THE Lead Left

The Premier Middle Market Newsletter

The New Wave

Maybe it was the high caliber attendees and top-notch panels. Could have been the stellar master of ceremonies and sponsor. Whatever the reason, the Wells Fargo Middle Market BDC CEO Forum may have breathed new life into the leveraged loan industry.

Led by Jonathan Bock, this gathering of gurus spent the day discussing the role of business development companies and what's needed to take the sector to the next level.

Readers of *The Lead Left* who have followed our BDC series over the past five weeks won't be surprised to hear how those companies have infiltrated the world of leveraged loans. But at the conference, panel after panel signaled an evolutionary shift.

With banks in full retreat, CLOs under risk retention pressure, and loan mutual funds fixated on rate expectations and cash swings, BDCs are poised to go from a relatively small ($60 billion) participant, to a more significant deal player over the next decade.

But for these vehicles to become more meaningful, respected principals in leveraged lending - as CLOs for twenty years dominated the space - institutional investors and sophisticated asset managers outlined four conditions:

1. **Build scale** - Scale is tough to achieve with only one vehicle. It's also hard with a small team. Larger firms can field analysts closely covering a broader range of industries. They can also add distressed investing expertise - a critical specialty to take advantage of opportunities when the next downturn comes.
2. **Originate senior yield assets** - There's a big difference between flow names and yield names. Unlike loan mutual funds, which buy when they have cash and sell when they need cash, BDCs invest in middle market loans. You can't find these assets on a Bloomberg screen. It takes close relationships with sponsors, lenders, and investment banks to generate good yielding deal flow.
3. **Focus on collateral value** - Maintaining superior credit performance on its portfolio of loans is just about the whole ballgame for a BDC manager. Middle market vehicles are not

QUOTE OF THE WEEK

"If the US middle market was a separate country, it would be the world's fifth largest economy by GDP after Japan."

– Kevin Burke, Senior Managing Director, GE Capital Markets.

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trading platforms. They don't underwrite, then sell to zero. They own and build assets to perform through any cycle. That's not easy now, given where we seem to be in this cycle. One middle market veteran pointed out, however, that while leverage is back to pre-crisis heights, it's off a lower ebitda trajectory (*Chart of the Week*).

4. **Manage for shareholders** - Investors in publicly traded BDCs always look for relative value. That means managers need to demonstrate asset growth, higher earnings, and sufficient dividend yield to compete for retail dollars. Successfully meeting those goals (a likely outcome of accomplishing goals #1-3 above) will mean BDCs can match other public alternatives; namely, high-yield funds, REITs, MLPs, and mutual funds.

It will take time to see whether the genuine thought leadership displayed at the conference this week translates to constructive behavior by the broader set of BDC participants. Given the opportunities presented by the changing demand dynamics in the leveraged loan market, the rewards certainly seem worth it.

Click here for "The Case for Senior Secured First Lien Loans" as presented by Kevin Burke at the Wells Fargo Middle Market BDC CEO Forum.



THE LEAD LEFT SPOTLIGHT

This week we speak with Bob Jesenik, CEO, Aequitas Capital. Aequitas provide access to private credit and equity capital along with industry-specific operational expertise in healthcare, education and financial services. The company is headquartered in OR with offices in NY, CA, FLA.

