THE Lead Left

The Premier Middle Market Newsletter

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Week of September 8, 2014

Innovate This!

This first appeared in Middle Market Growth, the official publication of ACG. Randy Schwimmer's column, MidPoints, is a regular feature there. You can read MMG by clicking on this link.

Who invented the airplane? Depends what you mean by "invent."

"Birdmen," a new book by historian Lawrence Goldstone, describes how the Wright Brothers became so obsessed with litigating competitors, they neglected critical flight design improvements that would have ensured success. Others forged ahead with better models, draining the Wrights of their resources and sending Wilbur to an early grave.

Successful innovation isn't just about getting there first. It's about meeting market demand. History is replete with other examples- TV, the polio vaccine, the personal computer-of inventors failing to grasp basic business precepts and being overtaken by more nimble follow-on rivals.

Founder-led companies tend toward less bureaucracy, creating easier environments for new product launches. Once customer demand is established, however, sponsors or strategics can provide capital and processes for future growth.

But how do you fan the flame of innovation at those portfolio companies or corporate subsidiaries once they're part of more rigid hierarchies? One veteran PE partner, who specializes in consumer brands, told me he asks his management team two questions:

1. What problem are you trying to solve; and 2. Do consumers actually want it?

QUOTE OF THE WEEK

"We are in different economic cycles with opposite direction in interest rate policy between the US and the eurozone."

– Rob Waldner, chief market strategist, Invesco Fixed Income.

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Can one product be a potential game changer? "We don't take existential risk," he said. "We prefer creating an umbrella brand to house different products. That stimulates ongoing innovation. Next, we ask our entrepreneurs, 'What's holding you back?' We take from their plates anything that distracts from the creative process."

Can innovation be measured? "We implement key performance indicators to track how each product is doing," the partner said. "That grounds innovation in reality, and the feedback drives continuous improvement. Innovation becomes an iterative process."

Another top investor agreed: "Find out what percent of revenue comes from new products," he suggested. "Too high a number creates too much volatility; too low risks lower growth." So what's the difference between true innovation and good old-fashioned product development? "Everyone innovates!" the investor said. "Otherwise they'd be left behind."

"Right now, the buzz word is 'tech-nabled,'" one IT-focused partner reported. "Anything with that label is getting higher multiples. But we look closer to see if that's really driving revenues, new customers or efficiencies. Otherwise, you're overpaying.

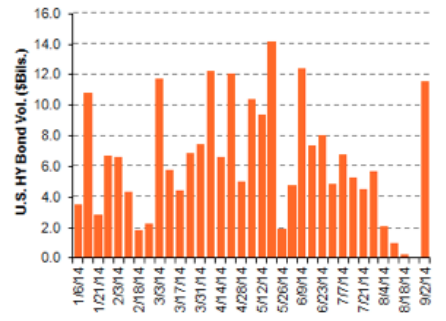
"Innovation isn't always coming up with something new," he continued. "Sometimes it's looking at the obvious in a new way. How many apples fell in the history of the world before Isaac Newton had his aha moment? And he didn't have to invent the apple!"

No, Steve Jobs did that.

CHART OF THE WEEK

Libor Day

Pent-up demand post-Labor Day drove high-yield volume to its best week since early June. Year-to-date issuance is $208.8 billion - squeaking by last year's $206.1 billion.



Source: Thomson Reuters

THE LEAD LEFT SPOTLIGHT

This week we conclude our conversation with Stephen Lewis, founder, Cross Border Strategies LLC. His firm provides advice to global middle market companies as they structure transactions internationally and assists those companies in sourcing the necessary financing.

Second of two parts - View part one

The Lead Left: *Steve, last week we discussed how it's easier for European companies to do cross-border business there. There's also less ground to cover.*

Stephen Lewis: By definition, expansion in the European middle market includes doing business in someone else's backyard. But because of higher capital requirements and hits to hurdle rates, it's tough to find bank financing. Due to new regulation post-crises, the availability of Leveraged loans from banks has tightened up.

TLL: *What about alternative lenders as*

STAT OF THE WEEK

	August 2014	May 2012	Mar 1992	June 1962
US Milk Price ($/cwt)	23.70	16.20	12.50	3.72

Source: USDA

LOAN STATS AT A GLANCE

Provided by:

STANDARD & POOR'S Leveraged Commentary & Data

	This Week	Last Week	6MO Ago	YR Ago
New-Issue Clearing Yields				
$200M or less	7.07%	7.69%	6.30%	6.18%
$201M - $350M	6.08%	6.59%	5.24%	6.16%
$351M - $500M	6.01%	6.35%	5.01%	5.62%
$501M+	5.19%	5.17%	4.49%	4.83%
Middle market (≤ $50M)	6.26%	6.21%	6.49%	5.46%
Large corporate (> $50M)	5.39%	5.32%	4.66%	5.23%
Large corporate single-B (> $50M)	5.40%	5.35%	4.84%	5.37%
Middle Market Credit Stats				
Sr/EBITDA	4.7	4.7	5.1	5.9
Debt/EBITDA	4.9	4.8	5.1	5.9
Middle Market Index Data				
Monthly Returns	0.11%	0.20%	0.16%	0.05%
Average Bid	98.32	98.40	99.38	98.96

Source: S&P Capital IQ

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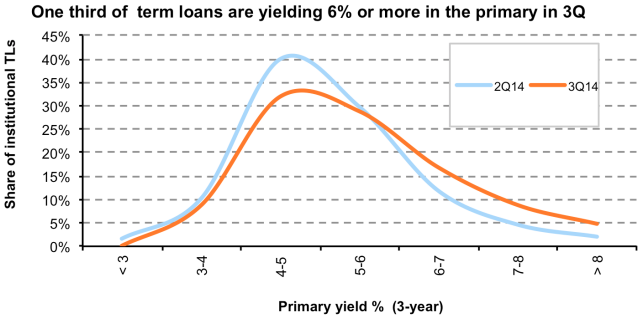
LEVERAGE LOAN INSIGHT & ANALYSIS

Provided by:

THOMSON REUTERS



Source: Thomson Reuters LPC

The average yield assuming a three year term to repayment, on first-lien institutional tranches is at 5.56 percent so far in 3Q14, up from 5.17 percent in 2Q14. Moreover, 30 percent of first-lien term

financing sources?

SL: Unlike the US, where banks' share of leveraged loans has been around to 20% historically, the reverse has been true in Europe where banks have predominated. That's changing. Alternative lenders there realize they have to lend money cross-border and take security. To do that, they either have to have the regulatory authority to lend cross border or work with someone who does. This process is called "passporting."

"We're at an unfair disadvantage. Double taxation prevents US corporations from repatriating overseas cash."

***TLL:** What does that involve?*

SL: Prior to the creation of the European Union, it was very difficult for a lending institution in one country to lend in another country. With the European Union and the subsequent implementation of the euro, the landscape changes such that if you had a license to lend in one EU country, you were allowed to "passport" your license to another EU country to serve the needs of your client. What that means for non-bank, non-licensed lenders is that they need to partner with a licensed bank, often referred to as a "clearing bank" . local to lend money in another jurisdiction. Those domestic institutions are happy to assist other firms and grow their fee business.

***TLL:** Steve, could you address the issue of corporate inversions, which seems to be a hot button now.*

SL: What's now called "inversions" has been going on a long time. In the late '90's, the first question any M&A advisor would ask in a merger with a European entity is: Can you create a holdco that lowers the tax rate of the enterprise? Luxembourg-based companies were common, for example.

***TLL:** But not necessarily moving the headquarters out of the US. That's the politically sensitive issue.*

SL: That's why this spate of mergers is attracting attention. Inversion is merely an extension of what's been going on for years. Cross-border M&A always has involved elaborate analysis of the ways to minimize the overall tax rate of the global enterprise. No less a scholar than former Supreme Court Justice Learned Hand once said, "...anyone may arrange his affairs so that his taxes shall be as low as possible." In seeking to move corporate headquarters outside the US, more companies are following that

loans have priced at a yield of 6 percent or above, up from 18 percent last quarter. Meanwhile, 41 percent of the deals have a yield of less than 5 percent, down from 52 percent in 2Q14. The shift came as the loan market reacted to global volatility and investors took a step back. In August a few deals were postponed and many had to sweeten terms before crossing the finish line. Twenty three first-lien institutional term loans flexed up in August, surpassing this year's previous record of 22 upward flexes in both April and May. In contrast, only 5 deals were flexed down. In turn upward price flexes outnumbered downward price flexes by 4.6:1. This is a complete reversal of the trends seen in the loan market in the past few years. On a cumulative basis, downward price revisions have exceeded upward price flexes by 2.1:1 since January 2012. Underliers

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MARKIT RECAP

Provided by:

markit

Argentina's interminable struggle with bondholders continues, but at least one element of the saga has reached a resolution. The credit event auction was held on September 3, and the final price was determined as 39.5. As we can see from the chart, this was in line with market expectations. Markit's composite recovery rate was around 40% in the days prior to the auction.

However, the chart also shows that the market had a different view only weeks before the settlement. Until the end of June, the consensus recovery rate was about 25%, the standard assumption for emerging market CDS. It then started to increase as it became clear that a near-term default was a real possibility. By the time Argentina's bondholders failed to receive their payments on July 30, the sovereign's recovery rate

principle.

***TLL:** And if the company is public, it will command more attention.*

SL: If it's private, where's the noise? Deals like AstraZeneca and Walgreens are high profile. But if I'm a public shareholder, I'm happy! The value of my shares goes up. That's anti-American? Really?

***TLL:** Take an example.*

SL: Let's say Abbott Labs wants to do an inversion. The combined entity pays lower taxes, provides more cash flow, and thus more jobs. Nothing else changes at the US level. The consumer benefits as well.

***TLL:** Does the reverse happen? Merged companies moving to the US?*

SL: Of course, but no one pays attention to that. I don't think anyone knows the tax revenue loss, or if it's offset by gains from new jobs, or higher capital gain taxes. It's probably a fraction of what they're worried about. The real problem is the tax code. The focus should be on real growth and eliminating the tax disadvantages US companies face when compared to their competitors based elsewhere.

***TLL:** Instead of worried about everyone moving to Switzerland?*

SL: While the goal is to lower the tax rate, there are always complications. If you move to Switzerland, you're subject to Swiss law. All corporate governance laws there now apply. For example, generally speaking US companies can provide cross corporate guarantees to help members of the corporate group obtain financing. You can't do that in Switzerland. There may be other impairments to executing a long-term strategy. And directors may become liable for the debts under certain circumstances if the company becomes or teeters on the brink of insolvency.

***TLL:** You mention our tax code. Any chance that gets addressed in our lifetime?*

SL: It's a fundamental problem. And not just for big companies. It trickles down to cash going into the economy, and more jobs. We need to level the playing field with the other major global economies. We're at an unfair disadvantage. Double taxation prevents US corporations from repatriating overseas cash. That's where the tax code is particularly disincentivizing. It makes zero sense!

***TLL:** Let's close with our standard final question, Steve. What's been your biggest surprise?*

was 45%. It then declined to 40% as the auction came into view.

Much of the volatility was due to uncertainty around which bonds were deliverable, particularly notes denominated in Yen. ISDA initially declared that the Yen bonds wouldn't be deliverable because of a dearth of necessary documentation. This decision was subsequently reversed when the prospectus was produced, but that wasn't the end of the matter as ISDA's ruling was challenged.

It was eventually resolved with ISDA deciding that Yen par bonds would be deliverable, but the delay to the auction and the uncertainty over the deliverability of the Yen bonds no doubt caused fluctuations in the composite recovery rate.

The 39.5 final price may have been in line with market expectations, but it seems likely that the Yen bond had an influence on the settlement level. There was significant net buy interest in the first round of the auction, and someone may well have ended up buying a Yen bond at 39.5 that was trading at around 24 before the auction.

Argentina will probably fade from view for most investors, though the country's problems with its bondholders will surely extend into next year. The focus for the broader market was the ECB, and its surprise decision to cut rates even further. The central bank also announced a bond purchase programmes for ABS and covered bonds, which some are calling "private QE".

The ECB is aiming to increase the size of its balance sheet from the current €2 trillion to €3 trillion, its magnitude back at the beginning of 2012. Whether the combination of bond purchases and the impending TLTROs is capable of achieving this is debateable, which leaves the question of will the ECB eventually take the step of buying government bonds. There are considerable legal and political obstacles to this policy, notably in Germany, and there are differing views on the ECB's intentions.

Nonetheless, the markets welcomed the prospect of a massive liquidity injection. The Markit iTraxx Europe tightened to 55.25bps, and traded through the Markit CDX.NA.IG (57bps). Apart from a brief period in June, this was the first time that the indices had reversed their typical positions since May 2010. Given the differing trajectories of US and European monetary policy, this trend could accelerate over the rest of the year.

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THE PULSE OF PRIVATE EQUITY

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SL: Not so much a surprise, as an observation. The combined European GDP is about equal to the US GDP, at $17 trillion. We know that middle market companies drive much of the growth here, but smaller companies may actually be bigger contributors to the European economies. With financing options more limited there, it seems to me there's a huge opportunity to provide capital to those companies.

