THE Lead Left
The Premier Middle Market Newsletter

Churchill Asset Management
A TIAA-CREF Company

A Review of European Direct Lending (Second of a Series)

Burger King isn't just selling Whoppers any more. Last week the second largest burger giant began serving hot dogs at all its locations year-round. "We're applying sixty years of flame-grilling expertise," said Alex Macedo, President of North America. "We also have to chop the onions a little differently," he added.

The thesis regarding opportunities today in European debt is reminiscent of this fast food story. Why shouldn't investors think about private credit overseas the same way they think about US loans: isn't it the same grill, just different meat? Or perhaps there's a reason there are no national hot dog chains.

Turns out there are fundamental differences between the U.S. and European markets. One is the way each developed alternative lending. The disintermediation of regulated U.S. lenders by non-banks has been going on for twenty years; in Europe that process only restarted immediately post-credit crisis (see *Chart of the Week*).

"People don't realize that Europe is the much more efficient bank market for loans compared to the U.S, which is controlled by institutions," one leading UK credit provider told us. "We're beginning to see a shift as leverage comes down and regulations go up," he continued. "But banks still hold sway in many regions."

This is particularly true for the middle market. "Smaller deals - below €25 million ebitda - are attracting bank attention," another private fund head reported. "Libor spreads are dropping, and floors are falling away," he said.

"Supply/demand in Europe is relationship-driven," our friend went on. "Private equity sponsors are bringing their lenders to the table. Where there's an opening is offering up-and-down-the-capital-stack solutions. But that will close when banks come back. It's mostly option value for U.S. firms trying to come into this market."

Timing is also critical. Different technicals have been driving loan prices in different directions. The U.S. is being challenged by energy-related fears and retail loan outflows, while Europe is still in the relatively early days of its own QE program.

But even that's changing. While one CEO of a US-focused debt fund characterized Europe's loan market was "frothy," he admitted that "negative sentiment began filtering through the Euro market, as risk-off dominated the US. At first it was like speaking to different planets. Europe was cranking out L+475 at 99 like crazy, while deals here were getting hung. Now Euro deals like *B&B Hotels* and *Photobox* are flexing up."

And European LBOs are smaller. That means banks are still able to club some deals amongst themselves, rather than having to distribute to institutional accounts.

For broadly syndicated loan investors, toggling between relative value

QUOTE OF THE WEEK

"Negative rates have become part of the furniture."

– Andrew Milligan, head of global strategy, Standard Life.



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plays may be working short-term. *Vivid Seats*, for example, looks pretty cheap for Euro buyers. But that's hardly a long-term strategy to build market share and lending capabilities.

Next week we look at legal, cultural, and logistical hurdles for Europe's direct lenders.

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THE LEAD LEFT SPOTLIGHT

CPP INVESTMENT BOARD

This week we chat with Edwin Cass, Chief Investment Strategist, Canada Pension Plan Investment Board. Mr. Cass is responsible for CPPIB's overall fund level investment strategy. He also chairs the Investment Planning Committee, which approves all new investment programs and oversees all portfolio risks, including passive, active, credit and liquidity risk.

The Lead Left: Ed, we're witnessing market turmoil, yet the worries seem to be familiar ones. What's different now?

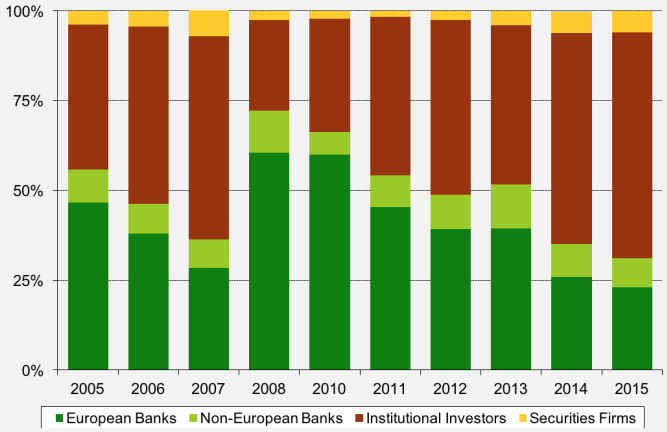
Edwin Cass: We have been asking ourselves the same question internally. What we're seeing now is a series of bad data points in the U.S. The U.S. has been the engine of growth and has made the most progress in terms of economic stimulus. If the U.S. heads into a downturn, then the knock-on effects to the financial system could be pronounced. This comes at a time when oil has taken a further leg down, jeopardizing earnings and further impacting CAPEX.

