

What's Ahead for 2015? (Part Two)

One of the enduring mysteries of life, other than the fact that Kanye West is Bruce Jenner's son-in-law, is getting a handle on deal supply in the leveraged loan markets.

By the numbers, the forward institutional pipeline has been drifting south since Labor Day. According to S&P Capital IQ, last week's calendar stood at \$40 billion, up slightly from the \$35 billion low point at Halloween.

Actual institutional loan volume is up to \$400 billion, per Thomson Reuters LPC, with full year numbers close to \$500 billion. Impressive, but well short of last year's \$639 billion.

M&A stats generally also point to very healthy flow. Global volume has topped \$3.2 trillion (Dealogic); the best performance since 2007, and significantly ahead of 2013. The same holds true for financial sponsor-related activity. YTD 2014 volume is just shy of \$700 billion; again, best in seven years.

Digging into the PE flow a bit more, PitchBook reports 440 US deals, with sponsor investments of \$91 billion, have hit the market this quarter alone. But that's way off the 784 mark (\$163 billion) recorded for the comparable 2013 quarter.

Whatever the reason - intimidating purchase price multiples, absent tax motivation, competition from corporates with cash - it's not for lack of funds. Sponsors raised \$127 billion through 3Q this year; not shabby, though likely not headed for 2013's \$230 billion.

These trends have been echoed in the middle market, though overall activity has been even more subdued of late. Smaller institutional loans, measured by LPC, dropped from \$13 billion to \$10 billion to \$6.5 billion in the first three quarters of the year. 4Q is at \$4.4 billion with just a few shopping days left.

With that as a backdrop, here's our forecast on elements of deal supply for 2015:

Private Equity Fundraising: GPs always have an eye on their next fund, so we anticipate (despite less than propitious investing

QUOTE OF THE WEEK

"I think you're going to see a lot of different approaches as the market grapples with the leveraged-lending guidance."

– Jeffrey Ross, partner, Debevoise & Plimpton LLP.

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The screenshot displays a sample of the 'The Lead Left' newsletter. It features a blue header with the logo and navigation links. The main content area is divided into several sections: 'Now Where Were We?' with a paragraph of text, 'Quote of the Week' with a quote and attribution, 'Chart of the Week' showing a bar chart, and 'Loan Stats at a Glance' with a table of data. The footer includes a 'JOIN' button and contact information for Robert K. Kohn.

JOIN

conditions) they will keep hitting the road with LPs. Expect 2015 to look like 2014: we're calling for \$150 billion raised.

Private Equity Investing: Macro-economic tailwinds are strong, but so is competition for deals. Sponsors are desperate to put LP money to work, but lacking external stimuli, 1Q 2015 has little steam behind it. That'll mean playing catch-up for the rest of the year. Our forecast calls for \$450 billion; less invested by sponsors than 2014.

Leveraged Loan Volume: As our [Chart of the Week](#) depicts, there's a hole in the new loan tank. As with PE investing, we think 2015 will kick off with less than a bang. For full year middle market volume: \$40 billion - better than 2014, but well off 2013's pace. For the overall institutional market, we're calling for \$475 billion, also down from this year.

Next week: What to expect for loan pricing and structures in 2015.

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.

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State of the Capital Markets: Review and Outlook



State of the Capital Markets:
Third Quarter Review and
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THE LEAD LEFT SPOTLIGHT



This week we continue our conversation with M. Grier Eliasek, President and Chief Operating Officer of Prospect Capital Management. Prospect is a \$7+ billion AUM leading provider of flexible private debt and equity capital to sponsor and non-sponsor owned middle market companies.

Second of two parts - [View part one](#)

The Lead Left: How much do CLOs represent? What are you seeing happening with spreads?

Grier Eliasek: Of our over \$7 billion in total AUM, CLOs represents about \$1.2 billion. Our BDC is a yield animal. We get lots of repeat business on the sponsor side. But you can't be 200 bps wide of the market. Spreads have continued to decline, with such trend more acute on the smaller end of the middle market.

TLL: Interesting. I would have thought more on the larger end. How active are things right now?

GE: More lenders can hold smaller deals, increasing spread compression at smaller deal sizes. And larger companies are better credits, all other things being equal. We have invested with over 50 sponsors. This year has been a good one. We're already at around \$3 billion in gross originations. We've had about \$1.5 billion in refinancings, so we've had around \$1.5 billion in net asset growth. But our business of originations and repayments can be lumpy, so it's tough to predict from one

CHART OF THE WEEK

Leaking Oil

With no compelling reason to close deals by year-end, new loan volume has declined every month since June.



STAT OF THE WEEK

	Dec 5 2014	Jan 4 2012	Mar 3 2009	Dec 28 2004
Health Care Index	817.34	405.21	254.54	350.99

Source: S&P 500

LOAN STATS AT A GLANCE

quarter to the next.

