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State of the Capital Markets: Third Quarter 2015 Review and Fourth Quarter 2015 Outlook



The Unitranche - What it is, and Why it Matters (Third of a Series)

So far in our unitranche series we've examined the structural variations of this increasingly popular financing tool for leveraged lenders and sponsors. This week we look behind the curtain at the dynamics between lenders in the unitranche itself.

For some unitranche options, one debt provider alone mimics the leverage that would be offered by both first and second lien (or senior and sub) lenders at a blended pricing of the two debt layers. Size is less a limiting factor today as one-stop credit solution suppliers can underwrite and hold \$250 million or more, distributing the paper within various vehicles under their control.

The unitranche can also be bifurcated behind the scenes into first-out and second-out term loans with different lenders providing each piece. Unlike a multi-tranche financing with separate credit and security agreements (and distinct security interests), the relationship between unitranche lenders is governed by one document called an Agreement Among Lenders, or AAL.

The AAL is outside of the credit and security agreement between the unitranche provider and the borrower, and is negotiated by the lenders. The main purpose of the AAL is to clearly outline the intercreditor terms and conditions. As we discussed last week, because so many unitranche alternatives exist, each AAL is unique.

First each tranche must be clearly defined. If an ABL revolver is involved, it is typically included in the first-out loan and everything else is second-out. If there are other debt layers, each must be distinguished in terms of rights and provisions to the others.

Sharing of the economics is straightforward. Unitranche is a synthetic blend of first-out and second-out costs to the borrower - higher than the first-out and lower than the second-out typically receive alone. Accordingly, the first-out lender must pass along a share (or "skim") of the blended rate to the second-out lender. The amount of skim depends on how leveraged the first-out is, thus how much risk is borne by that lender.

Interest and principal payments are shared *pari passu* unless a "waterfall trigger event" occurs. Triggers include payment or covenant defaults under the credit agreement, and bankruptcy. In those cases payments or liquidation proceeds go first to the first-out.

Voting rights may be the most important, and heavily negotiated, of AAL provisions. In general, consent of both required (i.e. majority of) first-out and second-out lenders is necessary to amend or waive the credit agreement. When the second-out is over-weighted relative to the first-out

QUOTE OF THE WEEK

"The question here is how long the suspense is going to be this time."
– Stanley Sun, interest rate strategist, Nomura Securities, on Congressional budget negotiations.

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(the "upside-down" unitranche), that lender might have more favorable rights than the first-out. The same is true of buyout rights.

A complete analysis of all AAL permutations is beyond the scope of this commentary, but we will be working to aggregate expert opinions for our readers on this timely topic.

Given the growing complexity of unitranches, it is crucial to have a high level of trust among first-out and second-out participants. As one attorney puts it: Know your lender!

Next week we continue our series by looking at the universe of unitranche players.



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THE LEAD LEFT SPOTLIGHT



This week we chat with **Robert A. Hamwee**, president and chief executive officer of New Mountain Finance Corp. (NMFC). NMFC is a public BDC investing in debt securities in all levels of the capital structure, primarily focusing on middle market companies with Ebitda between \$20-200 million.

The Lead Left: Rob, how do you explain the strategy for New Mountain's debt practice?

Robert Hamwee: We're not positioning ourselves as turnkey providers for all your needs. We're a great source of capital in different formats, mezzanine or unitranche in the industries we focus on. For example, heavy industrial deals aren't in the category of things we know well. The key for New Mountain is utilizing our relevant private equity members to be strategic about what we know well. That speaks to the broader platform of the firm.

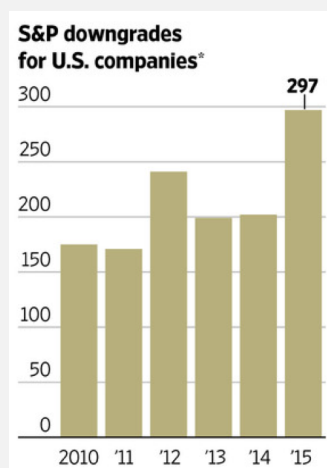
TLL: So what are the industry verticals that comprise your firm's core practices?

RH: Some examples would be enterprise software, tech-enabled business services, niche healthcare, distribution and logistics, federal services, and education. That's the bulk of it. We've done a little bit of energy

CHART OF THE WEEK

On Watch

The number of risk rating downgrades in the corporate sector has hit a five year high - worst since the credit crisis.



