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THE Lead Left
The Premier Middle Market Newsletter

Churchill Asset Management
A TIAA-CREF Company

The Summit for Middle Market Debt Finance™
May 5-6, NYC: CLICK for 54-Speaker Roster
22ND Annual! Atlantic Conferences Symposium

"An extraordinary networking event."
– JIM HUNT, Chairman, THL Credit
Vigorous Discussion. Great Networking.

Why Credit Standards Matter (First of a Series)

Much attention has been paid to regulators' concerns over banks pushing leverage and other risk elements. What goes missing in these discussions is what lenders, including non-banks, think about the credit environment we're currently in. Specifically, regardless of what the Fed, OCC, and FDIC (the Big Three) are doing with their Leveraged Lending Guidance, the real question is, what are debt originators and investors thinking about credit standards? Are they being eroded, and if so, what can be done about it?

For the next several weeks, this column will devote itself to these questions. With the help of some of our friends in senior credit positions around the industry, we'll take a look at financial covenants, debt baskets, amortization, cash flow sweeps, projection models, risk ratings, valuations, and other components of credit agreements being scrutinized by market players today.

We'll also take a look at some basic, tried-and-true credit parameters that may have escaped notice of some parties as conditions in the leveraged lending market have heated up in the five years since the end of the Great Recession.

Let's begin with a look at financial covenants. In a conversation we had recently with the credit chief of a leading middle market shop, we asked what he thought of the direction financial tests were headed, given where leverage has migrated.

It's not the test themselves that are the problem, he explained. In a more normal market, lenders would get 15-20% cushions off a reasonable base case. Today covenants are being built off a sandbagged case with 30% or wider cushions. If the borrower has been demonstrating double-digit revenue growth for the past five years, why show 3% growth going forward? It's not a matter of being conservative, it's being realistic.

Another key metric is capital expenditures. Our risk pro noted the growing lack of capex tests, either in the cash flow definition or as a stand-alone covenant. And forget about a minimum Ebitda test. Incremental debt, either associated with acquisitions or restricted payments such as dividends, is allowed with increasingly liberal terms.

Sponsors ideally want to incur debt without necessarily going back for approval of the lenders. Or in the case of acquisitions, provide for cash going to earn-outs alongside debt repayment. That's fine, says our credit officer, but show how you will pay for it. Tough for a $12 million Ebitda business that models a $10 million payout over two years.

Equity cures - the right of the sponsor to put cash into the borrower without having to repay debt - has been a feature in the middle market for a while and remains a hot topic among lenders. PE firms are willing to inject new equity dollars to fix a troubled credit, but aren't fans of proceeds simply reducing lenders' exposures. Cures are heavily negotiated, our friend reports. Lenders want to be

QUOTE OF THE WEEK

"The increasingly desperate search for yield is the single greatest source of risk in the financial system."

– Laurence Fink, CEO, BlackRock.

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back at the table in the case of a melting ice cube.

So-called "builder baskets" allow borrowers to increase restricted payments based on a cumulative excess cash flow test that builds over time. Lenders more easily tolerate this in the context of an otherwise reasonable covenant package.

Next week: our series on credit standards continues with further color on covenants.

Attention Subscribers! Our **State of the Capital Markets - First Quarter 2015 Review and Second Quarter 2015 Outlook** is now ready for download. Click *here* to access this report.

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Wednesday May 6, 2015
Marriott Marquis, New York City

AHEAD OF THE CURVE?
RESILIENCE AND STRENGTH
IN THE MIDDLE MARKET

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THE LEAD LEFT SPOTLIGHT

Enhanced Capital

This week we continue our conversation with Doug Cruikshank, Managing Partner and Rafael Castro, Director, Enhanced Capital. Enhanced Capital is a small business investment firm focused on established lower middle market companies often overlooked by traditional sources of capital due to location or size.

Second of two parts - View part one

The Lead Left: What are sponsors attitudes to this type of lending? My experience is that guaranties are a bright line they rarely allow lenders to cross over.

