THE Lead Left
The Premier Middle Market Newsletter

Churchill Asset Management
A TIAA-CREF Company

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

As with all great capital market innovations - price flex, CLOs, and second-lien term loans - the unitranche seems obvious in hindsight. Having one lender provide a senior secured tranche that mimics a combined senior and subordinated debt structure solves a number of borrower issues. Yet its development was hardly a foregone conclusion.

A decade ago the notion of one debt provider bridging the divide between a secured and unsecured obligation was far-fetched. Banks still dominated the senior debt space, and private funds ruled the mezzanine class. But then two things happened.

In late 2007 GE Antares and Ares developed the first unitranche fund - the Senior Secured Loan Program. The $3.6 billion SSLP fund offered one tranche to borrowers by synthetically blending pricing for a first-out tranche (provided by GE) with a second-out tranche (Ares' contribution).

Then came the Great Recession. In the face of uncertain liquidity and a derailed loan syndication market, the unitranche offered certainty of execution. Private equity sponsors are typically reluctant to put all their financing eggs into one provider basket. But the unitranche became an increasingly attractive one-stop credit solution for a number of concerns raised by disruption in the capital markets.

First, it avoided syndication risk - arrangers unable to execute due to market conditions. Second, there was no worry about market flex; unitranche providers guaranty their pricing and terms because they can hold the entire tranche. Finally, with only one tranche, inter-lender issues are often managed behind the scenes.

The popularity of the unitranche grew even when liquidity returned to the markets. The overhang of volatility - prompted by Greek exits and US debt rating downgrades - compelled sponsors to continue seeking the safe haven of the one-stop. Also with the advent of Leveraged Lending Guidance, banks struggled to compete effectively with their syndicated product.

Over the past few years, the unitranche has grown in importance. Thanks to the success of SSLP, and now its competitors, sponsors now have a wide range of one-stop options.

William P. Brady, a partner at Proskauer and noted expert on multi-tranche financings, told us how things have changed. "Pre-crisis, the unitranche was a single product with a simple five-page Agreement Among Lenders," he said. "Today the unitranche has evolved from a single product to a platform that replicates an increasingly complex variety of debt structures."

Over the next several weeks we'll examine all aspects of the unitranche phenomenon, including:

- Who are the players?
- How do these players structure their unitranche funds?

QUOTE OF THE WEEK

"I don't think the Fed is going to raise rates in this environment. A rate hike is a 2016 story."

– Daniel Mulholland, senior US Treasury trader, Credit Agricole SA.

Trick or Treat?

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- What are the loan document issues?
- Where is pricing and terms today for unitranche debt?

Next week we continue our series by looking at the different types of unitranche structures.

THE LEAD LEFT SPOTLIGHT

This week we chat with Timothy J. Conway, chairman and chief executive officer of NewStar Financial. Founded by Mr. Conway in 2004, NewStar is focused exclusively on providing sophisticated financing options to mid-sized companies through four national lending groups: leverage finance, business credit, equipment finance, and real estate.

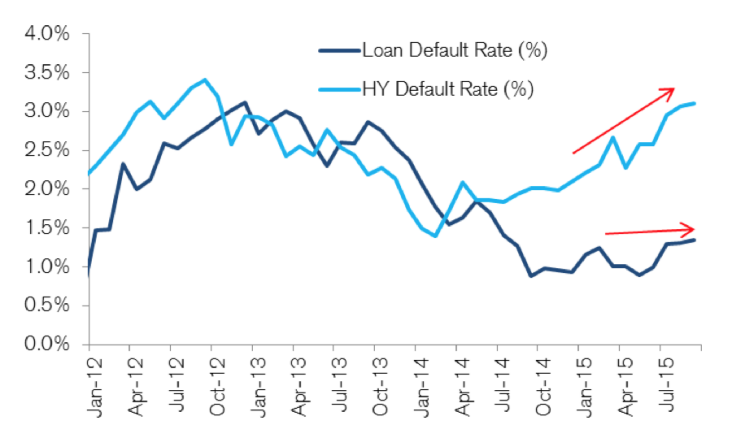
The Lead Left: Your first question, congrats on FOC Partners...

Timothy Conway: Thanks. We are excited about the opportunity to accelerate the growth rate of that part of our business and FOC is a great platform. NewStar operates as a combination of a direct balance sheet lender and an asset manager. Our strategy is to prudently grow the balance sheet and to expand our asset management capabilities in areas that are consistent with our core strengths. The launch of our relationship with Blackstone and GSO has been a catalyst for growth in both the balance sheet and asset management. Feingold O'Keeffe fits perfectly into our thinking on the asset management side. FOC's capabilities, which are centered on liquid loan strategies, complement our existing asset management platform which has been focused on co-

CHART OF THE WEEK

By Default

Since early 2014 high-yield default rates have more than doubled, while the same metric for loans remains below 1.5%.