The same is true with concerns about China and its transition to a consumer-driven economy from an export and investment-driven one. These risks became increasingly transparent during

CHART OF THE WEEK

Hard Floors

While their share of European leveraged loans has steadily dropped to 31%, banks are still about where they were pre-crisis.



Sources: S&P Capital IQ; Primary Market by Broad Investor Type, 2009 date not meaningful

STAT OF THE WEEK

	Nov 2015	June 2014	July 2008	Dec 2005
Consumer Price Index	120.88	123.24	113.52	100.86

Source: FRED

LOAN STATS AT A GLANCE

Provided by:

S&P CAPITAL IQ

2015, but didn't really hit until this year.

TLL: Are any risks that are surprising to you?

EC: There are certainly lots of risks in the market, but they didn't really impact pricing in a material way until now. We saw valuations go up last year, but spreads have subsequently widened significantly more recently. Are prices correct or cheap? It's a mixed tale, and it's hard in some cases to disentangle sector effect from the market more generally.

Currently the opportunity set is greater than we see on average. There are certainly enough assets being offered, but we are trying to be very selectively focused. These opportunities are everywhere, but most particularly in the credit and energy space.

"We don't target returns. We calibrate risk tolerance, then work to maximize our returns under those parameters."

TLL: Are you prepared for the next downturn?

EC: When we look back at 2009, we feel that there were very attractive valuations in the market, but we didn't necessarily have the investment framework then to take advantage of them. We saw opportunities in 2008-09 in credit, infrastructure, direct private equity, and real estate that we thought offered good risk-adjusted returns. Ideally we would have increased our overall risk appetite back then to take advantage of the situation, but we were constrained by anchoring our risk appetite close to that of our Reference Portfolio.

TLL: What was the balance between equities and fixed income in the Reference Portfolio?

EC: The Reference Portfolio was comprised of 65% equities and 35% debt. We had active risk limits which specified how much we could deviate from those weightings, but practically speaking our ability to deviate was limited. Looking back at those

	This Week	Last Week	6MO Ago	YR Ago
New-Issue Clearing Yields				
$200M or less	6.76%	6.43%	6.44%	7.09%
$201M - $350M	7.02%	6.49%	5.78%	6.27%
$351M - $500M	5.66%	6.34%	5.47%	6.48%
$501M+	5.83%	5.84%	4.89%	5.85%
Middle market (≤ $50M)	6.72%	6.35%	6.16%	7.01%
Large corporate (> $50M)	6.01%	6.05%	5.18%	6.04%
Large corporate single-B (> $50M	6.24%	6.31%	5.33%	6.17%
Middle Market Credit Stats				
Sr/EBITDA	4.6	5.6	5.2	4.8
Debt/EBITDA	4.6	5.6	5.4	4.8
Middle Market Index Data				
Monthly Returns	-0.68%	-0.79%	-0.53%	0.90%
Average Bid	92.20	92.22	96.39	95.78

Source: S&P Capital IQ

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MIDDLE MARKET DEAL TERMS AT A GLANCE

Provided by:

SPP CAPITAL PARTNERS

February Update

Deal Component	Feb 2016	Feb 2015
Cash Flow Senior Debt (x EBITDA)	Micro Cap 1.50x-2.50x Small Cap 2.50x-3.50x Midcap 3.00x-4.00x	Micro Cap 1.50x-2.00x Small Cap 2.00x-3.50x Midcap 3.00-4.25x
Total Debt Limit (x EBITDA)	Micro Cap 3.00x-4.00x Small Cap 3.75x-4.50x Midcap 4.00x-5.50x	Micro Cap 3.00x-4.00x Small Cap 3.75x 4.50x Midcap 4.00x-5.00x
Senior Cash Flow Pricing	Bank: L+3.00%-4.00% Non-Bank: <$10.0MM EBITDA L+7.00%-8.00% Non-Bank: >$15.0MM EBITDA L+4.50%-6.50% (potential for a 1.00% floor)	Bank: L+3.00%-4.00% Non-Bank: L+4.50%-6.00%
Second Lien Pricing (Avg)	Micro Cap L+9.00%-11.00% floating (1.00% fl) Small Cap L+7.00%-9.00% floating (1.00% fl) Midcap L+5.50%-7.50% floating (1.00% fl)	Micro Cap L+8.00%-11.00% floating (1.00% fl) Small Cap L+6.50%-8.50% floating (1.00% fl) Midcap L+6.00%-7.50% floating (1.00% fl)
Subordinated Debt Pricing	Micro Cap 12.0%-14.0% Small Cap 11.0%-13.0% Midcap 10.0%-12.0% Warrants in special situations; Second lien may buy down to ~9.0%. Equity co-invests readily available.	Micro Cap 12.0%-14.0% Small Cap 11.0%-13.0% Midcap 11.0%-12.0% Warrants in special situations; Second lien may buy down to ~9.0%.
Unitranche Pricing *Micro Cap= <$7.5mm EBITDA *Small Cap= >$10mm EBITDA *Midcap= >$20mm EBITDA *Changes from last month are in red	Micro Cap L+8.50%-11.00% (1.00% fl) Small Cap L+7.00%-8.50% (1.00% fl) Midcap L+6.00%-7.50% (1.00%-1.50% fl) Potential for fixed rate with BDC or mezz lender. Equity co-invests readily available.	Micro Cap L+8.00%-11.00% (1.00% fl) Small Cap L+6.00%-8.00% (1.00% fl) Midcap L+5.50%-7.50% (1.00% fl) Potential for fixed rate with BDC or mezz lender.Most Unitranche lenders allow a small ABL facility outside of the loan.

