

Why Volatility Matters (Last of a Series)

With the passing of Yogi Berra, the position of sports legend/philosopher is now vacant. While no obvious candidates have stepped forward, we offer to nominate Cam Newton, star quarterback of the Carolina Panthers. Second-guessed on a play call by a reporter at a press conference last October, he replied with a shrug, "Hindsight is always 50/50."

This notion resonated with us given the challenge of anticipating buyer behavior in today's credit markets. With the Fed's stance on raising rates oscillating between "not now" and "maybe tomorrow," managers wonder if their next move will be decided by a coin toss. Are we headed for a downturn, or for an era of improved yields and growth?

Retail cash, meanwhile is still headed for the exits. Though floating rate assets are likely beneficiaries of a Fed move, the nine-week string of cash outflows from mutual funds (see *Chart of the Week*) is likely to be extended. That totals about \$8.2 billion year-to-date (per Lipper); high-yield outflows (\$2.8 billion) are comparatively more modest.

One friend on a money-center trading desk, exasperated at the contrariness of these buyers, echoed the Zen of Cam: "Don't these investors remember how well-behaved loans were through the credit crisis? Don't they understand the relative value?"

This steady leak of demand impacts liquidity in the broader markets. Ongoing volatility has created what one observer termed a "bifurcation" between "stressed" and "sleep at night" loans. The latter performed through the cycle and have a strong institutional following, while the former - "story" credits in cyclical sectors - struggle to find buyers.

The dearth of distressed investors is blamed on flight to quality. But continued volatility means no one knows when prices of out-of-favor loans will see another leg down. As public equities have demonstrated since mid-August, it's hard to call a floor.

Meanwhile in the land of middle market credit, the story for the rest of the year will remain one of supply and demand. Private equity sponsors care less about macro trends and more about value creation around specific investments. While topy purchase price multiples have dampened investment activity, firms are still putting money to work.

And middle market lenders are lined up to help them. Thomson Reuters LPC reports middle market institutional volume has increased gradually each quarter so far this year: from \$5.7 billion, to \$6.8 billion, and (so far this quarter), \$8.3 billion. These numbers are down overall compared to 2014's levels, but the trend is decidedly positive.

Middle market managers are encouraged as well with what one firm's CEO calls "the stability of loan metrics" - meaning pricing and leverage. To wit, mid cap all-in spreads continue to hover around 6.25%, at least a 100 bps premium to large cap spreads.

Leverage has been steady at around 5.5x total debt to Ebitda this year, but

QUOTE OF THE WEEK

"Volatility is never a friend of M&A."
- Gregg Lemkau, co-head of global M&A, Goldman Sachs.

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that may be changing. LPC reports this week that middle market LBOs have seen leverage spike just over six times. While this may reflect the size of the data set, there's no question that non-bank arrangers are able to push beyond where regulated banks can go.

There are no signs volatility will ease anytime soon. But disciplined mid cap lenders know how to create asset value whether the market shows heads or tails.

Click here to Download PitchBook's **3Q 2015 Global PE Deal Multiples & Trends Report**.



THE LEAD LEFT SPOTLIGHT



This week we continue our conversation with Tim Hopper, managing director and chief economist for TIAA-CREF. Tim has over 20 years of experience writing and speaking about the global economy. Prior to joining TIAA-CREF, Mr. Hopper held various leadership positions in global banking and real estate. He also served as a senior economist with the Federal Reserve Bank of Dallas for over 10 years.

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

TLL: Which raises the question, where are we in the economic cycle?

Tim Hopper: The length of the business cycle depends less on time and more on exactly what bubble is forming, and how long that bubble will take to build. It's the Fed's job to reanimate an economy after a recession, but to do so in a manner that doesn't provide too much stimulus or create distortions. Of course QE has created distortions which need to be addressed very carefully.

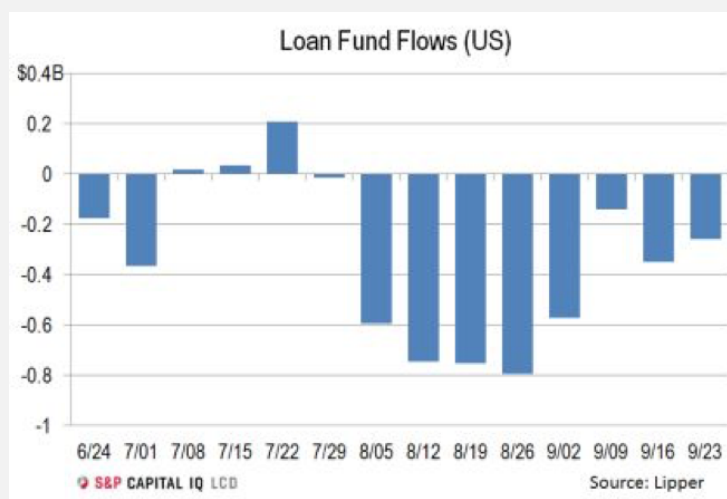
TLL: Do you think, for example, 17 million new auto sales is a sign of a bubble?