The Lead Left: *Bob, tell our readers about your firm.*

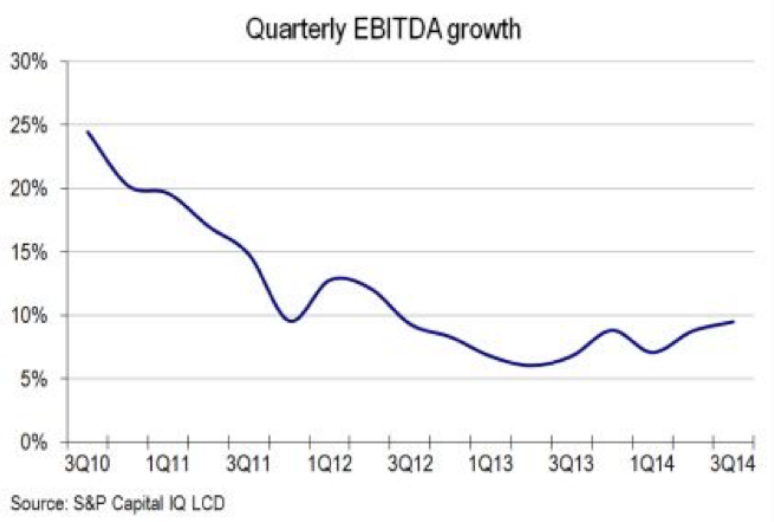
Bob Jesenik: Thanks, Randy. I co-founded Aequitas back in 1993 and we were probably ahead of our time then, as we were very focused on private credit and really helping middle market companies raise debt and equity capital. Specifically we were looking in areas that were not well served by in traditional banking solutions. Early on our roots were working in the commercial finance space, for example working with institutional investors like insurance companies to provide private credit to our clients. Fast forward, we made it through the dot com cycle and 2008 doing the same thing.

TLL: *No small feat.*

CHART OF THE WEEK

Yearnings for Earnings

Reported cash flow growth from publicly filing leveraged loan issuers is improving, but off from immediate post-crisis period.



STAT OF THE WEEK

	Nov 2014	Nov 2013	May 2012	Jan 2011
China House Prices Change (YoY)	-2.6%	9.90%	-1.50%	5.9%

Source: National Bureau of Statistics of China

BJ: And since 2008 we've seen that the world seems to be much more focused on yield and safety and we feel that private credit is an optimal solution for the needs in the marketplace. Today, we're primarily on the origination side investing private credit and private equity into three sectors: healthcare, education, and financial services. We leverage this expertise to offer innovative solutions, and are expanding our offerings all the time.

"Specialty finance to us means working in small business lending and consumer lending, or helping large corporations finance their customers."

TLL: *Talk more about how you do that?*

BJ: We've seen some trends in the market since 08 and one is the desire for alternatives in general and secondarily supporting advisors to equip and educate themselves to include appropriate alternative investments in their client's portfolios. We are also building out a best-in-class alternative asset management platform that will be made available to our clients who are RIAs [Registered Investment Advisors] and wealth managers.

TLL: *I noticed on your website [link] you have something called Aequitas Capital Partners.*

BJ: Yes, that is part of the wealth management platform that we are building out. That's the business we've created as a membership network for RIAs to provide training and education around alternative investments, as well as access to unique alternative products and growth capital.

TLL: *What's the breakout between your advisory revenues and investment income?*

BJ: The majority is origination from investment management business as our wealth management platform was just recently launched. We have just under $1 billion in AUM.

TLL: *How much equity vs. debt investments?*

BJ: It's probably 75% credit and 25% equity. On the credit side, we have a specialty

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	6.90%	7.11%	6.01%	6.50%
$201M - $350M	6.27%	6.26%	5.58%	5.70%
$351M - $500M	6.45%	6.61%	5.34%	4.60%
$501M+	5.40%	5.34%	4.85%	4.64%
Middle market (≤ $50M)	6.33%	6.64%	5.75%	6.10%
Large corporate (> $50M)	5.81%	5.75%	5.14%	5.00%
Large corporate single-B (> $50M)	6.06%	5.92%	5.25%	5.20%
Middle Market Credit Stats				
Sr/EBITDA	4.9	4.9	5.2	4.5
Debt/EBITDA	4.9	4.9	5.2	4.7
Middle Market Index Data				
Monthly Returns	-0.31%	-0.18%	0.36%	0.32%
Average Bid	95.92	96.42	98.80	99.42

