THE Lead Left
The Premier Middle Market Newsletter

Churchill Asset Management
A TIAA-CREF Company

New Release
For Subscribers Only

State of the Capital Markets
Second Quarter 2015 Review and
Third Quarter 2015 Outlook

Why Volatility Matters (Part One)

According to Merriam-Webster, the word "volatility" comes from the Latin, *volātilis*, meaning *flying*. Any investor who has remotely been paying attention to market events over the past several weeks can appreciate that etymological derivation.

Even this community grown accustomed to wild swings of value over the past seven years was taken aback by the gyrations on display in the public equity markets, first overseas, then in the US. The Dow plummeted some 2000 points in the one week beginning August 18th, but has recovered almost half of that ground through this week.

What caused these dramatic moves is unclear. Ostensibly the slowdown in growth coming out of China was a contributing factor, despite the fact that this trend had been developing and trumpeted for months.

Or it could have been the general uncertainty on interest rates, despite the fact that the Fed has been telegraphing an increase all year.

Whatever the reason, after the worrisome headlines last month, investors reassessed the situation and determined that things weren't quite as bad as they looked - at least, in the equity markets.

Meanwhile in the public credit markets, volatility lived up to its name's origins as flying to quality manifested itself in heady outflows from retail bond funds. The final week of August saw $1.6 billion depart from bond funds, according to Lipper FMI.

With risk off, this seemed a reasonable response for investors in the junk asset class. As our *Chart of the Week* depicts, the high-yield premium and volatility index have moved in concert for ten years, demonstrating almost perfect correlation.

What made less sense was the equally dizzying $800 million of retail cash that exited loan funds that same week. While certainly some of that money went to CDs and Treasuries, the result was a puzzle, as one friend of ours highlighted:

"I get the bond outflows," he told us. "It's all about rates and risk. But *loan* outflows? Don't investors know what loans are? They're secured, unlike bonds. They're floating rate so perfect hedges against a Fed move. And there's little exposure to Asia. What gives?"

It was instructional to witness as well, in contrast to major zig-zags in public equity valuations, loan prices in the secondary market barely budging over the same period. Per S&P LCD, the aggregate price for the most liquid loans softened only 1 point, from around 99 to just over 98

QUOTE OF THE WEEK

"It's sort of a rate ruckus."

– Jim Dunigan, chief investment officer, PNC Wealth Management.

Back to School!

30-DAY FREE MEMBERSHIP

Join the leading voice of the middle market. Try us free for 30 days.

JOIN

(with par issuance being 100).

Over the next few weeks, we'll explore the questions raised by market movements in the current environment. In particular, we'll examine the role volatility plays in the credit markets, and how experienced investors are looking for opportunities amid what looks like an extended period of general uncertainty.

21ST ANNUAL
THOMSON REUTERS LPC
LOAN & CLO CONFERENCE

Thursday September 10, 2015
Marriott Marquis, New York City

THE NEW LOAN MARKET - READY OR NOT, HERE IT COMES

Risk retention, Leveraged Lending Guidance and Basel 3 are just a few factors impacting the loan market.

Join LPC this September for our 21st Annual Loan and CLO Conference, where industry experts will discuss the dramatic changes coming to the loan market - and what they might mean for you.

loanpricing.com/2015conference

THOMSON REUTERS

THE LEAD LEFT SPOTLIGHT

Moore&VanAllen

This week we chat with Wayne McKinzie, a partner at Moore & Van Allen PLLC. Named in *Best Lawyers in America for Banking and Finance Law*, Wayne represents investors in various senior and mezzanine financing transactions and investments. Moore & Van Allen, based in Charlotte, is one of the largest law firms in the Southeast, employing nearly 300 attorneys, with approximately 80 attorneys on the Financial Services team.

The Lead Left: Wayne, from your perspective representing the buy-side, how do you see terms evolving for leveraged loans?

Wayne McKinzie: Clearly 2015 has continued the trend with financial sponsors having lots of negotiating leverage, given the strong demand for leveraged paper. What everyone says about structures weakening - or becoming more flexible, depending on your viewpoint - is accurate. We focus mostly on the middle market.

TLL: What are some trends in the middle market?

WM: I would say the big theme is what has moved down from the larger middle market in terms of structures.

CHART OF THE WEEK

Correlation Nation

The high yield bond premium over Treasuries and volatility as measured by the VIX have proven to be highly correlated.

