THE Lead Left
The Premier Middle Market Newsletter

Churchill Asset Management
A TIAA-CREF Company

A Review of European Direct Lending (Fourth of a Series)

So far in this series we've covered the unique lending characteristics of European jurisdictions as well as the inherent advantages held by European banks. This week we look closer at the opportunities presented to non-bank direct lenders.

Selling high-yield bonds in Europe has generally been unchanged over the past five years. It's still a public market with the same investment bank underwriters, trading dynamics, and investors. By contrast the landscape for loans has seen an influx of funds from global asset managers, investment firms, and private equity sponsors.

But as we've highlighted, banks still have the upper hand as arrangers of middle market senior debt. This is particularly true for private equity backed borrowers. The manager at one leading European fund put it this way: "As is increasingly true in the US, sponsors in Europe control every aspect of deal structure, who's invited into the financing, even who trades the paper. If you're a bad actor, it's tough to break in."

Another source agreed. "Forget about getting a decent allocation if you're on somebody's black list. You won't even be allowed to trade in the secondary market."

That means that "job number one" (as our first fund manager called it) for direct lenders is to get an introduction to the sponsor. Be prepared to explain why you should be allowed to work with them. If you're lucky, you may get some early bird looks. But understand that this is a "small subset of a very private market."

Because of fee structures, direct lenders require yields in the 8-10% range. That's a step or two above the bank market. Rather than migrating towards second lien, which has effectively disappeared from both sides of the Atlantic, direct lenders are seeking these returns from unitranche financings. But these carry a higher level of credit risk.

And it's an expensive proposition to market effectively. "You need to knock on all the doors in Europe," our second source told us. "It's really Middle Market Lending 101. While the majority of sponsors are in the UK, you still need to have experienced executives in every major city who have a strong Rolodex of PE relationships."

Not to say unitranche isn't popular with PE. According to Deloitte, roughly half of all debt structures are single-tranched, with less than 40% involving some mix of senior and mezzanine. As in the US, the one-stop gives sponsors more flexible covenant packages, more accommodative debt baskets, and, of course, higher leverage.

One major difference in Europe is that unitranche is structured with 50% cash-pay and 50% PIK. All-in yields also vary widely, depending on the credit - ranging from 6-11%.

QUOTE OF THE WEEK

"This space is controlled by the worst mis-pricers of risk in the world, which is banks."

- Howard Sharp, head of mid-market lending, Park Square Capital, on direct lending in Europe

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Ironically, after so much media focus on direct lending in Europe, what's attracting investor attention at the moment is secondary trading in the US broadly syndicated market. As our *Chart of the Week* shows, prices have fallen well below their European counterparts. So much so that some credit teams in London are, temporarily at least, relocating to New York to take advantage of this cross-border arbitrage.

Nest week we look at what it takes to be an successful direct lender in Europe.

4TH ANNUAL
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THE LEAD LEFT SPOTLIGHT

LSTA

On Wednesday, February 24 th , Meredith Coffey, EVP of the Loan Syndications and Trading Association, testified before the House Financial Services Subcommittee on Capital Markets. The point of her testimony was four-fold: i) To explain the importance of loans to non-investment grade companies, ii) to explain the role CLOs play in this financing, iii) to explain what risk retention could do to CLOs, and iv) to describe a viable form of re tention (H.R. 4166, or the "QCLO bill") that should work for lawmakers, regulators, CLOs and companies.

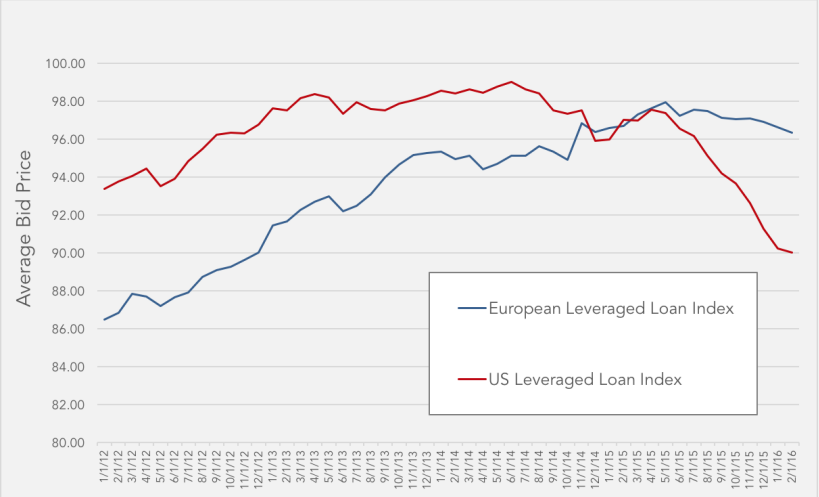
Meredith developed the following summary of her testimony for our Lead Left readers:

