Floor Plans

"The idea that the loan market could trade the floors that exist today for additional spread is pure fantasy." - Beth MacLean, bank portfolio manager, PIMCO.

It's March 2008. The Fed has dropped rates precipitously to forestall a liquidity crisis. One-month Libor craters to 2.8% from 5% only three months before. Libor spreads for single-B issuers, which had bottomed out at 225 bps in 2007, rise to over 380 bps. Thus did the leverage loan market flip from sell-side to buy-side, and Libor floors took hold.

As the crisis deepened, debt investors demanded a minimum Libor rate, effectively a subsidy boosting their all-in returns. The further Libor dropped below the floor, the more of a premium was earned over the spread itself. By the time Lehman collapsed in September 2009, Libor was near zero. Floors, which had opened as high as 350 bps, settled down to (and have remained) around 100 bps.

Fast forward to today: the Fed's intention to increase rates later this year has investors concerned that issuers will press to eliminate floors altogether. Who needs a subsidy (goes the argument) when actual Libor will soon rise above the floors?

The problem is the interim between when Libor rises, and floors disappear. Debt buyers may get squeezed if they can't recoup rate costs with higher spreads. What if the Fed loosens 25 bps, then sits tight? It could take months before Libor reaches levels floors are at now.

Of course, each asset manager's level of concern depends on rate expectations and funding mechanisms. CLO managers, whose liabilities are Libor-based, worry that if rates rise, so will their costs, compressing equity returns. They hope that by dispensing with floors they will have a good argument to demand higher Libor spreads.

The flaw with that logic is that lenders will jockey for any advantage in a hyper-competitive market. Lower floors dipping below 100 bps have been on offer for some time, and spreads are not widening, at least not for broadly syndicated loans.

For the middle market, floors may be stickier, in part because large deal terms are more subject to market swings than those of club transactions. Also, as we discussed last week, midcap loans are less exposed to mark-to-market drive-by re-pricings.

Memories of 2008-09 are still fresh in the minds of market players. Having witnessed so much rate volatility, investors and issuers alike seek to maximize their future optionality.

We think everyone should be rooting for more normative Libor levels. Modestly rising rates would point to a much healthier recovery than we've had so far. That should prove to be good for all assets, regardless of which

QUOTE OF THE WEEK

"When you're this weak, little things can knock you off course, whether it's the Arab Spring...or 'Snowmageddon.' "

– Dan Greenhaus, chief global strategist, BTIG

side of the floor you're on.

THE LEAD LEFT SPOTLIGHT

STAR MOUNTAIN CAPITAL

This week we chat with Brett Hickey, chief executive officer, Star Mountain Capital. Based in New York with regional offices and a network covering over 25 U.S. cities, Star Mountain provides strategic partner capital for private equity, mezzanine and other private capital funds as well as growth debt and equity financing for small and medium-sized businesses (typically companies with under $15mm of annual EBITDA).

The Lead Left: Brett, we've been reading more about your firm recently. What's your focus?

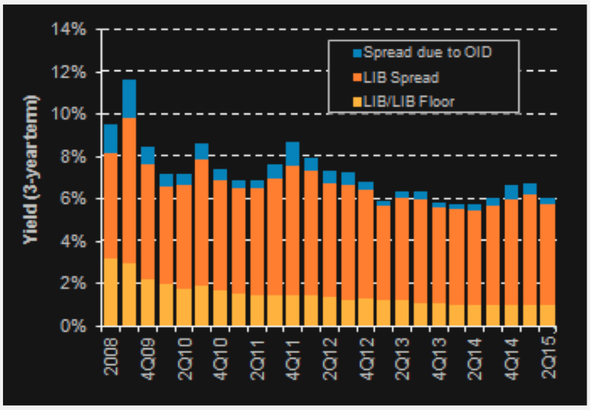
Brett Hickey: Randy, we focus on the less competitive lower end of the middle market. Our strategy is to be a value-added partner to companies and to fund managers including working as a partner with our fund managers to provide a "one-stop shop" capital solution for high quality growing businesses that, generally have less than $15 million in EBITDA. Across our portfolio, which on a look-through basis consists of approximately 150 businesses, the average EBITDA is just over $6mm. These are smaller, but established and high quality businesses that don't have as efficient of access to capital and appreciate investment partners who can bring more than just capital to help with their growth.

TLL: Smaller companies are in a less

CHART OF THE WEEK

Falling Floors

As Libor rates dropped post-crisis, Libor floors on leveraged loans have followed suit, although remaining in the 100 bps range.