TH: Not necessarily. This is a sign that manufacturing is returning to the economy, but also shows that the fleet of cars on the road is extremely old and we are going through a replacement cycle.

CHART OF THE WEEK

Retail Outlet

Cash leaving loan funds has slowed, but still sees nine consecutive weeks of \$4 billion outflows.



STAT OF THE WEEK

	Sept 29 2015	Apr 10 2015	Dec 5 2008	Aug 13 2004
Volkswagen Shares	95.2	253.2	29.8	21.2

Source: Google Finance

LOAN STATS AT A GLANCE

Provided by:



"The length of the business cycle depends less on time and more on exactly what bubble is forming, and how long that bubble will take to build."

TLL: Let's turn to China. Give us your view of what's going on there.

TH: The important question to answer with regard to China is whether its slowing is cyclical or a trend, and is it dampening to the global economy? Certainly their growth rate is slowing, but given the sheer size of their economy, it has to slow. China is also trying to retool from a manufacturing and export-driven economy to one that's more balanced to meet consumer demand from a growing middle class. This is not like the old Soviet style of command and control. China is accounting for the change of consumer patterns and tastes. I would call China a managed capitalist economy, which is a good thing.

TLL: Where's the trajectory of their economy headed? Why were markets spooked in August?

TH: Look, as the economy gets bigger, its growth rate will naturally slow. But this process of liberalizing and changing will also impact that growth rate - imagine changing capital flows, exchange rate regimes, currency flows, interest rate and bond markets - all at once. Sometimes you will make a mistake, and that's what we say this summer.

TLL: Why did they try to manipulate their stock market?

TH: It's a long walk to reform, and they stumbled. They don't understand how markets work, and their reaction to the stock market route proved it. When you have a bubble in equity markets, it's going to deflate - you can't stop that. And that deflation isn't over. Not until the market reaches a floor supported by earnings.

Their second stumble related to the change in the parity rate setting mechanism, the process by which they controlled the value of their exchange rate. They were trying to address a criticism coming from the IMF. But the change spooked markets and caused the currency to depreciate quickly. This

	This Week	Last Week	6MO Ago	YR Ago
New-Issue Clearing Yields				
\$200M or less	6.78%	6.78%	6.51%	6.68%
\$201M - \$350M	5.73%	5.62%	6.29%	5.97%
\$351M - \$500M	5.59%	5.57%	6.21%	5.92%
\$501M+	5.02%	4.93%	5.45%	5.06%
Middle Market Credit Stats				
Middle market ($\leq$ \$50M)	6.32%	6.32%	6.74%	6.21%
Large corporate ($>$ \$50M)	5.26%	5.20%	5.71%	5.44%
Large corporate single-B ($>$ \$50M)	5.33%	5.33%	5.81%	5.52%
Middle Market Index Data				
Sr/EBITDA	5.5	5.4	5.0	4.9
Debt/EBITDA	5.8	5.6	5.0	5.1
Monthly Returns				
Monthly Returns	0.30%	0.45%	0.89%	0.10%
Average Bid	96.21	96.47	96.63	97.93

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

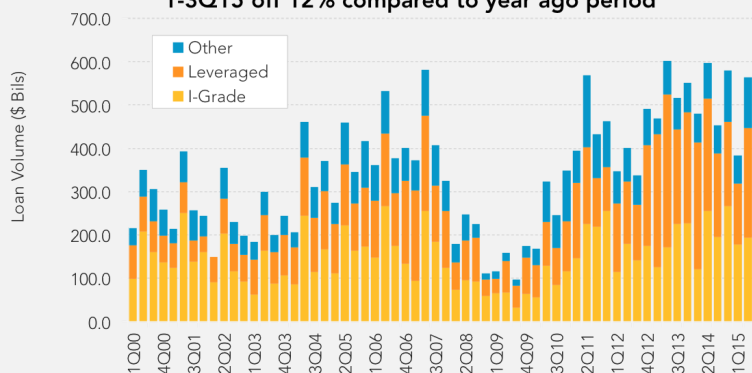
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LEVERAGE LOAN INSIGHT & ANALYSIS