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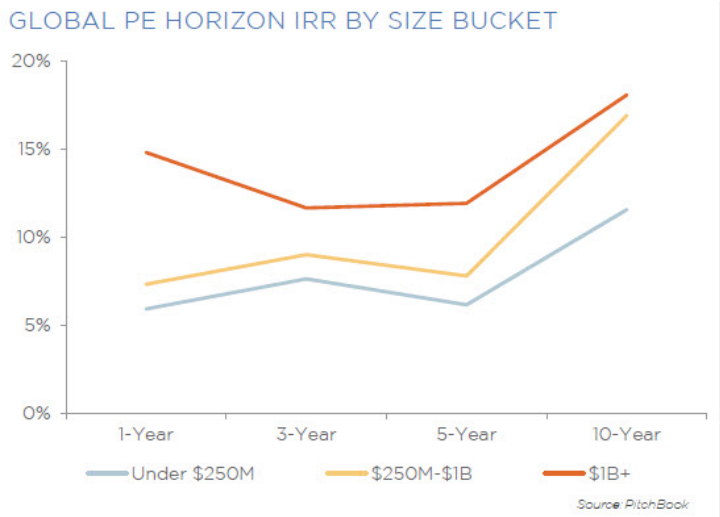

Going back several quarters, larger PE funds have performed better than smaller funds, generally speaking. Funds of at least $1 billion outpaced smaller size buckets across the 1-, 3-, 5- and 10-year IRR horizons through 4Q 2013, which was also the case in the previous quarter. What's interesting is that, despite the relative underperformance of smaller PE funds, LPs have begun to shift more toward middle-market and lower-middle-market funds over the last few quarters. Through 1H 2014, 37% of all fund closings this year have been for sub-$100 million funds, compared to just 25% in 2008. The outperformance of larger funds have made smaller vehicles look less competitive and less expensive than larger funds, particularly given the valuations at the upper end of the market.

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Mark your calendar now for the Commercial Finance Association's Cross-Border Lending Summit: Wednesday, September 10, 2014.

CFA's Summit will bring together an international roster of commercial finance leaders who will explain the essentials of cross-border lending.

Industry thought leaders will explore the latest trends, best practices, risks, legal issues and operational concerns. Q&A sessions will be included so attendees will be able to get answers to their cross-border lending questions.

Session topics include:

- Impact of international asset-based lending on the domestic market - why you need to think about cross-border lending
- How global credit facilities are constructed (the co-lender's perspective)
- Syndication issues in cross-border lending
- Operational issues
- Due diligence essentials for global transactions
- The other side of the coin: practical strategies for cross-border workouts and insolvencies

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Deal	Arranger	Sponsor	Industry	Facility*	Spread	LIB Flr	OID	Rating
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Clarity Telecom (1)	GE	Pamlico	Telecom	95	425	100	99.5	NR/NR
Datapipe Inc (1L)(2)(AO)	MS	ABRY Partners	Computers & Electron	32.5	425	100	98	B/B3
Datapipe Inc (2L)(1)(AO)	MS	ABRY Partners	Computers & Electron	30	750	100	98	B/B3
Element Materials (1)(CL)	RBC	3i plc	Services & Leasing	285	425	100	99.5	B/B2
Energy Services Holdings (2)	Key Bank	Cadent Energy	Oil & Gas	125	550	100	99	B/B3
EP Minerals (1L)(2)	BMO	Golden Gate	Metals & Mining	180	450	100	99.5	B/B3
EP Minerals (2L)(3)	BMO	Golden Gate	Metals & Mining	70	750	100	98.5	B/B3
Expera Specialty Solutions (D)	BOA	KPS Capital	Forest Product	195	NA			B/B3
Hardware Holdings (2)	Barclays	Littlejohn	Building Materials	155	575-600	100	99	NR/Caa1
Ignite Restaurant Group	CS	J.H. Whitney	Restaurants	165	700	100	98.5	NR/NR
MSX International (2)	RBC	Court Square	Services & Leasing	220	500	100	99	NR/NR
Nielsen & Bainbridge (1L)(2)	GE	Kohlberg & Co.	Home Furnishings	200	500	100	99	B/B2
Nielsen & Bainbridge (2L)(5)	GE	Kohlberg & Co.	Home Furnishings	90	925	100	98.5	B/B2
Safe-Guard Products (2)	CS	Goldman Sachs	Insurance	210	525	100	99	B/B3
The Engine Group (1)	BNP	Lake Capital	Services & Leasing	88	500	100	99	NR/NR
Averages				**144**	**580**	**102**	**99**	

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

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