THE Lead Left
The Premier Middle Market Newsletter

Churchill Asset Management
A TIAA Company

Covenants in the Coal Mine (Last of Two Parts)

The onset of renewed market volatility last week reminded credit participants that exogenous events do impact prices and new issuance, though to differing degrees.

Broadly syndicated loan and high-yield bond markets both saw price declines in secondary trading. But new junk issuance slowed to a crawl after the Brexit vote, while loan activity continued uninterrupted.

This divergent behavior is unsurprising. High yield investors, knowing their assets are unsecured and set at a fixed interest rate, are more sensitive to both rate and recessionary expectations. This was certainly borne out by cash exiting from retail funds last week - around $1.6 billion, according to Lipper.

The loan market, featuring senior secured, floating rate instruments, tends to soldier on despite market hiccups, albeit at costs to spreads and structures. Because the impact of Brexit looks to be fairly limited in the US, at least in the short-run, loans have recovered more rapidly.

Where observers expect more of a pushback is with edgier credits and aggressive dividends. In part this is due to the still uncertain market capacity as seen by sell-side arrangers. As we quoted one top syndicator last week, "Volatility clouds visibility."

There is also concern about the risk of a slowing economy Brexit may have hastened. Although the drag on the US is expected to be minimal, economists worry that global growth, hardly robust at the moment, could melt away over the next year.

All the more reason that the buy-side has been cautious about broadly syndicated loan structures, particularly covenants. As our experts from *Covenant Review* pointed out in their two-part interview with us [link], the focus has been on deterioration of such features as MFN sunset provisions and debt incurrence baskets.

For the middle market, covenants are a given. During periods of froth, large cap bank debt arrangers will try to sneak in a covenant-lite transaction here and there, particularly for issuers around $50 million ebitda. In general, though, smaller borrowers have at least one maintenance financial covenant. Indeed, as our *Chart of the Week* shows, almost two-thirds of middle market loans have two or more such covenants.

Experienced managers of middle market loans tell us that quality, more than quantity, determines the strength of a covenant package. "Sponsors are still pushing the envelope," one says. "I worry most about ebitda adjustments. The debt-to-ebitda test may look like tight, but if the ebitda definition is fluffy, the cushion is actually wide."

Another lender agrees. "I'm less worried about a recession scenario than I am about integration risk. If the borrower isn't executing on cost reductions, a good leverage covenant can catch it. Same with expected synergies. Neither is growth-driven."

QUOTE OF THE WEEK

"This is the real stress test."

– Simon Johnson, professor of global economics and management, MIT Sloan School of Management.

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Like the proverbial canary in the coal mine, covenants are good early warning systems for lenders. It looks like Brexit will keep them front and center for a while.

THE LEAD LEFT SPOTLIGHT

This week we chat with Michael Babiarz of Clayton, Dubilier and Rice. Michael is a partner of the firm and been with CD&R since 1990.

The Lead Left: Michael, you've been with CD&R for 26 years. Tell us how the firm has evolved?

Michael Babiarz: In many ways, we still operate with the mindset that Martin Dubilier and Joe Rice had in 1978 when they formed CD&R. The firm built itself around a simple premise: blending professional investment judgment with world-class operating skills was, and still is, an intelligent and practical way to buy, improve and sell businesses. CD&R pioneered the operating partner PE model. We've differentiated ourselves from other private equity firms through our long track record and a distinctive mix of financial and operating talent. Having operating experts around a business who can step in and provide guidance and leadership if they need to provides downside protection for both our financing sources and for our equity.

Historically, we've been most successful in situations where there were operating challenges and/or complexity. A good example is divestitures from large corporates. That was a major differentiating factor in the early days. When you're dealing with a seller or management team that cares who the owner is, we do very well in those situations. They recognize the value we can bring to the table. When IBM decided to give their brand to someone for five years when we acquired their printer business (Lexmark), they really cared who the new owner was. The importance of being viewed as a trusted partner is as important today as it's ever been.

"The importance of being viewed as a trusted partner is as important today as it's ever been."

