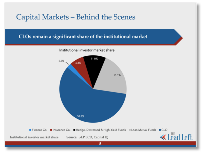
THE Lead Left
The Premier Middle Market Newsletter

Churchill Asset Management
A TIAA Company

 Week of May 16, 2016



Private Credit and Business Cycles (Last of a Series)

The question of where we are in the business cycle may ultimately be answered only in hindsight. Similarly what triggers the next cycle will likely different than what set off previous downturns. Subprime mortgages, tech, or sovereign defaults will probably not be culprits, though fallen energy credits could certainly qualify.

Given the mature recovery, credit investors are understandably focused keenly on which part of the capital stack prospective managers play in. Yet unlike the corresponding end stage of the last cycle, rates remain at rock-bottom. It's hard to remember now, but Libor in September 2007 was 5.5%. Today it stands at 0.44%.

Growth has also been severely challenged. First quarter US GDP barely registered at an anemic 0.5%. Even Italy - that engine of European capitalism - did better at 0.7%. Given how weak global economies are, it's hard to imagine a precipitous downturn. Tough to crash your plane when you're flying one foot above the ground.

Chris Godfrey at CEPRES highlights the connection between capital availability and cycle timing. "Our analysis is that the biggest determining factor of future returns is volume of capital in the market. It's a direct correlation. If we see significantly increased capital, then future value in that segment deteriorates."

That view argues against public credit where "hot money" predominates. Both high yield and large cap loans have seen outflows from retail funds this year, as investors toggle between "liquid" alternatives. The Fed's inaction on rates heightens this activity.

In contrast, Godfrey says, there's increasing interest in private credit. "It's been recognized as a real asset class that should be part of every investor's portfolio. So it's a good time to invest in private debt if you believe the public markets may be overheating."

How about default rates? "Recovery rates have been higher over the last few years. And there's been less mezz flow, so quality has improved. It's fair for investors to ask themselves, would I have been better off in high-yield? Probably not, but timing is key."

We've worked for years educating investors on private credit. What strikes Chris Godfrey is how long it's taken for interest in the asset class to take off. "It's quite a complex market," he told us. "Investors are still not clear on where private debt fits. This has historically restricted deployment of capital that could potentially come into the market going forward."

That's a heartening perspective, given how much chatter there's been about new debt funds being formed.

"We believe we're still at the early part of the growth curve," Godfrey concludes. "There's

QUOTE OF THE WEEK

"The good times are rolling again, at least for this month."

- Josh Harris, co-founder, Apollo Global Management, on the high-yield market.

plenty of room for private debt. It's taken a long time, but sophisticated investors are finally putting dollars to work there."

THE LEAD LEFT SPOTLIGHT

Deloitte.

This week we continue our conversation with Deloitte's Ned Music and Fenton Burgin. Mr. Music is an SVP in the US firm's Deloitte Corporate Finance LLC Capital Advisory team while Mr. Burgin heads up Deloitte LLP's UK Capital Advisory practice. Capital Advisory has 140 debt professionals in 30 countries dedicated to the middle market. Mr. Music will be a moderator at the upcoming Middle Market Symposium on May 17-18.

Second of two parts - View part one

TLL: Where's bank pricing shaking out?

NM: The first out piece is typically priced at L+350 and the second out piece is at L+700. The blended cost is lower than where unitranche pricing is.

TLL: How do you compare the relative merits of lending in Europe vs. the US?

NM: Structures are more flexible and pricing is currently better in the EU than in the US. The market is more competitive in Europe, and some lenders are less disciplined on credit controls than in the US. Some newer funds try to be more competitive with elements such as covenant flexibility.

Recently we've also seen European banks expanding their US teams.

"If you had said 18 months ago there would be $40 billion dry powder among all these firms, not many would have believed you."

TLL: I would assume cross-border deals are becoming more prevalent as well.