Source: Bloomberg

STAT OF THE WEEK

	July 2015	Feb 2010	Nov 1990	Sept 1947
Consumer Loans at All Commercial Banks ($Bs)	1,230	812	374	5

Source: FRED

LOAN STATS AT A GLANCE

Provided by:

S&P CAPITAL IQ

The tension for our investor clients is financing companies that are not as large, often with unproven management and business plans. Some of these firms have had a bumpy ride.

" There are a variety of debt baskets in documentation - builder, starter, and 'free-and-clear (FAC)'. "

TLL: What terms are coming down market from larger issuers?

WM: Investors are being asked to build in all sorts of flexibility, which may not be appropriate at the front end. If the borrower wants lots of room on covenants or baskets, investors may prefer to accommodate them down the road when a specific transaction or situation is at hand. Right now we're helping clients pick their battles.

TLL: Could you share with our readers some of the big issues you're wrestling with?

WM: It's about overall structures. We have clients pitching multiple options - first lien/second lien, first lien/mezzanine - often with ancillary revolving credits. I know you had a column on RCs. We spend a lot of time on RC needs and draw conditions. No question our clients need to offer that capacity in the current market.

TLL: It seems to be the price arrangers pay for leading transactions.

WM: You don't want the RC to end up as additional long-term debt. It's often important to build in an incurrence or other incremental long-term debt test. You can borrow but you have to show you're in covenant compliance. For example, leverage at draw needs to be no greater than starting leverage. We also sometimes see a 45-day clean-down of the RC to ensure it's a true working capital facility.

TLL: How about inter-creditor issues?

WM: They come up in a number of middle market deals. We've seen them when dealing with seller notes, usually structured as hold co securities. Also, when sponsors fund acquisitions they sometimes structure a portion of their investment as hold co debt. One big issue relates to structuring for future

	This Week	Last Week	6MO Ago	YR Ago
New-Issue Clearing Yields				
$200M or less	6.38%	6.29%	6.51%	6.68%
$201M - $350M	5.73%	5.64%	6.29%	5.97%
$351M - $500M	5.50%	5.47%	6.21%	5.92%
$501M+	4.93%	4.87%	5.45%	5.06%
Middle market (≤ $50M)	6.13%	6.05%	6.74%	6.21%
Large corporate (> $50M)	5.19%	5.13%	5.71%	5.44%
Large corporate single-B (> $50M)	5.35%	5.28%	5.81%	5.52%
Middle Market Credit Stats				
Sr/EBITDA	5.2	5.2	5.0	4.9
Debt/EBITDA	5.4	5.4	5.0	5.1
Middle Market Index Data				
Monthly Returns	0.02%	-0.54%	0.27%	0.11%
Average Bid	96.19	96.25	96.26	98.32

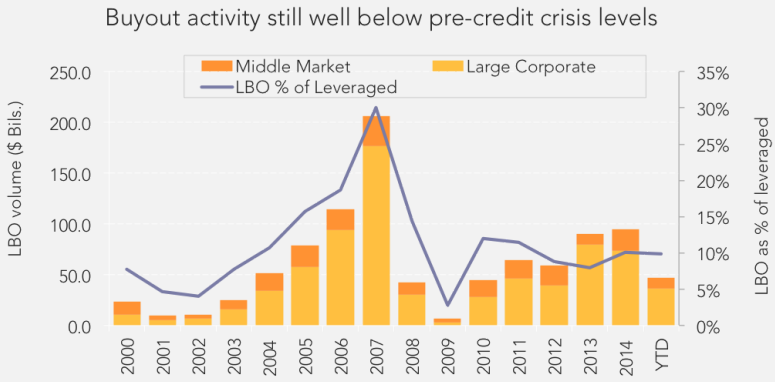
Source: S&P Capital IQ

Contact: Daniel Mena
daniel.mena@spcapitaliq.com

LEVERAGE LOAN INSIGHT & ANALYSIS

Provided by:

THOMSON REUTERS



Source: Thomson Reuters LPC

M&A activity in the syndicated loan market is as strong as ever, however the volume is simply not coming from buyout deals. Private equity shops continue to struggle with winning and making buyout deals work given lofty valuations and extreme competition. Completed LBO issuance so far in 2015 has only reached $47 billion, about half the levels seen in 2014 of $95 billion and a fraction of the $206 billion logged back in 2007 during the buyout boom. Furthermore, buyout activity is only making up 10% of leveraged loan volume compared to roughly 20-30% of leveraged activity pre credit crisis. With Labor Day behind us, many leveraged loan investors are hoping for a pick up in the remaining months. However, with much global macro economic uncertainty swirling around the markets, many are questioning whether fourth quarter activity could be affected. As of this week, investors are patiently awaiting the launch of a few large deals including Belk's US$3.0 billion buyout financing by Sycamore Partners. Blackstone also recently announced they would purchase Strategic Hotels & Resorts for $6.0 billion, however financing details are unknown and the deal is slated for a 2016 close.

