THE Lead Left
The Premier Middle Market Newsletter

Churchill Asset Management
A TIAA Company

Why Sponsors Matter (First of a Series)

Our discussion last week of the Fed's confusing position on interest rates drew a number of favorable comments. "This is precisely right," one reader wrote us. "They should just go ahead and raise rates. The more they delay, the tougher it'll get."

But our reference to the economy as a "Goldilocks environment" left at least one reader puzzled. "Loved your article," this young banker tweeted us, "but was wondering what the state of the US economy has to do with the Three Little Pigs?"

Nursery rhyme confusion seems to be just one of the many symptoms afflicting investors today. Amid numerous cross-signals from both the Fed and the economy, it's a wonder anyone retains a clear sense of direction.

Bullish signals from governors following their August meeting resulted in the "Jackson Hole rally" in which markets headed higher. But worries about interest rates, oil prices, and corporate earnings have caused the Dow to sink 500 points in the past week.

This bewildering state of affairs reminded us that investors now put a premium on non-correlated assets. They also crave access to leadership that understands how to operate in an environment in which market volatility will be a long-term factor.

That view has inspired us to address a topic that seems to be much on the minds of institutional investors; namely, what are the benefits of investing in private equity owned middle market companies, compared with non-sponsored, mid-corporates?

Over the next several weeks, we'll examine the features of both types of lending, with particular attention to the role private equity sponsors play in the management and governance of their investments. We'll also take a look at the non-sponsored lending landscape - who are the players, what are the upsides, and what are the risks?

To begin, let's state the obvious: private equity sponsors are professional investors/managers whose job it is to invest their capital (and that of LPs) to produce the consistently highest returns at the lowest risk. As we've often highlighted in this space, PE-backed companies are chosen because they represent the best opportunities for revenues and earnings growth, as well as enhancement of enterprise value.

Middle market companies are often begun by entrepreneurs with visions of fulfilling a consumer or corporate need. These founders can be long on creativity and short on management skills. Their businesses display early growth, then plateau unless more experienced executives are recruited to help guide corporate development.

It's for precisely that reason that lending to mid-corporates is tricky. Without better managers, these companies find it difficult to "get to the next level," and may run into trouble in challenging economic or industry climates. Ironically, these are the very companies sponsors look to invest in. And they bring unique tools to the table.

Next week, we take a look at what those tools are, and how private equity and lenders work together to create successful middle market investments.

QUOTE OF THE WEEK

"What a strange world we live in. For a long time people thought it was surreal yields were negative and now think it's surreal they're positive."

– Seamus Mac Gorain, global rates portfolio manager, JP Morgan Asset Management.

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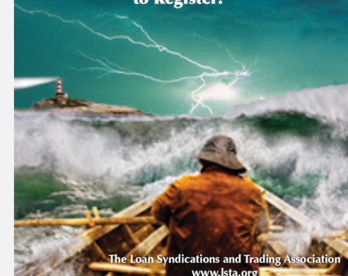

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THE LEAD LEFT SPOTLIGHT

This week we chat with Ted Koenig, president and CEO, Monroe Capital. Monroe is and has been a leading provider of senior and junior debt to middle market companies in the U.S. for the last 14 years.

The Lead Left: Ted, it's been a while since you've done an interview with us. What's going on in the world of private credit?

Ted Koenig: What's happening is that the investment world has become much more sophisticated and is segmenting the market. Limited partners are looking to deploy capital in the private credit space across the market in order to build diverse investment portfolios and allocate more dollars to the space just as they have been doing for years with private equity. In the public or liquid credit space, mostly company EBITDA size of $100 million and up, there are lots of investment alternatives with liquid loan funds. At the middle market larger EBITDA company size, say starting at $25 million and up to $100 million, firms like Ares, Antares, Cerberus, Golub, GSO and Madison Capital do a good job covering that part of the direct lending market. For club and participation transactions in that same middle market, firms like yours (Churchill) and a several other large name brand asset managers offer an alternative product. In the lower part of the middle market, EBITDA company size of $5-$25 million, we at Monroe I think have built the best in class direct lending alternative. Investors need access to all of these market segments in constructing thoughtful private credit investment portfolios.

