

New Release
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The Lead Left – A Special Report: Why CLO's Matter

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The Art of Pricing Loans (Fourth of a Series)

We noted with interest the "Pi Day" celebrations last Saturday. 3/14/15 echoed that mathematical constant (the definition of which escapes us for the moment), spawned dozens of matrimonials, and marked the birth of Albert Einstein. March 14 was also the birthday of Billy Crystal, though we haven't figured out the π connection there yet.

Speaking of irrational numbers, we continue our series on pricing loans with a look at the middle market.

As we covered in our first installment, middle market loans - generally defined as issued to companies with less than \$50 million ebitda - tend to be syndicated by arrangers who will also hold on to a significant chunk of the exposure. That means mid cap players, unlike bookrunners in the broadly syndicated world, eat their own cooking. Besides being priced "at market," a deal needs to meet the leads' own yield requirements.

An increasing number of non-bank lenders are building underwriting capacity by creating diversified pockets of capital within (or alongside) their firms. Any deal they take to market needs to also meet the return hurdles of those vehicles. That's a good first test to ensure pricing works for other middle market lenders with similar CLOs, BDCs, or separately managed accounts.

Another benchmark is how the loan is priced relative to their large cap counterparts. As our [Chart of the Week](#) highlights, middle market loans generally carry an "illiquidity premium" over more liquid names. That premium is the offset for the less-deep market funds perceive is available for smaller loans. Depending on market conditions, the differential varies between 50-200 bps. Today it's around 120 bps.

Historically, middle market spreads follow large cap spreads with a time lag. But as more institutional money has entered the asset class, that lag has diminished. This influx has also caused more correlation between mid and large cap yields, meaning smaller deals will be less insulated by technicals such as oil prices and Fed rate expectations.

QUOTE OF THE WEEK

"Bond yields are at the lowest they have been since the Black Death."

– Jeremy Whitely, head of UK and European equities, Aberdeen Asset Management.

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As banks with their lower cost of capital reduce on-balance sheet exposure to leveraged middle market loans, non-banks are stepping in with increased capacity. To some extent, the larger hold levels of the top middle market arrangers have removed "market risk" from the equation. Syndications are increasingly club affairs, with pricing agreed to by a smaller set of lenders, rather than a broad range of institutional accounts.

Finally, the enhanced one-stop capability of some middle market lenders is providing private equity clients with more deal pricing options. Besides first and second-lien term loans, unitranche create a blended spread of the alternative senior/subordinated structures. Single tranche pricing must be consistent with the current market for each of the senior/sub components, and competitive with the overall capital cost of two tranches.

Next week: We wrap up our series by looking at the separate components of pricing.

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THE LEAD LEFT SPOTLIGHT



This week we continue our conversation with Chris Flynn and Sam Tillinghast, co-CEOs and co-CIOs of THL Credit. Headquartered in Boston, with investment teams in Chicago, New York, Los Angeles and Houston, THL Credit manages a BDC that invests primarily in middle market mezzanine debt for companies seeking capital for growth and acquisitions.

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

The Lead Left: The demand side does drive crazy structures and pricing at times.

Chris Flynn: We struggle when you tell us that 70% of the capital structure is debt and carries a cost of 6% and 30% of the capital structure is equity with a target return north of 25%. Lots of people are chasing deals, but it's up to the senior managements of these firms to incentive people the right way.

TLL: *Do you think the pressure on leveraged lending guidelines will restore some sanity?*

Sam Tillinghast: The pressure from regulators does appear to be getting more focus, so we're seeing pushback on structures. The opportunity for us is to come in with more flexibility to give sponsors more room and potential alternatives to traditional bank financing.

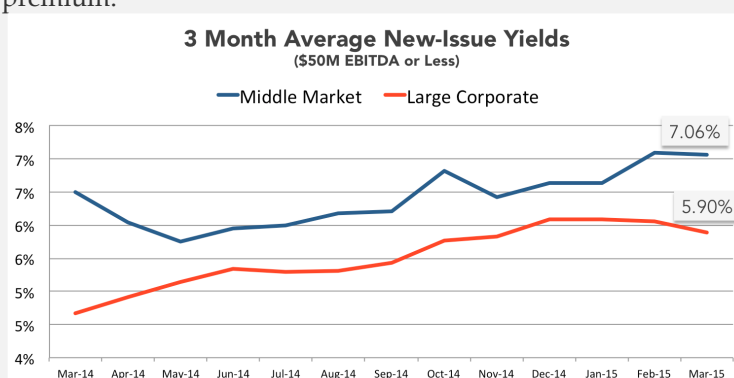
"Origination is a huge component of being a good investor, being given more opportunities allows you to be more selective."

