming off a slow start to the year which included the completion of a series of financing slogged in late 2015, 2Q16 lending was up over 55% compared to 1Q16 results on the back of improved market sentiment. In turn, market sentiment seemed to be hinged on borrower efforts to time the market to take advantage of brief windows of opportunity to extend tenors or, occasionally, trim spreads. Both investment grade and leveraged lending was boosted - 67% and 64% respectively - quarter over quarter. Nevertheless, lenders say that some of this issuance represented a "false" supply of deal flow given limited new money lending opportunities. Less than 23% of 2Q16 investment grade loan volume represented new

the permitted acquisition basket, the MFN isn't always there.

TLL: Why not?

JR: No one noticed. We've seen it in a number of deals. Even with a sidecar, if it's a bond, you can do first lien secured bonds and the MFN won't apply.

JF: Or the company can call the incremental debt a "note purchase agreement" and since it's not technically a TLB, MFN won't apply.

TLL: How about the middle market?

JF: We don't look at the middle market, but it depends on the sponsor. The large cap sponsors will push through large cap terms to smaller companies. Sometimes in the $50-75 million ebitda range you can't tell the difference between terms for a middle market borrower and one with $500 million ebitda.

TLL: What about the unitranche trend?

JR: We don't see a ton of unitranche. There was a big unitranche in the news recently; that one was the biggest we've seen. It's more a supply/demand dynamic.

JF: It's a very appealing product for the borrower; a blended rate and one lender. It's very convenient. Where it will go remains to be seen.

TLL: What's been the biggest surprise for both of you in terms of covenant trends?

JF: Things were decently steady in terms of a pipeline earlier in the year, but the last couple of weeks have exploded, especially going into the summer. That was very surprising to see.

JR: Is this the look of things to come? Or are we headed for a new cycle? We are certainly seeing more defaults. We've had a ton of questions on oil and gas bonds. Will they file?

JF: There's lots of money out there. It makes sense there's an uptick in refinancings and new buyout business. It does seem it could

assets. For leveraged lenders, the news was arguably better with 47% of 2Q16 representing new money lending, but even this result was qualified given the series of opportunistic refinancings and an uptick in dividend recaps.

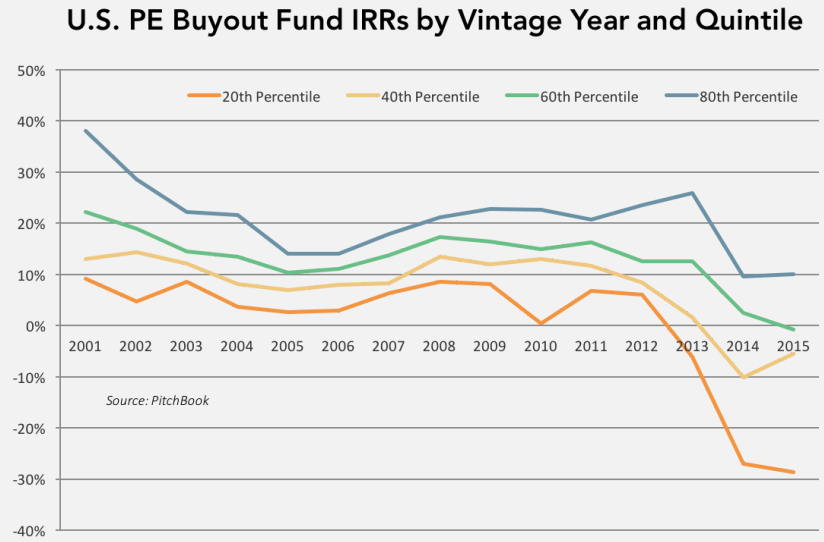
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THE PULSE OF PRIVATE EQUITY

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PitchBook



Recent Wave of Exits Differentiated U.S. PE Fund Managers

The boom in private equity-backed selling observed over the past few years, cresting in 2015, yielded rich returns for certain U.S. buyout funds. More than that, it proved a differentiating area for the top tier of U.S. fund managers. As illustrated by the chart above, certain vintages far outpace others in the long run in terms of IRR, while the financial crisis helped tighten performance across the board. But since 2009, significant variance began to arise once more, with the top quintile of PE fund managers able to post considerably higher performance all the way through 2013 vintages.

