THE Lead Left
The Premier Middle Market Newsletter

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Markets at the Midpoint (Last of a Series)

The setting was Arlington Park, a storied horse racing venue about a forty-five minute Uber ride northwest of Chicago. We had just lost $50 on a "sure thing" in the 5th race, though we should have been suspicious of a horse named *Diminishing Return*.

The summer gathering there was hosted by one of the leaders in middle market finance, and has always been a superb forum for conversations with industry players. It turns out bankers' views of market activity mirrored the action on the track - periods of inactivity punctuated by brief cheering and ticket shredding.

"Things are definitely picking up," one participant commented, "especially over the past few weeks. But it remains competitive. We see properties with sponsors in the early stages of auctions where leverage is being pushed. Some businesses can handle six times [total ebitda] or more, but others can't. That's where our focus is."

How about senior leverage? "Around four times, give or take, for good credits," another top capital markets veteran said. "But on what ebitda? Is it pro-forma, adjusted, run-rate on quarterly numbers? That's more important than the leverage multiple."

That sentiment was echoed by others as well. We chatted with a top arranger as they cashed in their trifecta winnings. Are we in for a more sell-side friendly market?

"For some credits, yes," he answered. "Particularly with proven track records and good sponsors. Deal flow is better than it was, but that's relative to a weak first quarter."

Is the pipeline building, we asked? He nodded. "We're working on a ton of sponsor bids, but the hit rate isn't great. Plus there are so many financing options for them to choose from. Unitranche, stretch senior, even second lien is available at a price. And if someone wants to throw a bit more leverage at a deal, they can and will."

How's pricing holding up? "At the moment, pricing is still in a range around L+500," he reported. "To some extent, that's thanks to the banks stepping away from leverage loans. It's also due to sponsors being willing to accept more coupon for certainty of execution and locking in their relationship lenders. There's a cost to doing that, but sponsors accept that, up to a point."

We asked a number of lenders how the post-Labor day calendar was shaping up. One market leader said they had a number of transactions on the runway for early September. But there's still caution about being too aggressive on underwritings. "You don't want to be long with limited visibility," they said. "We've seen how markets turn on a dime. If we hit an air pocket like we did last August, you could be wearing paper."

But a big difference between bank and non-bank arrangers is the latter doesn't need to distribute paper. If the market backs up, they don't mind holding a good asset at a reasonable yield. That's creating a horse race in which non-banks have a growing, and perhaps unbeatable, advantage.

QUOTE OF THE WEEK

"The market is getting a little nervous that the Fed is not a doornail forever."

– Steven Englander, global head of G10 strategy, Citibank.

Attention Subscribers! Our State of the Capital Markets - Second Quarter 2016 Review and Third Quarter 2016 Outlook is now ready for download. Click here to access this report.

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THE LEAD LEFT SPOTLIGHT

Babson CAPITAL MANAGEMENT

This week we continue our conversation with Eric Lloyd, the head of Global Private Finance for Babson Capital Management. Babson is one of the world's leading asset management firms with investment teams on four continents managing over $243 billion in assets for clients in more than 20 countries around the world.
Second of two parts - View part one

TLL: Do you do more lead transactions, or participations?

EL: It moves around quarter-to-quarter. We look first for attractive investments. We try not to let ego get in the way. We do our own due diligence and carefully review all the documentation. We've led over half of all our transactions, but if we don't lead, we're ok with that also as long as we are doing our own direct due diligence.

TLL: What's your minimum yield requirement?

