

Why Credit Standards Matter (Third of a Series)

In the previous two issues of our special series on the state of credit standards in the leveraged lending market, we took a deep dive on covenant trends. This week we take a step back and look at the overall picture of middle market credit fundamentals.

So much of leveraged lending is tied to the fortunes of the private equity sponsors we support. That's why it's easy to forget the goal of debt providers differs from that of equity investors in at least one aspect. When PE firms succeed for themselves and their LPs, they stand to gain significant upside by not only recapturing their original investment, but multiples of that investment as well.

Lenders, on the other hand, don't benefit from outstanding borrower performance. If the company just squeaks by and still pays the loan in full, fine. That's why experienced managers underwrite to a base case, rather than on an ethereal management case showing hockey stick growth.

But lenders and PE are aligned when examining certain deal elements that point to both debt and equity success or failure. Here are a few:

Barriers to Entry - If your borrower has a dominant market position with high margins, competitors know it. What's preventing a larger company getting into the market, or an existing competitor from cutting prices? In niche markets, it may not be worth the trouble. If the borrower has made considerable investment in infrastructure to meet client demand, that may discourage competition. But evolving technology may give someone else an edge. Can you identify where that threat is likely to come from?

Customer Concentrations - Middle market companies, particularly smaller ones and in certain sectors, tend to have lumpier clients. If Walmart, for example, represents 30% of sales, what happens if it goes away? How quickly can it be replaced? What's the impact on Ebitda? Can the company cover fixed charges?

Performance in a Downturn - Asking how most companies might perform in a recession is no longer a theoretical question. Yet it's disconcerting to see how many information memos only show historic financials from 2010 on. Cyclicalities is not a crime. Knowing how an issuer fared in the worst recession known to mankind helps underwriters judge what would happen in a more likely, less drastic, future downturn.

Management Expertise - Managing in a leveraged environment is a different animal than with a typical corporate. The cushion for mistakes is less, the focus on cash flow is greater, and the drive for growth is more intense. PE sponsors are professional managers, but they expect management teams to run portfolio companies. Those with buyout experience are given greater credence and more running room by lenders.

QUOTE OF THE WEEK

"It is spring cleaning. Everything that made money this winter is being pushed away."

- Thomas Flury, head of currency management, UBS Wealth Management.

Spring Cleaning 30-DAY FREE MEMBERSHIP

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Free Cash Flow - Being able to dedicate more cash flow to debt service is a real plus. High capex businesses (retailers, of course, are examples) may be hard pressed, even in a downturn, to generate enough free cash even to cover interest. Failure to keep spending some minimal level of capex (which always turns out to be more than expected) can result in significant diminution of enterprise value.

Next week: our series on credit continues with our favorite due diligence items.

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First Quarter 2015 Review and
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THE LEAD LEFT SPOTLIGHT



This week we continue our conversation with John Katzman, founder and CEO of Noodle. Noodle is a NYC-based company providing on-line tools to help students find resources to find the right schools, services, and learning materials.

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

The Lead Left: But can you really scale individualism?

John Katzman: We do it in many sectors of the economy; Chipotle competes with In-N-Out Burger and thousands of local delis; we don't decide that everyone in a city or state must eat the same lunch. How many stocks can you buy? How many toilets? We need to allow schools to differentiate, and allow parents to choose the right curriculum for their kids.

TLL: *Could you give us an example?*

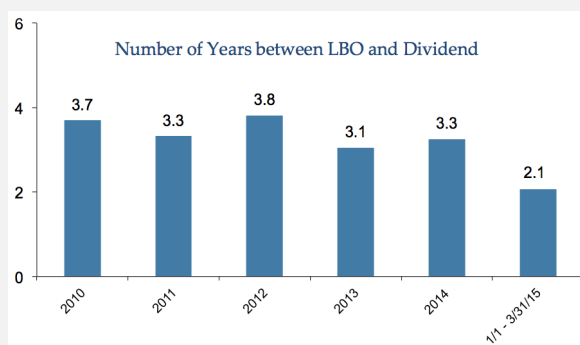
JK: In higher ed, there are lots of choices. The Minerva School is a new one, and its partnership with KGI [Keck Graduate Institute] is a truly differentiated model. Features like an interdisciplinary curriculum, focus on cognitive learning, cultural immersion. It's really about advancing the science of learning. It's easy to say, here's a five year plan. It's harder to create and maintain robust marketplaces. That's what I spend my time thinking about, and that's what The Noodle Companies are all about.