Of course, the J-curve effect comes into play for more recent vintages, although the extent to which the bottom quintile dips is illustrative of a current scarcity in quality targets. Given the roughly concurrent timing of the exit boom, it's clear that top U.S. buyout fund managers differentiated themselves quickly when the opportunity came by securing good deals as multiples grew more heated over the past few years. Those buyers capitalized on the worldwide surge in M&A and secondary buyouts, even after only a relatively brief holding period.

Their overall performance across all vintages, meanwhile, underlines the rationale for limited partners to maintain exposure to the asset class, recommitting to their most trusted fund managers that have been able to post such consistently high performance. The question now is whether or not such outperformance can be maintained as the buyout cycle winds down. Given the broader investment market, it's likely that LPs will continue pouring money into PE allocations, willing to accept lower rates of return than historical highs in exchange for relative stability and even a slim margin of outperformance.

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COVENANT TRENDS

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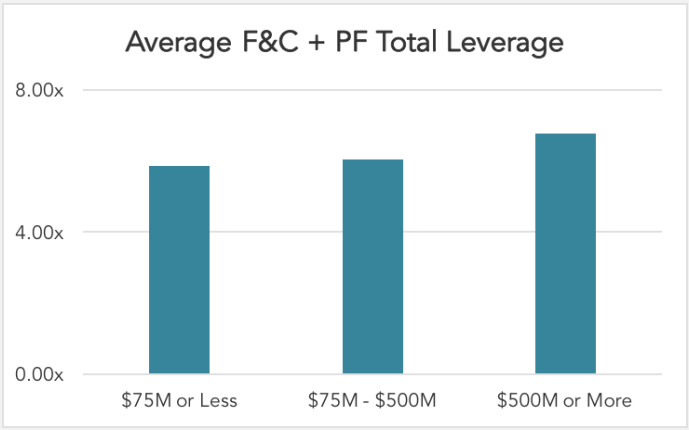
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continue, but for how long? One month, six months?

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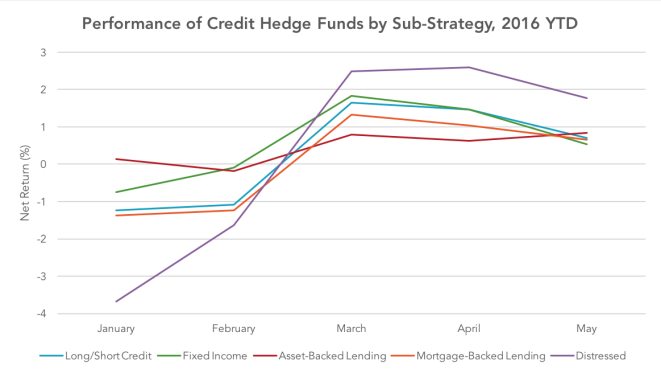


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PRIVATE DEBT INTELLIGENCE

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Credit Hedge Fund Performance in 2016 YTD

The first months of 2016 were characterised by continued market volatility, and credit-focused hedge funds recorded losses across all sub-strategies in January and February. However, as global turbulence has calmed moving into Q2, all sub-strategies have seen improved performing and posted three consecutive months of gains from March to May.

Distressed hedge funds have experienced the greatest volatility of any credit strategy, suffering the heaviest losses in January (-3.68%) and February (-1.63%), before returning the highest gains through March (+2.48%), April (+2.59%), and May (+1.77%). Given their reliance on capitalising on macro-economic events, it was perhaps little surprise to see distressed funds struggle early on in the year. Conversely, asset-backed credit hedge funds have performed consistently, with returns not exceeding the 0.84% seen in May nor falling below February's 0.18% losses. Asset-backed hedge funds saw the highest overall returns of any credit sub-strategy through 2015 as they made gains of 7.33%; this consistency in the early part 2016 suggests that funds are once again successfully hedging against widespread swings in value seen across global markets.

Long/short credit vehicles and mortgage-backed lending hedge funds have seen highly correlated returns in the first five months of the year, perhaps suggesting that the larger relative size of these industries makes them prone to following broader market trends. Mortgage-backed hedge funds saw the losses of 1.37% in January, slightly below the 1.24% losses incurred by long/short credit funds. Performance of both strategies rose above 1% in March to reach 1.33% and 1.64% respectively, but since then gains have diminished, and long/short credit funds saw performance of 0.70% in May, while mortgage-backed lending funds gained 0.66%.