Source: The Daily Shot, @WSJ Markets

STAT OF THE WEEK

	2017*	2015	2013	2012
E-Signature Transactions (MMs)	754	322	143	89

Source: Forrester Data

*Forrester forecasts: 53% annual growth, 2014 to 2017

LOAN STATS AT A GLANCE

Provided by:



and some other miscellaneous sectors.

"We're more concerned about leverage as a percent of enterprise value."

TLL: What are the common attributes?

RH: What knits it all together are these are generally companies with repetitive revenue models in acyclical industries and having niche market dominance. Typically these are high ROE types of businesses, not capex intense, and with variable cost structures.

TLL: How about size of company?

RH: We're not so dogmatic about that. We're agnostic about whether they are \$1 billion in Ebitda, or \$75 million. Obviously there's more risk involved with smaller companies. We price around that. I would say 75% of the companies we invest in have enterprise values between \$150-500 million.

TLL: How do you source your deals?

RH: The majority of transactions we've originated since inception has been materially underwritten for the private equity side of the house, but for some reason, typically valuation, they didn't do. We don't invest in debt in the companies owned by our PE practice. These are situations where they didn't end up owning the equity, but we somehow got our way in.

TLL: Are most of your debt investments with sponsor backed companies?

RH: Probably 75% come from our own sponsor coverage. The balance comes from relevant intermediaries. That's everyone from Credit Suisse all the way to smaller advisory firms.

TLL: How do you like to structure your debt investments?

RH: I would say it's 50/50 in terms of first-lien, non-first-lien, with the latter comprised of about 80% second-lien and the rest subordinated and unsecured debt. We have very few equity co-investments, probably 1-2%. And of the first-lien transactions, roughly 40% are unitranche and 60% the traditional senior and stretch senior.

TLL: How about yield requirements?

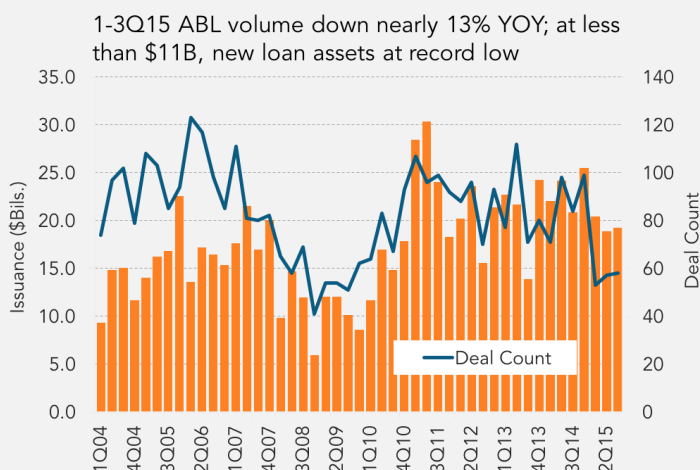
	This Week	Last Week	6MO Ago	YR Ago
New-Issue Clearing Yields				
\$200M or less	7.05%	7.03%	6.00%	7.75%
\$201M - \$350M	5.89%	5.90%	6.06%	6.31%
\$351M - \$500M	6.18%	6.11%	5.81%	6.52%
\$501M+	5.13%	5.13%	4.93%	5.32%
Middle Market Credit Stats				
Middle market ($\leq$ \$50M)	6.33%	6.27%	5.82%	6.81%
Large corporate ($>$ \$50M)	5.48%	5.47%	5.23%	5.76%
Large corporate single-B ($>$ \$50M)	5.64%	5.60%	5.32%	5.94%
Middle Market Index Data				
Sr/EBITDA	5.8	6.2	4.8	5.0
Debt/EBITDA	5.8	6.2	5.2	5.0
Monthly Returns				
Average Bid	95.83	95.99	97.03	96.81

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

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LEVERAGE LOAN INSIGHT & ANALYSIS

Provided by:



Source: [Thomson Reuters LPC](#)

In sync with the broader leveraged cash flow market, asset-based lenders struggled to source new dealflow in 3Q15. At just over US\$19bn, 3Q15 ABL volume was modestly higher from 2Q15 totals to bring year to date volume to US\$58.5bn, down nearly 13% compared to the year ago period. More noteworthy, at US\$10.6bn, the volume of new syndicated loan assets marks a historical low at 18% of total issuance. But the numbers may be a bit skewed - lenders note that smaller, clubbed transactions and upsizings have dominated lending at the expense of larger, chunky deals, in many cases bypassing the retail market. In fact, 65% of ABL issuance so far this year is among deals of less than US\$200m while only 18% of issuance represents deals of at least US\$500m.