Source: Thomson Reuters LPC, quarterly middle market term loan yields

STAT OF THE WEEK

	Apr 2015	Apr 2009	Jan 2006	Jan 1972
US Housing Starts (MM)	1.135	0.478	2.273	2.494

Source: YCharts

LOAN STATS AT A GLANCE

Provided by:

S&P CAPITAL IQ

competitive space, for sure.

BH: We believe that the risk-reward of the lower end of the market where we play, provides a superior risk-reward; however, it is a challenging market to operate in a scalable, efficient manner as these smaller businesses often take longer to analyze and invest in than larger companies do...and of course for a much smaller average check size! Having invested exclusively in this market for over a decade, we have built a relatively efficient way of investing in this space, providing us with competitive advantages and a differentiated value proposition for certain investors.

"It's much easier for a small company to double or triple in value which allows us to create attractive returns for our investors."

TLL: What's your marketing strategy?

BH: We have partners in 8 locations across the U.S. as well as approximately 20 additional local offices through funds where we are often the largest limited partner and sit on the board as an active and value-added partner to them. This, along with our events and other constant engagement in the marketplace helps us cover a lot of ground within this fragmented marketplace consisting of approximately 200,000 businesses in the U.S. alone.

TLL: And what do you offer investors?

BH: The opportunity to gain access to this tiny asset class in a scalable and superior risk-reward manner. As mentioned earlier, there are probably 200,000 companies with revenues between $10 and 150 million. It's hard to find, analyze and manage these small company investments in a prudent way, but when done well, it can be a very rewarding investment. It's much easier for a small company to double or triple in value which allows us to create attractive returns for our investors in an asset class that has low correlation to the larger markets which investors often like as a stable portfolio diversifier.

TLL: Let's back up, Brett. How did you get started in the business?

BH: It's a random path, but as you'll see, I'm an entrepreneur at heart. I was raised in a small town in western Canada where we were used to sharing resources and working as a team with our neighbors, which is part of Star Mountain's core culture of a "Collaborative Ecosystem" - working with versus competing with others. I started a clothing store in high

	This Week	Last Week	6MO Ago	YR Ago
New-Issue Clearing Yields				
$200M or less	6.26%	6.27%	6.84%	5.98%
$201M - $350M	5.92%	5.90%	6.24%	5.72%
$351M - $500M	5.49%	5.50%	6.37%	5.32%
$501M+	4.71%	4.71%	5.51%	4.85%
Middle market (≤ $50M)	6.09%	6.12%	6.42%	5.75%
Large corporate (> $50M)	4.99%	5.00%	5.84%	5.14%
Large corporate single-B (> $50M)	5.14%	5.15%	6.08%	5.25%
Middle Market Credit Stats				
Sr/EBITDA	4.4	4.5	4.7	5.2
Debt/EBITDA	4.9	5.2	4.7	5.2
Middle Market Index Data				
Monthly Returns	0.76%	0.64%	0.25%	0.57%
Average Bid	97.32	97.33	96.77	98.77

Source: S&P Capital IQ

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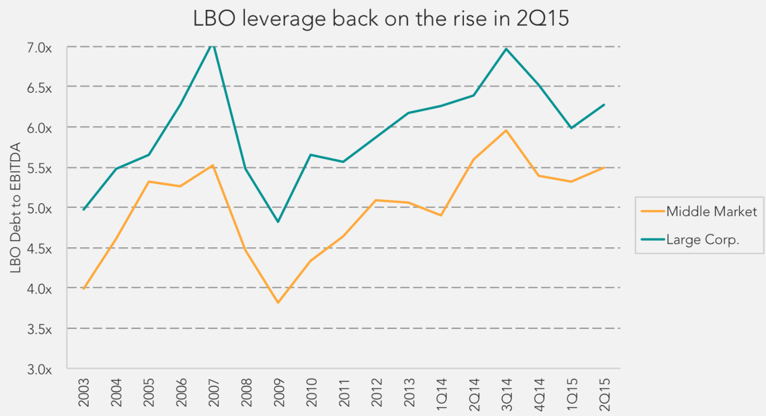
LEVERAGE LOAN INSIGHT & ANALYSIS

Provided by:

THOMSON REUTERS



Source: Thomson Reuters LPC

After declining dramatically for two consecutive quarters due to fears of being penalized by the regulators, LBO leverage is back on the rise this quarter. Debt to EBITDA on large corporate and institutional middle market buyout deals has risen to 6.27 times and 5.50 times respectively so far in 2Q15, up from 5.99 and 5.32 times last quarter. It seems sponsors and lenders have pushed leverage to the mid-to-high six times area on quite a few deals this quarter including Prime Source Building Products, Air Medical, WASH Multi Family Laundry, and Sterigenics. And even one deal was able to obtain leverage over seven times. The largest LBO deal this quarter, Informatica Corp, is exhibiting "adjusted" leverage of over 9 times according to Moody's Investors Service. However, the issuer's high recurring revenue stream and impressive gross margins supports a strong de-leveraging profile. Institutional middle market LBO deals, though few and far between this year, have also showed lofty leverage levels. The vast majority all have leverage over five times bringing the average back to buyout boom levels. Supply of middle market paper has been strapped, so buyout deals to hit market have experienced pretty favorable executions and strong demand.