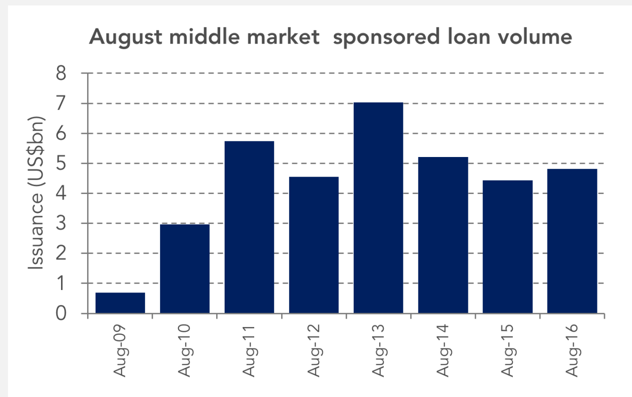
TLL: So investors are figuring it out? Or are they driving change?

TK: The sophistication level of investors is increasing thanks to the consulting community. Over the last five years, the asset class has come into its own. Post-crisis, beginning in 2011 and 2012, things began opening up. In 2008-2009, it was mostly distressed private credit investing. We were one of

CHART OF THE WEEK

Summer Slump

While last month's loan volume seemed exceptionally slow, it was actually better than 2015's level, and consistent with the past five years.



Sources: Thomson Reuters LPC

STAT OF THE WEEK

	Aug 2016	Nov 2015	Jul 1977	No 1972
Cocoa Futures	2,921	3,353	4,652	687

Source: Quandl

LOAN STATS AT A GLANCE

Provided by:

	This Week	Last Week	6MO Ago	YR Ago
New-Issue Clearing Yields				
$200M or less	6.49%	6.70%	7.09%	6.78%
$201M - $350M	6.28%	6.28%	6.91%	5.86%
$351M - $500M	5.60%	5.81%	6.35%	6.02%
$501M+	5.15%	5.12%	6.04%	5.10%
Middle market (≤ $50M)	6.32%	6.48%	7.10%	6.30%
Large corporate (> $50M)	5.36%	5.35%	6.18%	5.41%
Large corporate single-B (> $50M)	5.77%	5.75%	6.64%	5.50%
Middle Market Credit Stats				
Sr/EBITDA	N/A	N/A	4.6	5.8
Debt/EBITDA	N/A	N/A	5.1	6.1
Middle Market Index Data				
Monthly Returns	0.28%	0.04%	0.15%	0.16%
Average Bid	93.26	93.15	91.92	96.20

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MIDDLE MARKET DEAL TERMS AT A GLANCE

Provided by:

August Update

the first private credit firms post-crisis to raise a fund in 2010. We had a good track record coming out of the financial crisis. Investors believed that if we were able to generate solid returns in the 2008-10 time period in an uncertain and difficult credit environment, then we should do very well for them in a more benign time.

"One of the most important lessons I learned in the financial crisis is we need to diversify our funding base."

TLL: What were the lessons you learned from that period?

TK: Those that were able to raise money in 2010-12 learned that we needed to diversify our funding base. That was one of the most important lessons I learned in the financial crisis. What almost brought us down and actually brought many of our competitors down at the time was having too concentrated a funding base, with (in our case) two large financial institutions, both of which locked up during the financial crisis and failed. We were fortunate however; we had solid performance and long term locked up capital in one of our funds. That long term capital allowed us to be buyers when the entire market were sellers.

TLL: How did you diversify those sources?