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**3Q15 Loan volume down 29% compared to 2Q15
 1-3Q15 off 12% compared to year ago period**



Source: [Thomson Reuters LPC](#)

Volatility returned to the loan market in 3Q15 to contribute to a deeper and more sustained summer slowdown which saw just over \$401 billion of issuance work its way through syndication. This marked a decline of nearly 29 percent compared to 2Q15 figures and an 11 percent drop compared to the year ago period. Similarly, at less than \$1.4 trillion, 1-3Q15 loan volume was down 12 percent compared to the year ago period to mark the lowest total for the first nine months of a year since 2012. At \$204 billion, 3Q15 investment grade volume was up roughly 6 percent on the back of a solid M&A pipeline set in motion earlier in the year. Nearly \$69 billion or about 34 percent of 3Q15 volume represented new loan assets, up from less than \$40 billion last quarter. Investment grade M&A volume specifically, topped \$63 billion in 3Q15, bringing 1-3Q15 totals to just over \$126 billion. Sources note however, that 3Q15 ushered a slow down, so there is mixed confidence that completed investment grade M&A volume for the year will hit \$150 billion. The choppy market had a greater impact on leveraged lending. Sources note that a real bifurcation between the haves and have nots took hold with the haves securing good execution and the have nots getting beaten up in the bond market and avoiding the loan market. The good news was that there was no loan market backup given the limited pipeline. A relatively thin \$142 billion of leveraged loan volume cleared the market down over 44 percent from last quarter, bringing 1-3Q15 totals to \$537 billion.

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MARKIT RECAP

is another lesson they need to learn. You can't just go about making changes to regulation without some measure of transparency and preparing markets for that change.

TLL: *How far does the devaluation have to go?*

TH: It will continue. The problem is that the rest of the world assumes the worst, which creates the uncertainty.

TLL: *Outside of China, what's the outlook for other emerging markets?*

TH: If you look back to 2003-2008, there was a shift in central bank reserves, from the developed to emerging markets. This, of course, weakened the dollar, created higher inflation and growth in emerging market countries, and higher commodity prices. That process is now reversing itself. Slower growth in the EM has been going on for a number of years. When market observers complain about global growth, they're really referring to EM.

TLL: *So Tim, what's been your biggest surprise in this economy?*

TH: If you think about the current cycle, all we hear about is a lower potential growth rate, a lost business cycle and the "New Normal", referring to how slow growth will be from now on. But economies go through cycles. My "Aha moment" came when I put this shifting reserve story together with commodity prices, the dollar, trade and growth. The US economy is repatriating manufacturing jobs at lower costs thanks to lower oil prices. Guess what, that will boost productivity and help keep inflation in check. Reserves are sloshing around the world's central banks like water in a bathtub, and today the flow is moving back towards DM markets. That means a stronger dollar, faster potential growth and stronger purchasing power for US consumers. The next five to ten years will see the reversal of the negative trends we are so focused on right now.

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In recent years, the credit markets have become accustomed to volatility, despite the best efforts of central banks to tame the beast. But where it was sovereigns and banks that were the instigators during the crises of 2007-2012, in 2015 it is the commodities sector that is providing the oscillations.

Nowhere was this more evident than in the performance of Glencore. The company's spreads exceeded 900bps and its curve inverted on Monday September 28 following reports that the firm's equity would be wiped out if commodity prices stayed at current levels. This is well into junk territory; indeed, Glencore now has an implied rating of CCC, according to Markit data. It couldn't be clearer that Glencore's efforts to reduce debt and salvage its investment grade rating (including a \$2.5bn share issue, assets sales and cancelling dividends) haven't convinced the credit markets.

By Thursday October 1, Glencore's curve had tightened at the short-end (though it was still inverted) and five-year spreads had recovered to 600bps, an improvement from earlier in the week but still more than 400bps than where it was trading three months ago. Some may question liquidity in Glencore's CDS given the drop in trading activity compared to pre-crisis levels. The bid-ask spread ballooned to over 100bps in Monday when the name was at its most distressed, suggesting that liquidity has been impaired. But DTCC data showed that Glencore was the second-most heavily traded corporate credit in the week ending September 25, with \$2.2bn gross notional (only Volkswagen traded in higher volumes). It would be no surprise to see it take first place this week. Anglo American, the credit most directly affected by the Glencore contagion, also traded heavily.

Glencore has taken steps to reassure investors that its debt reduction plans are credible, and has opened up its balance sheet - sometimes criticised as opaque - to greater scrutiny. In particular, it has revealed details on its \$17bn of inventories and said it will free up capital by reducing less profitable trading activity. We will find out soon if this is enough to prove the markets wrong and stave off a descent to junk.