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MARKIT RECAP

Provided by:

school using free office space I found and getting clothing on consignment. That was my first business foray. I then paid for college by working on the oil drilling rigs for a year in Northern Canada. Post the oil rigs, I was on the national speed skating team in Canada while attending college. During this time, in the late 90's, I started my second small business, a work placement agency in the health care industry. I sold my stake in that business to pursue a finance degree at McGill University in Montreal. I moved to New York to work for, at the time, the investment banking division of the largest financial institutional in the world, Salomon Smith Barney / Citigroup. After the typical analyst program I again came up with an idea to focus on combining my love for small businesses and structured finance, and launched a small business focused investment fund....11 years later, I'm still basically doing the same thing, and always focusing on improving the mouse trap and increasing the value we add to our investors and business owners.

TLL: That's pretty cool.

BH: Though I didn't see a lot of correlation early on in my career, the focus and discipline from speed skating and hard labor have been large contributors to my success I believe.

To be continued the week of June 8

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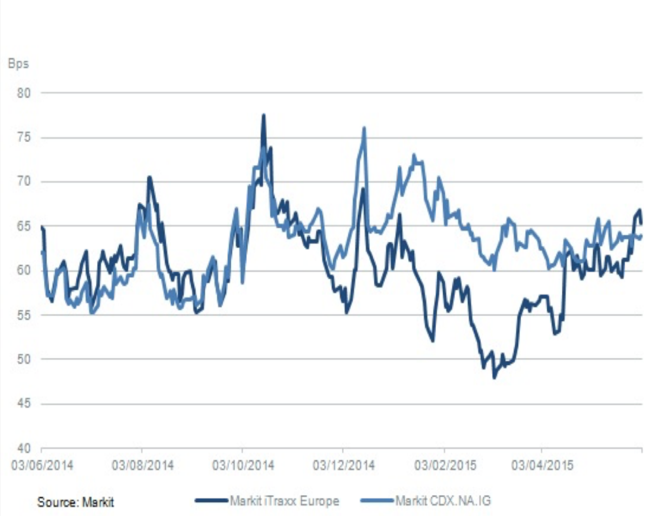
MIDDLE MARKET Growth

Take Two and Call Us in the Morning

Generic drugs were once the pharmaceutical versions of knockoffs: cheap, low quality and unreliable. Not anymore.

From Allegra to Zyrtec, formerly patented meds are not only available for much less than we used to pay, but thanks to the expedited approval process afforded by the 1984 Hatch-Waxman Act, generics account for about 80 percent of all drugs on the

markit



Many expect the European economy to perform better this year - not difficult, come might say - but recent spreads movements suggest the credit markets are sceptical.

Since the index roll on March 20, the Markit iTraxx Europe has widened by 10bps to 65bps. Contrast this with the performance of the North American investment grade equivalent, the Markit CDX.NA.IG. The index was trading at 64bps this week, less than 1bp wider than its closing level on March 20. It is the first time that the European index has traded wider than its North American counterpart since November 2014.

The composition of the Markit iTraxx Europe probably accounts for some of the underperformance. Banks make up 30 of the 125 names in the index - a share that increased at the last roll - while the Markit CDX.NA.IG doesn't include banks at all. This means that when there are fears over the stability of the eurozone -as there are now due to the ongoing saga around Greece - banks are often viewed as the most vulnerable sector. The underperformance of the Markit iTraxx Senior Financials index - a subset of the iTraxx Europe - supports this view.

Macro investors often use the index as their preferred tool for hedges and defensive positions. Index liquidity is all but guaranteed, whereas trading in large size at reasonable bid-offer spreads in the single name market can sometimes be a challenge. We can see that the index is the weapon of choice by looking the basis between the traded index level and its theoretical level, sometimes known as the skew. The index widened from 59bps to 67bps from May 21 to June 1, while its theoretical level moved from 61bps to 65bps, thus reversing the direction of the basis. The Markit CDX.NA.IG experienced a stable skew over the same period.