TK: In 2009-10, we put a lot of new business on the books, mostly buying from hedge funds that dabbled in private debt but got caught with massive redemptions or mark to market short term financing. We raised a new private equity style, long term locked up LP fund in 2010. Then in 2012, we did an IPO for our BDC (MRCC). Then in 2013 and 2014, we raised additional long term LP funds, and several large single investor managed accounts. All during that time period, we issued CLOs, both middle market and broadly syndicated. So we developed a deep diversified pool of capital to deploy in self originated, middle market private credit.

TLL: How about the last few years?

Deal Component	August 2016	August 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+3.00%-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

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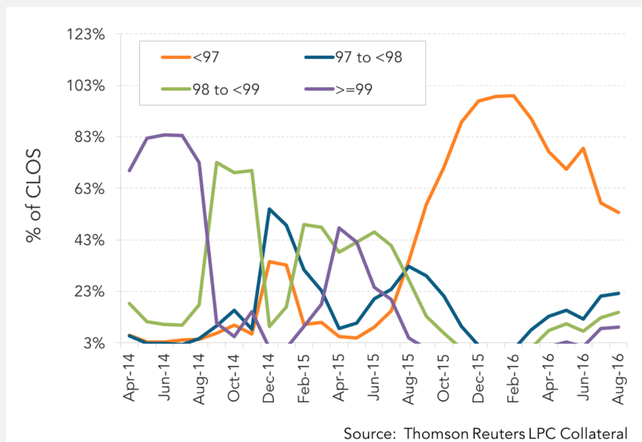

Nearly half of U.S. CLOs see weighted average bids on underlying assets climb to 97 or higher

The upward trend seen in secondary loan bids is mirrored when tracking all the assets held by CLOs in LPC's Collateral database. Through mid-February, bids on loans held by CLOS had been grinding down in line with other markets given slowing demand, risk aversion, and deals getting shelved amid market volatility. At the height of the February freeze, nearly every CLO in the U.S. had a weighted average bid on their assets below 97. However, with upward movement in oil prices, stability first the bond market and inflows into loan retail funds, CLO issuance began to pick up and secondary bids started to recover. Until Brexit in late June, when asset prices in both US and European CLOs dropped. The share of CLOs with weighted average bids below 97 jumped to 80% of CLOs but began recovering within a few weeks. Jump to this summer, when the secondary has not only recovered, but candidates for repricings have been materializing once again, reflecting that investors continue to be anxious for assets and looking to the primary post Labor day and hoping for a robust pipeline.

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THE PULSE OF PRIVATE EQUITY

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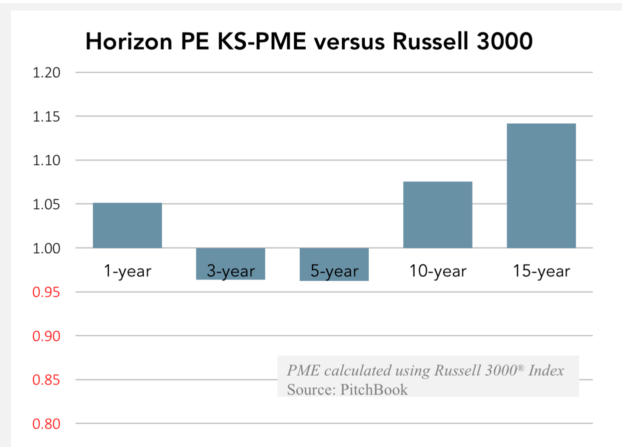
TK: The market has continued to mature. By 2013, we had established a solid ten year plus track record. Then, the consultants began to focus heavily on the space. They dug in and determined which firms were actually creating alpha as opposed to beta by buying the market. As luck would have it, the world was experiencing unprecedented prolonged low interest rates. That created a perfect storm for private credit.

On the other side of the equation, pension funds need yield to pay their bills. That is a fundamental fact. They found themselves with significant amounts of assets to deploy and no place to generate acceptable fixed income yield. They also dramatically increased their allocations in the private credit space from non existent or low single digits to up to 10%. Again, the perfect storm. Once the sophisticated LP investors segmented the space, it changed the game. Management teams from firms that blew up during the financial crisis were looking for new homes, and hooked up with institutions eager to take advantage of the macro asset management trends and get into private credit. Case in point, ten new private debt platforms have been created in the U.S. within the last 12 months. Also, most all of the large brand name private equity asset managers now have dedicated credit teams amassing assets under management.