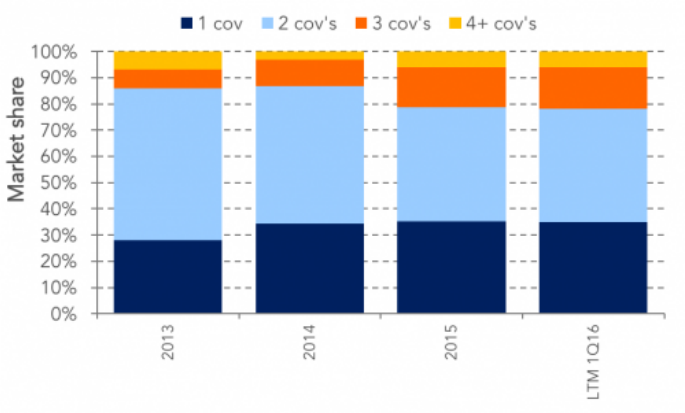
TLL: How has the firm adapted to the realities of private equity

CHART OF THE WEEK

Cov-Like

Almost two-thirds of middle market leveraged loans have two or more maintenance covenants; only 2.5% of middle market loans are cov-lite.

US middle market covenant counts



Sources: Thomson Reuters LPC; SEC Filings

STAT OF THE WEEK

	July 2016	Nov 2013	Oct 2001	Apr 1977
Coffee Price (Cents/LB)	146.2	102.16	42.5	339.86

Source: Trading Economics

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	6.85%	6.85%	6.43%	6.53%
$201M - $350M	6.21%	6.21%	6.35%	5.90%
$351M - $500M	6.23%	6.26%	6.40%	5.52%
$501M+	5.15%	5.21%	5.67%	4.78%
Middle market (≤ $50M)	7.03%	7.03%	6.64%	6.36%
Large corporate (> $50M)	5.36%	5.40%	5.87%	5.09%
Large corporate single-B (> $50M)	5.60%	5.65%	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	0.00%	0.00%	-0.75%	0.02%
Average Bid	92.88	92.99	94.21	97.02

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MIDDLE MARKET DEAL TERMS AT A GLANCE

Provided by:
SPP CAPITAL PARTNERS

June Update

investing in today's world?

MB: We have always been business model investors meaning that we look for companies with very particular characteristics, including market leadership, broad spread of risk and clear operating improvement potential. Today we apply that business model focus and superimpose it over certain industry verticals. We have operating partners with expertise in four key industry sectors: healthcare, consumer/retail, industrials, and business services. We can bring in experienced senior executives from Fortune 100 businesses - all of whom have multi-decade exposure running global enterprises.

Examples include: John Krenicki who ran GE's $50 billion energy business and Ron Williams, the former CEO of Aetna. In business services, we have Russ Fradin, the former president and CEO at Sungard. On the consumer front we've got Paul Pressler who had senior executive roles at both the Gap and Disney, Vindi Banga, who was the #2 executive at Unilever, Sir Terry Leahy, the former CEO of Tesco, and John Compton, who had a 30 year career at Pepsico, most recently as President.

Those human capital assets give us a competitive bidding advantage. For example, when we bought High Ridge Brands, John Compton and Vindi Banga helped us by virtue of their extensive and deep networks in the consumer industry. Having their insights and strategic guidance from the beginning of our due diligence through our exit in the future, in addition to their ability to attract high caliber portfolio company senior management, is extremely helpful.

TLL: How do you view auctions these days? I'm sure you hope to avoid them.

MB: We'd love to have all proprietary deals, and about half of our investments since 2009 have been fully exclusive or very limited processes. Often times these are partnership structures where the seller is trying to avoid parting with a business at the worst point of the cycle. It can be a win-win outcome, as we saw when we and Ingersoll-Rand sold Hussmann to Panasonic earlier this year.

TLL: Do you get deal flow from investment banks? How about your operating partners?