Join us on September 10th to hear views from our Middle Market Panel and more - Register with code **IB2015** for $200 discount.

Contact: Fran Beyers
frances.beyers@thomsonreuters.com

MARKIT RECAP

Provided by:

incremental debt and having the note holder agree to be subordinate to these new facilities.

TLL: What about second liens?

WM: Not all players have the same conception of what it means to be a second lien. Some are expecting second lien with no payment blocks as part of the inter-creditor agreement, just lien subordination. But some first lien lenders expect the second lien to accept a payment block as well.

TLL: And you represent both first and second lien holders.

WM: One tricky situation is when you have the same arranger and agent for both first and second lien facilities. When you're representing a second lien lender, one key is negotiating when the second lien can be released by the first lien lenders. Ideally that happens only when the first lien lenders are exercising remedies and proceeds go to pay down the first lien, or in any transaction permitted by the second lien documents.

TLL: Where are the pain points for you representing second lien holders?

WM: We push back on forced lien releases in connection with an asset sale approved by the first lien lenders when the borrower wants to keep the proceeds for "liquidity." The downside is when there's a problem and the sponsor is not compelled to fix the problem.

TLL: Wayne, could you help clear up the confusion on debt baskets? How do you think about incremental debt from the lender's perspective?

WM: There certainly are a variety of debt baskets in documentation - builder, starter, and "free-and-clear (FAC)". Let me first take the incremental baskets. These typically have ratio-based components. One question is, can you use a leverage based component first, and then add debt using a FAC basket?

To be continued the week of Sept 14

Contact:
Wayne McKinzie

markit

Brazilian bonds sink prior to downgrade

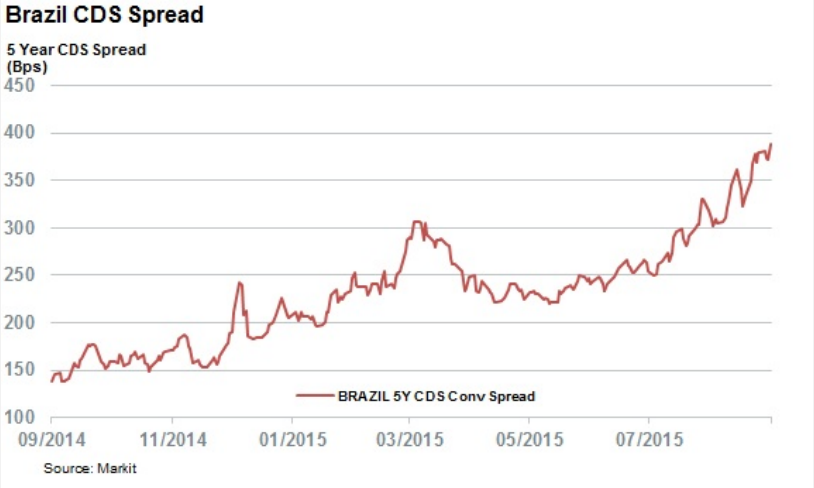
Brazil's recent downgrade to junk will come as little surprise to market observers given the increasingly bearish sentiment seen in Brazilian sovereign bonds.

- Brazilian CDS spreads at 371bps, twice where they stood a year ago
- The Markit iBoxx USD Brazil Sovereigns Index crossed the 6% threshold for the first time
- Local bonds still offer positive total return for the year despite a 2% spike in yields ytd

Brazil's ongoing struggles came to a head today when US rating agency Standard and Poor, **downgraded** its debt rating to junk. Competing rating agencies, Fitch and Moody's continue to rate Brazilian debt as investment grade, yet ongoing political strife and budget deficit forecasted to hit 9% of GDP the suggest these ratings could come under strain.

CDS spreads already junk

The S&P downgrade represents a heavy setback for the country after seven years in the investment grade universe, yet the news will come as little surprise to market observers as Brazil's **CDS spread** has been trading with a junk implied rating for quite some time. Brazil's sovereign CDS traded with an implied rating of B, a lower grade than even the most pessimistic credit agency rating.



