THE Lead Left
The Premier Middle Market Newsletter

Churchill Asset Management
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Payback Time

One bedrock tenet of sound lending practices is establishing the borrower's capacity to repay its debt over the contractual life of the obligation. So it's not surprising that regulators have taken banks to task in recent reports highlighting a growing number of leveraged loan issuers which lack that capacity.

Specifically, in its 2014 Leveraged Loan Supplement, the Gang of Three - Federal Reserve, OCC, and FDIC - cited banks in which only 77% of portfolio companies managed to show they could successfully amortize the loan over a seven-year period. That was down from 83% measured in the prior year's examination.

Projected cash flows should indeed leave plenty of room for principal and interest payments. But a bit of perspective on the topic is in order.

To paraphrase F. Scott Fitzgerald's observation about the rich, leveraged borrowers are different than other borrowers: they have more debt. Private equity sponsors use leverage to enhance their returns, and not every business is a good candidate for high debt levels. Premiums are paid for companies that demonstrate significant free cash flow generation.

The buyout industry has spent decades developing a base of sophisticated credit investors willing to take the risk - and earn the high returns - involved with these loans. Given many of these buyers match-fund their long-term assets and liabilities, they don't want to get paid back - at least, not too quickly.

It was precisely to accommodate these funding requirements that bank loan arrangers created the "term loan B" product in the early 1990's. Crossover investors from high-yield bonds were accustomed to a lack of amortization, so payments were back-ended with balloons in the final two years, and just enough interim installments (for example, $250,000 quarterly) to meet funds' average weighted life tests.

Payback schedules are often moot. Leveraged loans are governed by excess cash flow recaptures, which apply cash generated above and beyond mandatory uses (such as capex) to repay principal. So these borrowers often delever more quickly from periodic sweeps than from scheduled amortization.

Private equity shops buy companies to sell them - often within seven years. Sponsors also like tweaking debt structures. Whether to refinance on better terms, provide for an acquisition or merger, or recap for a shareholder dividend, original PE financings rarely survive untouched to final maturity. Any recalcitrant banks often get the opportunity to exit along the way.

We appreciate regulators' concerns about "risky loans" that don't seem to

QUOTE OF THE WEEK

"It's going to be hard for the Fed to justify not raising interest rates in September."

– Karyn Cavanaugh, senior market strategist, Voya Investment Management.

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get repaid, but the vast majority of these loan buyers (88.5%, at last count) aren't banks. Mutual funds, CLOs, hedge funds, and insurance companies like assets with longer maturities. Having to redeploy returned cash is an expensive nuisance.

Yes, loan arrangers hold significant chunks of institutional loans during the early syndication process, and regulators worry about banks getting hung with these deals if markets turn. But underwriters have learned the lessons of 2008. Today the overhang of unsold loans is a fraction of what it was before the crisis.

In thirty years we've helped finance hundreds of leveraged loans and seen only a handful go full term. Ironically, those few were among the less successful investments of our private equity clients. But lenders care less about return *on* principal, than return *of* principal.

This column first appeared in the weekly newsletter of Creditflux, a leading global information source for the credit trading and investment market.

THE LEAD LEFT SPOTLIGHT

This week we continue our conversation with Brett Hickey, chief executive officer, Star Mountain Capital. Based in New York with regional offices and a network covering over 25 U.S. cities, Star Mountain provides strategic partner capital for private equity, mezzanine and other private capital funds as well as growth debt and equity financing for small and medium-sized businesses (typically companies with under $15mm of annual EBITDA).

Second of two parts - View part one

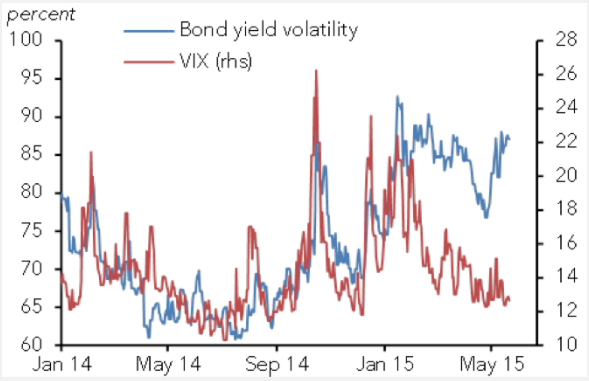
The Lead Left: What else did you do in order to help build your rather unique firm?