Source: Credit Suisse

STAT OF THE WEEK

	2015	2014	2013	2012
US Digital Video Ad Spending (Bs)	$7.77	$5.96	$4.20	$2.89

Source: eMarketer

LOAN STATS AT A GLANCE

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investment strategies in middle market loans, which we offer through a series of side-car style funds.

TLL: How did the deal come about?

TC: I was introduced to Andrea and Ian by a mutual friend and we had the opportunity to have several conversations about a combination of the firms. That helped us get to know each other and figure out the strategic and cultural fit. They have built a great business that was independently successful, but there were constraints on their ability to grow related to the whole issue of risk retention. They also recognized that scale is becoming increasingly important. As part of NewStar they will continue to operate their business focused on CLOs, hedge funds and retail funds. The transaction will add about $2.3 billion to our AUM, increasing our total AUM to $6.4 billion. The larger platform and proprietary deal flow from direct origination will clearly enhance the products they can offer investors in the future. So, it's a very attractive investment for us and an opportunity for them to grow faster with our help.

"We can now write a larger check to lead senior financings and GSO can provide junior capital and larger uni-tranche facilities."

TLL: You said they invest primarily in BSL?

TC: Yes, a significant part of their AUM is managed across six CLOs employing liquid loan strategies. They have an excellent track record and performance in the top quartile for most of the CLOs. I believe that some of their success results from finding opportunities in over-looked, less liquid assets in the smaller end of the syndicated market, which crosses over into the higher end of the middle market where we play.

TLL: Isn't it amazing that more of the smaller players haven't taken a similar approach and partnered up with platforms like yours?

TC: I guess we've all been anticipating more of it for at least 10-years. That said, there is probably more to come and we will look to scale our business.

TLL: Talk about the Blackstone GSO

	This Week	Last Week	6MO Ago	YR Ago
New-Issue Clearing Yields				
$200M or less	6.78%	6.78%	6.00%	7.75%
$201M - $350M	5.76%	5.80%	6.06%	6.31%
$351M - $500M	5.65%	5.65%	5.81%	6.52%
$501M+	5.04%	5.04%	4.93%	5.32%
Middle market (≤ $50M)	6.33%	6.33%	5.82%	6.81%
Large corporate (> $50M)	5.27%	5.28%	5.23%	5.76%
Large corporate single-B (> $50M)	5.36%	5.37%	5.32%	5.94%
Middle Market Credit Stats				
Sr/EBITDA	5.8	5.8	4.8	5.0
Debt/EBITDA	6.1	6.1	5.2	5.0
Middle Market Index Data				
Monthly Returns	-0.11%	0.30%	0.15%	-0.11%
Average Bid	95.98	96.21	97.04	97.62

Source: S&P Capital IQ

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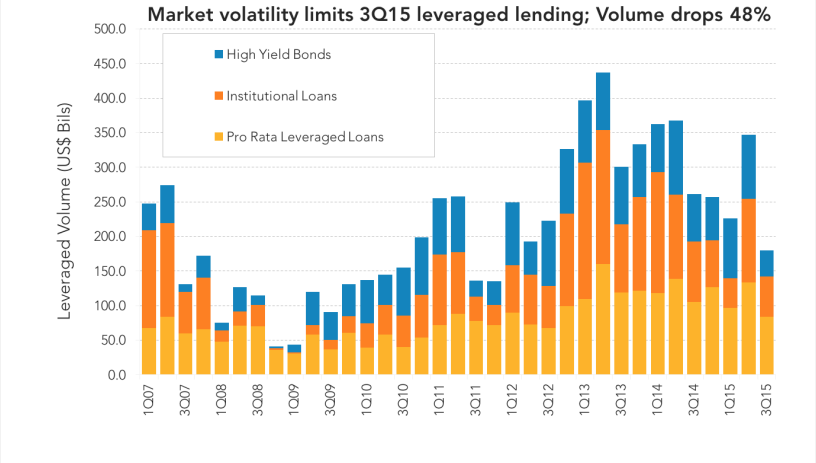
LEVERAGE LOAN INSIGHT & ANALYSIS

Provided by:

THOMSON REUTERS



Source: Thomson Reuters LPC

US Leveraged lending tumbled in 3Q15 as market volatility fueled a flight to quality and heightened risk aversion. At less than $180 billion, 3Q15 leveraged lending was down nearly 50% compared to 2Q15 totals to bring 1-3Q15 totals to $753 billion, down 24% compared to the same time last year. Most of the shortfall was rooted in a steep HY bond market slump in 3Q15. In sympathy with the jitters observed in the equity markets in late August, HY bond issuance stalled with just over $37 billion of new issues working their way through the market. This represented a 60% drop compared to 2Q15 totals. The loan market was a bit more measured in its its response, but opportunistic refinancings evaporated thereby limiting lending activity. Institutional investors became more selective, committing to a relatively thin $58.5 billion in loan assets during the quarter (down from over $121 billion in 2Q15). Pro rata lenders fared a bit better to log nearly $84 billion of issuance, down from $133 billion in 2Q. At just under $537 billion, 1-3Q15 leveraged loan volume was down 28% year over year.