"We have less fervor being defenders of the middle market than competitors who are talking their own book."

TLL: What about structures? Have you seen the same general loosening of terms everyone else has?

GE: There have been attempts to migrate broadly syndicated loan packages to the middle market. Middle market issuers have had less success eliminating covenants altogether compared to the broadly syndicated market. Many middle market lender facilities from banks to BDCs and private lenders require covenants for facility eligibility, so that's a limiting factor.

TLL: Plus you have all the big baskets, aside from the financial covenants.

GE: Yes, for example, builder baskets allowing dividend distributions. Some of these asks have gotten through at the larger end of the market, though in a limited fashion.

TLL: Does it feel like we're back in 2007?

GE: No, because spreads have not declined to the same levels. Interestingly, we see spreads decrease at a faster rate in the middle market than with broadly syndicated loans. The larger and more liquid loans may not have covenants, but they've stayed within the L+350-400 range. Compare that with when they were at L+200-250 in 2007.

TLL: True, although Libor was 4% back then. And there's still a middle market premium.

GE: The middle market premium has shrunk, but there will be a floor premium based on illiquidity. We have less fervor being defenders of the middle market than competitors who are talking their own book. That's why our broadly syndicated CLO business is so attractive. We're enjoying 20% returns on a cash basis with a far less than a one percent default rate. That's pretty attractive versus a 6% yield for straight middle market loans. We can pivot between middle market and broadly syndicated loans.

Provided by:



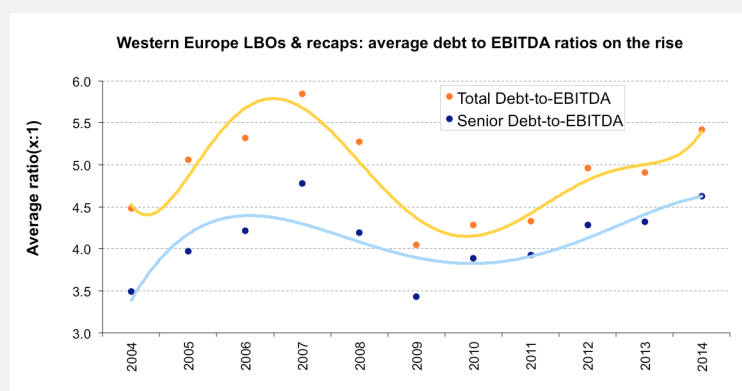
	This Week	Last Week	6MO Ago	YR Ago
New-Issue Clearing Yields				
\$200M or less	6.76%	7.04%	6.14%	6.66%
\$201M - \$350M	6.15%	6.16%	5.68%	5.64%
\$351M - \$500M	6.43%	6.31%	5.64%	5.01%
\$501M+	5.54%	5.49%	4.84%	4.58%
Middle market ($\leq$ \$50M)	6.29%	6.37%	5.95%	6.85%
Large corporate ($>$ \$50M)	5.87%	5.80%	5.35%	4.87%
Large corporate single-B ($>$ \$50M)	6.10%	6.04%	5.49%	5.07%
Middle Market Credit Stats				
Sr/EBITDA	4.2	4.7	5.3	4.2
Debt/EBITDA	4.5	4.7	5.4	4.2
Middle Market Index Data				
Monthly Returns	-0.38%	0.25%	0.23%	0.09%
Average Bid	96.32	96.77	98.86	99.38

Source: [S&P Capital IQ](#)

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LEVERAGE LOAN INSIGHT & ANALYSIS

Provided by:



Source: [Thomson Reuters LPC](#)

The trend toward higher leverage seen in the U.S. has been mirrored across the pond as private equity firms increasing their reliance on the debt markets to finance buyouts and dividend recaps. Average debt-to-EBITDA levels for LBOS and dividend recaps in Western Europe have increased in 2014 to 5.4 times for total debt-to-EBITDA and 4.6 times for senior debt-to-EBITDA, close to the highs reached in 2007 of 5.85 and 4.77, respectively. CVC Capital's €2.15 billion buyout of Spanish health care company Grupo Hospitalario Quiron was the largest buyout of the year and the most representative with leverage of 5.7 times total debt and 4.7 times senior debt. The deal with the highest leverage was EQT's €840 million buyout of Dutch information provider Bureau Van Dijk with 7.6 times total debt and 5.5 times senior debt. With the ECB keeping interest rates low for an extended period of time, private equity firms are likely to increasingly rely on the debt markets and leverage levels may remain

TLL: How much of your overall business is control related?

GE: The breakout is about 50% sponsored transactions, 20% CLOs, 25% operating and financial buyouts, and 5% other. Other includes real estate properties, aircraft leasing, and online lending to consumers and small businesses.

TLL: How big is online lending?

GE: Online lending is only about one percent of our total business, but growing rapidly. When the BDC rules were written in 1980, it was focused on small entrepreneurial companies. But it wasn't realistic to dispense \$50,000 loans to these groups. Now thanks to the internet, you can. Stay tuned to that online business. We're positioning ourselves as market leaders in that industry for the future.

TLL: Grier, what's been your biggest surprise so far this year?

GE: The degree to which regulation can impact your business. Some divide the lending world simplistically between regulated banks and non-regulated so-called "shadow banks." This description is misleading because "shadow banks" like BDCs are heavily regulated. Regulation is intense across our industry and needs to be carefully monitored. People will come to realize how many resources are needed to comply with regulations as a BDC. Roughly 50% of our headcount - including accounting, tax, and legal - is dedicated to compliance.

TLL: That's a big expense base to carry around.

GE: Large incumbent BDCs have a first mover scale advantage because they can afford the infrastructure to deal with all these growing regulations.

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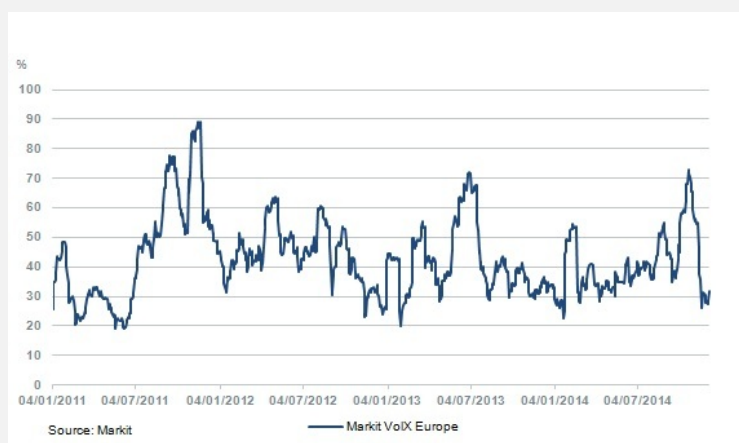
high but will they go higher than the levels seen in 2007? [Underliers](#)

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MARKIT RECAP

Provided by:

markit



Volatility was the name of the game earlier in the first-quarter as credit was swept up in the maelstrom affecting other asset classes, particularly US Treasuries and equities. The main credit indices spiked upwards and the Markit VolX Europe, which tracks realised volatility in European investment grade CDS, spiked upwards to 75%, its highest level since the taper tantrum of 2013.

But if investors expected this trend to continue into year-end then they appear to be mistaken. Spreads have recovered from the widening we saw in October, and the VolX has dropped back to 28% - a level more in keeping with the current QE dominated era. Expectations that the ECB will implement full QE (government bond purchases), probably in the first-half of this year, are surely driving the improvement. But there is considerable opposition to such a policy, particularly in Germany, and we may see volatility flare up if the legal obstacles appear insurmountable.

Other factors might also disturb the clement conditions. The price of oil continues to plummet, which creates winners and losers. A look at how sovereign CDS has performed recently shows clearly which countries are losing out. Russia's spreads breached 400bps for the first time since 2009, and Venezuela's CDS are quoted at an eye-watering 59.5 points upfront. Both countries are, of course, major exporters, and an oil price of \$65 a barrel creates serious damage on their finances.

But the huge difference in their spreads is down to the fact that Russia has considerable reserves that help it see out periods of low oil prices, while Venezuela, alas, does not. The latter country is now the worst credit in the sovereign CDS by some distance, though Ukraine (42 points

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

upfront) is catching up.

Greece has also returned to the news agenda. A snap presidential election was called, and if the government fails to get a majority it could force a general election early next year. Uncertainty about the result and the possibility of the leftist Syriza party gaining power was enough to send Greece's CDS wider. They were quoted at 31 points upfront, which is the widest level since Greece resumed trading in the CDS market back in June 2013. The sovereign is still relatively illiquid and the recent changes to the ISDA definitions mean sovereigns trade slightly wider than the previous contract. Nonetheless, it is back in the top 1000 DTCC entities, and Greece's CDS will be closely watched as the political.

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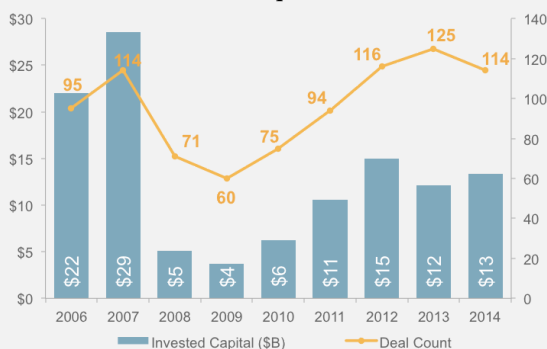
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THE PULSE OF PRIVATE EQUITY