CF: As an example, banks require

CHART OF THE WEEK

Ahead of the Curve

Spreads on middle market loans have risen in concert with those of their broadly syndicated counterparts; now at a 116 bps premium.



Source: S&P LCD

STAT OF THE WEEK

	2014-2015	2004-2005	1995-1996	1993-1994
Boston Seasonal Snowfall (Inches)	108.6+	86.6	107.6	96.3

Source: National Weather Service

LOAN STATS AT A GLANCE

Provided by:



amortization. So on a 3.5x/4.5-5.0x [multiple of Ebitda] transaction, the 3.5x will be a first-lien bank tranche with substantial amortization. We'll instead offer 4.5x with all one tranche that requires minimal amortization. That's particularly helpful for sponsors looking for the ability to reinvest cash flow.

TLL: *What are the leverage parameters on your overall portfolio?*

ST: The BDC portfolio averages around 4.5x. Again, we're at the lower end of the middle market with EBITDA in the \$5 - \$35 million range.

CF: It certainly depends on the deal. We won't necessarily go deeper to win a deal.

ST: Energy is a good example. We've only done three energy transactions in the last three years. Certainly we may have missed some opportunities, and faced some skeptics, but glad we stayed conservative especially given the recent drop in oil prices. We may only be in the first innings of that correction.

CF: We will look at more energy deals, but will stick with a diversified strategy across basins. And we expect to deploy only first lien debt.

TLL: *With all the new capital coming into the middle market, you must be finding a lot of competition.*

CF: It's tough to find out how much there is out there. We know it's hard to unseat an incumbent. We've been at this for seven years at THL Credit. It's a function of maintaining good relationships, so it's an uphill battle for the new guys to unseat long term relationships.

TLL: *How many deals have you closed this year?*

ST: We've closed 15 new transactions plus several add-on investments, which is down from prior years.

CF: But we've reviewed significantly more transactions this year. We are consistently lumpy by design. Some quarters we like the quality of deals better than others. We figure out what makes sense to do.

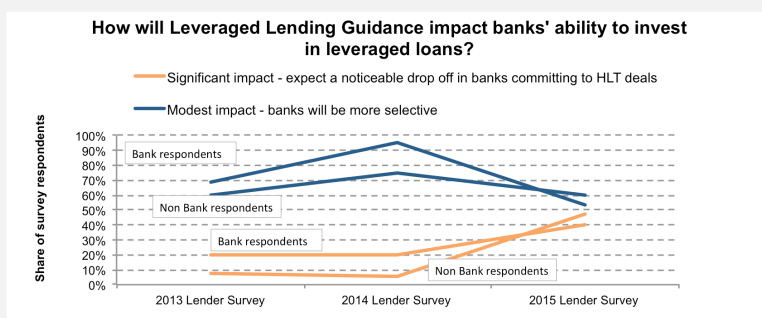
	This Week	Last Week	6MO Ago	YR Ago
New-Issue Clearing Yields				
\$200M or less	6.82%	6.82%	6.68%	6.08%
\$201M - \$350M	6.37%	6.37%	5.97%	5.24%
\$351M - \$500M	6.31%	6.26%	5.92%	5.04%
\$501M+	5.70%	5.68%	5.06%	4.45%
Middle market credit stats				
Middle market ($\leq$ \$50M)	7.06%	7.06%	6.21%	6.49%
Large corporate ($>$ \$50M)	5.90%	5.87%	5.44%	4.67%
Large corporate single-B ($>$ \$50M)	5.96%	5.91%	5.52%	4.84%
Middle Market Credit Stats				
Sr/EBITDA	4.8	4.8	4.9	N/A
Debt/EBITDA	4.8	4.8	5.1	N/A
Middle Market Index Data				
Monthly Returns	0.49%	0.27%	0.20%	0.30%
Average Bid	96.57	96.26	98.28	99.43

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

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LEVERAGE LOAN INSIGHT & ANALYSIS

Provided by:



Source: [Thomson Reuters LPC's Middle Market Survey](#)

According to Thomson Reuters LPC's latest survey of buy-side and sell-side institutions active in the middle market, the impact from Leveraged Lending Guidance on banks' ability to invest in deals is becoming significant. Less than 10 percent of non-banks and one fifth of banks surveyed in the past two years reported seeing a significant impact on bank behavior. In the recent survey, however, 40 percent of banks and nearly half of non-bank survey respondents are expecting to continue to see a noticeable drop off in banks committing to HLT deals. The majority of lenders and investors surveyed reported that the opportunity created by the shift toward non-regulated entities is the biggest change they expect to see in the middle market lending arena this year. Is Leveraged Lending Guidance driving volumes away from traditional players and structures, sources ask while others expect a re-balancing of market share based on the restrictions of LLG. Meanwhile, demand keeps ramping up with a slew of strategic partnerships and new investors targeting the middle market leaving players to wonder if supply will be sufficient to meet growing demand. [Underliers](#)

We hope to see you at our [3rd Annual Middle Market Loans Conference](#) on May 6th!