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MARKIT RECAP

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markit

investment. That really is a game changer for you.

TC: You are right, it has been a game changer in many ways. Since closing in the 4th quarter of 2014, we have broadened our product offering to our customers which has enabled us to double origination volume, lead more deals and earn more fees. I have known the GSO team for many years. They were exploring ways to expand their coverage into the lower end of the middle market and decided to accomplish that through an investment in us rather than building it themselves. After a series of conversations, they agreed to invest $300 million as part of a broader strategic partnership. We complement each other very well. With our existing customers, we can now write a larger check to lead senior financings and we can bring GSO to the table to provide additional junior capital and larger uni-tranche facilities. For transactions they originate with larger customers, we often provide the first-out facility, which has given us new access to the larger end of the middle market. Their ability to deliver large, flexible financing solutions is pretty unique and I think we help them do that in certain situations.

TLL: How does the split between you and GSO work?

TC: It depends on the type of deal, but let me provide an example. Let's say $250-300 million of debt is required for an acquisition. We would typically provide $50-60 million of a uni-tranche in a first out position and they hold the remainder. On a risk adjusted basis, I really like the pricing on the first out. We have done about $400 million in volume using this approach since closing the deal in November.

TLL: What size can you speak for?

TC: NewStar will now underwrite $150 million in senior debt in a deal and will hold more than $50 million. The largest deal we have done in conjunction with GSO is $400.

TLL: Impressive. How is the rest of your business outside of Leveraged Finance?

TC: The Asset Based Lending and Equipment Finance are synergistic with the rest of the business, and they work well in the GSO relationship. For

Eastern Europe is generally viewed by credit investors as one of the safer segments of increasingly shaky emerging markets asset class. But the aggressive presence of Russia poses risks, as its neighbours know all too well. On September 23rd theRepublic of Ukraine failed to pay principal on its $500m 6.875% coupon bond. A drawn out conflict with pro-Russian separatists in its eastern region and a plunge in price on its most lucrative exports have left the Eastern Bloc country struggling to meet its debt obligations.

Before the missed payment, the ISDA issued a statement citing a potential moratorium event (legal right to delay payment). The reason being that on August 27th, Ukraine decided to "technically" suspend bond payments as the country looked to restructure around $18bn of its debt to shore up its finances. It agreed with bondholders a deal which included a 20% write down in the face value of its bonds.

The restructuring agreement was well received by bond markets. Ukraine's $1.5bn Eurobond due 2020, which incidentally also missed an interest payment last month, saw its price spike 20pts on the back of the restructuring announcement. Its latest bid price is above 80 (cash basis to par), according to Markit's bond pricing service; double the level seen since the depths of March.

News of the missed payment and the subsequent failure to redeem by the end of the grace period wasn't taken lightly by those holding CDS contracts on Ukraine. CDS is used to hedge against potential bond losses.

Unsurprisingly, credit spreads have tightened significantly since the bond restructuring agreement. While still trading on an upfront basis, the cost to insure against $10m of Ukrainian debt over five years has dropped dramatically from $4.6m + 500k annually, to $1.9m + 500k annually.

On Monday morning the Determinations Committee of 15 ISDA members, who include banks and major asset managers, decided that both a Repudiation/Moratorium Credit Event and a Failure to Pay Credit Event with respect to the Republic of Ukraine occurred on or around October 3rd. The two part process, a unique case, led to an auction the following day administered by Markit/Creditex to determine the value of the defaulted bonds and subsequent CDS payouts. It was the first sovereign credit auction since Argentina in September last year.

The final price of the auction was 80.625, which was more or less in line with where Ukraine's Eurodollar debt was trading.

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THE PULSE OF PRIVATE EQUITY

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example, we can efficiently provide an asset based revolving credit facility in a uni-tranche solution. Equipment Finance is a natural cross-sell into our private equity relationships. Given where we are in the cycle and with continued competition from banks, ABL is in a slower growth phase. Demand is usually counter-cyclical, so we will see more opportunities in a down market. Equipment Finance is growing nicely and the yields are very attractive for secured debt.

