THE Lead Left
The Premier Middle Market Newsletter

Churchill Asset Management
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NEW New Release For Subscribers Only

State of the Capital Markets
First Quarter 2016 Review and
Second Quarter 2016 Outlook

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Where's the Deal Flow? (First of a Series)

With the first quarter of 2016 in the books, we kick off the second with a look at our *Chart of the Week*. Our content partners at Thomson Reuters LPC report middle market activity with sponsors slumped to $7.3 billion - the lowest level since 2010.

Anecdotally mid cap lenders confirm this trend. "We're pretty slow right now," said one regular player in the space. "It's quiet out there," agreed another. "And the stuff we're seeing isn't that interesting. Deal quality has definitely deteriorated."

Yet in recent meetings with top-tier private equity firms, a more upbeat view emerges. "We're seeing a record number of books this year," a managing partner told us. "January and February are historically slow," he said, "but not this year. There's a lot of very aggressive bidding going on. But it does include some class B properties."

This inflow of confidential information memoranda doesn't always translate into meetings with potential sellers. "It's not a question of stuff coming over the transom," one PE principal said. "There's plenty of that. The real question is, do you have an angle? Huge premiums are being paid out there. Can you compete at those levels?"

Another sponsor agreed. "If a firm isn't willing to get on the treadmill and grind it out on a bunch of auctions, you're just not that busy right now. Valuations between buyers and sellers still aren't aligned."

Among some veteran investors, we've heard a more nuanced approach. "Our firm has made five acquisitions so far this year, and all of them were proprietary," a long-time partner reported. "But our deal origination process has been developed over three decades. We don't rely on auctions, so our pipeline is much less volatile."

He went on. "Mining truly proprietary opportunities is extremely hard work. Our operating partners and management teams with decades of experience spend a ton of time sorting through hundreds of businesses. That model is less affected by cycles."

Not all PE investors are as sanguine about the economic backdrop. "Let's face it," a leading midcap sponsor told us, "the economy is not growing and financing markets aren't particularly stable. That makes us cautious. Are we active buyers? Absolutely. But current supply/demand dynamics won't change until real supply comes to market."

Are sponsors more active sellers than buyers in this market, we wondered, unloading (as one PE chief memorably put it) everything that isn't nailed down? "That depends on where you are with your fund life," was one answer. "In our case we took advantage of favorable purchase price multiples last year, and had

QUOTE OF THE WEEK

"I think it's a very confused market right now."

– Craig Sterling, head of equity research, Pioneer Investments.

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excellent realizations."

Over the next few weeks, we'll examine in more detail how both sponsors and key middle market lenders are viewing deal supply for the coming quarter, and whether (as we believe) things are not quite as bad as statistics seem to show.

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THE LEAD LEFT SPOTLIGHT

This week we continue our conversation with Tim Kelly, a 30+ year veteran of private equity and capital markets. Since retiring as a senior investment Partner with Adams Street Partners, Tim has completed his Ph.D. in Organizational Psychology. His focus is what investors, LPs, GPs, and capital market participants can learn by applying new perspectives on people, culture, decision-making, and performance.

Second of two parts - *View part one*

The Lead Left: Anyone paying attention to presidential primaries this year would agree with that.

Tim Kelly: In a comical sense, people are as irrational as the moth that flies into a candle flame. We commonly use cognitive shortcuts, or heuristics, when we make decisions. We rely on past experiences, our perceived judgment, and other factors to arguably inform our decision whether to invest or not, and at what price. But, many investment committees display similarly common techniques and, yet, experience varying results.

If one studies *how* decisions are made, it often uncovers subtle and oftentimes unconscious errors in the process that directly impairs the investment's long-term potential. An overly simple example is when we believe we have deeply rooted and repeated success in an area of domain expertise. People have a tendency to be overly confident

CHART OF THE WEEK

Slow Motion

Middle market loan activity with sponsors during the first quarter has slowed to a six-year low.

Quarterly Sponsored Middle Market Loan Volume

Sources: : Thomson Reuters LPC 2Q MM Investor Outlook Survey

STAT OF THE WEEK

	Q4 2015	Q1 2010	Q4 2008	Q1 1994
Net Interest Margin for all U.S. Banks (%)	3.02	3.83	3.15	4.91

Source: FFIEC

LOAN STATS AT A GLANCE

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S&P CAPITAL IQ

in their abilities and in assessing their judgment on a given matter of uncertainty. I help uncover how investment teams and committees unconsciously imbed such error-prone tendencies into their processes.