Source: SPP Capital Partners

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LEVERAGE LOAN INSIGHT & ANALYSIS

Provided by:

THOMSON REUTERS

opportunities the question to ask is: can we put in place a governance framework that will allow us to more easily take advantage of those situations?

TLL: Do you selectively stretch your risk parameters to meet your returns?

EC: That's a mistake we try not to make. We don't target returns, per se. We calibrate our risk tolerance every year, then work to maximize our returns under those parameters. Otherwise you could engage in activity that involves stretching for yield, which is very dangerous. You end up having to overleverage to meet your return objectives when markets are the most richly priced.

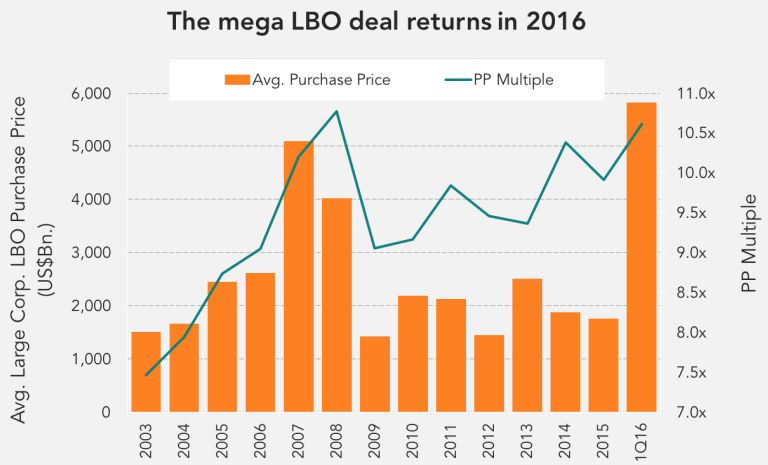
TLL: What's the biggest change you've made since 2009 to adapt to what you learned then?

EC: We've changed our orientation from relative returns to total, or absolute, returns. In the past, with the Reference Portfolio, the majority of focus was on generating relative returns. We got caught in this relative performance bind back in 2009. The question is how to alter our strategy to optimize flexibility and incorporate an absolute return focus as well.

Back in 2009, after our March 31st fiscal year-end, we reported minus 18% returns. It made front page headlines in all the Canadian newspapers. What was not highlighted was the fact that we had record relative returns 200 bps better than the market - but no one cheered returns being down 18% instead of 20%!

So we then instituted a program called "CPPIB 20/20," which re-examined where we were, and where we wanted to be by 2020. One of our conclusions was there needed to be a greater focus on total or absolute returns. Total returns are important. They pay our stakeholders.

For example, we believe strongly that we can maximize total risk-adjusted returns through efficient diversification, but we had never been explicit on



Source: Thomson Reuters LPC

Despite significant market volatility, PE shops are moving full speed ahead on select mega deals in 2016. While the dataset is still limited, the average purchase price for large corporate buyout deals so far in 2016 has skyrocketed to US$5.8bn, up from just US$1.8bn in 2015 and surpassing the US$5.1bn record set in 2007. Keurig Green Mountain at US$13.5bn and ADT at a whopping US$15.0bn are extremely sizeable deals and a departure from the more modestly sized buyout deals the leveraged market has become accustomed to seeing each quarter post credit crisis. ADT is the third largest deal by enterprise value post credit crisis behind Heinz and Dell (excluding current EMC/Dell deal). The average purchase price multiple for large corporate buyouts is estimated at around 10.6 times based on LPC data, up from 9.9 times last year and not too far behind the 10.8 times record multiple tracked in 2008. Despite the lofty multiples and large deal sizes, the average total leverage level on large corporate buyouts is still reasonable at 4.1 times first lien debt to EBITDA by 6.1 times total debt to EBITDA.