TLL: Tim, let's talk about the economy and the markets. What are you seeing out there?

TC: Our portfolio is my best barometer for where we are in the U.S. economy. Based on that, I would say the economy is performing pretty well. There is reasonable GDP growth with some obvious sector-specific volatility, but not related to fundamental, underlying growth issues. We are underweighted in energy and materials, so we are not seeing the impact of commodity prices too much, in addition to the fact that we finance domestic companies that are less impacted by the value of the dollar.

In terms of the middle market, we have seen yields widen about 50 bps to 6.00%-6.25%. Funding costs have widened a bit, high yield has traded off and then we have seen choppiness in the second lien markets. The banks are pulling back from leveraged finance and most BDCs are not raising capital, so it will be interesting to see how much impact all of that has on the loan markets; although the middle market is much more relationship-oriented and less volatile than the more liquid markets.

To be continued the week of Oct 12

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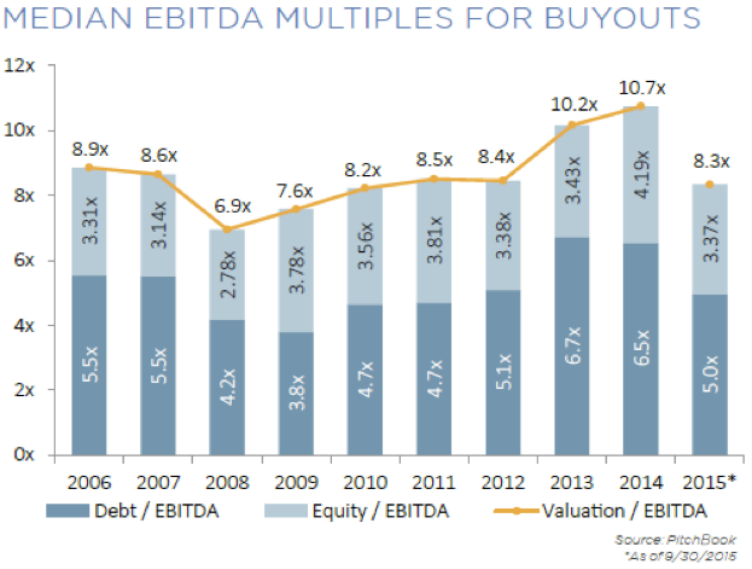

Median Multiples for U.S. PE Wane Further

Even taken with a grain of salt, the decline in median EBITDA multiples for U.S. private equity buyouts has become more and more pronounced as third quarter numbers roll in. Faced with the headache of high valuations, PE firms have not only been dialing down activity-albeit at a sedate pace - but also paying less. An array of drivers are behind this shift, with the usual suspects a decline in the supply of quality targets after a couple years of heavy deal flow as well as reluctance to overpay and depress future returns. The PE industry's usage of debt correlates with credit market cycles, too. Even though sponsors are likely to remain active in the middle market, as volatility in lending markets persists, the types of pricey buyouts that spike median multiples are going to be seen less and less. The question is how low of a floor median leverage levels will eventually hit. The Fed increasing interest rates shouldn't spell too much trouble, mainly because the rate of increase should be slow and steady and, moreover, has been anticipated for some time. Middle-market PE sponsors will likely continue to utilize proportions of debt similar to what we've seen for the first three quarters of 2015, adjusting to supply constraints, although that last is a variable factor. Non-bank arrangers are only ramping up middle-market lending, with BDCs scenting opportunity for steady yields as many banks decrease their exposure. Non-bank lenders can push terms more aggressively than banks can in order to capture new business-it'll be interesting to see how such courting of PE firms will affect lending trends going forward.

To Download PitchBook's 3Q 2015 Global PE Deal Multiples & Trends Report, please click here.

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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...

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

SELECT DEALS IN THE MARKET

Deal	Arranger	Sponsor	Industry	Facility*	Spread	LIB Flr	OID	Rating
CRGT Inc (4)(AO)	CS	Bridge Growth	Computers & Electronics	80	650	100	99.75	B-/B3
DigiCert (CL)(1)	Jefferies	Thoma Bravo	Computers & Electronics	220	450	100	99	B-/B3
Foundation Building Materials (1L)(1)	RBC	Lone Star Funds	Building Materials	245	625	100	97	B/B3
Foundation Building Materials (2L)(3)	RBC	Lone Star Funds	Building Materials	80	975-1000	100	97.5	B/B3
Integro (1L)(1)	CS	Odyssey Partners	Insurance	220	475-500	100	99	B/B3
Integro (2L)(3)	CS	Odyssey Partners	Insurance	80	875-900	100	98.5	B/B3
Novetta Solutions (1L)(CL)(1)	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				151	615	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

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