"How many very smart people are utterly thoughtless about how

CHART OF THE WEEK

Snap Recaps

Over the past three years, private equity sponsors have cut the time in half they are taking dividends from LBOs.



Source: S&P/LCD

STAT OF THE WEEK

	May 2015	2010	2002	1993
Rise in Sea Level (Millimeters)	75	46.24	26.97	-3.86

Source: University of Colorado

LOAN STATS AT A GLANCE

Provided by:



education works, what we want education to look like, and how for-profits can be part of that change."

TLL: What should the goal of education be then?

JK: From K through 12 we should expect to produce students who are employed in jobs they like over the next forty years, who are good citizens, who are happy and healthy with low suicide, obesity and diabetes rates. If we can turn out graduates like that, it's a pretty good educational system. And all of those are measurable goals.

TLL: But we don't always have the ability to measure them.

JK: Well, it would not be that hard to track Brown University graduates for certain characteristics in the two decades after college, but we generally haven't tried. And we certainly don't try to measure outcomes for PS 47. We're measuring things like test scores, with very little evidence that those scores correlate to the outcomes we care about.

TLL: But aren't test scores important in making educators accountable?

JK: Closing down a school or university based on metrics is almost impossible. The public just doesn't believe the scores tell the whole story, and they're largely right. But marketplaces are brutal engines of accountability-Blockbuster and Nokia did nothing wrong except change too slowly, and they're gone.

TLL: Tell us about Noodle.

JK: Noodle is an umbrella organization; right now, we house three companies sharing a brand like the Virgin companies. Our shared mission is to create transparency and efficiency in the education market, and our first company, Noodle.com, is trying to be TripAdvisor for education. We help find you the right tutor, school, college, lacrosse coach, negotiating seminar, or wine tasting course.

TLL: Sounds pretty straight-forward.

JK: It's harder than it sounds - coalescing a lot of incomplete data sets, and wrapping it in your community as well as opinions from outside experts about a \$1.3 trillion (US) industry. Worse, most students don't really know what they're looking for. How many high school students really understand how a large suburban college will be different from a small rural one. When we do it right, Noodle asks about you--that's something you should know

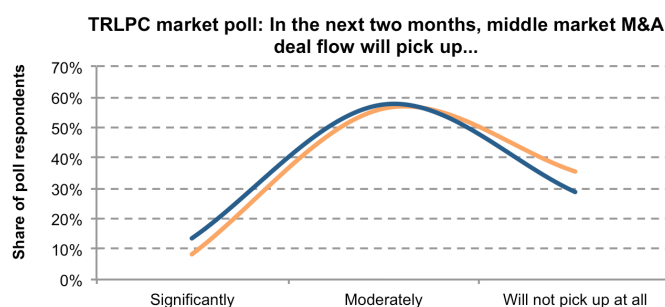
	This Week	Last Week	6MO Ago	YR Ago
New-Issue Clearing Yields				
\$200M or less	5.92%	5.86%	6.84%	5.98%
\$201M - \$350M	6.01%	6.04%	6.24%	5.72%
\$351M - \$500M	5.61%	5.66%	6.37%	5.32%
\$501M+	4.92%	4.96%	5.51%	4.85%
Middle market (≤ \$50M)				
Large corporate (> \$50M)	5.16%	5.22%	5.84%	5.14%
Large corporate single-B (> \$50M)	5.26%	5.31%	6.08%	5.25%
Middle Market Credit Stats				
Sr/EBITDA	4.8	4.8	4.7	5.2
Debt/EBITDA	5.2	5.2	4.7	5.2
Middle Market Index Data				
Monthly Returns	0.23%	0.05%	-0.18%	0.20%
Average Bid	97.28	97.13	96.42	98.88

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

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LEVERAGE LOAN INSIGHT & ANALYSIS

Provided by:



Source: [Thomson Reuters LPC's 3rd Annual Middle Market Loan Conference](#)

Roughly one third of banks and non-banks polled at TRLPC's 3rd Annual Middle Market Loan Conference last week reported that sponsored M&A deal flow will most likely not materialize over the next two months. The percentage grew to 36 percent of respondents expecting that deal flow will not pick up at all in the non-sponsored or corporate M&A segment either. Where are the optimists? Fifty-eight and 56 percent of respondents respectively expect a moderate pick-up in activity in both segments. Although a minority, 14 percent and eight percent respectively expect a significant pick-up in deal flow. Financing conditions are ripe but valuations remain high and sources don't expect to see them come down at anytime soon. With higher multiples and lower leverage in large part due to banks implementing Leveraged Lending Guidance, sponsors have been less willing to pull the trigger as a buyer. However sponsors have been sellers and sponsor to sponsor transactions make up a large chunk of sponsored M&A transactions. Given the implementation of Leveraged Lending Guidance, sponsors have undergone an education process as to what their lenders' new tolerance may be and ultimately the guidance may also lead to a shift away from traditional players and structures for credits that are out of the box.