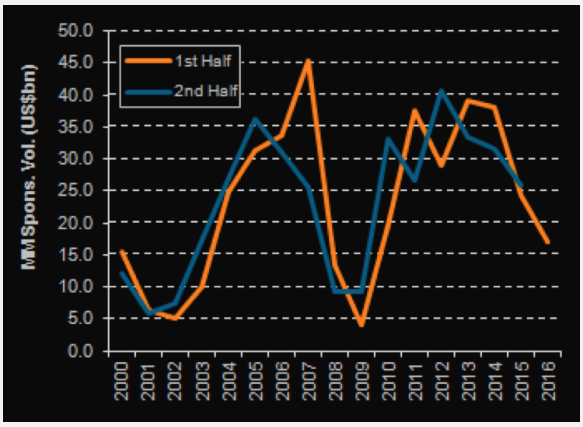
EL: We have some lower yielding vehicles, so that allows us to do deals in the high [Libor +] 400's to low 500's. It depends on the vehicle. We look at the deal, then find the right fund to put it in.

"I believe in basic things: empowerment, meritocracy, respect, and upward mobility"

CHART OF THE WEEK

Half Baked

Middle market sponsored volume for the first six months of 2016 was the lightest in seven years.



Sources: Thomson Reuters LPC

STAT OF THE WEEK

	May 2016	July 2014	Apr 2009	Dec 2007
Durable Goods New Orders ($MMs)	230,352	290,825	144,239	242,879

Source: US. Bureau of the Census

LOAN STATS AT A GLANCE

Provided by: S&P CAPITAL IQ

	This Week	Last Week	6MO Ago	YR Ago
New-Issue Clearing Yields				
$200M or less	6.60%	6.60%	6.43%	6.53%
$201M - $350M	6.42%	6.43%	6.35%	5.90%
$351M - $500M	6.12%	6.15%	6.40%	5.52%
$501M+	5.11%	5.10%	5.67%	4.78%
Middle market (≤ $50M)	6.76%	6.74%	6.64%	6.36%
Large corporate (> $50M)	5.35%	5.35%	5.87%	5.09%
Large corporate single-B (> $50M)	5.69%	5.67%	6.12%	5.25%
Middle Market Credit Stats				
Sr/EBITDA	N/A	N/A	5.6	5.1
Debt/EBITDA	N/A	N/A	5.6	5.1
Middle Market Index Data				
Monthly Returns	0.83%	0.59%	-0.58%	0.52%
Average Bid	93.33	93.16	93.33	97.34

TLL: Eric, what do you think the virtues of private credit are today?

EL: Historically, the asset class has proven through cycles to outperform, if you can withstand the illiquidity. Timing your entrance into private credit is very difficult. From the time you pitch a new fund strategy to the time you start investing, conditions may have dramatically changed. Even within the period it takes to ramp the same vehicle. Within 18 months, we may see several different risk return environments.

We have to work harder today to find the right balance between risk and reward. It's a little more challenging, yes, but that's ok. It's also a little bit more competitive.

TLL: What's the outlook for the year?

EL: Our average senior debt to ebitda has been remarkably consistent for the past three years. It hasn't moved up much with the markets. We're continuing to see opportunities in the U.S., Europe and in the Australia/New Zealand and developed Asia markets, and while we've seen value between these markets ebb and flow over the last year or so, deal terms and structures remain in reasonable territory. We have an investment process that we stick to which we believe will serve us well through economic cycles.

TLL: What's your biggest concern when you look at recent events?

EL: There's the geopolitical uncertainty; from time to time one-half of our investments are outside the US. So we look at relative dynamics - Brexit, Australia, the US, or some bad event like terrorism. Those underwritten events are our concern.

Also, as the world gets more competitive, we need to take care of our talent. That's a major concern of mine.

TLL: What keeps people in their jobs these days?