Brett Hickey: I had good financial modeling skills but not management skills. So I attended Harvard's 3 year graduate program for business owners and joined the Young Presidents' Organization to get access to other business leaders and try to learn as much as possible from them. I believe that team building and culture will ultimately be our largest long-term competitive advantages and we invest a lot of time in team and culture including building a large, active advisory committee, with interests aligned to help us be as successful as possible for our team, our investors and the businesses and funds we provide capital to.

CHART OF THE WEEK

Two Way Street

Expectations in recent months of higher rates have caused volatility in options markets to diverge between equities and bond yields.



Sources: Citi, Bloomberg, IIF via The Daily Shot

STAT OF THE WEEK

	May 2015	Jan 2009	Oct 1970	Aug 1952
US Manufacturing Payrolls (k)	7	-289	-519	572

Source: Trading Economics

LOAN STATS AT A GLANCE

Provided by:

TLL: And today?

BH: Many successful asset management firms have grown larger and generally moved even more upmarket. So the smaller business marketplace we are focused on, still provides a lot of opportunity. We also believe that the U.S. is a better risk-reward than elsewhere at the moment. Knowledge is the most valuable asset in the medium-term and we believe the U.S. has stronger CEOs, and more high level talent and board members available than in the rest of the world - at least for the smaller end of the market we invest in. Basic technology, such as smart phones also being "payment processors" and the cloud providing opportunities to have more efficiently manage and scale data management and storage, helps a small business on average, more than a larger business, we believe.

" Team building and culture will ultimately be our largest long-term competitive advantages. "

TLL: And how does Star Mountain fit into this picture?

BH: Star Mountain is institutional but nimble and entrepreneurial. We offer investors customized separate account and co-mingled fund options. We offer both our investors and the companies we invest in with flexible solutions to best fit their needs vs needing to sell them on why our single fund or product is the best fit for them.

TLL: How do you distinguish underwriting smaller companies from larger middle market ones?

BH: It's definitely different. If you ask me to choose between a 3x leveraged unitranche for an $8 million EBTIDA issuer or a 6x leveraged through mezz for a $20 million EBTIDA issuer, I'd prefer the former in case there are future challenges, where we feel safer with lower company leverage in our end of the market. The smaller businesses often have better alignment of interest with management and we have tighter financial covenants and controls. These smaller companies definitely take a lot of work to underwrite properly, but it's worth it and gives us a reason to exist! We believe this approach carries lower risk and higher returns, albeit less relevant for the larger firms who want to put larger sums of money to work.

TLL: Do you worry about having to own the companies if things don't work out?

BH: If we have to take it over, we can. But we try to box risks and work with management through challenges as a

	This Week	Last Week	6MO Ago	YR Ago
New-Issue Clearing Yields				
$200M or less	6.43%	6.26%	6.91%	6.19%
$201M - $350M	5.97%	6.02%	6.23%	5.93%
$351M - $500M	5.64%	5.50%	6.40%	5.53%
$501M+	4.74%	4.74%	5.90%	5.04%
Middle market (≤ $50M)	6.17%	6.17%	6.64%	5.95%
Large corporate (> $50M)	5.05%	5.03%	6.08%	5.33%
Large corporate single-B (> $50M)	5.21%	5.19%	6.35%	5.44%
Middle Market Credit Stats				
Sr/EBITDA	4.0	4.0	4.5	5.3
Debt/EBITDA	4.7	4.7	4.9	5.4
Middle Market Index Data				
Monthly Returns	0.13%	0.76%	-0.38%	0.20%
Average Bid	97.36	97.32	96.32	98.86

Source: S&P Capital IQ

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LEVERAGE LOAN INSIGHT & ANALYSIS