While most of the recent deterioration was already priced in, as evidenced by the tripling of Brazilian CDS spreads in the last 12 months to 371bps as of Wednesday's close, today's announcement saw the country's CDS spread deteriorate even further to a new all-time high of 395.

Dollar bonds dive

Brazil's ongoing issues are also reflected in its dollar denominated sovereign bonds which have slumped to new recent lows according to the **Markit iBoxx** USD Brazil Sovereigns index. The index's yield has jumped past the 6% mark for the first time since its inception on the 3rd of this month and yielded 6.16% as of Wednesday's close, an all-time high since the index's inception in 2010.

waynemckinzie@mvalaw.com

MIDDLE MARKET Growth

No Parent Left Behind

"What did you learn in math class today, honey?" Picking up my 5-year-old from her second day of an after-school program this past spring, I hoped to hear about her progress toward coding stardom and launching the next Uber. Or at least toward getting straight-A's in kindergarten.

Plopping into the car seat, she clipped her seat belt and made a face. "Numbers again," she sighed.

Numbers count more than ever today in education, along with science, technology and engineering. Born of our national fears of technical inadequacy, curricula have shifted from writing to 'rithmetic. No Child Left Behind's legacy is that test scores are the ammo in a global high-tech job war....

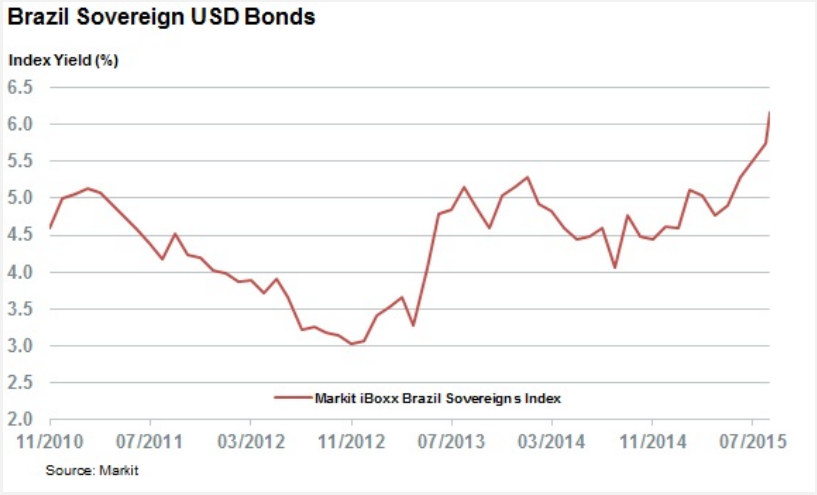
Click here
to read Randy Schwimmer's MidPoints column in the latest issue of Middle Market Growth magazine.

nyssa society of security analysts

25th Annual High Yield Bond Conference and Master Class

The 25th Anniversary New York Society of Security Analysts High Yield Bond Conference will take place on September 9-10. Presenters at the Master Class on September 9 will instruct attendees on the most up-to-date methods of credit analysis, valuation, and portfolio management. The Conference's general sessions on September 10 will describe the outlook for default rates and returns for high yield bonds, distressed debt, and leveraged loans. Attendees will hear from leading experts where the best opportunities are and what the latest research on the market reveals about maximizing performance. Each person attending the High Yield Bond Conference and Master Class will receive a copy of NYSSA's new book, High Yield, Future Tense, Cracking the Code of Speculative Debt, included as part of the conference fee, on the day of its publication.

For further information see here.



This latest deterioration means that investors are now requiring 1.5% of extra yield to hold Brazilian bonds than at the start of the year. This was driven predominantly by investors requiring more yield over benchmark US treasuries as the index's asset swap spread has jumped to a new all-time high of 359bps.

This deterioration means that the index is down 8.2% on a total return basis, its worst nine month run since 2012.

Real bonds also feeling heat

Domestic real denominated sovereign bonds which make up the Markit iBoxx GEMX Brazil, have also seen their yield surge since the start of the year with the index now yielding 14.3%, a new seven year high.