Add an organization's cultural imperfections into the equation and you end up with potentially disastrous outcomes. Consider Chernobyl, American Flight 191 that crashed in Chicago, and many other well-known engineering disasters. We all remember Flight 191 crashed because of a cracked pylon; but, did you know the real cause of the crash was a widespread organizational culture across the aviation industry that prioritized expense reduction above safety? The same with Chernobyl. The disaster was blamed on human error initially, but later found to be the result of organizational training procedures that were grossly deficient. I help investors uncover potential errors in their decisions that appear sound and complete on their surface, but problematic when analyzed objectively.

"Talent development should not be reactionary, it requires active focus and dedicated effort."

TLL: *How does "branding" intersect with the other work that you are doing for your clients?*

TK: This area is intriguing to me. Firms, like individuals, perceive themselves in a very defined way. I wrote a LinkedIn article recently entitled: "No really, tell me the truth, do I look fat in this outfit?" It explores a common problem that sponsors experience when they rely on their investors' feedback on how well they are doing in terms of performance, strategy execution, crisis management, etc. But, like consumer surveys and focus groups, interim performance feedback is not as telling as the moment the same consumer /investor commits to make a purchase or actually buy into your next fund. That's the moment real feedback is obtained.

TLL: *How do you get the right information you need to be successful?*

TK: I try to advance the feedback loop so that firms that rely on investors for capital are acting in their best interest to maintain high investor satisfaction ratings even when performance may be slipping. Having been an LP for 30+ years, I blend academic research with real life examples and experience to help firms create the best brand that they can for who they are, what they are good at, and why their investors

	This Week	Last Week	6MO Ago	YR Ago
New-Issue Clearing Yields				
$200M or less	6.96%	6.96%	6.53%	6.00%
$201M - $350M	6.97%	6.97%	6.13%	6.06%
$351M - $500M	6.35%	6.35%	6.62%	5.81%
$501M+	6.02%	5.97%	5.27%	4.93%
Middle market (≤ $50M)	7.13%	7.13%	6.36%	5.82%
Large corporate (> $50M)	6.18%	6.15%	5.58%	5.23%
Large corporate single-B (> $50M	6.64%	6.62%	5.91%	5.32%
Middle Market Credit Stats				
Sr/EBITDA	4.4	4.4	5.8	4.8
Debt/EBITDA	5.0	4.9	5.8	5.2
Middle Market Index Data				
Monthly Returns	0.00%	0.76%	-0.09%	0.13%
Average Bid	92.25	92.25	95.98	97.04

Source: S&P Capital IQ

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MIDDLE MARKET DEAL TERMS AT A GLANCE

Provided by:

SPP CAPITAL PARTNERS

March Update

Deal Component	March 2016	March 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+3.50%-5.00% 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+2.00%-3.50% Non-Bank: L+4.00%-6.00%
Second Lien Pricing (Avg)	Micro Cap L+9.00%-12.00% floating (1.00% fl) Small Cap L+7.50%-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+7.50%-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

should remain confident in their long-term potential.

TLL: I suppose it starts with good communication.

TK: Yes. A good example is how annual meetings are constructed and delivered. Investors often compliment GPs for the quality of their meeting, but are these compliments really honest or merely our human cognitive tendency to avoid confrontation?

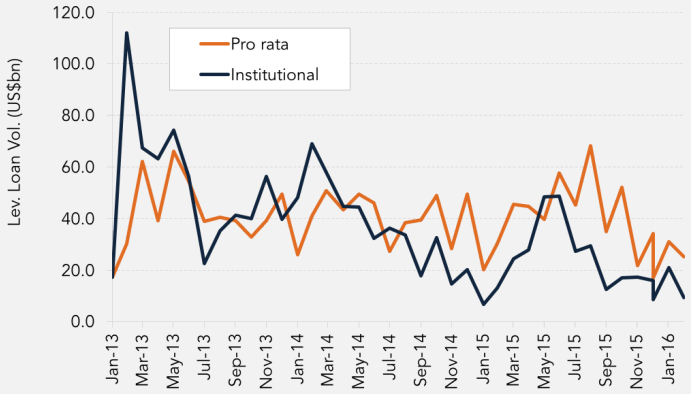
TLL: What type of research are you considering that could be helpful to private equity?

TK: It goes without saying that the research on the consistency of returns across multiple funds and even multiple investments is highly uncorrelated. A first quartile fund today does not really predict with any degree of accuracy the likelihood of the next fund being top quartile. Similarly, three prior successful investments, contrary to the "hot hands" theory, does not correlate well with the likelihood of a fourth successful investment.

I'm trying to figure out a way to analyze and better understand how otherwise successful firms have failed over time. While poor investment performance is the easy answer, wouldn't it be exciting to identify the real underlying organizational, decision process, or other firm-level dynamics that more accurately lead to failure? This would be an exciting study to perform. A type of firm morbidity or psychopathology study that would help investors better gauge and maybe even predict what firms are most at risk of failing. That would be valuable research!