The reality is that the vast majority of American companies are not large investment grade corporations like Microsoft, McDonalds and Wal-Mart. Most are non-investment grade - of the 2,000 companies Moody's rates, more than 70% are rated below Baa3. These are cable companies like Cablevision, airlines like Delta and American, food companies like Dole and Del Monte, restaurant chains like Wendy's, Burger King and Dunkin Donuts, and - to burn those donuts off - gym companies like

CHART OF THE WEEK

Atlantic Crossing

Last summer's market volatility in the US caused loan prices to plummet, attracting attention from European loan buyers.



Sources: S&P Capital IQ

STAT OF THE WEEK

	Mar 3 2016	Jan 19 2016	Nov 20 2008	Jun 24 2008
S&P Metals and Mining Index	931.52	599.71	856.66	4591.40

Source: S&P Dow Jones Indices

LOAN STATS AT A GLANCE

Provided by:

S&P CAPITAL IQ

24-Hour Fitness and Equinox.

The reality is that CLOs provide more than $400 billion of financing to companies such as these. So why do people get concerned when they hear "CLO?" In large part, it is because people assume that these must be "CDOs". But CLOs are not CDOs - and they didn't perform like them. CLOs are just simple and transparent portfolios of corporate loans and the proof is performance. Moody's calculated that the 10-year impairment rate for CLOs was 1.5%. For CDOs it was 44.8% - nearly 30 times the CLO impairment rate.

"While CLOs are not CDOs, unfortunately risk retention will do considerable damage to CLOs."

While CLOs are not CDOs, unfortunately risk retention will do considerable damage to CLOs - and the companies that rely upon them. In early February, Moody's issued a report on companies' need to refinance, and noted that "CLOs will meet a smaller portion of corporate refunding needs" due, in part, to risk retention.

And, in fact, even though it doesn't officially go live until December 2016, risk retention is already affecting CLOs. Starting in the second half of 2015, investors began requiring CLOs to be risk retention compliant - or at least have a detailed plan to comply. This is not because investors love risk retention - rather investors wanted to invest only in CLOs that could refinance and whose managers could survive risk retention.

The result? Due in part to market weakness and in part to risk retention, CLO formation dropped 20% in 2015. And second half 2015 CLO formation dropped nearly 40% from first half levels. Moreover, risk retention already is picking winners and losers: 30 smaller managers that issued CLOs in 2014 were unable to do so in 2015, largely due to risk retention.

	This Week	Last Week	6MO Ago	YR Ago
New-Issue Clearing Yields				
$200M or less	7.04%	6.76%	6.78%	6.51%
$201M - $350M	6.95%	6.86%	5.86%	6.29%
$351M - $500M	6.41%	6.31%	6.02%	6.21%
$501M+	5.98%	5.90%	5.10%	5.45%
Middle market (≤ $50M)	7.29%	6.99%	6.30%	6.74%
Large corporate (> $50M)	6.16%	6.10%	5.41%	5.71%
Large corporate single-B (> $50M)	6.67%	6.40%	5.50%	5.81%
Middle Market Credit Stats				
Sr/EBITDA	5.1	5.1	5.8	5.0
Debt/EBITDA	5.1	5.1	6.1	5.0
Middle Market Index Data				
Monthly Returns	0.09%	-0.70%	0.02%	0.26%
Average Bid	92.12	92.06	96.19	96.26

Source: S&P Capital IQ

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MIDDLE MARKET DEAL TERMS AT A GLANCE

Provided by:

SPP CAPITAL PARTNERS

March Update

Deal Component	March 2016	March 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%-5.00% Non-Bank: <$10.0MM EBITDA L+7.00%-8.00% Non-Bank: >$15.0MM EBITDA L+4.50%-6.50% (potential for a 1.00% floor)	Bank: L+2.00%-3.50% Non-Bank: L+4.00%-6.00%
Second Lien Pricing (Avg)	Micro Cap L+9.00%-12.00% floating (1.00% fl) Small Cap L+7.50%-9.00% floating (1.00% fl) Midcap L+5.50%-7.50% floating (1.00% fl)	Micro Cap L+8.00%-11.00% floating (1.00% fl) Small Cap L+6.50%-8.50% floating (1.00% fl) Midcap L+6.00%-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 11.0%-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+8.50%-11.00% (1.00% fl) Small Cap L+7.50%-8.50% (1.00% fl) Midcap L+6.00%-7.50% (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+6.00%-8.00% (1.00% fl) Midcap L+5.50%-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.