EL: I came out of the large corporate

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MIDDLE MARKET DEAL TERMS AT A GLANCE

Provided by:

SPP CAPITAL PARTNERS

July Update

Deal Component	July 2016	July 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-5.50x
Senior Cash Flow Pricing	Bank: L+3.50%-4.50% Non-Bank: <$10.0MM EBITDA L+6.00%-8.00% Non-Bank: >$15.0MM EBITDA L+4.50%-6.50% (potential for a 0.50%-1.00% floor)	Bank: L+1.75%-3.50% Non-Bank: L+4.00%-6.00%
Second Lien Pricing (Avg)	Micro Cap L+8.00%-11.00% floating (0.50%-1.00% fl) Small Cap L+7.00%-8.50% floating (0.50%-1.00% fl) Midcap L+6.00%-7.50% floating (0.50%-1.00% fl)	Micro Cap L+8.00%-11.00% floating (1.00% fl) Small Cap L+6.00%-9.00% floating (1.00% fl) Midcap L+5.50%-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 10.0%-12.0% Warrants in special situations; Second lien may buy down to ~9.0%.
Unitranche Pricing	Micro Cap L+8.00%-11.00% (0.50%-1.00% fl) Small Cap L+7.00%-8.50% (0.50%-1.00% fl) Midcap L+6.00%-7.50% (0.50%-1.00%-1.50% fl) Fixed rate alternatives available. Most unitranche lenders allow a small ABL facility outside of the unitranche facility though pricing likely to be impacted by size of revolver if external to unitranche. Capex, acquisition lines, and equity co-investments readily available.	Micro Cap L+8.00%-11.00% (1.00% fl) Small Cap L+6.50%-8.50% (1.00% fl) Midcap L+6.00%-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 with an ABL lender; larger ABL facilities are provided directly by unitranche lenders and internally arranged.

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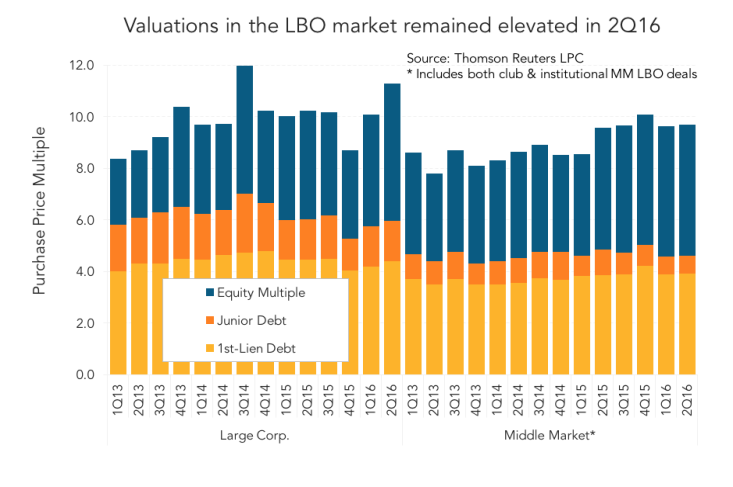
LEVERAGE LOAN INSIGHT & ANALYSIS

Provided by:

THOMSON REUTERS



The PE-backed LBO market continued to remain inflated and aggressive in 2Q16. The average purchase price multiple on large corporate LBO deals was elevated at 11.3 times while middle market deals also saw lofty valuations at 9.7 times. Historically middle market LBOs exhibited average purchase price multiples closer to 8 times but that started to rise into the mid-9x area in 2Q15 and never came back down. But with average leverage capped in the 6 to 6.5 times area across both markets, sponsors had to kick in sizeable equity contributions. Both the large corporate and middle market saw record high equity checks in 2Q16 at 44% and 52% respectively. In 2H16, it is likely that inflated valuations are here to stay given several factors including high public equity market valuations, lack of assets for sale and significant levels of unspent private equity capital commitments. Buyout and mezzanine fundraising totaled $93 billion in 1H16 which is slightly behind 2015 levels but

world; when I was there I was a bit of a culture nut and remain that way today. I believe in basic things: empowerment, meritocracy, respect, and upward mobility.

We've listened very carefully to the concerns our people have. What we know is it's important to be there for them if a tough personal event happens. How you deal with that means so much to people. If you take care of them, they're unlikely to leave for 10-15% more money.

In our industry we are incredibly blessed to do what we do. We've hired people from investment banks, private equity and everything in between.

TLL: Back to investing: What sectors do you like?