TLL: Tim, as you know, we always end these interviews by asking what your biggest surprise has been.

TK: My biggest surprise was realizing how often highly successful managers, founders, sponsors, and employers more generally through our industry can be at buying and building companies, while being awful at building and retaining talent on their teams. I'm a believer that few professionals fail for lack of skills or talent. Most professionals fail because of poor management. Talent development should not be a passive or reactionary activity, it requires an active focus and dedicated effort. One firm I think highly of has begun offering professional coaching to every team member when they become a Principal. This eliminates the potential stigma associated with being assigned a coach,



Source: Thomson Reuters LPC

Instability in oil prices and credit concerns in energy and metals and mining, coupled with worries that slowing global growth could impact the U.S., amplified what was already shaky sentiment heading into this year. Although seeing opportunities, some distressed funds waited to pull the trigger, worried that they could catch a falling knife. Amid this pervasive risk-off mentality, leveraged lending, at US$112bn in the first quarter, was down 20% year over year and down 29% compared to the fourth quarter. At US$73bn, leveraged pro rata lending was down 32% from the prior quarter and 24% from 1Q15. Institutional loan issuance hit a four-year low at US$39bn as investors sat on the sidelines or bought loans at sizable discounts in the secondary while arrangers looked for opportunities to clear last year's deals. However, growing confidence in the pace of growth of the U.S. economy, increased stability across global equities, and a surge of inflows into the high yield bond market helped the loan market regain some stability. Although there was less than US$3bn in institutional loan issuance geared toward refinancing in the first quarter, issuers with upcoming maturities as well as higher-quality issuers have emerged heading into the second quarter.

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MARKIT RECAP

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markit

Investors embrace long dated corporate bonds

Investors have been loading up on relatively higher yielding long term corporate bonds, in spite of the asset class seeing its average credit rating decline in recent years.

- Long dated corporate bond ETFs have seen $90m of inflows ytd, over twice the 2015 total
- BBB bonds make up 47% of the Markit iBoxx $ Corporates 10Y+ index, up from 41% in 2011
- Long dated US corporates have returned 7% year to date, twice that of conventional bonds

The desperate quest for yield in the fixed income market has made relatively higher yielding long dated bonds irresistible in current market conditions. ETFs tracking the asset class have seen their best ever quarterly inflows in the opening three months of the year, according to Markit's ETF analytics database.

While the majority of the inflows have been aimed at products that invest in government bonds, a small but growing portion of inflows have ended up in corporate bond funds which tend to invest in investment grade debt with a maturity greater than ten years. These bonds tend to offer a relatively higher yield than the average investment grade bonds bonds; 0.61% more for EUR denominated investment grade and 0.79% for USD debt, but also come with the increased risk linked to their longer maturity.

But increased risks associated with longer maturities hasn't put off investors, as the 11 long dated corporate bonds ETFs have seen $90m of inflows since the start of the year - over twice the haul seen over 2015 in total. These flows were the strongest in March when a newly dovish Fed and the inclusion of investment grade corporate bonds into the ECB's quantitative easing basket saw investors park $200m into long dated corporate bond funds.

and converts it into a value-added activity reflecting the firm's commitment to talent development and job satisfaction.

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MIDDLE MARKET Growth

Tipping Point

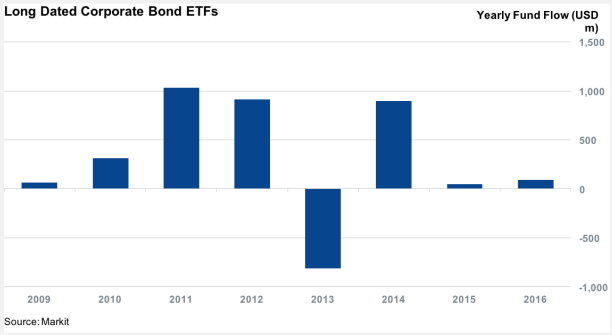
Danny Meyer startled the restaurant world in October with a dramatic announcement- he was eliminating tipping from all his Union Square Hospitality Group fine dining locations.

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...

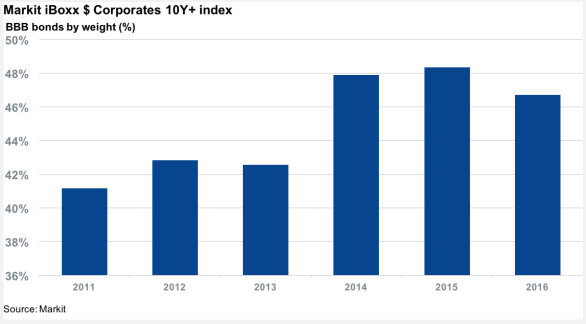
Click here to read Randy Schwimmer's MidPoints column in the latest issue of Middle Market Growth magazine.