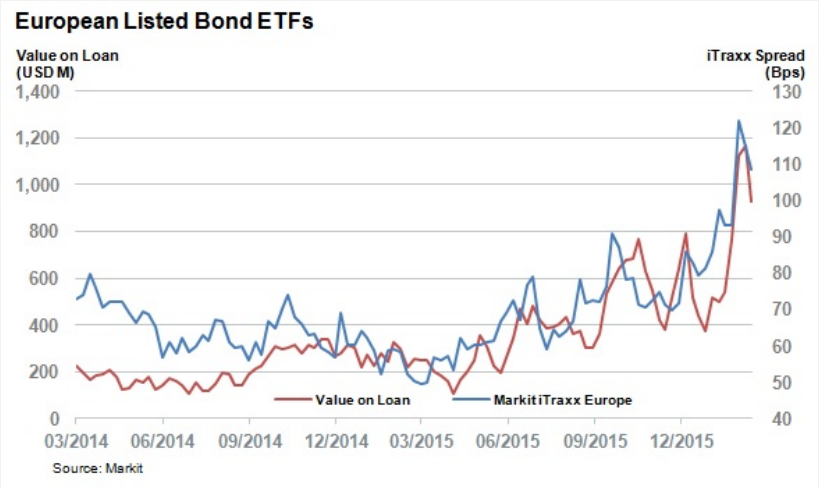
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MARKIT RECAP

Provided by:

markit



Last summer saw investors turn to shorting bond ETFs as the bond market kicked back to into life amid the Greek crisis. Volatility has continued in earnest in 2016 as the Markit iTraxx Europe index, which tracks CDS spreads across investment grade issuers, hit a three year high of 121 bps earlier this month. The surging credit risk across Europe (and globally) has seen investors short European listed bond ETFs with renewed vigour. This comes as the aggregate value of short positions across the asset class crossed the $1bn mark for the first time ever in

specific desired allocations for each asset class - whether it's private equity, infrastructure, or credit. Now we publish a strategic portfolio indicating how we want to be invested across regions and asset classes.

To be continued the week of Feb 29

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MIDDLE MARKET Growth

Tipping Point

Danny Meyer startled the restaurant world in October with a dramatic announcement- he was eliminating tipping from all his Union Square Hospitality Group fine dining locations.

Many revolutionary ideas seem obvious in hindsight. This one is being launched against a firmly entrenched practice that defies common sense yet remains the economic foundation for many service sector employees in the United States.

The reaction on op-ed pages was favorable, thanks to Mr. Meyer's sterling reputation among cuisine cognoscenti. Since launching the Union Square CafÃ© in 1985, he has consistently been on the forefront of restaurant trends, propelling him to the role of industry statesman.

It is also a campaign years in the making, dating back to Meyer's partnership at Gramercy Tavern with chef...

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

February to top out at $1.16bn last Monday.

While short interest across the asset class has receded back under the $1bn in the last week, the current $930M of aggregate short positions is still higher than that seen at any point last year, which shows that bearish sentiment across bonds is still highly elevated.

The products that have attracted the most bearish sentiment in the recent wave of shorting activity have been on the riskier end of the scale as two high yield funds currently top the list of the most borrowed European bond ETF. The two funds, the Ishares $ High Yield Corporate Bd Ucits ETF and Ishares Euro High Yld Corporate Bd Ucits ETF make up over half of the current short base as both funds now have more than $250m of shares out on loan.

Emerging market bonds have also been in the crosshairs as the Ishares J.P. Morgan $ Emerging Markets Bond Ucits ETF saw as much as $215m of borrow in recent weeks.

The fact that investors now use ETFs to short US high yield and emerging market bonds speaks volumes about the growth of European ETFs in recent years. Investors now use the asset class to express both long and short views on an increasingly diverse set of asset classes. In fact, investors can now access an all-time high $4.1bn of European listed bond ETFs now sitting in lending programmes, a number that has grown by 6% ytd, twice the rate of AUM growth seen by European ETFs.

The bond ETFs asset sitting in lending programmes are also proving increasingly lucrative to beneficial owners willing to lend them out. The increased demand to borrow the asset class in recent weeks has seen the stock lending revenue generated by bond ETFs sitting in lending programmes jump to a recent high of 25 bps on an annualised basis.

