Middle Market

The State of Middle Market Financing in the U.S.

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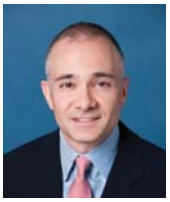

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Highlights

DEAL FLOW	• The supply/demand imbalance persists with 2015 seeing a slowdown in buyout activity, which was exacerbated by the market dislocation in 3Q 2015. The lower middle market has experienced little disruption, with deal flow remaining consistent. • Deal quality and lofty valuations are contributing to lower hit rates for sponsors and lenders. • Add-ons continue to dominate in the current elevated pricing environment. • Sectors leading M&A activity include healthcare, software, technology, and business services—consistent with industries cited for their above-average growth prospects.
CAPACITY	• Liquidity remains robust with several new partnerships announced, underscoring growing institutional interest in private middle market credit: Canada Pension Plan Investment Board/Antares; TIAA-CREF/Churchill Asset Management; Angelo Gordon & Co./Twin Brook Capital Partners. • Banks and BDCs are feeling the pressure of regulatory and capital constraints in the current environment. • Uncertainty around the global economy and interest rates is heightening risk aversion, yet lender behavior still suggests an aggressive posture.
COMPANY PERFORMANCE	• Revenue growth in middle market companies is outperforming the broader market, with larger firms (revenues between $100 million and $1 billion) seeing the biggest gains. Projected revenue growth is at the lowest level measured in the past year. • Portfolio credit quality is strong, evidenced by positive trends in revenue and EBITDA performance; however, there are signs that growth may be slowing. • Sectors cited for above-average growth include healthcare, software, technology, and business services.
VALUATION	• Purchase price multiples remain elevated, with inflation observed across the size spectrum. EBITDA multiple expansion of 1x-2x is observed with differentiated assets in growing sectors garnering multiples in the double-digits. • Asset selectivity is pushing higher given where we are in the economic cycle, with defensive plays more attractive in the current environment. • Strategic buyers are taking an even more active role in and winning middle market auctions, contributing to multiple expansion. • Valuations are viewed to have reached a plateau or peaked with a Fed rate hike on the horizon.
TERMS AND STRUCTURE	• Volatility has not really impacted leverage levels. Leverage creep of ~1/4 to 1/2 turn in 2015. • Leverage is being driven by nonbanks who are not governed by leveraged lending guidance, with highly levered transactions well above 5x EBITDA. • Firming of spreads across the board, 25-50 basis point upward bias across the market. • Spread widening is more pronounced in second lien. • Current market conditions, evidenced by leverage multiples and coverages, suggest we are at or near a peak in the credit cycle.
OUTLOOK	• Sentiment of cautious optimism with focus squarely on the economy and interest rates. • Interest rates expected to increase modestly impacting borrowing costs and valuations. • Nearing cycle peak and period of stabilization in leverage and pricing. • M&A to lead deal flow as company and market dynamics drive the need for increased exit activity by sponsors and private companies.

Deal Flow

The pace of middle market buyout activity slowed in 3Q 2015, according to PitchBook, which reported 499 completed transactions, a modest increase from 493 transactions in the previous quarter. A total of $81.8 billion in capital was invested in the quarter, which is down from $91.0 billion in 2Q 2015 and reflects nearly a 23 percent decline year-over-year. Middle market sponsored loan volume through 3Q 2015 is down over 30 percent from the year ago period. The traditional middle market remained relatively stable in the third quarter while the large middle market declined 36 percent. The private equity capital overhang ballooned to over $130 million, earmarked for the middle market.

The slowdown in LBO volume underscores the lingering supply/demand imbalance, which continues to fuel fierce competition in the sponsor finance market. Uncertainty around the global economy and interest rates rattled the equity markets in August, sending shock waves through the broadly syndicated loan market and stalling deal flow in the third quarter. The U.S. economy seems to be running in place, with lackluster growth concerning many lenders who view today's market as a cycle peak.

Lenders say deal flow came in fits and starts during the year, characterizing the quality as mixed. Sectors leading M&A activity include healthcare, software, technology, and business services—consistent with industries cited for their above-average growth prospects. