THE Lead Left

The Premier Middle Market Newsletter

Second Thoughts (Last of a Series)

It's hard to know exactly when second-lien term loans first appeared in the leveraged loan market. According to S&P's Loan Primer, they showed up in the mid-1990s, as the institutional market grew, and then vanished with the Russian debt crisis of 1998.

Our suspicion is these structures evolved from "over-advance" facilities in conjunction with asset-based loans, which were secured by priority liens on the current assets.

Regardless, the first such syndicated instrument to stand out in our memory was as part of J.W. Child's financing of the acquisition of*NutraSweet* from Monsanto in March, 2000.

Led by Deutsche Bank, the $360 million financing consisted of a five-year $50 million RC, a five-year $100 million term loan A (sold to the banks), and a seven-year $160 million term loan B (sold to institutional investors). These facilities were collateralized by first-lien security interests in the assets of the company.

What caught our attention was the final tranche: a $50 million second-lien term loan with an eight-year maturity priced at L+512.5 bps. That pricing compared favorably to the TLA and TLB, priced at L+287.5 and 350, respectively, and was seen as helpful in compensating for the longer tenor and junior collateral position.

From a credit perspective, while the company had strong cash flow characteristics, it was also replete with fixed assets and quality inventory and receivables. Intangible assets such as trademarks were also included in the collateral package.

A decade and a half later, that type of relative value analysis on deals continues. In not all cases, however, can lenders look to asset protection as an alternative source of repayment.

The resurgence of the second-lien institutional investor since the end of the credit crisis improved liquidity in the asset class. But as our *Chart of the Week* illustrates, it also dampened spreads as more cash flowed into the space. Additionally, the envelope was pushed on deal leverage and terms.

QUOTE OF THE WEEK

"You are seeing different securities with different fundamentals behaving differently."

– Stephen Wood, chief market strategist, Russell Investments.

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For those buyers, whether BDC, credit opportuity fund, hedge fund, or even CLO and mutual funds, the question is how far are they willing to be pushed?

As we discussed earlier in this series, market volatility took a toll on second-lien volume in the latter half of 2014. But the history of this asset class - indeed, most investments - is that eventually a clearing price will be found. At that point, we expect yield investors to come back into seconds with vigor.

Meanwhile, and probably for the next quarter or two, second-liens will be featured in larger syndications, where arrangers can entice funds to take a slice of second for more favorable allocations on firsts.

For smaller middle market deals, particularly with sponsors having historic mezzanine relationships, look for unsecured junior capital to play an increasingly significant role.

THE LEAD LEFT SPOTLIGHT

GOLUB CAPITAL

Fine-tuned.

This week we speak with Lawrence E. Golub, CEO of Golub Capital. Golub is a nationally recognized credit asset manager with over $10 billion of capital under management and four complementary business lines: Middle Market Lending, Late Stage Lending, Broadly Syndicated Loans and Opportunistic Credit.

The Lead Left: *Lawrence, what is the best way to think about Golub Capital's scale today?*

Lawrence Golub: Using the Thompson Reuters definition of traditional middle market LBO loans, we have been the number 1 bookrunner for the past four years in a row by number of deals. In larger middle market LBO loans up to $500 million, we have been number one for two years in a row, after a few years before that at number 2 or 3. In the first nine months of this year, we have sole agented or lead left agented 6 disclosed deals over $200 million each, with the largest about $350 million. We have a $10+ billion balance sheet. Our hold size is up to $250 million per borrower.

TLL: *Tell the story, if you will, how Golub got to where it is today.*

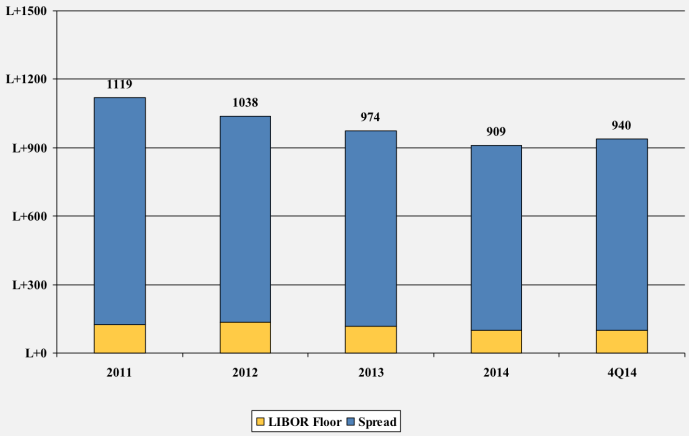
LG: Randy, to set the scene for that, twelve years ago, as the recovery from the 2000-2001 dot com recession was gathering steam, we were a little late learning about leveraging loan portfolios. But our mezzanine skill set was just as applicable. Our previous funding sources were not as interested in that venture, but we figured out how to apply CLO technology to middle market leverage lending. It was not our plan to be one of the leaders of the middle market senior debt industry. Our goal was to deliver consistent, reasonable

CHART OF THE WEEK

Yield Signs

Supply-demand dynamics - too much cash and too few deals - have pushed second-lien spreads down since the credit crisis.

Average Spread of Middle Market Second-Lien Loans



Source: S&P Capital IQ

STAT OF THE WEEK

	Jan 2015	May 2011	Oct 2008	Mar 2001
Australian Dollar/USD	0.79	1.10	0.60	0.48

Source: xe.com

LOAN STATS AT A GLANCE

Provided by:

S&P CAPITAL IQ

returns by having low default rates and by providing solutions to private equity firms.

" Investors and managers are thinking about whether they *can* get into the space, rather than whether they *should*. "

TLL: *What was your focus when you started in the loan space?*

LG: We had a private equity sponsor focus and emphasis on senior secured debt, particularly first and second lien, and one-stop loans.

TLL: *Including unitranche?*

LG: We prefer the term "one-stop," since it's not always a single tranche. The key is we lead and hold the facility ourselves. And we have stayed focused on defaults. They're cyclical. Credit losses happen on a correlated basis. Our ability to be a reliable, buy and hold solution provider means we need long-term borrowing facilities, and we always borrow long-term.

TLL: *How did you make out in the credit crisis?*

LG: Our competitors blew up or were badly wounded. We took some painful punches, but our capitalization was strong and our low credit losses allowed us to continue to raise money. That meant we were just about the only lender open for business to private equity firms in 2009. Twelve months of deals came to us. Since then, our balance sheet strategy has been to get even more resilient, to move from Category Two Hurricane-proof to Category Four Hurricane-proof.

TLL: *That's a challenge given your sponsor clientele.*

LG: I can understand why you might think so, but actually for us, our capital stability makes us even more valuable to private equity sponsors. First and foremost, we are good partners. We are in existence to make our borrowers succeed. Our success with

	This Week	Last Week	6MO Ago	YR Ago
New-Issue Clearing Yields				
$200M or less	6.78%	6.85%	6.07%	6.94%
$201M - $350M	6.34%	6.39%	5.88%	5.58%
$351M - $500M	6.08%	6.07%	5.53%	4.88%
$501M+	5.91%	5.86%	4.96%	4.47%
Middle market (≤ $50M)	6.62%	6.70%	5.99%	6.89%
Large corporate (> $50M)	6.01%	6.01%	5.27%	4.76%
Large corporate single-B (> $50M)	6.15%	6.21%	5.38%	4.94%
Middle Market Credit Stats				
Sr/EBITDA	4.8	4.8	4.8	5.4
Debt/EBITDA	4.8	4.8	4.9	5.4
Middle Market Index Data				
Monthly Returns	0.35%	0.17%	0.51%	0.56%
Average Bid	95.12	95.05	98.96	99.31

Source: S&P Capital IQ

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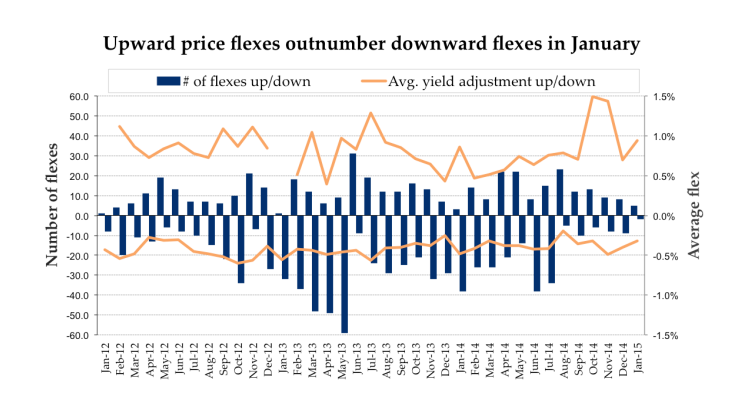
LEVERAGE LOAN INSIGHT & ANALYSIS

Provided by:

THOMSON REUTERS



Source: **Thomson Reuters LPC**

After a slow start, flex activity reactivated in the institutional loan market last week. So far in January, upward priced flexes on first-lien institutional term loans are outnumbering downward price revisions by over two times. The trend of the last few months in which stronger deals have garnered much investor attention, while weaker credits have to make some concessions to lure investors, seems to have trickled into this year. ANGUS Chemical Company, for instance, reduced pricing on both the euro and dollar portions of its $570 million buyout credit. Pricing on both tranches of the term loan was reduced to LIB/Euribor+425 with a 1 percent floor at 99.5 OID from 450bp with a 1 percent floor at 99 OID. On the other end of the spectrum IPC Systems widened pricing to LIB+550 from LIB+475 on its first-lien term loan and to LIB+950 from LIB+850 on its second-lien term loan. The OIDs were also widened to 97 from 99 on the first-lien and to 95.5 to 98.5 on the second-lien. All in all, yields are up so far this year. The average yield, assuming a three-year term to repayment is 6.52 percent so far in January, up from 6.11 percent in December. Underliers

repeat customers shows that. 75% of our business is with repeat sponsors. We have made sure that we will be there for our clients in the next downturn, too, by further diversifying our investor base and keeping billions of dollars of dry powder on hand at all times. We do have to be mindful of credit conditions, though. In today's market, we have reduce the amount of junior debt we're doing. In 2009 we ended the investment period of our mezzanine fund two years early.

***TLL**: How did that happen?*

LG: We did a management company review of the risk return for our mezz fund investors. Ending the investment period early was an expensive proposition for us, but it was good for our investors. They trust us, and that keeps them loyal and open to new ideas.

***TLL:** How do you explain the amazing popularity of the middle market asset class right now?*

LG: Investors and managers are thinking about whether they *can* get into the space, rather than whether they *should*. There are credit managers, like us, who are trying to build a business over a cycle. Then there are those who are just trying to grow, grow, and grow. It's all about shareholder value versus manager value.

***TLL:** Could you give us an example?*

LG: Take BDCs. Fifth Street did a giant issuance of shares at 85% of NAV. That certainly created manager value, but it would be hard to believe it did anything good for BDC shareholders. The issue is that some managers have ground down the net asset value of their stock. And this is a challenge for private equity GPs as well as BDCs. We're seeing a group of managers who risk hurting the space. They really don't care about true net income.

To be continued the week of

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MARKIT RECAP

Provided by:

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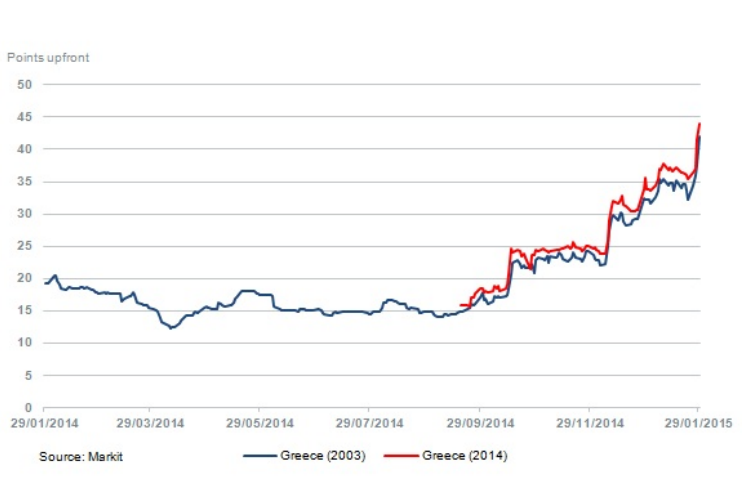

The result of the Greek elections on Sunday were quite clear - an emphatic victory for the anti-austerity SYRIZA party. The Greek public have signalled that they want to move in a different direction from the path of austerity that has caused so much pain.

But the implications for the broader credit markets are less transparent. Negative ancillary effects from the uncertainty surrounding Greece are battling it out with the ECB's recent QE announcement, which is compressing spreads. The Markit iTraxx Europe was trading at 57.5bps on Thursday, 4bps wider than where it started the week. This suggests that the turmoil in Greece is starting to affect risk appetite.

However, there is little sign of the contagion that afflicted the eurozone the last time Greece was dominating the agenda. Peripheral sovereign CDS have widened but the movements are modest. Spain, where the leftist Podemos party shares a similar ideology to SYRIZA, was quoted at 86bps on Thursday, 11bps wider than last Friday but still 10bps tighter than 2014 year-end levels.

Banks have underperformed over the week, with the Markit iTraxx Senior Financials giving up 8bps to trade at 65.5bps. The 10bps basis to the Main

Feb 2

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MIDDLE MARKET Growth

The Double Bottom Line

Virginia P'an had a dream: to build the premier eco-friendly products company. No naïve millennial, Ms. P'an was the first woman vice president at American Express Bank, the first female adviser to the Hong Kong Stock Exchange and the first female Chinese-American professional on Wall Street.

The road to that dream took a little longer than expected. Her passion to do good, Ms. P'an discovered, didn't lessen the challenge of gaining scale and mass distribution to get her plant-based cups, plates and bowls on retailers' shelves.

But the climate for entrepreneurs like Virginia P'an is changing. Investing in companies with measurable social or environmental impact is adding a conscience to capitalism...

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

index is the highest for almost six months. But European banks have significantly reduced their exposure to Greece in recent years - it is now the official sector holding the baby - so it is questionable how much the Hellenic Republic is responsible for this reversal.

Perhaps the travails of Austrian institution Raiffeisenbank are partly to blame. The banks saw its subordinated CDS widen dramatically from 691bps to 1,746bps amid concerns about its large Russian business and the effects of the Swiss franc appreciation on its eastern European operations.

Investors are well aware that if Raiffeisenbank requires state aid, subordinated bondholders will probably be bailed in. Under the ISDA 2014 definitions, this might well result in a credit event. The bank's spreads recovered on Thursday after management offered reassuring comments about reducing risk-weighted assets, but this will nonetheless be a name to watch in the coming weeks.

If the macro impact of Greece's election was ambiguous, the effect on the sovereign's own spreads was expected. Greek CDS widened to 44 points upfront under 2014 definitions, with the 2013 slightly lower at 42 points. The basis is attributable to the greater certainty around credit event triggers and deliverables under 2014 documentation. Both contracts remain relatively illiquid.

We can expect further volatility over the next few weeks as the new government negotiates with the troika, and if there is no sign of compromise then the oscillations will spread beyond south-east Europe.

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THE PULSE OF PRIVATE EQUITY

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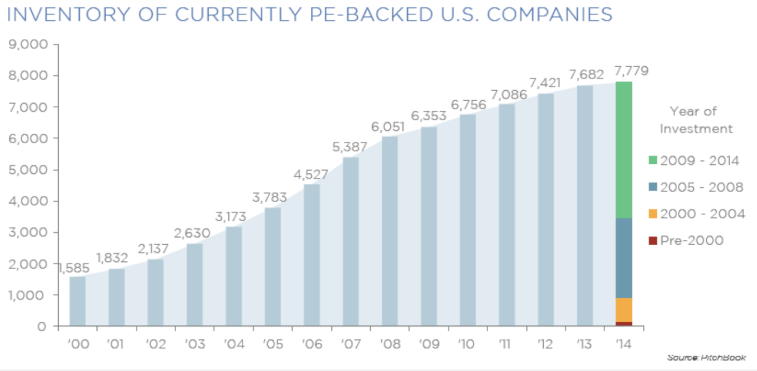

The U.S. Company Inventory is Plateauing

One of the concerns facing private equity over the past few years is the rising number of companies under PE control. The U.S. company inventory, which rose pretty dramatically between 2000 and 2008, now appears to be topping out just under the 8,000 mark. By the end of 2014 there were 7,779 U.S. companies in PE's portfolio, a miniscule increase over the 7,682 at the end of 2013. It's the first time the PE industry has added fewer than 100 new companies in a year since the 1990s.

For LPs, that's something of a relief. Between 2007 and 2013, the number of PE-owned companies rose from 6,051 to 7,682, a 27% increase. Yes, PE firms were putting their money to use, but exits weren't keeping pace to help balance the overall PE portfolio and provide liquidity back to LPs, and returns would suffer if holding periods weren't in line with typical PE timeframes. Fortunately, the exit doors started to open just in time, beginning in about 2012, and IPOs and strategic sales have allowed investors to transition portfolio companies out of the PE cycle altogether. Now LPs have a new conundrum on their hands: The worry over liquidity has given way to wondering what to do with all the cash that PE firms have distributed back to them.

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SELECT DEALS IN THE MARKET

Deal	Arranger	Sponsor	Industry	Facility*	Spread	LIB Flr	OID	Rating
Ascensus (1L)(1)(AO)	BMO	JC Flowers	Services & Leasing	72	400-425		99	B/B2
Ascensus (2L)(AO)	BMO	JC Flowers	Services & Leasing	15	800-825		99	B/B2
Cole-Parmer Instrument (1L)(CL)(AO)	Golub	GTCR Golder Rauner	Manufacturing	50	N/A			B/B3
Cole-Parmer Instrument (2L)	Golub	GTCR Golder Rauner	Manufacturing	24	N/A			B/B3
CSP Technologies (2)	Barclays	Wendel Group	Chemicals	170	525-550	100	98.5	B/B3
Digital River (1)	Macquarie	SIRIS Capital Group	Computers & Electronics	255	575	100	98	B-/B2
Global Knowledge Training (1L)(CL)(2)	CS	Rhone Capital	Services & Leasing	175	550	100	98.5	B+/B2
Global Knowledge Training (2L)(4)	CS	Rhone Capital	Services & Leasing	50	950	100	98	B+/B2
Hoover Container Solutions (2)	Macquarie	First Reserve Corp	Manufacturing	165	550	100	98	B/B2
Kaufman Hall & Associates (2)	Barclays	Madison Dearborn	Services & Leasing	150	575	100	97	NR/NR
Mirion Technologies (CL)(1)	CS	Charterhouse Equity	Computers & Electronics	280	475	100	99	B/B2
Nellson Nutraceutical (1)	GE	Kohlberg & Co.	Food & Beverage	240	450	100	99	B/B2
Paris Presents (1L)(1)	BNP	Wasserstein Perella	Healthcare	92	450	100	99	NR/NR
Paris Presents (2L)(3)	BNP	Wasserstein Perella	Healthcare	30	825	100	98	NR/NR
Averages				**126**	**600**	**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) 102/101
(4) 103/102/101
(5) 5 Month 101

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

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