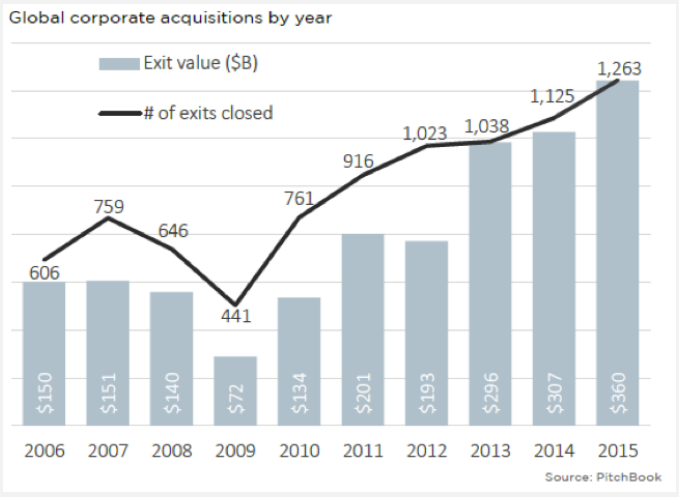
This trend is highly concentrated towards a minority of funds which see the most demand to borrow and in turn generate the most stock lending revenue however. In fact, five funds make 85% of the current annualised stock lending revenues.

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THE PULSE OF PRIVATE EQUITY

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Better Data. Better Decisions.



How much longer will the M&A boom sustain PE exits?

The M&A boom has been very kind to private equity sellers. Last year saw PE sellers close over 1,200 sales to strategic buyers, with total value just eclipsing $360 billion. That leaves the past three years at a total of $963 billion in total value exited via that ramp, a truly staggering sum, particularly given the levels before. Corporate buyers have plenty of reason to go hunting amid PE portfolios for

targets, given the challenges of appeasing shareholders amid what often is anemic economic growth. On the PE seller side, the current levels of PE-backed company inventory and valuations are still more than compelling enough to push firms to the exit.

What's interesting to ponder is how much longer corporates will continue to snap up PE-backed holdings. Even though competitors still seek acquisitive growth, driving companies to shift strategies away from traditional organic means of growing, it seems more than likely that a few factors may emerge to drive down the rate of PE exits, although the extent to which they will do so is set to be mild. First, particularly given the onset of unease and declines in global financial markets, buyers are likely to scrutinize potential acquisitions more closely in general, which could prolong deal timelines. The best companies, accordingly, may well be snatched up even more quickly, but by and large, issues of quality will predominate in acquirers' minds. Second, PE firms have likely already brought their best portfolio companies to market, capitalizing on high market valuations while they could. Hence, prospective strategic acquirers may simply not buy as much, as they may not find as many targets to their liking. Lastly, again especially in today's climate of heightened volatility, buyers may well take some time to digest and integrate their acquired targets, in a natural pause after such highly active selling. Granted, barring a major macroeconomic shock, these factors-among others-should not contribute to a significant slide in corporate purchases of PE holdings, but last year, perhaps even through 2014, is likely to remain a high point.

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SELECT DEALS IN THE MARKET

Deal	Arranger	Sponsor	Industry	Facility*	Spread	LIB Flr	OID	Rating
Alpha Media (2)	Citizens	Stephens Group	Services & Leasing	265	600	100	95	B/NR
Automobile Protection (2)	SunTrust	Ontario Teachers	Insurance	190	600	100	97	B/B3
Central Security Group (1)(AO)	CS	Summit Partners	Services & Leasing	50	562.5	100	97	B-/B3
Edgewood Partners (2)	JPM	Carlyle Group	Insurance	200	600-625	100	98	NR/NR
Lago Resort & Casino (1L)(4)	CS	Peninsula Pacific	Gaming & Hotel	225	950	100	98	B-/B3
Lago Resort & Casino (2L)(3)	CS	Peninsula Pacific	Gaming & Hotel	85	N/A	100	97.25	B-/B3
MedRisk (1)	Antares	TA Associates	Healthcare	202.5	500	100	99	B/B2
On The Border Mexican Grill (AO)	Antares	Antares Capital	Restaurants	20	450		99.5	NR/NR
Osmotica Pharmaceutical (CL)	CIT Group	Avista Capital	Healthcare	160	500	100	99	NR/NR
Sarnova Inc	Capital One	Water Street	Healthcare	220	475	100	99	NR/NR
Vivid Seats Ltd (1)	RBC	Vista Equity	Film	240	550-575	100	98	B/B3
Averages				**169**	**580**	**100**	**98**	

* 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) NC-2/104/102
(4) NC-2/102/101

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

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