TLL: Do you view yourselves as more originators or asset managers?

CF: We really think of ourselves as investors. Origination is a huge component of being a good investor, being given more opportunities allows you to be more selective. We will also partner with other investors and lenders to finance other parts of the capital structure when it makes sense.

TLL: Does it help to have an affiliation with a top branded private equity firm?

ST: There are certainly advantages, particularly from a resource perspective. Thomas H. Lee Partners has deep industry expertise combined with their vast network of industry contacts and investment banking relationships.

TLL: What do you think of BDCs as an asset class?

CF: It's still a drop in the bucket compare to other asset classes. BDCs are still at the beginning of something here. You need to take a longer view. There's more flexibility with BDC structures.

TLL: OK, guys, what's been your biggest surprise of the year?

ST: How poorly BDC stocks have traded. There's not much differentiation between those BDCs who have been conservative with their money, and those who haven't. Some of the sell off has occurred because of the expectation of rising rates. But BDCs are generally yielding double digits. There's also a negative outlook on the credit sector in general, despite the fact that most BDC portfolios are primarily secured paper (72% secured for us). It doesn't make sense for the sector to be trading so far below book value.

CF: If you look at the high-yield index, BDC dividend yields are much wider, despite having secured and floating rate assets.

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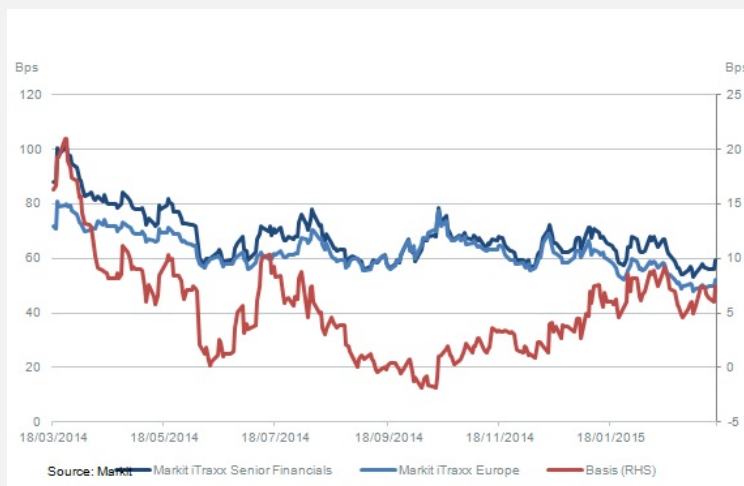
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MARKIT RECAP

Provided by:

markit



It's that time of the year again when CDS market participants turn their attention to technical, rather than fundamental, factors.

The Markit credit indices (iTraxx and CDX) roll every six months, and March 20 will see the first roll this year. This can result in significant dislocations between the tradable indices and their underlying constituents (often referred to as the skew) due to repositioning of trades into the new, more liquid indices.

We noted last week that the compression of spreads - no doubt driven by QE - had contributed to a rule change in the Markit iTraxx Crossover. Constituents now have to be trading at least 1.5 times the level of the Markit iTraxx Non-Financials, down from the previous threshold of 2.

But that isn't the only change in this roll. The Markit iTraxx Financials index (both Senior and Subordinated) is expanding from 25 to 30 names. The rationale behind this change is the disproportionate size of financial bond issuance compared to other sectors and the relationship between cash and CDS indices. The Markit iBoxx EUR index, a widely used benchmark, has a far higher weighting of financials (40-50%) than the current Markit iTraxx Europe (20%). Banks and insurers issue significantly more debt than non-financial corporates, and this will be better reflected in the new Series 23 index.

Liquidity in the single name CDS market also plays an important part in constituent selection. Credits such as Swiss Re and Danske Bank are established names and have been heavily traded for some time, hence their inclusion in the new index. The index will remain at 125 names in total, with the consumers sector making the biggest contribution to the removed credits.

Aside from the rule changes, Tesco's "relegation" from the Markit iTraxx

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MIDDLE MARKET Growth

Hold That Drone!

Amazon's launch a year ago of its Prime Air service seemed like something out of a William Gibson sci-fi novel. Shipping to consumers via aircraft drones? So we were startled to discover the identity of the company's recent partner to speed delivery this past Christmas: the U.S. Postal Service!