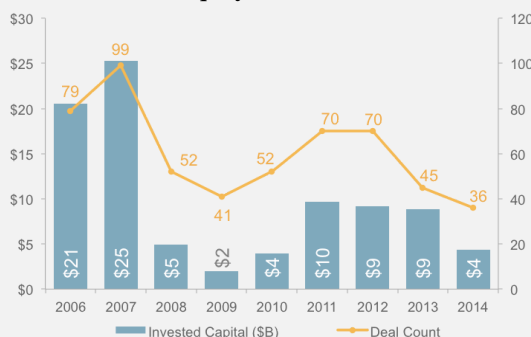
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PE and M&A Acquisitions in Retail



Private Equity Investment in Retail



Retail Wars: M&A and PE Activity Diverging

Poor consumer sentiment hasn't really dampened enthusiasm among private equity investors, which continue to target retail-focused companies. When PE targets a sector, more often than not they find a way

to get it, even if it means stretching their bids. But in the case of the retail sector, strategic buyers have gotten in the way. Notice the trend lines below, which present a stark contrast between recent M&A activity and PE investments. Combined PE and M&A activity has steadily increased since the 2008-2010 recession, hitting a post-crisis high of 125 deals in 2013 and another 114 through Thanksgiving weekend this year. Total PE and M&A value in the retail space this year has already eclipsed last year's mark, \$13.3 billion to \$12.1 billion. By itself, though, PE has struggled of late, recording just 45 of those 125 deals last year, down from 70 transactions in each of the previous two years. Year-to-date, 36 PE deals have closed totaling a meager \$4.4 billion, about a third of the combined \$13.3 billion between M&A and PE in 2014.

We mentioned in a previous Lead Left submission that strategics are outbidding PE in the consumer sector. Yes, some corners of the consumer markets are looking to PE for capital, particularly brands looking to finance their expansion plans and add new locations. On the whole, though, strategics are winning many of these options because they can balloon their bids to high levels, thanks to the synergies they're buying. In many cases, the real multiples strategics are paying are a turn or two lower than they are on paper. And however motivated PE buyers are in the retail space, they're not as hungry as strategics right now, which aren't seeing much organic growth and need to pay up for growth through M&A.

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SELECT DEALS IN THE MARKET

Deal	Arranger	Sponsor	Industry	Facility*	Spread	LIB Flr	OID	Rating
American Residential Services (AO)	Key Bank	Charlesbank Capital	Building Materials	40	450	100	99-99.25	B/B3
Creganna-Tactx Medical (1L)(CL)(1)	RBC	Permira	Healthcare	185	425	100	99.25	B/B2
Creganna-Tactx Medical (2L)(3)	RBC	Permira	Healthcare	90	800	100	99	B/B2
CRGT (1)	CS	Bridge Growth	Computers & Electroni	100	650	100	98	B-/NR
Distribution International (CL)(1)	BOA	Advent International	Services & Leasing	215.5	500	100	99	B/B3
Eyemart Express Holdings (1)(CL)	Wells Fargo	Friedman Fleischer & L	Retail	300	425	100	99	B/B1
HealthPort Technologies (CL)(1)	CS	New Mountain	Computers & Electroni	325	500	100	99	B/B2
Hospice Compassus (1)	GE	Audax Group	Healthcare	180	475	100	99	NR/NR
New Media Investment (1)(AO)	Citizens	Fortress Investment	Printing & Publishing	170	550-575	100	99	B/B2
Oasis Outsourcing (1L)(1)	RBC	Stone Point Capital	Services & Leasing	160	475-500	100	99	NR/NR
Oasis Outsourcing (2L)(3)	RBC	Stone Point Capital	Services & Leasing	60	850-875	100	98.5	
PhyMED Healthcare Group (2)	Fifth Third	Teachers' Private Capit	Healthcare	135	425	100	99.25	NR/NR
Q Holding Co (1)	RBC	3i plc	Chemicals	163	475-500	100	99	B/B3
SAFE Security	Citizens	ICV Capital	Services & Leasing					NR/NR
Sonneborn (1)	Macquarie	One Equity Partners	Chemicals	280	450	100	99.75	B/B1
Survey Sampling (1L)	GE	Huntsman Gay	Services & Leasing	208	475	100	99	B/NR
Survey Sampling (2L)	GE	Huntsman Gay	Services & Leasing	104	850	100	98.5	B/NR
Unitek Global Services	N/A	HM Capital	Building Materials	43	850	100		NR/NR
Unite Private Networks	SunTrust	Ridgemont Equity	Telecom	102.5	425	100	99.25	NR/NR
Unite Private Networks	SunTrust	Ridgemont Equity	Telecom	40	775	100	98.5	NR/NR
Averages				153	565	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

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 (3) 102/101
 (4) 102/101.5/101
 (5) nc-1/101

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

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