MB: We certainly have relationships, but we've built a reputation based on partnering with sellers and

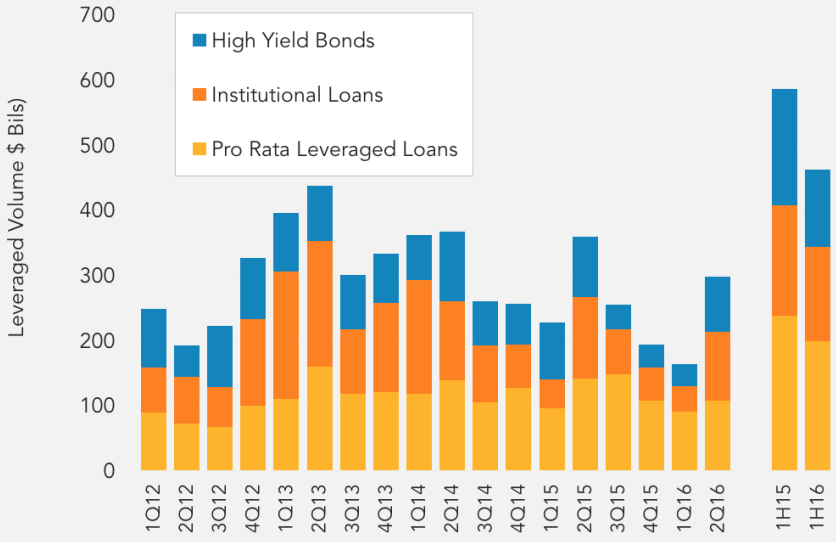
Deal Component	June 2016	June 2015
Cash Flow Senior Debt (x EBITDA)	Micro Cap 1.50x-2.50x Small Cap 2.50x-3.50x Midcap 3.00x-4.00x	Micro Cap 1.50x-2.00x Small Cap 2.00x-3.50x Midcap 3.00-4.25x
Total Debt Limit (x EBITDA)	Micro Cap 3.00x-4.00x Small Cap 3.75x-4.50x Midcap 4.00x-5.50x	Micro Cap 3.00x-4.00x Small Cap 3.75x 4.50x Midcap 4.00x-5.00x
Senior Cash Flow Pricing	Bank: L+3.50%-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+9.00%-12.00% floating (0.50%-1.00% fl) Small Cap L+7.50%-9.00% floating (0.50%-1.00% fl) Midcap L+5.50%-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= <$7.5mm EBITDA *Small Cap= >$10mm EBITDA *Midcap= >$20mm EBITDA *Changes from last month are in red	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) 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+6.50%-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.

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LEVERAGE LOAN INSIGHT & ANALYSIS

Provided by:

THOMSON REUTERS



Improved market sentiment boosts 2Q16 leveraged market; Opportunistic deals resurface

The market volatility that emerged at the tail end of 2015 and seeped into 1Q16, eased in 2Q - at least until the Brexit vote - allowing lenders to step back to assess their pipelines against the back drop of a stronger high yield bond market. The result? The re-emergence of opportunistic refinancings and dividend recaps as the loan market attempted to play catch up on a slow start to the year. At nearly US$300 billion 2Q16 leveraged issuance was up 81% compared to 1Q16 totals. After several fitful quarters, institutional loan and HY bond investors supported almost $106 billion of institutional loan volume and over US$84 billion of HY bond issuance (as of 6/28/16) the highest quarterly totals in a year. In turn, pro rata lenders - who have proven a steadier source of liquidity among higher quality leveraged credits - pushed over US$108 billion of loan volume through syndication. 1H16 leveraged loan volume totaled nearly US$463 billion of June 28, down 21% year over year due in large part to the slow 1Q16 start. The supply overhang which cast a shadow on the market was largley cleared and lenders noted the development of a more balanced, albeit slower, calendar. Despite some 2Q market bullishness that precipitated a series of opportunistic refinancings and repricings, lender fatigue settled in fairly quickly. Several lenders noted that deals that got caught at the end of the repricing

management teams that can't always do what's needed with a business. For non-core businesses, it's tough for a corporate owner to invest adequately. We're an ideal partner because we can pay strategic attention to the business, invest financial and human capital into the enterprise, and give teams and the incumbent owner some equity, so they can get the benefit as the value improves.