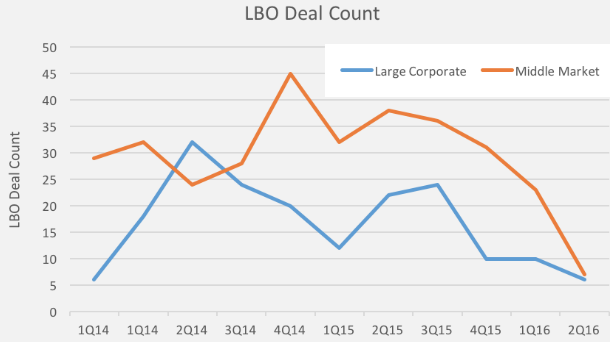
FB: There's definitely a push from European private equity to look for opportunities and deals in North America. Portfolio companies are asking the sponsor, "Can you get us access to the US market?" One good example is EQT expanding its North American PE operations. And you can add at least five to ten firms seriously thinking of opening their offices in the US.

TLL: But deal flow seems to be down overall so far this year.

CHART OF THE WEEK

Buyout Bottom?

Middle market and large cap LBOs totaled thirteen so far this quarter; there were sixty for 2Q 2015.



Sources: Thomson Reuters LPC

STAT OF THE WEEK

	Apr 2016	Jan 2016	Nov 2008	Oct 2001
U.S. Retail Sales (%)	1.3	-0.5	-3.7	6.7

Source: www.tradingeconomics.com

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	7.34%	7.34%	7.78%	6.36%
$201M - $350M	6.10%	6.16%	6.41%	6.01%
$351M - $500M	6.35%	6.64%	7.02%	5.62%
$501M+	5.66%	5.74%	5.47%	4.74%
Middle market (≤ $50M)	7.01%	7.01%	6.59%	6.33%
Large corporate (> $50M)	5.73%	5.83%	5.85%	5.01%
Large corporate single-B (> $50M)	6.00%	6.11%	6.27%	5.17%
Middle Market Credit Stats				
Sr/EBITDA	4.8	4.8	5.9	4.0
Debt/EBITDA	5.5	5.5	5.9	4.7
Middle Market Index Data				
Monthly Returns	-0.27%	-0.49%	-0.08%	0.47%
Average Bid	94.04	93.93	95.17	97.35

Source: S&P Capital IQ

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MIDDLE MARKET DEAL TERMS AT A GLANCE

Provided by:

SPP CAPITAL PARTNERS

May Update

FB: The US is improving, though high yield issuance is still tough, so loans can step in. Bigger deals are getting done by direct lenders. Normally, direct lenders are more expensive than the liquid market. But when liquidity dries up opportunities get bigger.

TLL: The relative economies are still not in sync.

NM: The fundamentals of the US economy are pretty robust. The EU has growth issues, along with Brexit worries. Very few economies are doing well at the moment.

TLL: Do you think there will eventually be a convergence?

NM: Some asset managers with global direct lending funds are reallocating funds from Europe to the US where they can earn better risk adjusted return. For example, M&A is relatively subdued in Europe so any decent credit should get good terms. Many smaller funds are being cut out of the market by larger funds and as a result they are trying to compete on flexibility. Increased competition will likely accelerate that trend. Scale and diversity typically benefits the larger firms.

TLL: What about cross border deals for middle market companies?

NM: Middle market companies are more international than five or ten years ago. More cross border deals are sought as the need grows to have operations on both sides of the Atlantic.

TLL: What about jurisdictional issues? We're told there's no such thing as "European lending."

FB: Absolutely correct, though Northern Europe has coalesced around some standards. Hungary, Turkey and other esoteric countries are still more complicated relative to the UK.

TLL: What's the long-term trend for banks?

NM: There's been real structural change. That will likely keep banks constrained. Pricing will likely continue to decrease. Direct lenders will likely continue to grow share. Many direct lenders are capped at 1:1 leverage while banks are 10:1. So we have a long way for pricing yet to drop.