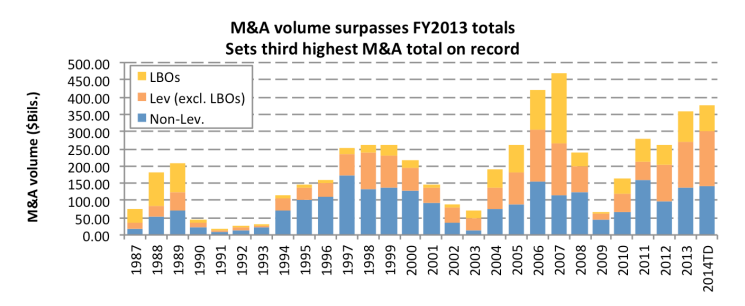
Source: S&P Capital IQ

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LEVERAGE LOAN INSIGHT & ANALYSIS

Provided by:

THOMSON REUTERS



Source: **Thomson Reuters LPC**

With just under $380 billion of loan issuance having been completed so far in 2014 and over $20 billion of additional volume in the pipeline, M&A issuance to date already exceeds full year 2013 totals, marking the third highest total on record (behind 2006 and 2007). Year to date, high grade M&A lending at over $142 billion of syndicated issuance (nearly $15 billion of additional deal flow is working its way through the market) represents the highest total since full year 2006 ($155.7 billion) while leveraged M&A lending at nearly $235 billion already exceeds full year 2006 totals (although still off from 2007 record levels). And there is little to suggest of any near term slow down. Most recently, Actavis Plc announced a jumbo $66 billion acquisition of Allergen Inc which includes nearly $46 billion in term and bridge debt. The Actavis deal follows briskly on the heels of Halliburton's announcement of a fully committed financing backing its $34.6 billion takeover of Baker Hughes. In the leveraged space, corporate issuers have been the backbone of M&A

finance focus as well as private credit itself. Specialty finance to us means working in small business lending and consumer lending, or helping large corporations finance their customers.

TLL: *How about a couple examples?*

BJ: In healthcare we are providing credit to patients in hospitals. We also have a portfolio company that has a motorcycle leasing business. We are able to be a unique partner providing both specialty finance and equity to these firms. On the private credit side we support corporate lending, real estate, to provide bridge financing, mezzanine, and senior secured lending. Our focus is on unique and more structured offerings.

TLL: *Where does your capital come from?*

BJ: We distribute through our RIA channel. Also institutional clients who allocate their capital with us. We are an investment manager.

TLL: *Obviously, yield is important, but what else is going on in investors' heads?*

BJ: We're seeing a real demand for safe yield and thoughtfulness around liquidity terms. Given where the stock market is, their focus is on uncorrelated assets in their portfolio. So its less about yield, more about liquidity terms right now.

TLL: *What assets are considered uncorrelated?*

BJ: For example, advisors have allocated into private REITs to get yield and those come with six to seven year lock ups but are now getting the same yield from us with one to two year locks which is a significant improvement on the liquidity front. We have vehicles with different options tailored to our clients' needs.

To be continued the week of November 24

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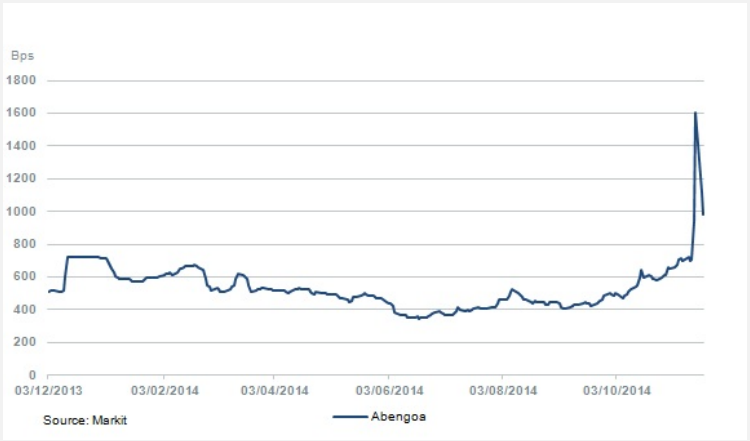
lending. At roughly $157 billion so far, leveraged M&A volume (exclusive of sponsor backed LBOs) exceed full year totals for each of 2006 ($152 billion) and 2007 ($151 billion) to set a new record. In contrast, leveraged buyouts have been qualified. Currently buyout financing for the year is shy of $80 billion - down from last year's total. Underliers