Hussmann is a timely example. Before we acquired 60% of the company from Ingersoll-Rand, Hussmann's EBITDA and market value were going down by the day. Our operating partner knew the business (refrigeration systems) very well from his Emerson Electric days. Other bidders offered higher purchase prices, but they eventually backed down when they realized how complex separating this business from IR was going to be. The sellers didn't like our price initially, but the bankers running the sale process had seen the CD&R playbook before. The competitive bidders ran for cover in the face of complexity, but we made money by refocusing the business, re-energizing the team, and holding on for a few more years so the business could start to show progress that it was on a positive trajectory. We and IR ended up selling Hussmann to Panasonic this past April.

TLL: What's made auction processes more competitive?

MB: In general, it's been financing. It's heated up today. Bankers accelerate timing because they recognize the strength of the capital markets. We can mobilize the resources when we need to, but we try not to play in large, transparent processes unless we really have a unique edge. Over 50% of the deals we've done in our last 2 funds have been completed outside of wide auctions. In those situations, where there's increased complexity and often times innovative structuring required, we generally have the time we need.

TLL: Speaking of capital markets, are you taking advantage of the non-bank capital out there?

MB: Historically, we have not had a lot of direct lending relationships because it's a real challenge for direct lenders to provide unfunded revolvers. We've learned over the years that adequate RC capacity is critical to protecting the downside and growing the business. As a result, we've chosen to put together club deals with banks rather than with institutional investors.

To be continued the week of July 11

cycle got done, but with greater than expected difficulty.

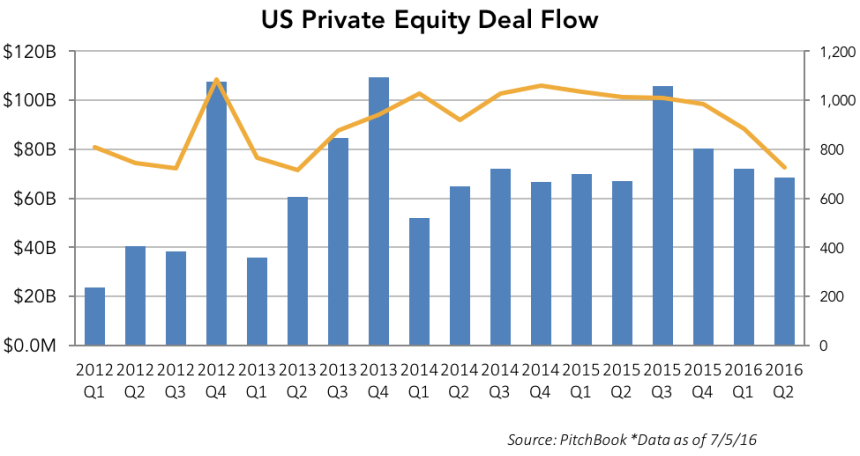
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THE PULSE OF PRIVATE EQUITY

Provided by:

PitchBook



The decline in US private equity activity deepens

US private equity activity continues to fall. Even if Q2 numbers are revised upward as time goes on, with additional datapoints backfilled, a quarter-over-quarter decline will still have occurred in the first half of 2016. As of early July, completed deal count for Q2 is more in line with the comparable period in 2013. What this diminishing count signals is that the primary trends driving PE dealmakers to cut back on activity are still in full force. Whether it's a lack of quality opportunities, disconnects between buyers and sellers regarding asking price, longer due diligence periods due to perceived risk of economic downturn or any other of the multiple factors affecting PE investors, they all relatively remain in place. Relatively, because some of those factors are prone to very slow shifts which are already ongoing, such as median market prices and dealmakers' pipelines. Valuations are already normalizing across much of the middle market, yet as capital overhang and the macroeconomic environment - among other factors - are also holding steady, it will take some time for those in particular to decline and encourage investors to pick up their pace. The earliest this may occur is in the back half of 2016, but unfortunately, many signs still point toward ongoing stagnation in key areas, such as the Fed holding interest rates steady in response to a disappointing jobs report. Given such persistence, it's possible business owners in the core and lower middle market, where PE investors are increasingly active, will choose to come to market rather than endure any more prolonged uncertainty, while others that are hit harder than most in certain industries may court PE buyers to keep their doors open. Accordingly, buyout activity could rise somewhat, but that remains an open question. What is more certain is the degree of the rise - if and when activity resumes, it is unlikely to be anything like the heightened clip of 2014 or 2015, but rather more akin to 2013.