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THE PULSE OF PRIVATE EQUITY

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Better Data. Better Decisions.

No Parent Left Behind

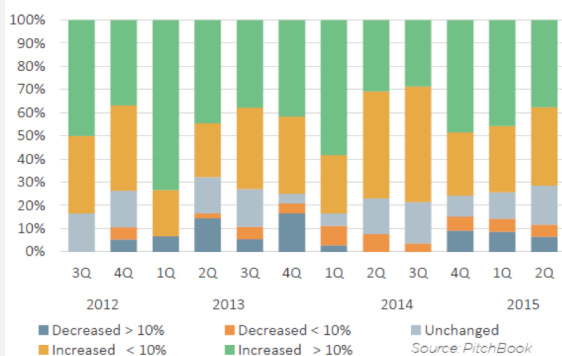
"What did you learn in math class today, honey?" Picking up my 5-year-old from her second day of an after-school program this past spring, I hoped to hear about her progress toward coding stardom and launching the next Uber. Or at least toward getting straight-A's in kindergarten.

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

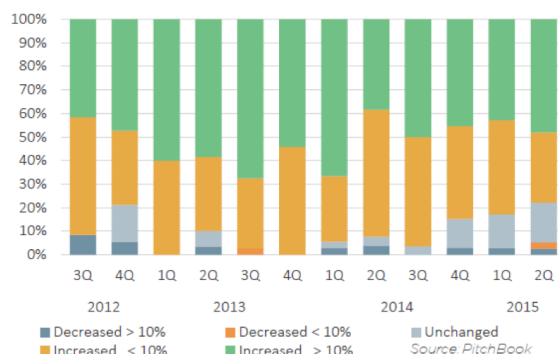
Numbers count more than ever today in education, along with science, technology and engineering. Born of our national fears of technical inadequacy, curricula have shifted from writing to 'rithmetic. No Child Left Behind's legacy is that test scores are the ammo in a global high-tech job war....

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

Revenue Change 12 Months Prior to Deal



Anticipated Revenue Change 12 Months Following Deal



Overall Optimistic, Investors See Choppiness Ahead

Private equity firms typically target companies that are in trouble. It's the heart of the traditional buyout model, which, although shifting as the industry matures, remains the core of PE dealmaking. However, the relative health of target companies can shift considerably depending on overall deal trends—nowadays is no exception. Since 3Q 2013, the percentage of PE firms stating their target acquisitions had positive revenue increases in the 12 months prior to the deal has stayed firmly above 70%. In and of itself, this doesn't mean PE firms have been purchasing healthy companies, as many other factors play into a company's wellbeing. But it does indicate that up until a few quarters ago, PE firms had to resort to acquiring companies that are better off, relatively speaking, than the typical picture of the struggling firm courting PE bids.

Things have been shifting as of late, however, with the percentage of acquired companies having had flat or decreasing revenues closing in on 30% in 2Q 2015. Coupling that with a small but significant uptick in the proportion of dealmakers who state that they anticipate no change, or even a decrease in acquired company revenues, it's clear investors are sanguine on the whole but expect some turbulence going forward. Choppy prospects in sectors hit hard by plunging commodity prices, as well as the strength of the U.S. dollar and uncertain global growth, are doubtless contributing on the macro level. From a micro perspective, since PE firms have been dialing back activity overall, the companies actually being bought are likely more troubled—worthwhile opportunities for general partners to flex their operational expertise. But honing a company's operations takes time—investors are planning accordingly.

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

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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
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	550-575	100	99	B/B3
Foundation Building Materials (2L)(3)	RBC	Lone Star Funds	Building Materials	80	975-1000	100	97.5	B/B3
Innovative XCessories (1)(AO)	GE	Olympus Partners	Automotive	95	425	100	99.5	NR/NR
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	450	100	99	B/B3
Novetta Solutions (2L)(3)	Jefferies	Carlyle Group	Computers & Electronics	85	850	100	99	B/B3
Smart Start (1)	BNP	ABRY Partners	Retail	145	475	100	99	NR/NR
Universal Fiber Systems (1L)(1)	BNP	HIG Capital	Textile & Apparel	165	525-550	100	99	B/B2
Universal Fiber Systems (2L)(3)	BNP	HIG Capital	Textile & Apparel	40	925	100	98	B/B2
Averages				135	536	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	<div>New Deal</div> <div>Flex Up</div> <div>Flex Down</div>	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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