Source: SPP Capital Partners

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LEVERAGE LOAN INSIGHT & ANALYSIS

Provided by:

THOMSON REUTERS

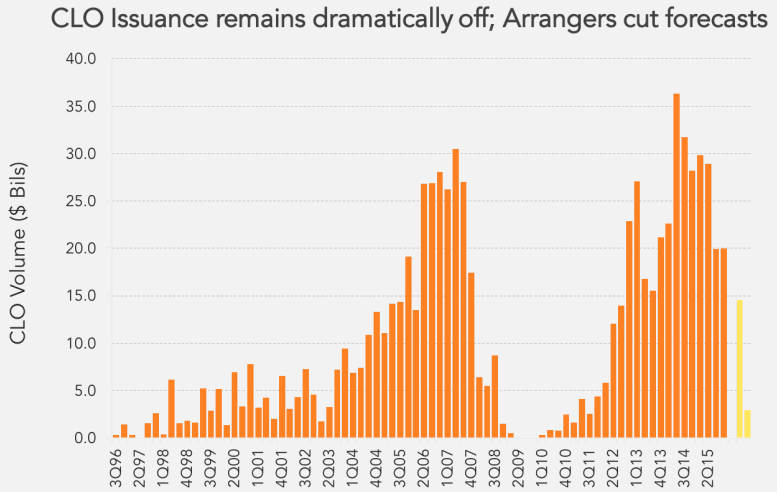
This is not just a CLO problem - it will impact a number of companies' ability to refinance their debt. Moody's said that non-investment grade companies will have nearly $700 billion of debt coming due in 2019-2020. Meanwhile, Bloomberg recently reported that Fed officials like Janet Yellen have begun worrying about credit availability, and the regulators themselves have said that risk retention will reduce the supply of credit.

So, what will happen? If US companies cannot refinance their debt because CLOs are not there for them, companies will either have to pay significantly more to alternative sources of credit like hedge funds. Or, worse, companies may not find credit, and this could lead to downsizing, job cuts or - at worst - possible liquidity crises.

But this scenario is totally avoidable. Instead of curtailing the CLO market, the LSTA asked the committee to consider and pass H.R. 4166, which contains a sensible alternative - the Qualified CLO or QCLO. How does the QCLO work? A CLO would have to meet requirements in six areas: i) Asset quality, ii) Portfolio diversification, iii) Capital structure, iv) Alignment of interest of manager and investor, v) Regulation of the manager, and vi) Enhanced transparency & disclosure.

If a CLO does this, then the manager can purchase and retain 5% of the equity which, along with subordination of its fees, would meet the 5% credit risk retention that DF requires. Thus, the QCLO not ONLY requires 5% credit risk retention, but it also adds restrictions into the mix. It is "Dodd-Frank Retention-Plus-Protections".

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Source: Thomson Reuters LPC

Just shy of three months into 2016, CLO issuance remains stalled, logging less than US$3 billion in new vehicles through the end of February. This represents an 80% drop compared to the same time last year. More notably, only a few days into March, a single CLO has come to market via a US$406.75 million vehicle for Highbridge Principal Strategies - substantially off from the US$2.1 billion via 4 CLOs which were completed at the same time last year. Although volatility across the capital markets and concerns around risk retention have factored into the slow down, issuance has also been hampered by higher yielding assets offered in the secondary market via older funds. None of this bodes well for CLOs, the largest and most natural buyer of leveraged loan assets. Arrangers including JPMorgan, Wells Fargo and most recently Deutsche Bank have reduced their projections for 2016 CLO volume, to expectations ranging from a low of US$35 billion to a high of US$60 billion, a 20-40% from forecasts set at the end of last year.