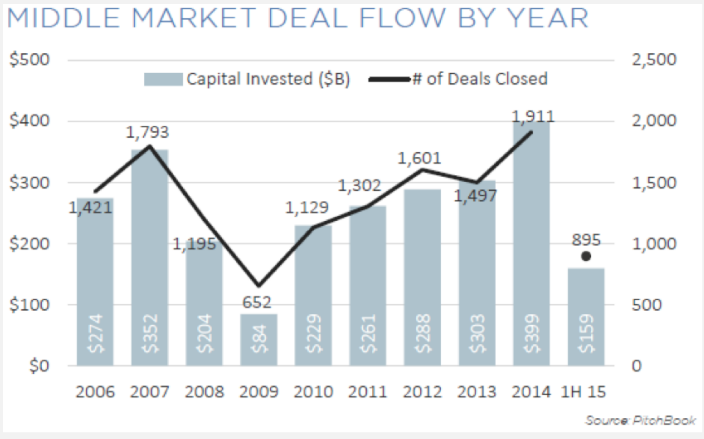
Interestingly, real denominated bonds already carried a relatively higher yield prior to the recent selloff which has helped ensure that the index has managed to deliver positive total returns for the year. The index has returned 1% of total returns so far this year, despite seeing its yield surge 2.3%.

Contact: Simon Colvin
simon.colvin@markit.com

THE PULSE OF PRIVATE EQUITY

Provided by:

PitchBook
Better Data. Better Decisions.



Opportunity Ahead for PE?

The finance community has been hit hard the past few weeks. Even long-term asset classes like venture are keeping tabs on short-term fluctuations in the market. Private equity doesn't seem as concerned, and shouldn't be. The biblical seller's market that began in 2013 was perfectly timed ahead of the current correction. Now the only headache is deal flow, which should stay buoyant despite the stormy market. In fact, the PE environment could be looking at a big opportunity over the next few years. Volatility in the public markets is tethered

to uncertainties in Europe and China, and to an extent in the Fed itself. But they have little to do with the U.S. economy itself, which is recovering by many measures.

Especially the U.S. middle market. The MM lacks significant exposure to the global economy, a definite positive in this environment. Two variables that will affect PE - an interest rate hike and fall in energy prices - will have negligible consequences for investors, and in the case of energy prices should help middle market managers lower production costs across their portfolios.

Two other possible perks: cratering stock prices could spur PE sponsors back into the public markets. Other investors may be wary of buying low with so much uncertainty, but PE can justify those take-privates if the margins are wide enough as is. Second, LP capital has begun shifting away from equities, bonds and hedge funds in recent weeks. PE firms haven't had any issue raising money of late, but they could be seeing even more demand from skittish investors going forward. Should that happen, PE will be facing the same competition levels as before, but with healthier deal-making opportunities in front of them.

Contact: Alex Lykken
alex.lykken@pitchbook.com

SELECT DEALS IN THE MARKET

Deal	Arranger	Sponsor	Industry	Facility*	Spread	LIB Flr	OID	Rating
Cole-Parmer Instrument (CL)(AO)	Golub	GTCR Golder Rauner	Manufacturing & Machinery	30	450	100	N/A	B/B3
Consolidated Aerospace (CL)(1)	Citizens	Tinicum	Aerospace & Defense	240	375	100	99.5	B+/B2
CRGT Inc (4)(AO)	CS	Bridge Growth	Computers & Electronics	80	650	100	99.75	B-/B3
Innovative XCessories (1)(AO)	GE	Olympus Partners	Automotive	95	425	100	99.5	NR/NR
Jet Support Services (3)(D)	UBS AG	1848 Capital	Aerospace & Defense	175	650	100	98	NR/NR
PetroChoice (2)(CL)	Barclays	Golden Gate	Oil & Gas	235	500	100	97.5	B/B2
PetroChoice (3)(CL)	Barclays	Golden Gate	Oil & Gas	90	875	100	98	B/B2
PowerTeam Services (CL)(1)(AO)	Jefferies	Kelso	Utilities	40	325	100	99.026	B/B3
Smart Start (1)	BNP	ABRY Partners	Retail	145	475	100	99	NR/NR
SRS Distribution (CL)(2)	Barclays	Berkshire Partners	Building Materials	325	425	100	99	B/B2
V. Group (CL)(1)	GS	OMERS Capital	Services & Leasing	90	400	100	100	B/B1
Vistage Worldwide (1)(D)	SunTrust	TowerBrook Capital	Services & Leasing	150	550	100	99	B/B2
Averages				141	508	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) 4 Months 101

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

Get Connected with Lead Left:

THE Lead Left

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

This publication is a service to our clients and friends. It is designed only to give general information on the market developments actually covered. It is not intended to be a comprehensive summary of recent developments or to suggest parameters for any prospective financing opportunity.