Contact: **Ioana Barza**
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MARKIT RECAP

Provided by:

something about!

TLL: *It must be hard to quantify this stuff.*

JK: You're right, but our operating metrics are steadily improving, and we think we're on our way to being useful in the same way Facebook and Google are useful.

TLL: *What's the second Noodle business?*

JK: Noodle Partners use technology to help make universities less expensive, more compelling, and more scalable. Our first services are "affinity tutoring" programs from NYU and USC. Coming soon are less expensive graduate and certificate programs.

TLL: *What do you see as the biggest challenges for education in the next 10 years?*

JK: Money. With the growth of charters, districts will have a harder time paying their unfunded pension obligations. And in higher ed, I expect 30-50% of colleges and universities to merge or disappear as others use tech to control costs, improve instruction, and scale up.

TLL: *What would you tell your younger (just starting out) entrepreneurial self?*

JK: I was always on top of my operating metrics, but not thoughtful about my financial ones. I would tell my younger self to hire a good CFO and fully immerse in his financial metrics.

TLL: *John, we always close our conversations asking what's been the biggest surprise about your journey in the business?*

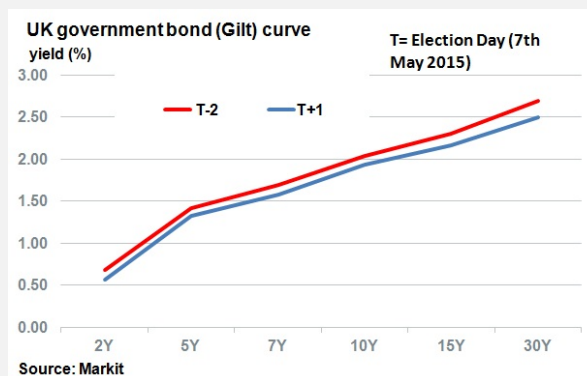
JK: (long pause) The biggest positive surprise is how committed and passionate educators are in the tech sector and in non-profit education. It's a compelling space, not just about 1's and 0's. I suppose the biggest negative surprise is how many otherwise very smart people are utterly thoughtless about how education works, what we want education to look like, and how for-profits can be part of that change.

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John Katzman

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markit



A weekend has passed since the UK's general election, allowing time for investors to digest last Thursday's surprising result. The victory confounded opinion polls, which had suggested another hung parliament. This uncertainty leading up to the election resulted in an increased level of volatility in the markets.

The surprise election result was welcomed by investors on two fronts. Firstly, the majority victory led to the elimination of any near term uncertainty around the consequences of a hung parliament. Secondly, Conservative policies are generally seen as more business-friendly than those of the main opposing parties.

Asset classes across the board rallied. The FTSE 100 index adding over 200 points in 24 hours and the pound strengthened against the US dollar and euro. The fixed income market also welcomed the news.

The gilt market tightened across the term structure. Uncertainty around the result led to increased levels of volatility in the run up to the election. The 30-yr rate shifted 18bps tighter from the three days pre election to the day after the election.

10-yr yields, as represented by the 5% coupon UK gilt maturing in 2025 yielded 1.84% at the start of last week, dashing towards 1.98% mid week, before closing at 1.87% post election. UK 5-yr CDS spreads also inched tighter.

The tightening was also seen on the corporate credit side. UK banks saw their 5-yr CDS spreads tighten across the board last Friday. The main opposition party, Labour, had threatened the breakup of large banks, a potential one off bonus tax and higher bank levy's. HSBC, Barclays and RBS all saw their 5-yr CDS tighten, eliminating risks that were associated with pre election jitters.

On the cash side, the best performing sector was healthcare, as represented by the Markit iBoxx £ Health Care index. The price level increased 1.15% on the back of the election result. Labour had promised to roll back privatisation in the sector, and post-election tightening reflects relief from bond investors.

The election also boosted Utilities, which was the second best performing sector. Opposition parties had threatened energy price caps which would have dented profitability.