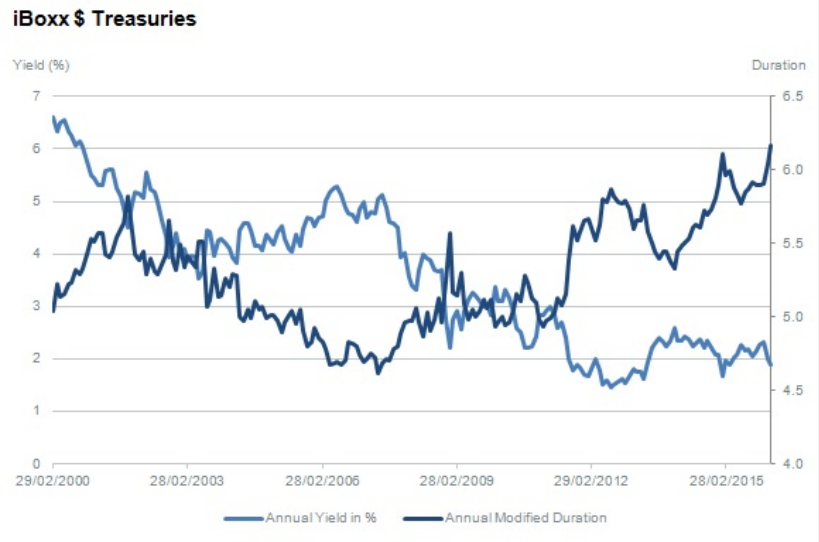
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MARKIT RECAP

Provided by:

markit



Investors have been flocking to government bond ETFs at a record pace since the start of the year, hoping to shelter from the surge in credit risk and profit as the market discounts the probability of nearing interest rate hikes. This has so far proved profitable as global government bonds have largely outperformed their corporate peers since the start of the year. But investors have also been loading up

MIDDLE MARKET Growth

Tipping Point

Danny Meyer startled the restaurant world in October with a dramatic announcement- he was eliminating tipping from all his Union Square Hospitality Group fine dining locations.

Many revolutionary ideas seem obvious in hindsight. This one is being launched against a firmly entrenched practice that defies common sense yet remains the economic foundation for many service sector employees in the United States.

The reaction on op-ed pages was favorable, thanks to Mr. Meyer's sterling reputation among cuisine cognoscenti. Since launching the Union Square CafÃ© in 1985, he has consistently been on the forefront of restaurant trends, propelling him to the role of industry statesman.

It is also a campaign years in the making, dating back to Meyer's partnership at Gramercy Tavern with chef...

Click here to read Randy Schwimmer's MidPoints column in the latest issue of Middle Market Growth magazine.

on duration risk, which could put a damper on returns, should yields start rising in earnest.

Duration is the average time it takes until all the cash flows from a bond are paid. The modified duration, a variant that measure which tracks the price sensitivity of a bond given a change in yield, has been steadily rising for over a decade, but the recent lows seen in European and US government bond yields means that this key risk metric is now hovering near record highs for both asset classes.

The latest duration of the Markit iBoxx € Sovereign is now 7.22 years, just shy of the all-time high 7.32 set in November of last year. US treasuries' duration, as gauged by the Markit iBoxx $ Treasuries, is slightly lower at 6.2 years - representing an all-time high for the asset class. Both measures stood at less than five years at the start of 2000, before the recent decade long slump in yields.

Another way to quantify duration risk is to look at the change in underlying yield which would wipe out the index's yearly income, gauged by forward yield. At the start of the last decade it would have taken more than 100bps of yield rises to wipe out the expected yearly income in both asset classes. That number has since fallen to 30bps in US treasuries and a meagre 13bps in eurozone sovereigns.

This means that a once unthinkable phenomenon is now increasingly likely. In fact the last 12 months have seen five months in which the yield of the iBoxx € Sovereigns index moved by a large enough extent over the course of a single month to wipe out its entire yearly expected income. The iBoxx $ Treasuries is also entering this territory, as a repeat of the 31bps rise in its yield experienced last February would wipe out the 1.88% forward yield it currently delivers.