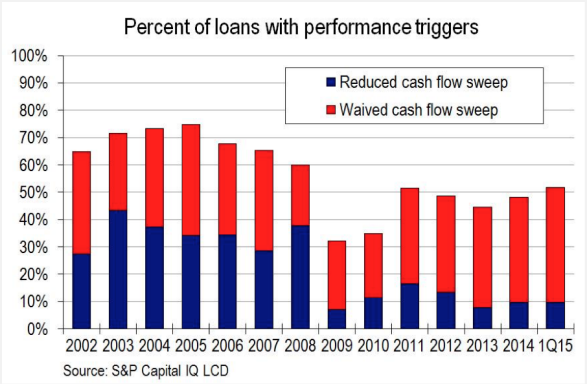
Rafael Castro: They love it. First, thanks to the credit crisis, hold periods for their investments have gone up, It's delayed take-outs to over six years. 40% of all companies owned by 2005-2008 vintage funds are still held by the PE firm. That means the fund is outside its reinvestment period.

Doug Cruikshank: But they still need to keep the capital invested, despite the fact that the fund is out of dry powder. These are pivotal companies that may be in disfavored industries. It helps, for example, that we don't need a quality of earnings

CHART OF THE WEEK

Sweep Stakes

The total share of loans that waived or reduced cash flow sweeps is still not back to pre-crisis levels, but those that waived sweeps is at an all-time high.



STAT OF THE WEEK

	2014	2013	2011	2009
U.S. Online Mobile Ad Revenue (Bn)	$12.5	$7.1	$1.6	$0

Source: IAB/PwC

LOAN STATS AT A GLANCE

Provided by:

S&P CAPITAL IQ

report. We frankly don't care about the portfolio company as much. And we move very quickly. We've closed deals in as little as 20 days. That's because it's all about the sponsor.

TLL: And how many portfolio companies do you now have?

RC: In the current fund we have ten companies across six different sponsors and one high net worth individual. Plus there are 5-10 other sponsors we're currently working with on deals. These are household names, not zombie funds. Many are successful but can't cross funds. So sometimes they'll have a great Fund One and Three, but need to support a company in Fund Two.

"We could do a cash collateralized deal without a guaranty and gotten paid 11-12%!"

TLL: Have you done any non-guaranteed deals?

DC: No, our mandate is guaranties only. We could do a cash collateralized deal without a guaranty.

TLL: Really? A sponsor would do to that?

DC: You'd be surprised. We've done it, and gotten paid 11-12%!

TLL: You do straight cash flow lending out of your mezz fund, correct?

RC: Yes, there we can go unguaranteed and have done so in our SBIC mezz fund run by Barry Osherow.

TLL: Could you give us an example of something you're working on?

RC: One down-the-middle-of-the-fairway example is a Texas-based GP with three funds. Fund Two has ten remaining portfolio companies - a mix of growth private equity and traditional LBOs - with NAV of $350 million. Two companies needed a combined $10 million of financing, both had negative ebitda.

DC: The first was frozen by its lender so couldn't borrow, and the second had a loan from a bank backed by uncalled LP capital, so their money was tied up. We provided 11-12% debt, no warrants or dilution which freed up the uncalled capital. Since then, the GP has raised a larger fund.

TLL: Would you characterize what you do as distressed lending?

	This Week	Last Week	6MO Ago	YR Ago
New-Issue Clearing Yields				
$200M or less	5.92%	5.89%	7.75%	5.70%
$201M - $350M	6.15%	6.25%	6.31%	5.59%
$351M - $500M	5.70%	5.84%	6.52%	5.27%
$501M+	5.16%	5.24%	5.32%	4.64%
Middle market (≤ $50M)	6.13%	6.02%	6.81%	6.04%
Large corporate (> $50M)	5.37%	5.49%	5.76%	4.92%
Large corporate single-B (> $50M)	5.42%	5.58%	5.94%	5.04%
Middle Market Credit Stats				
Sr/EBITDA	4.5	4.7	4.8	5.2
Debt/EBITDA	5.1	5.1	4.8	5.2
Middle Market Index Data				
Monthly Returns	0.69%	0.40%	-0.55%	0.29%
Average Bid	97.19	97.03	96.77	99.09

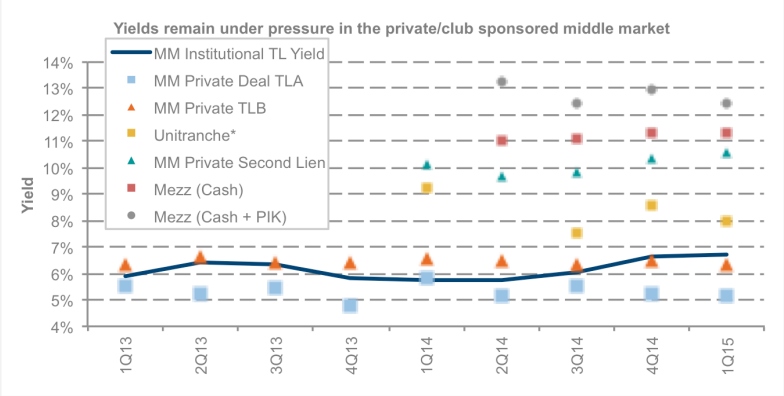
Source: S&P Capital IQ

Contact: Cuong Huynh
cuong.huynh@spcapitaliq.com

LEVERAGE LOAN INSIGHT & ANALYSIS

Provided by:

THOMSON REUTERS



Source: Thomson Reuters LPC

In 1Q15, higher yields in the leveraged loan market were apparent in both the large corporate and institutional middle market. However, data submitted to LPC from middle market lenders for smaller club sponsored deals indicated that pricing continued to remain tight at the smaller end of the middle market. While smaller deals tend to earn a liquidity premium over larger rated institutional middle market credits, that yield boost has been non-existent for two quarters now. Banks searching for sponsored deals that fit the Leveraged Lending Guidance criteria drove Term Loan A yields down to 5.15% in 1Q15, from 5.25% in 4Q14 and 5.54% in 3Q14. And even investors and finance companies drove issuer yields tighter last quarter. Term loan B yields tightened to 6.31% in 1Q15, down from 6.46% in 4Q14. Smaller non-rated term loan Bs were priced 40bps lower than the institutional middle market rated deals to hit market last quarter which averaged 6.71%. Even mezzanine and unitranche yields were under pressure given the abundance of capital chasing the limited dealflow out in the market. However, second lien yields did rise last quarter, in line with the broader markets. MM private second lien yields incrased to 10.56%, from 10.34% in 4Q14 and 9.85% in 3Q14.

We hope to see you at our 3rd Annual Middle Market Loans Conference on May 6th!

Contact: Fran Beyers
frances.beyers@thomsonreuters.com

MARKIT RECAP

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DC: It could be a tool for that, but many of our borrowers are good companies. One of the ones we mentioned had tripled its revenues in two years, but the situation is taking time to resolve. Because of the nature of the guaranty, these opportunities tend to self-select. The sponsor has already made the decision to support the business.

RC: We'd rather finance that deal than one from which the GP has decided to step away, handing the keys to the bank. Two-thirds of our portfolio borrowers are growth equity stories.

TLL: Interesting.

DC: Another way we can help is where the GP has put half their investment in as equity and the other half mezz. We can provide 5-10% of the financing at the holding company to give the sponsor the ability to skinny back their equity check. We care less about the borrower, than the sponsor.

TLL: What's been the biggest surprise about your experience at Enhanced?

DC: It's two-fold. First, how hard it is to get in front of the sponsor to talk to them about our strategy. Second, once it clicks with them, how easy the sale is. As someone once told me, I can explain it to you, I just can't understand it for you!

Contact:

Doug Cruikshank
DCruikshank@enhancedcapital.com

Rafael Castro
rcastro@enhancedcapital.com

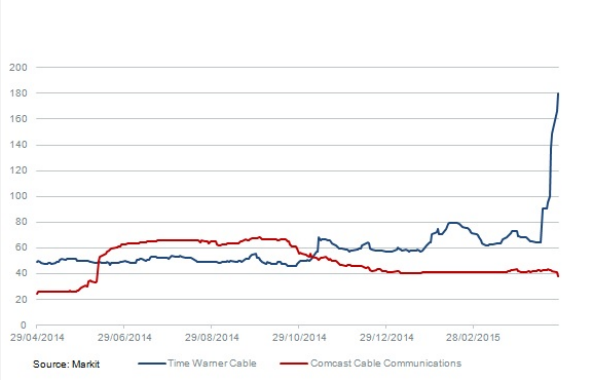
MIDDLE MARKET Growth

Demographics Are Destiny

Who am I?

According to the U.S. Census Bureau, I'm a baby boomer. So are 78 million other Americans. Unlike the generations after us-

markit



Low interest rates have helped fuel M&A activity, so it is no surprise that several large transactions have been announced in recent months

But it's not always the market that determines deals. Governments and regulatory bodies also have a part to play, as we saw with the collapse of the Comcast bid for Time Warner Cable last week. Comcast pulled out after the antitrust division of the Federal Communications Commission recommended that the deal be referred to an administrative judge, effectively ending any chance of completion. This was confirmed when Comcast officially dropped its bid last Friday.