EL: It's more about things we won't do. As I mentioned, we shy away from cyclical businesses. We're not big on turnarounds. There's no number-one thing, but if it's something you talk about at a cocktail party, it's probably not for us. Senior debt's goal is to get your 7% plus unleveraged return, and get your money back. We don't want to take on significant risk for that kind of return.

TLL: Where do you think we are in the business cycle? Seventh inning like everyone else?

EL: I don't know. We assume that we'll hold our investment for the life of the asset. Wherever we are in the cycle, really doesn't matter. We assume something will happen to impact that asset. We are not top down investors; we are fundamental investors. We know we're going to cycle eventually.

TLL: What's been your biggest surprise this year?

EL: On a global basis, my biggest surprise has been the general rise of the populist movement. And it's not just coming from the UK or the US.

TLL: What about in North America?

EL: I'm surprised there hasn't been more movement from young people starting their careers into direct

still quite robust.

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THE PULSE OF PRIVATE EQUITY

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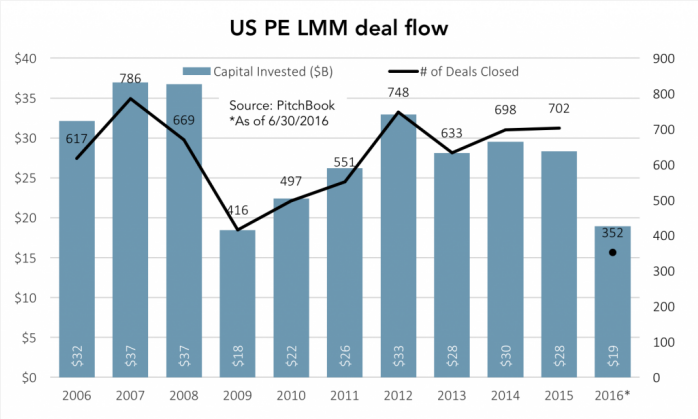
PitchBook



PE Interest in US Lower Middle Market Slumps Temporarily

After trending upward for over a year, private equity dealmaking in the US lower middle market (defined as transactions sized between $25 million and $100 million) fell sharply between 1Q and 2Q 2016. Granted, there were fluctuations in the upward trend, but 1Q recorded not only the highest spike in PE activity in the US LMM since the start of 2012, but also a clear peak in overall deal value. Yet 2Q fell by both counts, even though the overriding trends of adding on smaller companies and PE players' continued interest still hold.

Beyond the fluctuation that can be observed from quarter to quarter-and the consequent caution that must be observed when analyzing such numbers-the decline must be put in a broader context. First, on a yearly basis, US lower-middle-market companies are still on pace to enjoy roughly the same level of interest from PE investors as they did in the past two years, the heyday of the current buyout cycle. Second, given the size of the companies involved as well as the various political and macroeconomic risks that investors are trying to take into account, the steady rise of PE activity in the LMM was capped off with a peak in the first quarter of 2016 as dealmakers sought to close whatever worthwhile opportunities were in play as quickly as possible. On a quarterly basis, the supply of quality companies in market affects the rate of closed deal activity on a slight delay, suggesting that the current decline is also due to most of the best targets having already been bought. Finally, as the pipeline refills in certain sectors such as healthcare and technology, PE interest in the LMM could well revive to a healthier level, since many firms still need to put capital to work and industry trends in those aforementioned industries are still encouraging general M&A.

☞ **Read the PitchBook's 2Q US PE Breakdown Report** here. nbsp;

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COVENANT TRENDS

Provided by:

Covenant Review

Average Sector Leverage

lending from other areas. If I was advising a young person, I would tell them it's the place to be. You own the investment, you wear it. There's something that's very compelling about that for me.

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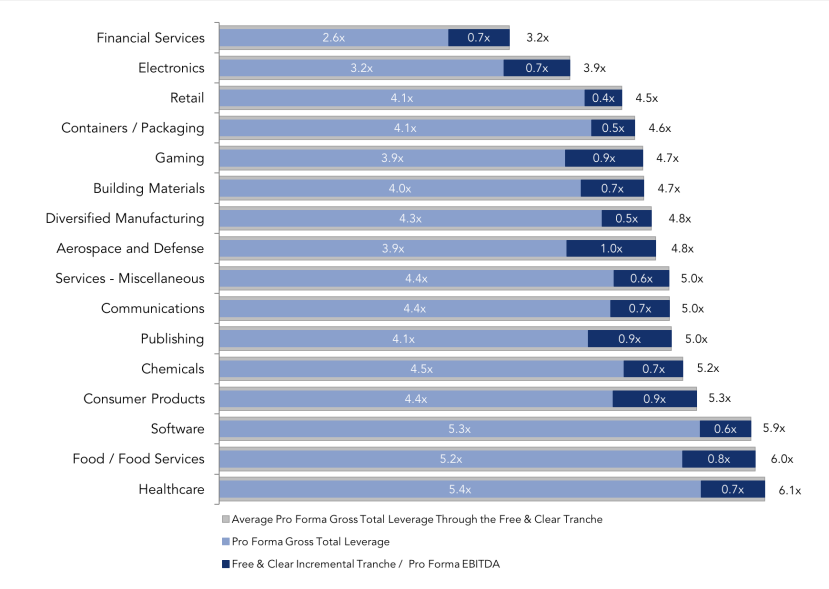

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PRIVATE DEBT INTELLIGENCE

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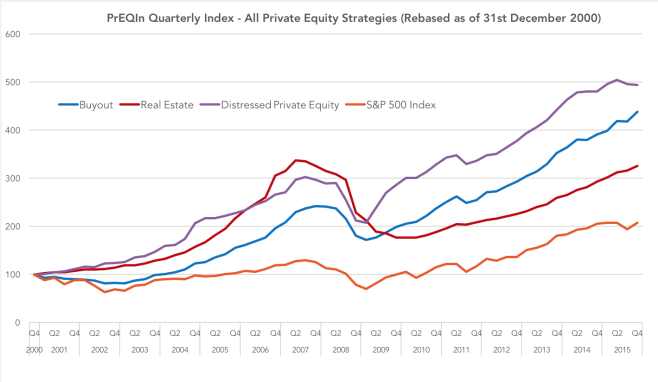

Distressed Private Equity Excels in PrEQIn Performance Index

The PrEQIn Index captures the returns earned by investors, on average, in their private equity portfolios, based on the actual amount of money invested and rebased to a chosen point in time. This makes comparisons possible between different strategies and also with the S&P 500.

Rebased to Q4 2000, Preqin's full 2015 data shows that distressed private equity outperformed all other large closed-end private capital funds, as well as the S&P 500. As of the end of Q4 2015, distressed private equity reached a PrEQIn Index value of 494, more than double the level that the S&P 500 has achieved over the same period, with the public market index showing performance of 208 and only surpassing the value of 100 in Q3 2005.

During the property bubble preceding the Global Financial Crisis (GFC), the PrEQIn Real Estate Index outperformed distressed private equity between Q2 2006 and Q1 2009, reaching a value of 335 which the asset class has not achieved since. However, an abundance of distressed investment opportunities after the GFC allowed the distressed private equity Index to recover from the crash rapidly, while real estate suffered from the ongoing property crash.

The PrEQIn Buyout Index also convalesced after both the GFC and the introduction of market-to market valuations which caused declines in 2008 and 2009, yet it has not outperformed distressed private equity since the Index was rebased in Q4 2000. However, buyout fund performance increased from a value of 312 at the end of H1 2015 to 438 by the end of the year, while over the same period the Index value of distressed private equity has seen two successive quarters of decline, falling from 505 to 494.