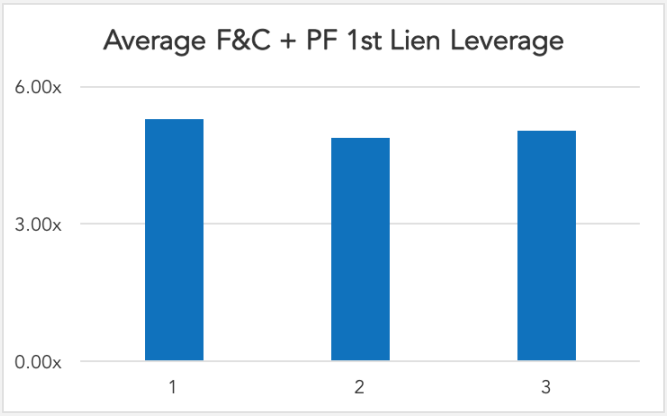
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COVENANT TRENDS

Provided by:

Covenant Review

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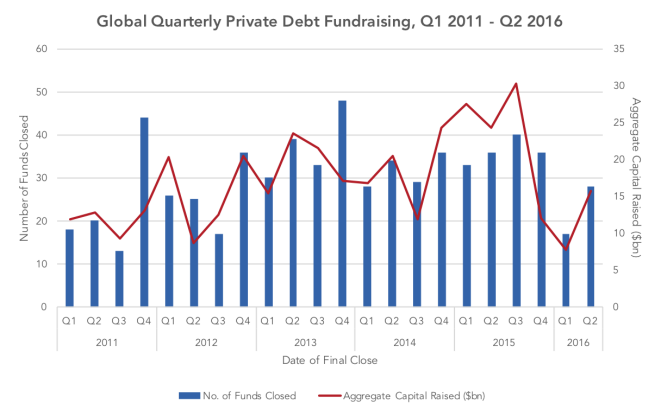


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PRIVATE DEBT INTELLIGENCE

Provided by:

preqin



Private Debt Fundraising Shows Signs of Acceleration in Q2

Preqin's quarterly fundraising update on the private debt industry finds that Q2 showed healthy signs of acceleration, boosting hopes the industry will return to the record fundraising levels seen over the twelve month period between Q4 2014 and Q3 2015.

Over the quarter, 28 vehicles reached a final close securing an aggregate $16bn of investor capital, more than double the total just shy of $8bn achieved through Q1, and also marking an increase on the total of $12bn raised in Q4 2015. Nonetheless, fundraising remains down on the record levels seen from the end of 2014 and through the majority of 2015; in each quarter from Q4 2014 to Q3 2015 private debt fund managers accrued in access of $24bn. The all-time quarterly peak in fundraising also occurred in this period when $30bn was raised in Q3 2015.

Direct lending funds dominated fundraising through Q2 with 11 funds raising a total of $9bn, 57% of combined investor commitments over the quarter. This total was achieved with the help of all three of the largest private debt funds that reached a final close over the quarter, each raising over $1.5bn of investor capital. Private debt fund of funds also saw a significant uptick in activity over the quarter with three funds securing a record $1.1bn of commitments, more than double the previous all-time high of $0.5bn in Q4 2015.

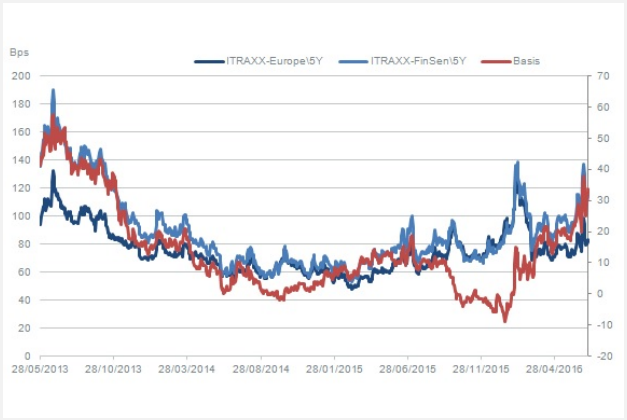
The competitive fundraising market indicates that private debt firms remain confident of securing investor commitments, with 276 vehicles currently on the road, targeting an aggregate $140bn. Direct lending funds dominate the number of vehicles in market, accounting for 41% of all funds, with 114 vehicles on the road seeking a combined $45bn. However, distressed debt vehicles are targeting the most investor capital of any debt type; the strategy is seeking a combined $46bn, despite marketing only 38 funds to investors.