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MARKIT RECAP

Provided by:

markit



We've commented in recent weeks on volatility, but it's been mainly a macro phenomenon. Geopolitics, Ebola and uncertainty over monetary policy have all contributed to spread oscillations.

But a little known Spanish renewable energy company provided the market with a welcome single-name credit story. Abengoa, an entrant to the Markit iTraxx Crossover index in March this year, saw it spreads widen dramatically after it revealed that €630 million in green bonds were classified as non-recourse, which ran contrary to the consensus understanding among investors. This clearly had serious negative implications for Abengoa's balance sheet, and the market responded accordingly. The company's spreads widened from just over 700bps on November 12 to 1,600bps, or 31 points upfront, only two days later, and the inversion of the credit curve signalled that Abengoa was now firmly in distressed territory.

However, by November 18 the company's spreads were back below 1000bps. The rebound was due to Abengoa clarifying that the green bonds were guaranteed by the company and have the same security as other recourse debt. In addition, Abengoa announced a €600bn bond buyback, news that is usually well received by credit investors.

Nonetheless, the debacle raises serious questions about the company's management, in particular its communications strategy. The lack of clarity surrounding the firm's capital structure could result in investors attaching an additional risk premium, and we could see more volatility on this name in the future.

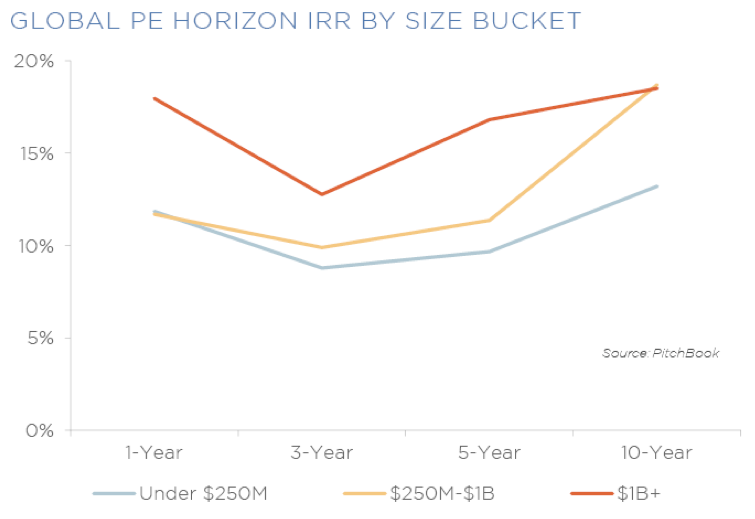
Elsewhere, the CDS market was relatively stable, with spreads trading in a comparatively tight range. Ukraine and Russia saw their spreads continue to widen amid risk of escalation in the conflict and the possibility of further sanctions down the line. Japan's CDS also lost ground after the country's poor growth figures and Prime Minister Abe's decision to call a snap election. The sovereign was quoted at 58bps, its widest level for over a year.

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THE PULSE OF PRIVATE EQUITY

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Bigger is Better in PE, but For How Long?

Bigger is still better in the global PE industry. Funds managing at least $1 billion are outpacing the $250 million--$1 billion and sub-$250 million size buckets at the 1-, 3-, 5- and 10-year IRR horizons, by significant margins in some cases. At the lower end of the spectrum, sub-$250 million funds are underperforming both larger size buckets at each horizon, and by about 5% at the 10-year horizon.