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MARKIT RECAP

Provided by:



RH: At the low end, we're in the mid-sevens, to a high of mid-teens. Average is in the 10% range.

TLL: And leverage?

RH: For regular way senior, leverage would be 4x, going up to 5.5x for stretch senior. Second lien multiples range from 5 to low sevens. We're more concerned about leverage as a percent of enterprise value.

TLL: Does where we are in the cycle inform your view of leverage?

RH: We're not smart enough to know where we are in the cycle. We're not trying to time cycles.

To be continued the week of Oct 26

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MIDDLE MARKET Growth

What's Bugging You?

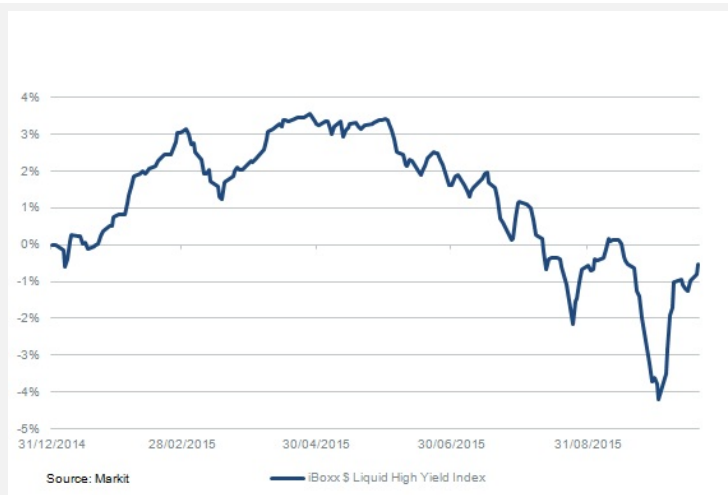
Say you're driving along the highway in your brand spanking new Jeep Cherokee. It's a bright sunny day. You're going 65, maybe 70. Listening to some Charlie Parker. Maybe headed to an ACG event.

Suddenly windshield wipers start flapping. The AC shuts off. Then so does Charlie Parker. Accelerator starts racing. Steering wheel jerks out of your control. The Jeep veers sideways, headed into a ditch. Your life flashes before your eyes, including the life insurance policy you meant to buy. Worst of all, the last thing you hear before plunging off the road is the radio blaring Taylor Swift.

The latest Liam Neeson hijack thriller? Actually it's similar to a car-hacking that made news in July. Two professional hackers named Miller and Valasek used a laptop to seize remote control of a Jeep and, yes, drive it into a ditch. The good news is that the driver was in on the experiment...

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



The last few months have proven to be a volatile time for the HY market, highlighting the risks involved in the asset class. But with significant yields on offer and different markets to explore, HY bonds remain a quandary for investors.

The recent volatility can be illustrated by looking at recent returns. September saw US high yield (HY) bonds, as represented by the Markit iBoxx \$ Liquid High Yield (HYG) index, return -3.05%, the worst month since August 2011. It was a similar story in the European HY market, as represented by the Markit iBoxx EUR Liquid High Yield index, which shed 2.5% last month on a total return basis. Both markets have, however, bounced back so far this month with US HY up 2.6% and European HY up 1.7% as investors returned to the asset class.

Overall, 2015 has so far proven better for European high yield investors as the asset class has managed to hold on to a positive total return, largely thanks to coupon returns, while its US peers are in the red for the year despite their recent rebound. While returns have literally fallen off a cliff since March, yields have conversely increased this year with European HY currently yielding 4.94% (up 70bps) and US HY yielding 7.28% (up 93bps). This equates to around 71bps in excess spread (premium) between the two markets.

One factor driving the trend is the fact that the European HY market is smaller and relatively composed of higher rated entities. Only 2.5% of the iBoxx EUR Liquid High Yield index is rated CCC compared to more than 10% of the US HY index.

Sectors also played an important role in risk sentiment across both markets. US HY spreads have been largely driven by two sectors, Oil & Gas and Basic Materials, where plummeting commodity prices weighed in on credit risk. Last month US HY spreads tipped over 600bps just as Oil & Gas and Basic Materials sectors spiked to over 1000bps, or 10% extra yield over US treasuries. Both these sectors make up 20% of the iBoxx \$ Liquid High Yield index, providing plenty of clout on the US HY market.

In contrast European HY has much less exposure to the energy sector, and credits are much more focused on Financials and large multinationals such as Altice and ThyssenKrupp.