But long term risks remain

While the election result has boosted markets, risks in the medium and long term remain. The Conservatives have promised an EU referendum in 2017, which could lead to businesses holding back plans for expansion. There is also threat of a second Scottish referendum with the Scottish Nationalist Party gaining considerable power. Further ashore, problems in Greece and tepid global growth remain, but the market seems to be taking these in its stride for now.

Contact: Neil Mehta

Take Two and Call Us in the Morning

Generic drugs were once the pharmaceutical versions of knockoffs: cheap, low quality and unreliable. Not anymore.

From Allegra to Zyrtec, formerly patented meds are not only available for much less than we used to pay, but thanks to the expedited approval process afforded by the 1984 Hatch-Waxman Act, generics account for about 80 percent of all drugs on the market.

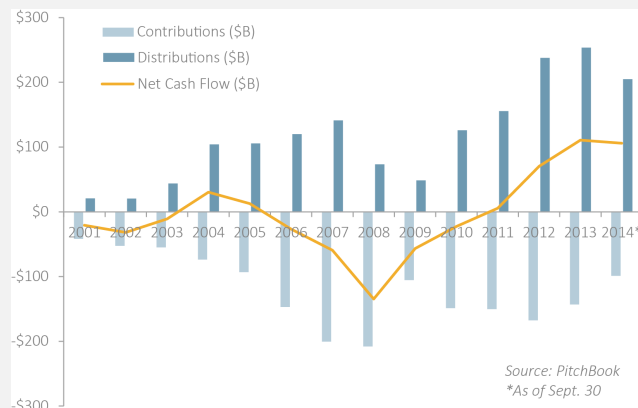
Generics also comprise more than 40 percent of the total \$300 billion U.S. revenue for major drug manufacturers, significantly more than the \$70 billion from generic drug companies alone. All this has resulted in an estimated \$1.5 trillion in health care savings for consumers over the past decade or so. That's nothing to sneeze at...

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

THE PULSE OF PRIVATE EQUITY

Provided by:



The latest numbers for U.S. private equity cash flows reveal just how successfully firms have taken advantage of recent exit opportunities. As of the end of 3Q 2014, PE distributions back to LPs were a huge \$205.9 billion while contributions were a more modest \$99 billion, producing a net cash flow of \$106 billion. With a full quarter's worth of data to be reported still, it's likely last year will end up even more lucrative in terms of distributions than 2012 and 2013.

These results aren't necessarily surprising, as the exit environment last year was markedly robust across all major exit channels. What is surprising is seeing some recent talk of PE investors being disappointed with returns, which perhaps says more about their unreasonable expectations than the returns themselves, or the context in which they are viewing results. Contrasting returns with the still-strong bull market may be overly skewing perceptions of success downward. There is a widespread consensus among prominent industry voices that as dealmaking remains highly competitive and the market bullish, PE firms will find it more and more difficult to succeed. But for now, with general partners still delivering their backers record amounts of cash, LPs still have plenty of reason to maintain or increase allocations. Plus, the exit environment does not show any signs of substantial change. M&A is still active across the board while public markets' strength should prove a welcoming environment for PE portfolio companies' IPOs.

PitchBook's 2Q 2015 Global PE & VC Benchmarking & Fund Performance report will be released shortly. Get your free copy by [Clicking here](#).

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SELECT DEALS IN THE MARKET

Deal	Arranger	Sponsor	Industry	Facility*	Spread	LIB Flr	OID	Rating
American Gaming Systems	Jefferies	Apollo Management	Gaming & Hotel	250	N/A	N/A	N/A	B/B3
Aria Energy Corp (1)	Barclays	Energy Investors Fund	Utilities	200	425-450	100	99	B/Ba3
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	99.75	NR/NR
ConvergeOne (5)(AO)	CS	Clearlake Capital	Services & Leasing	50	500	100	99.5	B/B3
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 (1)	BNP	Tricor Pacific Corp	Food & Beverage	109	450	100	99.5	NR/NR
Nellson Nutraceutical (AO)	GE	Kohlberg & Co.	Food & Beverage	60	500	100	100	B/B2
Sirius Computer Solutions (1)	Wells Fargo	Thoma Bravo	Computers & Electronics	295	525	100	100	B+/B1
The J. Jill Group (1)	Jefferies	TowerBrook Capital	Retail	250	500	100	99.5	B/B2
TouchTunes Music (1L)(1)	Citizens	Searchlight Capital	Computers & Electronics	170	450-475	100	99	B/B2
TouchTunes Music (2L)(3)	Citizens	Searchlight Capital	Computers & Electronics	62.5	825-850	100	98	B/B2
Averages				138	519	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) 200/100

(5) 2 Month 101

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

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