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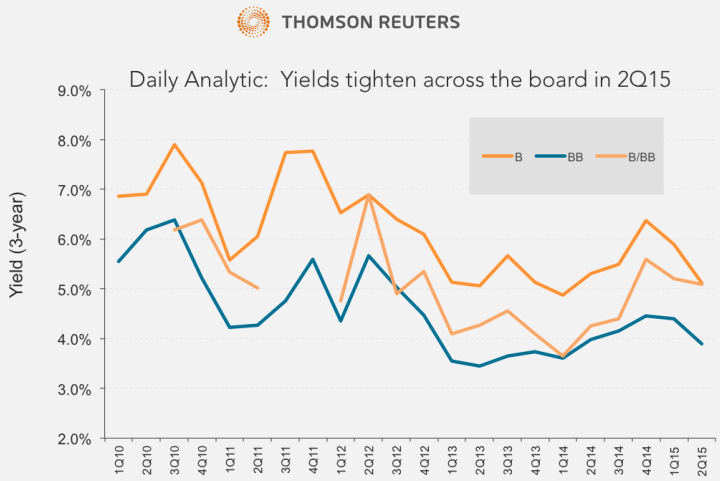

Source: Thomson Reuters LPC

Yields on institutional term loans have tightened in 2Q15. The average yield assuming a three-year term to repayment on first-lien institutional loans is at 5.01 percent so far in 2Q15, down from 5.71 percent in 1Q15, and down over 100bp from 4Q14's level. The current average is the lowest since 1Q14. Investors' appetite remains strong and issuers are taking advantage to cut costs or take out dividend loans. While there were some jumbo M&A announcements last week, refinancings and repricings have dominated so far this quarter. The decline has taken place across the risk spectrum, but more so for lower rated issuers. The average yield for B-rated issuers is 5.12 percent so far in 2Q15, down from 5.89 percent in 1Q15. BB-rated issuers follow with an average yield of 3.89 percent so far this quarter, down from 4.4 percent in 1Q15. The average yield for split-rated issuers is at 5.09 percent, slightly down from 1Q15's 5.2 percent and almost on par with the average for B-rated issuers.

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MARKIT RECAP

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patient and aligned partner.

TLL: What's been your biggest surprise at Star Mountain?

BH: I would say it's how we've been able to attract institutional investor partners who are willing to grow with us. This asset class is less sexy than the ones they were used to, but the risk-reward is attractive to them. I also feel blessed to have such an incredible group of business partners whom I consider friends and family. We are truly one team, aligned and focused on making a difference and enjoying the journey!

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MIDDLE MARKET Growth

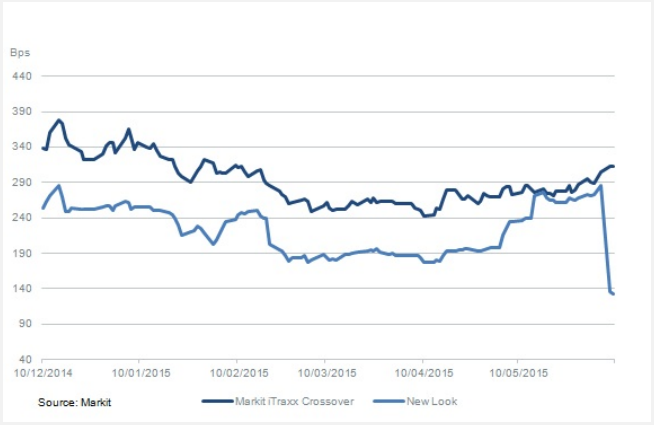
Take Two and Call Us in the Morning

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...

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



Macro themes continue to dominate fixed income markets, but investors shouldn't lose sight of the idiosyncratic stories that are unfolding in the background.

New Look, a British high street retailer, saw its spreads tighten dramatically this week after it announced a refinancing that should improve its credit profile. The company was bought by South African investment firm Brait last month, a move that initially saw New Look's spreads widen from 240bps to 270bps. New Look was highly leveraged after being taken private in 2004, and there was uncertainty around the company's financial strategy under new ownership.

But the situation changed this week when New Look released details of the refinancing. The company will issue seven-year senior secured notes and eight-year senior unsecured notes totalling $1.2bn, the proceeds of which will be used to pay down existing debt, including an expensive PIK facility. The refinancing will extend the firm's debt maturity profile and result in lower interest costs - clearly positive credit developments.