So it seems that the uncertainty over Greece's status in the eurozone - it faces an IMF payment on June 5, with more to follow - is affecting European credit disproportionately. We have also seen significant volatility in the government bond market, with German Bund yields rising sharply. This may indicate that the markets are pricing in higher expected inflation and higher rates, suggesting that the ECB's QE medicine is working. Inflation figures did exceed expectations, but it is far too early for victory declarations. What is certain is that the combination of central bank intervention and poor secondary market liquidity will continue to distort relationships between asset classes.

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THE PULSE OF PRIVATE EQUITY

Provided by:

market.

Generics also comprise more than 40 percent of the total $300 billion U.S. revenue for major drug manufacturers, significantly more than the $70 billion from generic drug companies alone. All this has resulted in an estimated $1.5 trillion in health care savings for consumers over the past decade or so. That's nothing to sneeze at...

Click here

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

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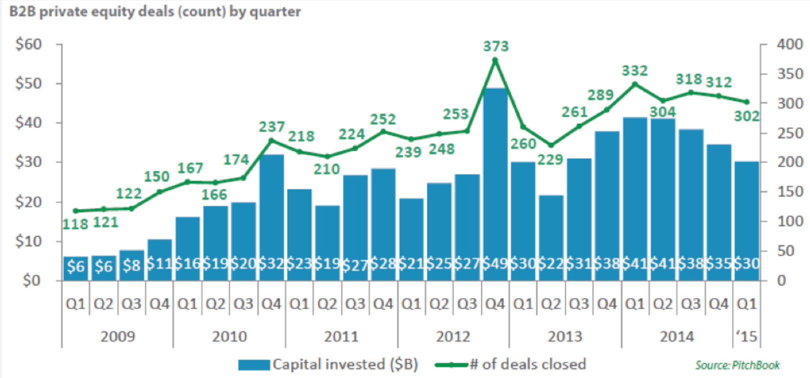

Energy prices should boost B2B

Assuming low energy prices are sustained, B2B PE activity should benefit, especially in the middle market. Activity is already pretty strong in the U.S., with another 300 deals done in Q1 totaling $30 billion. But there's reason to be more optimistic. Much of the recent boom in deal flow is because of cost reductions and efficiency improvements as middle-market companies recovered, slowly, from the recession. Lower energy costs will only add cushion and help companies continue finding more efficiencies and cut costs further. There's a concerted effort today to wean revenues away from brick-and-mortar sources and instead optimize online marketing strategies. PE firms are likely to be at the forefront of that change, and should cash in down the road once those companies are ready to exit.

Investors eyeing new platforms are tweaking their business models a bit to make up for high valuations. In some cases, one or two add-on targets are being identified and factored into the equation before the platform deal is even complete. Add-ons can help average down top-line multiples, and when they're done this quickly, they can force investors to concentrate harder on value-add starting on Day 1. Given the amount of dry powder in the market earmarked for B2B targets, it's unlikely valuations are going to come down much in 2015, but given the optimism in the sector, it's unlikely MM deal flow will go down much, either.

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SELECT DEALS IN THE MARKET

Deal	Arranger	Sponsor	Industry	Facility*	Spread	LIB Flr	OID	Rating
American Gaming Systems	Jefferies	Apollo Management	Gaming & Hotel	250	N/A	N/A	N/A	B/B3
Aria Energy Corp (1)	Barclays	Energy Investors Fund	Utilities	200	400	100	99	B/Ba3
Compusearch Software (1)	SunTrust	ABRY Partners	Computers & Electronics	115	450	100	99.75	NR/NR
ConvergeOne (5)(AO)	CS	Clearlake Capital	Services & Leasing	50	500	100	99.5	B/B3
Element Materials (1)(CL)(AO)	RBC	3i plc	Services & Leasing	70	400	100	100	B/B2
Gold Standard Baking (1)	BNP	Tricor Pacific Corp	Food & Beverage	109	450	100	99.5	NR/NR
Nellson Nutraceutical (AO)	GE	Kohlberg & Co.	Food & Beverage	60	500	100	100	B/B2
Sirius Computer Solutions (1)	Wells Fargo	Thoma Bravo	Computers & Electronics	295	525	100	100	B+/B1
The J. Jill Group (1)	Jefferies	TowerBrook Capital	Retail	250	500	100	99.5	B/B2
TouchTunes Music (1L)(1)	Citizens	Searchlight Capital	Computers & Electronics	170	475	100	99.5	B/B2
TouchTunes Music (2L)(3)	Citizens	Searchlight Capital	Computers & Electronics	62.5	825	100	98.5	B/B2
Averages				148	503	100	100	

* 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) 102/101
(4) 200/100
(5) 2 Month 101

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

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