TLL: Isn't it a huge challenge to differentiate between asset managers?

TK: Yes, it's a huge challenge for LPs. Today there are over 50 private credit firms operating in the U.S. and counting. The consultants help but differentiating is difficult without understanding the fundamental dynamics of the firms such as how much of the loan product is being directly originated and agented vs. how much is being bought from others; how much is subject to full and complete credit underwriting vs. how much is participated and/or clubbed with another agent; who is actually driving the bus in terms of setting and waiving



PE Still Outperforms in the Long Run

The key value-adding proposition of private equity fund managers is that they offer more stable, market-beating, safer returns across longer timelines that of course lead to relative illiquidity. And thus far, PE managers have made good on that value proposition. In addition to tracking vintage PE funds against comparable public market indices with KS-PME benchmarks, breaking out PE returns into horizon IRRs versus public markets can provide a perspective on population performance. As is clear from the above, midterm PE fund performance falls short of public markets' performance, yet in the long run, PE fund managers have beaten public performance by a fair margin, up to nearly 15% at the longest horizon.

Such numbers help explain continued strong fundraising by PE firms, but also contain much greater implications when considered within the broader macroeconomic landscape. As volatility and low interest rates remain much more significant factors-for public pension funds in particular-the illiquidity PE investment strategies entail may seem like a small price to pay for outperformance and stability. Is such outperformance guaranteed? No more than any other investment strategy, but the PE industry's results speak for themselves, particularly when considering that such long-lived investments underwent the financial crisis. Given the asset class's appeal, PE managers have to contend with a considerable level of competition and consequent costly auctions for quality companies nowadays, making outperformance all the more difficult, however. Accordingly, lofty returns of the like seen above may not be experienced again by many, but the thing is, will limited partners in PE funds be satisfied with lower performance as long as it still beats the market? In today's market, they well might be. So PE fundraising will likely continue apace, even if eventual saturation takes a toll and activity diminishes somewhat. As for PE managers being able to deliver on their proposition in a fashion at least somewhat similar to the past, only time will tell, although there is a clear historical basis for optimism, particularly when considering the nature of current PE buy-and-build strategies.

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MARKIT RECAP

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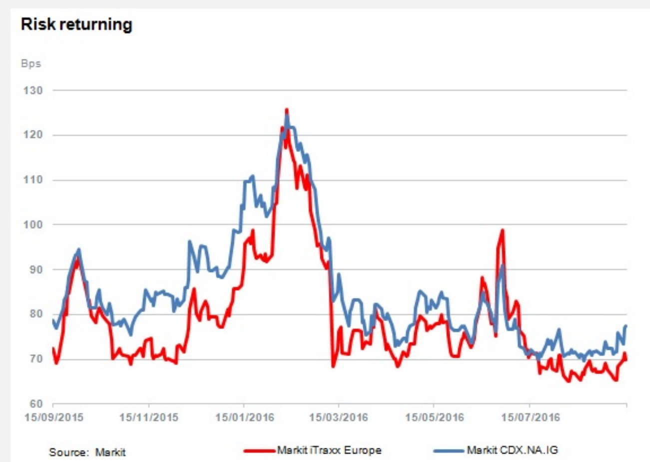

Credit risk has awakened from its summer slumber over the last couple of days with the CDX IG and iTraxx main now trading 8 and 11% higher than their close on Thursday. While it's still too early to see whether this latest surge is a passing event or a longer lasting trend both indices are still below their 12 month averages and now trade roughly 40% off the highs set earlier in the year.