New Look's spreads responded in kind, tightening by 150bps to 136bps. In contrast, the Markit iTraxx Crossover, of which New Look is a constituent, widened to over 300bps for the first time since the roll in March. There are several names in the Crossover that trade tighter than New Look; Clariant is quoted at 75bps, tighter than a quarter of the Markit iTraxx Europe constituents. But there also a significant number of names that trade at very wide levels are highly illiquid, resulting in the Crossover hittig levels in excess of 300bps.

New Look demonstrates that there are single names that don't get caught up in the macro tide, though there is little doubt what is currently driving the broader market. Greece is the driving force of sentiment in Europe, and at the time of writing the mood was one of cautious optimism that a deal can be agreed before the end of the month. Hopes have been dashed with wearying frequency in recent months and years, so caution is the watchword. Volatility in the government bond yields shows no sign of abating, with 10-year Bund yields rising above 1% for the first time since September and US yields at a 9-month high. Poor liquidity could see the swings exacerbated as we go into the summer lull.

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THE PULSE OF PRIVATE EQUITY

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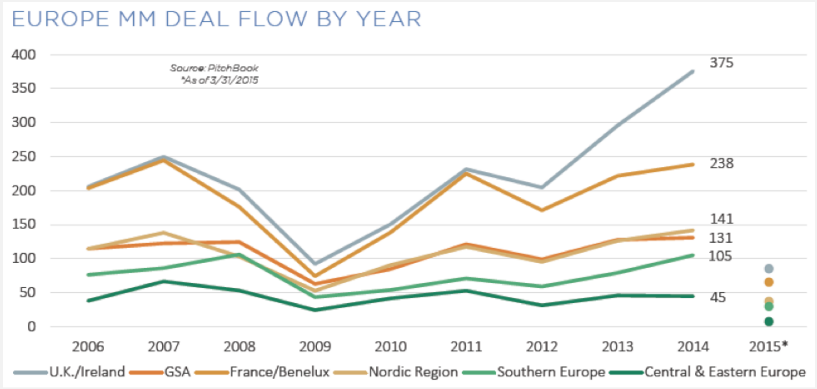

Not all recoveries are created equal

Top-line numbers never tell the whole story in PE. That's especially the case in Europe, where overall middle-market numbers show a pronounced boom in activity between 2009 and 2014. Since bottoming out, deal flow almost tripled by count in five years, to 1,035 deals last year from 350 in 2009. But that huge increase is mostly due to two rapidly improving regions, the U.K./Ireland and the France/Benelux region. The U.K. hit 375 deals last year, another record for the region and a 308% increase over '09. France/Benelux more than tripled its '09 output (222%) to 238 deals. From there, the percentages start to go down - 166% for the Nordic region, 144% for Southern Europe, 108% for Germany/GSA and 88% for Central & Eastern Europe.

Taking it a step further, you could argue that only the U.K. stands out post-recession. Between 2012 and 2014, the France/Benelux increase (+39%) almost mirrors the other four regions. The U.K.? 84% higher versus 2012. Earlier this year and for the first time, Britain's MM overtook Germany's "Mittelstand" as the largest MM in Europe by revenues and head count. Small surprise that PE firms have latched onto growth in the U.K., while deal flow elsewhere in Europe goes back to normal.

To download PitchBook's 1H 2015 European Middle Market Report, please click here.

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SELECT DEALS IN THE MARKET

Deal	Arranger	Sponsor	Industry	Facility*	Spread	LIB Flr	OID	Rating
American Gaming Systems(4)	Jefferies	Apollo Management	Gaming & Hotel	265	825	100	99	B/B3
Aria Energy Corp (1)	Barclays	Energy Investors Fund	Utilities	200	400	100	99	B/Ba3
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
Gold Standard Baking (1)	BNP	Tricor Pacific Corp	Food & Beverage	109	450	100	99.5	NR/NR
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	475	100	99.5	B/B2
TouchTunes Music (2L)(3)	Citizens	Searchlight Capital	Computers & Electronics	62.5	825	100	98.5	B/B2
Averages				153	553	100	#REF!	

* 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) 6 Months 102/101
(5) 2 Month 101

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

THE Lead Left

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