The rest of 2016, seems likely to be dominated by ongoing volatile situations in both the US and Europe. The US presidential election campaign will continue until November, while negotiations on Britain's exit from the EU is likely to provoke extended uncertainty throughout the region. As such, it is too early to cast predictions for credit funds over the remaining six months. Nonetheless, the ability of most credit strategies to provide uncorrelated returns through the year so far means that they may become increasingly

MARKIT RECAP

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markit



Those of us who stayed up to watch the Brexit television coverage knew that in a few hours' time the June 24 trading session would go down in history. The mainstream media were inevitably obsessing about the post-Brexit collapse in sterling, but the credit markets were focused on the Markit iTraxx indices. Big moves were expected by market participants, and they weren't disappointed.

The Markit iTraxx Europe opened the day at 75bps; it closed at 95bps, a widening of 26%. To put this in perspective, the move in the index after the Lehman failure was 22% (September 15 2008) and 18% immediately prior to the first Greek bailout (May 7 2010). The Markit VolX Europe, which shows realised volatility in the iTraxx Europe, was indeed at its highest level since Greece was forced into the hands of the Troika.

The magnitude of the moves is striking when placed in a historical context. But the subsequent days following the seismic impact of the Brexit referendum result suggest that we are in slight calmer waters. The Markit iTraxx Europe had recovered to 84.5bps by Thursday, just 8bps wider than where it started the year. As recently as February this year, the index was trading in excess of 125bps.

So, it seems that credit markets are not retreating to the panic room, at least not yet. Why is this time different from previous crises? We have credible commitments from central banks to do "whatever it takes" and the financial system is better capitalised (though few would say it is completely robust). Changes in OTC market structure have helped internalise systemic risk, with the caveat that the recovery and resolution of CCPs is still to be adequately determined.

But politics caused this crisis, and it is more than likely that political factors are tempering the credit deterioration. The view that Brexit may be delayed by the new Prime Minister, or even taken off the agenda entirely, is gaining traction. Given the rhetoric from both the Brexiteers and EU leaders, this seems far-fetched. But the enormity of the implications of the result is now setting in, both for the politicians and the electorate. A fresh general election, which could serve as a proxy second referendum, cannot be ruled out.

favourable among investors seeking safe havens.

UK banks are clearly suffering from the uncertainty, and their spreads hit new wides for this year. Italian banks also spreads blow out, though the damage was limited by the Italian government providing liquidity support through government guarantees. This was approved by the European Commission under "extraordinary crisis rules for state aid". More than anything else, the EU fears Brexit leading to contagion through the currency bloc. The narrow vote for the UK leaving the EU could yet lead to another, more serious phase in the eurozone crisis, and the ECB and Commission will do their utmost to prevent this happening.

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SELECT DEALS IN THE MARKET

Deal	Arranger	Sponsor	Industry	Facility*	Spread	LIB Flr	OID	Rating
Northstar Travel	Macquarie	Wasserstein & Co	Computers & Electronics	73	625	100	98.5	BBB-/Ba2
Cooke Aquaculture	Rabobank	AGR Partners	Food & Beverage	52	450	N/A	N/A	NR/NR
Service Logic	Antares	Sterling Investment	Manufacturing & Machine	103.4	500	100	99	NR/NR
Paramit	Regions Bank	Altaris Capital	Healthcare	105	475	N/A	N/A	NR/NR
Evergreen Industrial Services (1)	BNP	Sterling Group	Services & Leasing	107	500	100	99	NR/NR
Belcan Corp (AO)	CS	AE Industrial	Services & Leasing	25	600	100	97	B/B2
Cross Country Healthcare	SunTrust	Charterhouse Equity	Services & Leasing	40	225	N/A	N/A	NR/NR
Averages				72	482	100	98	

* Senior only
** May be estimate based on leverage. Assumes unfunded revolver
NA Not Available
All dollar amounts in $MM
Corporate ratings unless otherwise noted

(1L) First Lien
(2L) Second Lien
(CL) Covenant Lite
(D) Dividend
(AO) Add-On

New Deal
Flex Up
Flex Down

Call Schedules
(1) 6 Month 101
(2) 101
(3) NC-2/104/102
(4) NC-2/102/101

Source: S&P/LCD, Thomson Reuters/LPC, market sources

THE Lead Left

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