Turns out the paradigm of 21st century e-commerce sought out the symbol of mail's bygone era to help with Sunday shipping. Amazon also added seven additional sorting centers from which pre-boxed and labeled packages could be sent by truck to regional post offices...

Europe to the Crossover may raise eyebrows. The beleaguered UK supermarket group was downgraded to junk in January, a move that didn't surprise the markets as it was trading with an implied rating of 'BB' well before the downgrade, according to Markit data.

Nonetheless, Tesco was regarded as a mainstay of the investment grade universe for many years and its fall from grace is still remarkable. It is joined in the Crossover by its main rival J Sainsbury. Both are struggling with cumbersome business models and competition from discount retailers.

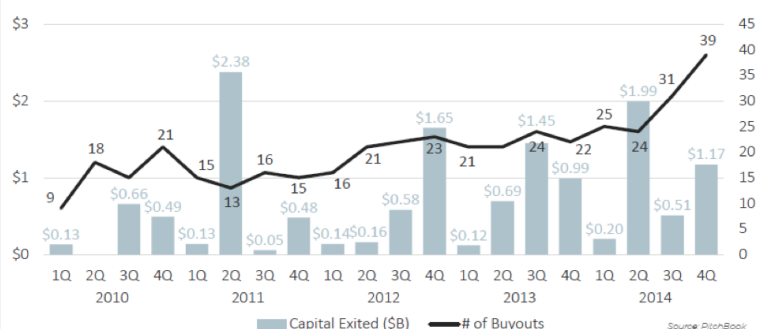
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THE PULSE OF PRIVATE EQUITY

Provided by:



BUYOUTS AND ADD-ONS BY QUARTER



Private equity is buying startups more often

Private equity isn't known as a big buyer of VC-backed startups, but that's beginning to change. There were 119 buyouts of VC-backed companies in 2014, a substantial increase (35%) from the 88 recorded in 2013. The 39 buyouts completed in 4Q 2014 were the most of any quarter in history.

Two things are going on today that help explain this. For one thing, PE firms have shifted to more of a buy-and-build approach, growing their existing platforms through smaller add-on acquisitions. A number of VC-backed companies fit that bill, given their size and market share. But the bigger factor behind the VC-to-PE trend goes back to the PE industry itself. As we've said in previous articles, private equity has become much more specialized and knowledgeable in niche sectors, particularly within the healthcare and IT industries. Specialty SaaS providers and medical device manufacturers, for example, have become much more viable investment options for PE, and many of those companies have already been financed and nurtured by VC investors for years. For PE buyers looking to build out their platforms, the issue of anemic cash flow hasn't been as problematic, since investors can factor in synergy capture through add-ons as opposed to buying startups as platform investments. As long as the PE industry continues to develop and gain expertise in these niche sectors, we should see PE and VC investors connect more often down the road.

Click here

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

To download PitchBook's 2015 Annual M&A Report, please click [here](#).



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SELECT DEALS IN THE MARKET

Deal	Arranger	Sponsor	Industry	Facility*	Spread	LIB Flr	OID	Rating
American Beacon Advisors (1L)(2)	RBC	Kelso	Services & Leasing	230	450	100	99.5	B+/Ba3
American Beacon Advisors (2L)(3)	RBC	Kelso	Services & Leasing	80	875	100	98	B+/Ba3
Cole-Parmer Instrument (1L)(CL)(AO)	Golub	GTCR Golder Rauner	Manufacturing	50	N/A			B/B3
Cole-Parmer Instrument (2L)(CL)(AO)	Golub	GTCR Golder Rauner	Manufacturing	24	N/A			B/B3
DBRS Limited (CL)(2)	CS	Carlyle Group	Services & Leasing	225	525	100	99	NR/NR
Digital River (1)	Macquarie	SIRIS Capital Group	Computers & Electronics	255	650	100	98	B-/B2
Express Energy (CL)(3)	UBS AG	Apollo Management	Oil & Gas	220	750	100	98.5	B/B3
Hoover Container Solutions (2)	Macquarie	First Reserve Corp	Manufacturing	165	675	100	98	B/B2
Mirion Technologies (CL)(1)	CS	Charterhouse Equity	Computers & Electronics	280	475	100	99	B/B2
Sabre Industries (CL)(1)	BNP	Kohlberg & Co.	Metals & Mining	255	475	100	99	B/B3
Vestcom International (CL)(5)(AO)	GE	Court Square Capital	Services & Leasing	15	425	100	99.5	B/B2
Averages				164	589	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) 103/102/101
 (5) 1 Month 101

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



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