This trust in the asset class has proved to be a winning strategy so far this year as long dated dollar-dominated investment grade bonds which make up the iBoxx $ Corporates 10Y+ index have delivered a total return of 7% in the opening three months of the year, which is nearly twice those delivered by the benchmark investment grade universe.

While the dynamics have been positive for the asset class this year to date, it's worth noting that duration risk among these long dated debt instruments could see returns wiped out, given that this measure of risk is twice as high as than the overall Markit iBoxx $ Corporate Index.

Asset class riskier
Another potential risk faced by investors loading up on long dated corporate bonds is credit risk. The asset class has seen a deterioration in credit worthiness in recent years as lower rated companies profited from loose monetary policy to issue longer dated bonds.



To this end, the portion of BBB rated bonds in the Markit iBoxx $ Corporates 10Y+ index, the lowest rung in the investment grade ladder, has grown to 47% over the last five years from 41% in March of 2011.

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THE PULSE OF PRIVATE EQUITY

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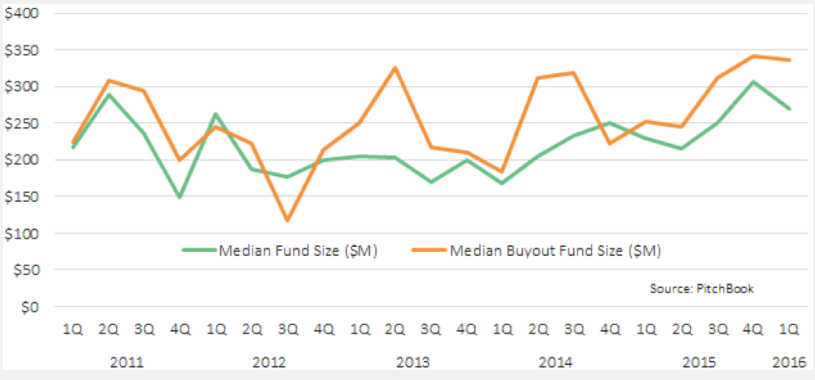

The Bigger, the Better: Private Equity Funds Still Trending Upward in Size

Although there is a fair amount of quarterly variance in median private equity fund sizes, there has been a distinct trend upward since the end of 2013, with the closing quarter of 2015 cresting at just over $300 million across all PE fund types. Buyout funds have trended even larger as of late, avoiding a quarter-over-quarter slump in 1Q 2016. Through the end of March, 2016 saw 104 PE vehicles close, a tally that was roughly in line with most of the past several quarters, yet down from the highly active heights of 2013. Thus, even as overall fundraising activity has softened slightly, fund sizes have trended upward, and as these figures are global medians, it's clear that the industry as a whole has been targeting at least modestly higher when it comes to fundraising. This is well in line with current PE fundraising trends, both observed and anecdotal: With a growing number of active PE firms courting limited partner dollars, strategies are growing more

niche and sector-specific as firms seek to demonstrate untapped opportunities or their particular areas of expertise and tout strong track records. LPs, meanwhile, have been seeking to at the very least maintain their allocation to the PE asset class on the whole, looking to commit to larger, most-proven fund managers. Especially in today's dealmaking environment, it's unsurprising to see larger fund closes, consequently, as risk-averse LPs subscribe to vehicles of bigger fund managers, which do tend to outperform other fund size classes, by and large. The concentration of buyout fund sizes around $300 million speaks to not only the characteristics of the PE firms raising recently but also that particular strategy's popularity, most likely generated by more and more fund managers looking toward the core and upper bounds of the middle market for best-valued opportunities.

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SELECT DEALS IN THE MARKET

Deal	Arranger	Sponsor	Industry	Facility*	Spread	LIB Flr	OID	Rating
API Technologies Corp (1)	BNP	J.F. Lehman & Co	Computers & Electronics	115	600	100	98	NR/NR
DYK Automotive (1)	BNP	Sterling Group	Automotive	134	475	100	99	NR/NR
Edgewood Partners (2)	JPM	Carlyle Group	Insurance	200	600-625	100	98	B/B3
Survey Sampling (AO)(1)	Antares	Huntsman Gay	Services & Leasing	30	500	100	99	B/B2
Top Knobs (1)	Antares	Jordan Company	Home Furnishings	195	500	100	98.5	NR/NR
Averages				**135**	**519**	**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) NC-2/104/102
(4) NC-2/102/101

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

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