The large question hanging over the asset class still remains the underlying ability of borrowers to meet debt commitments. While actual defaults have so far been well off the worst case scenarios painted by some market observers, CDS investors are still wary, given that the median implied probability of default for the 100 Markit iTraxx CDX HY (current spread is 454bps vs 564bps for HYG) names is 27.35%, well above current prevailing default rates in underlying cash bonds.

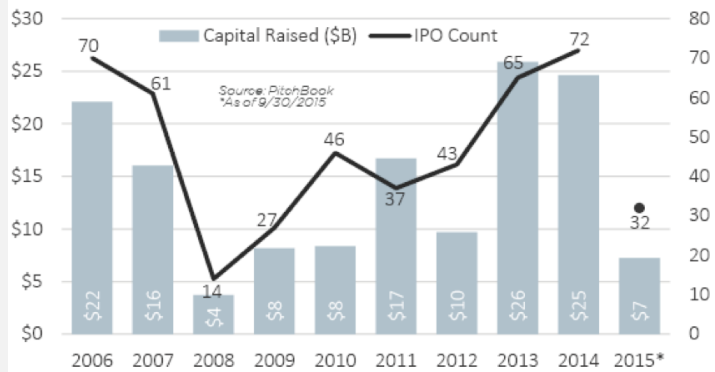
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THE PULSE OF PRIVATE EQUITY

Provided by:

U.S. PE-SPONSORED IPO FLOW BY YEAR



After a slow third quarter, 2015 has only seen 32 private equity-sponsored initial public offerings (IPO), raising a combined \$7 billion. The IPO window for PE sponsors in the fourth quarter of 2015 may be narrowing, although it's unclear how much concern that should really cause for now. After all, even though an initially disappointing debut can prompt fear of subdued performance for some time, PE firms can defer much liquidity until they can execute secondary offerings in a more welcoming climate. But for now, fear of volatility and underwhelming debuts from Blackstone's Performance Food Group (NYSE: PFGC) and KKR's First Data (NYSE: FDC) seem to have spooked Cerberus Capital Management-backed Albertson's, for one, although a slide in results posted by Walmart (NYSE: WMT) didn't help matters. With many pointing to the sheer mass of debt on the balance sheets of First Data as one of the causes for investor wariness—given a potential uptick in interest rates at some, undetermined future date—fellow PE portfolio companies that are similarly leveraged, however healthy their overall financials, may well steer clear of going public in what remains of 2015. But as the First Data offering again signifies, timing isn't restricted to just the amenability of public markets when it comes to some of these PE portfolio companies. First Data was one of the last holdovers of the buyout boom era, with KKR likely biting the bullet and taking it public regardless of volatility in order to achieve some liquidity. Other prominent PE-backed companies in the pipeline, such as Univision, may eventually follow suit, if debt payments become an issue. It's either that or court a strategic buyer, but some of the companies are fairly hefty prospects for corporate acquirers to absorb. In the end, it comes down to how much PE investors will weigh various timing factors against each other. The potential increase in leverage costs, how much longer volatility will persist, and whether going public now will substantially weigh performance for some time will all be carefully considered by the PE firms whose companies are currently in the pipeline.

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SELECT DEALS IN THE MARKET

Deal	Arranger	Sponsor	Industry	Facility*	Spread	LIB Flr	OID	Rating
DigiCert (CL)(1)	Jefferies	Thoma Bravo	Computers & Electronics	220	450	100	99	B-/B3
Foundation Building Materials (1L)(2)	RBC	Lone Star Funds	Building Materials	245	625	100	95	B/B3
Foundation Building Materials (2L)(3)	RBC	Lone Star Funds	Building Materials	80	1050	100	94	B/B3
Integro (1L)(2)	CS	Odyssey Partners	Insurance	270	575	100	96	B/B3
Integro (2L)(4)	CS	Odyssey Partners	Insurance	105	925	100	98	B/B3
Novetta Solutions (1L)(CL)(2)	Jefferies	Carlyle Group	Computers & Electronics	200	500	100	99	B/B3
Novetta Solutions (2L)(3)	Jefferies	Carlyle Group	Computers & Electronics	85	850	100	99	B/B3
Universal Fiber Systems (1L)(1)	BNP	HIG Capital	Textile & Apparel	165	550	100	99	B/B2
Universal Fiber Systems (2L)(3)	BNP	HIG Capital	Textile & Apparel	40	950	100	98	B/B2
Averages				172	711	100	97	

* 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) NC-1/103/101



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