TLL: How about default rates?

FB: It's hard in this ultra-low rate environment to think that default rates are going to spike meaningfully any

Deal Component	May 2016	May 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+6.50%-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+8.50%-11.00% (0.50%-1.00% fl) Small Cap L+7.50%-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.

Source: SPP Capital Partners

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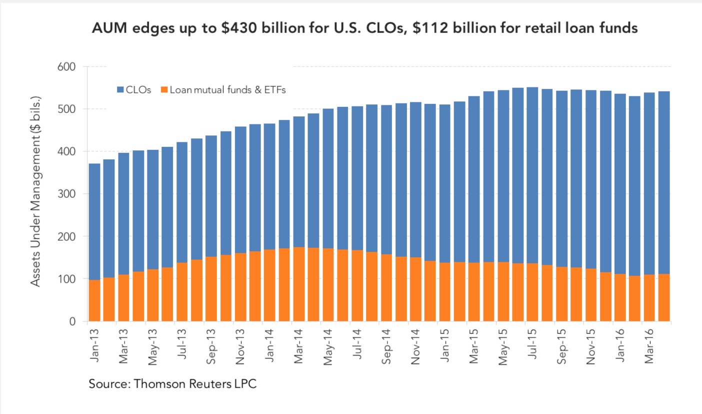
LEVERAGE LOAN INSIGHT & ANALYSIS

Provided by:

THOMSON REUTERS



Assets under management (AUM) increased in April for both U.S. CLOs and retail loan funds. CLO AUM edged up to $430 billion, while loan mutual funds & ETFs AUM increased to nearly $112 billion. Over the past year, CLOs and retail loan funds have experienced contrasting fortunes. In that time period, U.S. CLO AUM is up roughly $28 billion, while loan fund AUM is down by nearly the same amount ($27 billion). Recently, CLO AUM has been aided by steady though not spectacular issuance, as CLO deal flow trended marginally higher in April, amounting to $5.9 billion (14 deals), up from $4.9 billion in March and $2.5 billion in February. This brought year to date issuance to $14.1 billion (34 deals), down sharply from $41.2 billion (76 deals) in the same period last year. More recently, there have been an additional $1.7 billion of issuance (4 deals) so far this month through May 13. For retail loan funds, though outflows have been the dominant trend in recent times, early May has seen modest inflows of $387 million (based on funds which report flows on a weekly basis).

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MARKIT RECAP

Provided by:

markit

European hybrid bonds continue to underperform

Idiosyncratic risk in the European corporate hybrid bond sector has seen new issuance stall and credit time soon.

TLL: What's been your biggest surprise in the past twelve months?

FB: The pace of market developments. At the end of 2014 there were twenty mainstream direct lenders in London. Now there are over fifty institutions targeting European middle market deals. The scale of fundraising also caught people by surprise. If you had said 18 months ago there would be $40 billion dry powder among all these firms, not many would have believed you.

NM: It's a year now that the European market has generally been more attractive for borrowers than the US. How long will that last? It'll be interesting to see how long it takes markets to converge.

FB: There's also a greater range of banks willing to engage with direct lenders. Currently pricing is down and covenants have weakened to levels that would have been reserved for larger borrowers.

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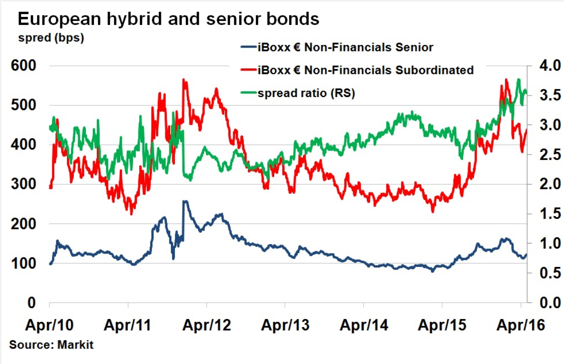
spreads rise.