The PrEQIn Index shows that private capital strategies stand in good health,

MARKIT RECAP

Provided by:

markit

Back in July 2010, not long after the first Greek bailout, results of stress tests conducted by the Committee of European Banking Supervisors (the predecessor of the EBA) were released on the EU's banks. They didn't make for happy reading. Seven institutions failed, and they were required to raise additional capital to reach the 6% tier one ratio under the test's adverse scenario. Five of the failures were Spanish, along with one German and one Greek bank.

Six years later, it seems inconceivable that Italian banks, and one in particular, emerged unscathed from the tests. Monte dei Paschi de Siena (MPS) managed to pass the tests, albeit by a small margin. It also passed the following year, and it wasn't until 2014 that it failed.

The results of the 2016 tests due to be released after the close on July 29 won't classify banks as 'passed' or 'failed', but will specify capital shortfalls under shock scenarios. Given the deterioration in its balance sheet, it seems inevitable that MPS won't escape this time.

The CDS market has reflected MPS' dire predicament for some time, with spreads widening sharply earlier this year. But the increasing probability of default has also highlighted some of the idiosyncrasies in the CDS market. The bank's subordinated five-year spreads under 2014 definitions are trading at 25 points upfront, while the 2003 levels are a full 15 points lower. The gap reflects that 2014 protection buyers enjoy the benefit of an additional credit event: Governmental Intervention. We saw in the case of SNS Bank in 2013 that the 2003 definitions, particularly the Restructuring credit event, can struggle with states intervening in banks. If subordinated bondholders are bailed-in, then contracts under the 2014 definitions are more likely to trigger.

But it is not just the subordinated spreads of MPS that show the quirks of the CDS market. The performance of the bank's senior CDS has also shed

with all strategies showing an upward trajectory since the GFC. Distressed private equity, in particular, has demonstrated that investors willing to expose themselves to a riskier strategy, could see strong and consistent returns.

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light on how things have changed since the introduction of the new definitions. Unlike the subordinated spreads, MPS senior CDS is tighter under 2014 than 2003 - 345bps to 395bps respectively. How can this be when 2014 contracts include the Governmental Intervention credit event? The most likely explanation is that under 2014 definitions, if there is a Restructuring or Governmental Intervention on subordinated debt it won't also trigger the senior CDS. This is in contrast to 2003 contracts, where senior would trigger if there is an event on subordinated debt (as we saw with Novo Banco in 2014). This if the bail-in only affected subordinated bonds, the senior CDS wouldn't trigger, hence the tighter spreads on 2014 contracts.

It may be that this is all moot if MPS manages to raise capital without enforcing burden sharing on bondholders. We should find out next week.

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SELECT DEALS IN THE MARKET

Deal	Arranger	Sponsor	Industry	Facility*	Spread	LIB Flr	OID	Rating
Cooke Aquaculture	Rabobank	AGR Partners	Food & Beverage	52	450	N/A	N/A	NR/NR
TRANZACT Holdings (1)	SunTrust	CD&R	Insurance	185	600	100	98.5	B/B3
Paramit	Regions Bank	Altaris Capital	Healthcare	105	475	N/A	N/A	NR/NR
Cross Country Healthcare	SunTrust	Charterhouse Equity	Services & Leasing	40	225	N/A	N/A	NR/NR
AmSpec	Antares	Olympus Partners	Services & Leasing	170	500	100	99	NR/NR
Array Technologies	Jefferies	GFI Energy Ventures	Computers & Electronics	200	N/A	N/A	N/A	NR/NR
Parts Authority (1)	BMO	Jordan Company	Automotive	145	475	100	99	NR/NR
Liquid Web (AO)	SunTrust	Madison Dearborn	Computers & Electronics	57	450	100	N/A	NR/NR
Penn Engineering (CL)(1)(AO)	CS	Tinicum	Building Materials	100	300	100	99.5	B+/B1
Inteva Products	Deutsche	Renco	Automotive	250	N/A	N/A	N/A	NR/NR
Mister Car Wash (CL)(AO)	Jefferies	Leonard Green	Automotive	20	400	100	N/A	NR/NR
Averages				120	431	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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