Essentially, the current low yielding environment means that bond returns are increasingly dictated by macro events such as announced and expected changes in monetary policy, rather than the yields delivered by holding bonds over time. With this in mind it's not hard to see why some have likened bond investing to "picking up pennies in front of a steamroller"

This phenomenon has also been driven by investors seeking extra yields further down the yield curve. Long term government bond ETFs, which have seen a record $4bn of inflows so far this quarter, hold much more duration risk than their shorted dated peer, as the yearly yield shift required to wipe out the income delivered by the iBoxx $ Treasuries 10Y+ index is 15.7bps - roughly half that of the overall index.

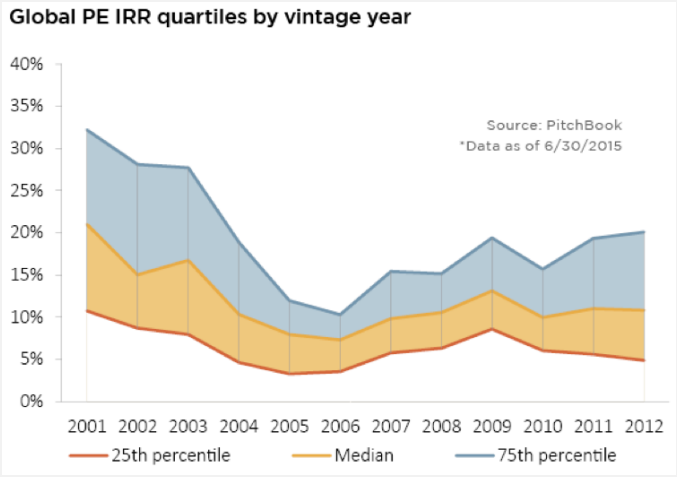
Long dated eurozone sovereign bonds are arguably the most exposed to duration risk, as a 10.8bps rise in the yield of the iBoxx € Sovereigns 10+ index would wipe out the entire 1.5% which an investors stands to yield in the next 12 months.

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THE PULSE OF PRIVATE EQUITY

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PitchBook
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How Will Competition Among Fund Managers Affect Future Industry Performance Disparity?

Post-recession private equity funds experienced a tightening of IRR spreads across several different vintages, as fund managers of all tiers weathered the economic downturn. 2010 and more recent vintages, however, have seen a widening of the spread. This is partially attributable to how intense the dealmaking environment has been as of late, as well as a consequent delay in deployment, which in turn has depressed IRRs of certain recent vehicles. But how much further could these spreads widen in the coming years? Given the preponderance of capital overhang in the PE industry, as well as the sheer number of firms competing to put that overhang to work, it's reasonable to expect a fairly sizable disparity in performance going forward, although if the healthy seller's market persists, then all quartiles may shift upward by a minute degree. The timing of such shifts, however, is likely to be prolonged. The level of competition is unlikely to slack, armed as general partners are with plenty of dry powder, and as uncertainty around prospective economic growth continues unabated, sustained quantitative easing may well keep asset prices at relatively high levels. These factors combined will discourage substantial investment levels, leaving only top-tier performers with strong track records and ample supplies of dry powder able to win competitive auctions and, moreover, exit at robust multiples, while broad swathes of the PE investor population may well see delays in their pace of investing and selling. Accordingly, the spread of performance is likely to remain wide for some time, until more recent vehicles are able to deploy capital in ever-more specialized strategies and potentially experience short-term upticks in IRR performance. Perhaps then, as time wends on, the performance gap will shrink somewhat, with general IRR quartiles tightening, much as seen in vintages prior to 2010.

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SELECT DEALS IN THE MARKET

Deal	Arranger	Sponsor	Industry	Facility*	Spread	LIB Flr	OID	Rating
Alpha Media (2)	Citizens	Stephens Group	Services & Leasing	265	600	100	95	B/B2
Edgewood Partners (2)	JPM	Carlyle Group	Insurance	200	600-625	100	98	B/B3
Imagine! Print Solutions (1)	RBC	Oak Hill Capital	Printing & Publishin	320	600-625	100	97	B/B2
Lago Resort & Casino (1L)(4)	CS	Peninsula Pacific	Gaming & Hotel	225	950	100	98	B-/B3
Lago Resort & Casino (2L)(3)	CS	Peninsula Pacific	Gaming & Hotel	85	N/A	100	97.25	B-/B3
MedRisk (1)	Antares	TA Associates	Healthcare	202.5	525	100	99	B/B2
Vivid Seats Ltd (1)	RBC	Vista Equity	Film	253	600	100	93	B/B3
Averages				**222**	**669**	**100**	**97**	

* 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

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