It will be interesting to see what effect, if any, the increased amount of LP commitments going into the lower middle market will have on those numbers. LPs have shifted their attention recently to middle-market and lower-middle-market funds, spurred in part by the competition and expenses incurred at the upper end of the market. They must be looking past the performance of sub-$250 million funds in recent years, which have historically trailed their larger counterparts. LPs may be betting that 2013 and 2014 vintages will fare better in the deal-making environment over the next few years, as smaller transactions in niche markets are more abundant and less pricy than bigger, bread-and-butter buyouts.

MIDDLE MARKET Growth

You'll Want to Read This Column-Trust Us

From prehistoric times until 2003, humans cumulatively created five exabytes of data. That's five billion gigabytes. We now produce that much information every 48 hours. We send out 100 million emails every minute. Bombarded by this blizzard of bytes, we can't possibly manage it coherently. What to do?

Welcome to the era of curation. Like museum curators, custodians of wisdom and taste guide you to smart decisions about what to read, what to wear and what to buy-all saving you time and money. Just trust our judgment, they tell us.

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

For LPs looking to remain exposed to the biggest funds in the market, past returns data looks positive. But IRRs for the largest PE funds may soften as future returns are released; GPs managing $1 billion+ funds have been lamenting this year that the current market isn't helpful to strong deal flow. The most recent vintages for $1 billion+ funds have had to sideline themselves in recent quarters, which will have an effect on their IRRs down the road. Time is money, after all.

Download 4Q 2014 U.S. Private Equity Breakdown Report

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SELECT DEALS IN THE MARKET

Deal	Arranger	Sponsor	Industry	Facility*	Spread	LIB Flr	OID	Rating
Abaco Energy Technology	DB	Riverstone	Services & Leasing	175	575	100	99	B-/B3
Affordable Care (AO)	GE	ACAS	Healthcare	60				NR/NR
American Residential Services (AO)	Key Bank	Charlesbank Capital	Building Materials	40	450	100	99-99.25	B/B3
Bluestem Brands (2)	CS	Centerbridge Partners	Retail	300	750	100	96	B/B2
Creganna-Tactx Medical (1L)(CL)(1)	RBC	Permira	Healthcare	185	450-475	100	99	B/B2
Creganna-Tactx Medical (2L)(3)	RBC	Permira	Healthcare	90	825-850	100	98.5	B/B2
Emcore Photovoltaics (1)	Citizens	Veritas Capital	Computers & Electroni	57.5	450-475	100	99	NR/NR
HealthPort Technologies (CL)(1)	CS	New Mountain	Computers & Electroni	325	550	100	99	B/B2
Independence Contract Drilling	CIT Group	Lime Rock	Oil & Gas					NR/NR
NAVEX (1L)(CL)(1)	GE	Vista Equity	Computers & Electroni	200	450-475	100	99	B-/B3
NAVEX (2L)(3)	GE	Vista Equity	Computers & Electroni	90	825	100	98.5	B-/B3
Novetta Solutions	SocGen	Arlington Capital	Computers & Electroni	140	475-500	100	99	NR/NR
PSC Industrial Outsourcing (1L) (1)	BNP	Littlejohn & Co	Environmental	180	450-475	100	99	NR/NR
PSC Industrial Outsourcing (2L) (3)	BNP	Littlejohn & Co	Environmental	45	825-850	100	98	NR/NR
Summit Research Labs	Citizen	One Rock	Chemicals	80	450-475	100	99	NR/NR
Unitek Global Services	N/A	HM Capital	Building Materials	43	850	100		NR/NR
Unite Private Networks	SunTrust	Ridgemont Equity	Telecom	85	450	100	99	NR/NR
Unite Private Networks	SunTrust	Ridgemont Equity	Telecom	47.5	775-800	100	98.5	NR/NR
US LBM Holdings (4)	CS	BlackEagle	Building Materials	150	700	100	98	NR/NR
Averages				151	630	100	99	

* 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) 102/101
(4) 102/101.5/101

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

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