The second quarter of 2016 saw the reversal of two consecutive quarters of private debt fundraising decline, allowing fund managers to deploy the record capital that they had raised through most of 2015. However, with a high number of vehicles on the road targeting substantial quantities of

MARKIT RECAP

Provided by:

markit



The parlous condition of the European banking system keeps coming back to haunt the global economy, with the latest attack of lurgy coming from Brexit. The UK electorate's vote to leave the EU has laid bare the weak credit quality of lenders, a state of affairs that needed little revealing.

Markit's iTraxx Senior Financials index, which indicates credit risk on banks and insurers (banks have a higher weighting) in Europe, was trading at 95bps prior to the referendum. Just two business days later it closed at 137bps, close to the wides reached in February. Unlike the bout of credit deterioration earlier this year, however, non-financial and financial investment grade names have not moved in tandem. When the Markit iTraxx Senior Financial index hit 138bps in February, the Markit iTraxx Europe was only 13bs tighter. Post-Brexit, the basis had stretched to 38bps. This is the highest difference since October 2013.

Technical factors may partially explain why the Main index outperformed (though it still widened 23bps following Brexit!). Payer options on the Main were a popular way of hedging the tail risk of Brexit, and the activity related to this useful strategy is probably contributing to the rally.

But fundamental drivers of spread widening in banks shouldn't be underplayed. Italian banks are the most conspicuous representation of Europe's failure to implement a wholesale recapitalisation programme akin to the US TARP. Monte dei Paschi di Siena, Italy's most beleaguered financial institution, has non-performing loans that make up about 35% of its assets. The ECB has ordered MPS to reduce its NPLs, which will require a fresh injection of capital. As MPS trades at 10% of its book value, this won't be forthcoming from the private sector.

Unfortunately, the obvious solution - Italy's government coming to the rescue - is not as easy to implement as it once was a few years ago. The EU's BRRD (Bank Recovery and Resolution Directive) states that a public recapitalisation may only come after participation of shareholders and creditors. Such a bail-in would be politically toxic in Italy due to the upcoming referendum on constitutional change, a vote the government may struggle to win.

investor capital, there is hope that the private debt fundraising industry will return to these levels through the remainder of 2016.

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But there may be a convenient get out clause. As MPS is not yet considered failing or likely to fail (some may debate this) a precautionary recapitalisation may be permitted, with the impending stress test providing the justification. Such a compromise may give some temporary relief, but the endemic credit quality problems in Italy (and banks elsewhere in Europe) won't go away unless a more radical solution is implemented. MPS subordinated CDS was trading at 37 points upfront on July 7, a level indicating high probability of default and the threat of bail-in. This won't be the last Brexit-inspired distress story over the coming months.

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SELECT DEALS IN THE MARKET

Deal	Arranger	Sponsor	Industry	Facility*	Spread	LIB Flr	OID	Rating
Northstar Travel (1)	Macquarie	Wasserstein & Co	Computers & Electronics	73	625	100	98.5	BBB-/Ba2
Cooke Aquaculture	Rabobank	AGR Partners	Food & Beverage	52	450	N/A	N/A	NR/NR
Service Logic	Antares	Sterling Investment	Manufacturing & Machine	103.4	500	100	99	NR/NR
Paramit	Regions Bank	Altaris Capital	Healthcare	105	475	N/A	N/A	NR/NR
Evergreen Industrial Services (1)	BNP	Sterling Group	Services & Leasing	107	500	100	99	NR/NR
Belcan Corp (AO)	CS	AE Industrial	Services & Leasing	25	600	100	97	B/B2
Cross Country Healthcare	SunTrust	Charterhouse Equity	Services & Leasing	40	225	N/A	N/A	NR/NR
Averages				72	482	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

THE Lead Left

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