- European Hybrid bonds have underperformed their senior counterparts over the last year
- Idiosyncratic risk has been key driver, with Volkswagen and Total seeing spreads widen
- [Markit iBoxx EUR Liquid High Yield Index] yields just 20bps more than the Markit iBoxx € Non-Financials Subordinated index

The past year has been a testing time for the European hybrid corporate bond* market. New issuance has stalled and bond spreads have widened as market volatility has put investors in a risk-off mode. Even as the market outlook has brightened over the past couple of months, hybrids have continued to underperform their senior European corporate counterparts.

Hybrid on the rails



This underperformance marks a contrast to the start of 2015, [when hybrids saw a resurgence in issuance] as major European corporations exploited low interest rates. Risk in the sector tumbled, with the Markit iBoxx € Non-Financials Subordinated index seeing its spread (interest premium over German bunds) fall to 236bps as of last March. Since then, spreads have widened significantly, hitting 565bps in mid-February; the same level seen during the heights of the European sovereign debt crisis in 2011. Spreads have since come down to 437bps as of May 17th.

The spread ratio of the Markit iBoxx € Non-Financials Subordinated index and the iBoxx € Non-Financials Subordinated index has risen sharply since mid-last year, highlighting the underperformance of the hybrid market on a spread basis in comparison to senior corporate bond counterparts. The spread ratio is currently 3.55, a near six year high, from as low as 2.49 last July. Interestingly, even as market volatility has subdued and issuance in the senior European bond market has picked up over the past two months, the spread ratio has continued to remain at elevated levels.

Idiosyncratic drivers
A closer look at the hybrid issuers presents a clearer picture, with idiosyncratic risks one of the main drivers of underperformance over the past year.

	Index Weight in %
Volkswagen International Finance NV	14.1
Total SA	9.3
Bayer AG	9.3
Electricite de France	8.9
Orange SA	8.8
source: Markit	

Over 14% of the Markit iBoxx € Non-Financials Subordinated index is composed of hybrid bonds issued by Volkswagen, the largest issuer in the index by weight. The German car maker saw its bond spreads flare up on the back of an emissions scandal last September, as the company faced drawn out litigation charges and reputational damage. French oil group Total, the next largest issuer of hybrids by weight, has struggled to deal with deteriorating oil and gas prices over the past year, forcing the company to restructure parts of its business. Its hybrid bonds currently trade at just under 400bps over German bunds...**READ MORE**

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PRIVATE DEBT INTELLIGENCE

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THE PULSE OF PRIVATE EQUITY

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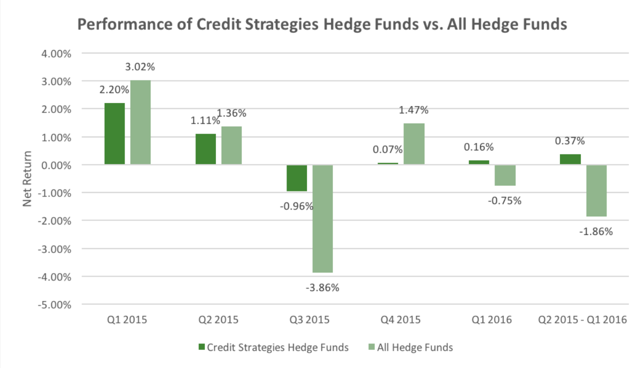

Credit Strategies Hedge Funds Face Testing Times

Credit strategies hedge funds saw a trade-off between limited volatility and near-neutral returns through 2015 and the opening quarter of 2016. Quarterly performance through the period saw highs of 2.20% (Q1 2015) and lows of -0.96% (Q3 2015), as credit strategies funds recorded lower volatility than the wider hedge fund industry, which saw performance range from -3.86% to +3.02% in the same period. As such, twelve-month performance for the strategy to the end of Q1 2016 marked gains of 0.37%, while the hedge fund industry as a whole recorded losses of -1.86%.