This recovery has not lifted all investment grade issuers however, as Markit CDS pricing data indicates that 26 global investment grade bond issuers have liquid CDS contracts referencing their debts with spread levels more in line with junk issuers than their current investment grade status. This analysis is based on all

covenants, defaults, dealing in loan collateral; how much of the product is PE sponsor backed vs. non sponsored; and, what size EBITDA companies are actually being financed and for what purposes. All of these questions are relevant for differentiation among asset management firms in the private credit space today.

TLL: What is your thesis relative to the newer players who are raising money in the space today?

TK: I think the more recent and new entrants are going to be surprised at how difficult it is to originate and find good credits to invest in. The European asset managers in private credit are finding that out now. It's not like the liquid markets where you can accumulate loan assets easily by pushing numbers on a Bloomberg terminal. We have 18 origination professionals spread across 8 offices in the U.S. and Canada. We reviewed over 1,700 deals last year just to do 64. This is very much a relationship business and we have been working with our deal referral sources and private equity firm clients for over 20 years and have been executing loan transactions with them over a very long period of time. Reliability and certainty of close is critical in this space. New entrants are going to have a hard time displacing the industry standard firms. The way to really break into this space today is with lower interest rates and looser credit structures - both of which are recipes for long term failure.

TLL: Why has your firm been so successful in fundraising over the last several years?

TK: I like to think it is because we are best in class in our space and we consistently generate "alpha." I do not believe that we should grow our AUMs simply for the sake of generating more scale and management fees. We seek to generate alpha with each fund that we raise and with each product that we offer to our LPs in our various private funds and to our shareholders in our public BDC. The results speak for themselves. Our firm is 100% owned by senior management; no pension funds, private equity firms, hedge funds or

CDS contracts with at least five market makers that reference issuers with a credit rating of BBB or above and that currently trade at least two notches below investment grade based on the Markit's CDS sector curves.

In a stark departure from what that list would have been at the height of the credit market volatility earlier in the year, the list of investment grade issuers whose CDS spread implies otherwise is replete with consumer focused firms. Ten consumer services and five consumer goods names have made the list.

Retailers, which roll up to the consumer services sector are the biggest contributor they also include two of three of the names which trade most deeply in junk territory with a CCC implied rating. This includes US clothing conglomerate Gap whose CDS spread is north of 270bps and European retailer Casino which trades even wider at 280bps.

Although both firms have seen their CDS spreads tighten from the highs set earlier in the year, the improvement in sentiment hasn't been enough to take them back to single B territory.

The other CCC investment grade candidate is South African utility Eskom Hldgs SOC Ltd which trades north of 400bps.

Names to watch in the consumer goods sector includes US carmakers GM and Ford and toymaker Mattel.

Despite a slew of downgrades and improving investor sentiment, commodities firms are still represented in the screen of companies trading with a mismatch between their current credit rating and CDS spread. The current mismatch screen includes three energy and one basic material constituent. The most prominent energy name in the screen is Mexican national energy firm PEMEX whose CDS implies a B rating, two notches below its current BBB rating.

The sole member of the basic materials space is commodities trading house Glencore which has a single B implied rating. Although it's CDS spread has fallen by over 80% from the highs in January, CDS market makers are still requiring over two and a half times the spread than the 88bps commanded by its BBB rated basic material peers.

Energy firms still have the highest investment grade threshold as the BBB barrier for energy firms is with BBB names carrying a spreads of over 110bps. Healthcare comes in on the other side of the scale with an investment grade threshold that is less than half that of energy with 52bps.