The credit market's reaction demonstrated that the deal's failure is likely to have different consequences for the two parties. Comcast Cable's spreads rallied slightly to 38bps after the news, and the firm still has its solid single 'A' credit profile. The contrast with TWC could not have been more stark. The firm's spreads immediately widened following the announcement, and by April 28 was trading at 180bps, 115bps wider than where it was quoted less than two weeks previously.

TWC no longer has the prospect of benefitting from Comcast's robust balance sheet, and this was obviously a factor driving the credit deterioration. But the situation was made worse by reports suggesting Charter Communications is preparing to make a bid for TWC. Charter, which doesn't trade in the CDS market, has a leveraged balance sheet and TWC bondholders will naturally view it as a less desirable acquirer. Charter's $10.4bn deal to buy Brighthouse Networks was contingent on the Comcast/TWC transaction being completed. These events show that, while it may be relatively easy to raise finance for large deals, governments still have the power to stop them being completed.

Contact: Gavan Nolan
Gavan.Nolan@markit.com

THE PULSE OF PRIVATE EQUITY

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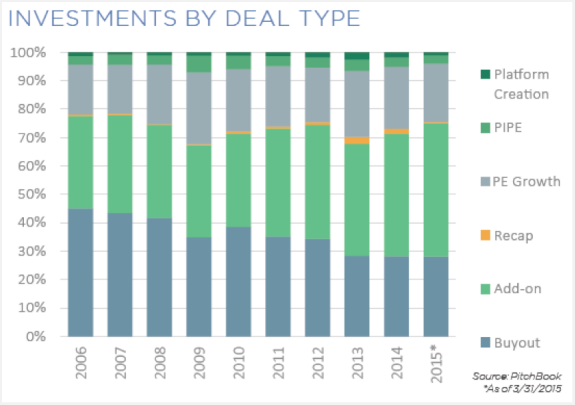
PitchBook
Better Data. Better Decisions.

Generation X and the millennials-boomers are now entering retirement; the youngest just turned 50. Over the next 17 years, 10,000 boomers will retire every day.

Here's another fact: Nine million of the total 15 million businesses in the United States are owned by boomers (or older). Of those, 4 million- two-thirds of all companies with employees-could change hands. For both buyers and sellers, these numbers have profound implications...

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



The Decline of Platform Buyouts

We've talked previous about the decline of platform buyouts, as add-ons rise and competition from strategic acquirers makes platform targets more expensive from a valuation perspective. While that's still undoubtedly true, it's worth pointing out that many platform acquisitions are still happening, due in large part to some changes in strategy on the part of PE. Today, many of the platform buyouts that are happening are being prepared for months in advance, specifically add-on strategies. Platforms are being targeted with multiple add-on targets waiting in the wings. PE firms, with mountains of dry powder, need to continue investing, but are doing so with much more acquisitive preparation today. It's not uncommon to see platform announcements followed closely by add-on announcements, sometimes with two or three companies already prepared to be rolled up.

We expect to see more of this in 2015, as valuations are likely to remain high for the foreseeable future.

To download PitchBook's 2Q 2015 U.S. Private Equity Middle Market Report, please click here.

Contact: Alex Lykken
alex.lykken@pitchbook.com

SELECT DEALS IN THE MARKET

Deal	Arranger	Sponsor	Industry	Facility*	Spread	LIB Flr	OID	Rating
Bendon Publishing International	GE	Irving Place Capital	Printing & Publishing	118.5	450	100	99	NR/NR
Compusearch Software (1)	SunTrust	ABRY Partners	Computers & Electronics	115	450	100	99	NR/NR
Element Materials (1)(CL)(AO)	RBC	3i plc	Services & Leasing	70	400	100	100	B/B2
EveryWare		Monomoy Capital	Home Furnishings	40	900	100		NR/NR
Gold Standard Baking	BNP	Tricor Pacific Corp	Food & Beverage	109	475	100	99	NR/NR
Nellson Nutraceutical (AO)	GE	Kohlberg & Co.	Food & Beverage	60	500	100	100	B/B2
Pet Supplies Plus (1)	BNP	Irving Place Capital	Retail	125	475	100	99	NR/NR
Sage Automotive (AO)	UBS AG	Clearlake Capital	Automotive	30	500	100	99	B/B2
Sirius Computer Solutions (1)	Wells Fargo	Thoma Bravo	Computers & Electronics	295	525	100	100	B+/B1
Averages				106	528	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

THE Lead Left

The Lead Left, LLC
15 East Putnam Avenue Suite 205
Greenwich, CT 06830

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