The asset flows of credit strategies paint a mixed picture. Globally, funds secured net inflows of $3.6bn in 2015, although this came entirely in Q2, which saw net inflows of $15.1bn. The other three quarters of the year all witnessed net outflows of investor capital, and in Q1 2016 credit strategies saw further outflows of $11.9bn, the greatest losses of any top-level hedge fund strategy.

These outflows reflect low investor appetite, with just 4% stating at the end of 2015 that they would be increasing their exposure to credit strategies hedge funds. Furthermore, hedge fund managers surveyed by Preqin in November 2015 were downbeat about returns prospects for credit strategies funds in the year ahead. A third of managers felt that credit strategies would be the worst performing fund strategy in 2016, while just 4% felt that it would be the best performing. It is worth noting, however, that a similar proportion of fund managers (30%) made the same forecast at the end of 2014; ultimately, credit strategies funds outperformed several other strategies through 2015.

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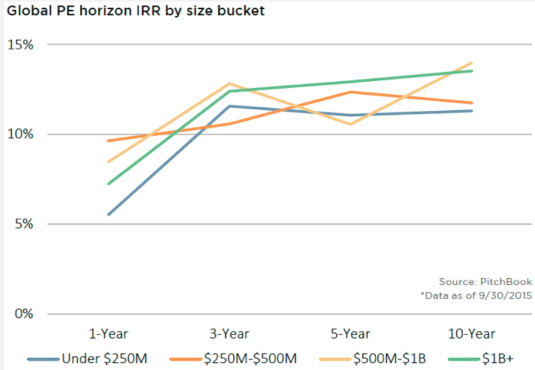

Larger PE Funds Continue to Realize Gains at Longer Horizons

From the one-year mark to the 10-year, the horizon internal rates of return (IRRs) of private equity funds worldwide gradually advance from 8.2% to 13.1%. Breaking down fund performance by size bucket yields further insights, most notably that on a sufficiently long time horizon, funds of $500 million or more are the only vehicles seeing improvement. This could be attributable to larger fund managers' greater resources, as they have the wherewithal to devote significant resources over a longer timeline and potentially reap gains even on portfolio companies that have been held for that long. It could also be a result of larger acquisitions simply requiring more time to turn around before exits can be achieved. In addition, larger funds can employ a more generalist strategy, seeing more diversification and perhaps larger exits at correspondingly greater returns.

Looking at smaller funds, it's instructive that vehicles under $250 million in size essentially do not see their performance budge once past the one-year horizon. Basically, the passage of time does not hurt the performance of the smallest category of funds, with capital flows essentially plateauing at a certain level, implying an unrelenting if unspectacular realization of most investments. In a similarly stable fashion, midsized funds-those between $250 million and $500 million-have seen the least fluctuation in IRR over all horizons. This could be a product of the recent exit environment, with strategic buyers looking more frequently to companies in PE fund portfolios of that size range to achieve growth in an environment where it's hard to come by organically. As such exit activity slides overall, however, and aging holdings remain in PE portfolios, there have been declines in IRRs across multiple horizons. 10-year horizon IRRs across all PE vehicles slid lower for the fourth consecutive period to 13.1%, while five-year horizons came in at their lowest level since 4Q 2013, at 12.2%.

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SELECT DEALS IN THE MARKET

Deal	Arranger	Sponsor	Industry	Facility*	Spread	LIB Flr	OID	Rating
API Technologies Corp (2)	BNP	J.F. Lehman & Co	Computers & Electronics	115	650	100	98	NR/NR
DYK Automotive (1)	BNP	Sterling Group	Automotive	134	475	100	99	NR/NR
Foundation Building Materials (AO)	RBC	Lone Star Funds	Building Materials	70	625	100	N/A	B/B3
Top Knobs (1)	Antares	Jordan Company	Home Furnishings	195	500	100	98.5	NR/NR
Averages				**129**	**563**	**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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