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COVENANT TRENDS

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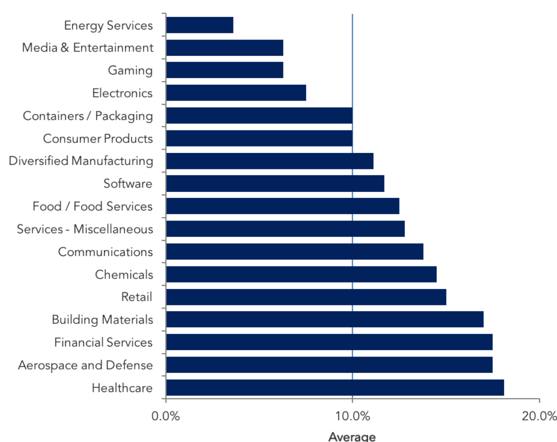
Covenant Review



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PRIVATE DEBT INTELLIGENCE

Provided by:

preqin

insurance companies. We are completely aligned with our LP investors and our public shareholders to create safe and stable long term absolute returns. We are focused on proprietary, self-originated and agented loan transactions for companies with between $5-$25 million of EBITDA. I would put our ten year track record of generating returns up against anyone in the private credit business, anywhere.

To be continued the week of Sept 19

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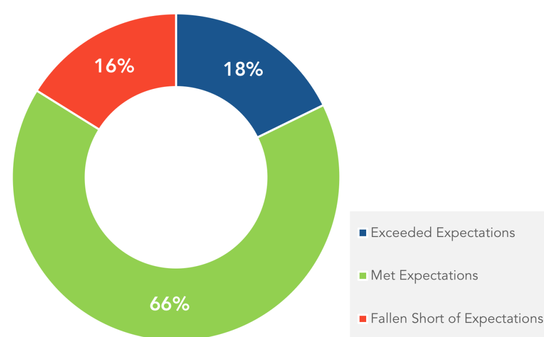

Private Debt Performance Spurs Potential Inflows

The private debt industry has only become a mainstay of many investors' portfolios relatively recently, but there is mounting evidence that the returns the asset class is providing for them are spurring investors to allocate ever-increasing levels of capital to the debt market. Preqin's H2 2016 Investor Outlook survey of over 161 institutional investors in private debt revealed that they view recent performance of their investments very positively: almost a fifth (18%) of investors stated that their private debt commitments had exceeded their expectations in the past 12 months, and a further two-thirds (66%) said that their expectations had been met.

Overall, investors regard the industry well; 59% stated they held a positive perception of private debt, compared with just 9% which have a negative opinion. Moreover, over a quarter of investors (27%) stated that their confidence in the ability of private debt to achieve portfolio objectives has increased in the past 12 months, suggesting that they may seek to increase their holdings in the market.

As a result of this investor confidence, the private debt industry could be set for increased inflows. The majority of surveyed investors plan to make their next private debt investment either in H2 2016 or H1 2017, keeping up a fast pace of commitments. Additionally, 46% of investors anticipate committing more capital to the asset class in the next 12 months than in the previous year, with a further 41% planning to maintain their current level of investment.

In the longer term, this level of confidence becomes even more pronounced: two-thirds of investors plan to increase their allocation to private debt, compared to just 17% which aim to decrease their participation in the industry. Given that over a third (38%) of investors remain under their current target allocation to private debt, the next 12 months might presage a return to the peak levels of fundraising seen in 2015.

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SELECT DEALS IN THE MARKET

Deal	Arranger	Sponsor	Industry	Facility*	Spread	LIB Flr	OID	Rating
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 (1)	Antares	Olympus Partners	Services & Leasing	170	500	100	99	NR/NR
Parts Authority (1)	BMO	Jordan Company	Automotive	145	475	100	99	NR/NR
SciQuest	Antares	Accel-KKR	Computers & Electronics	163	475	100	99.5	NR/NR
Liquid Web (AO)	SunTrust	Madison Dearborn	Computers & Electronics	55	500	100	99	NR/NR
Mister Car Wash (CL)(AO)	Jefferies	Leonard Green	Automotive	20	400	100	N/A	B/B2
Beaver-Visitec (1L) (1)	UBS AG	Texas Pacific Group	Healthcare	170	500	100	99	B/B3
Beaver-Visitec (2L) (4)	UBS AG	Texas Pacific Group	Healthcare	80	875	100	98	B/B3
Averages				**105**	**492**	**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) 102/101

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

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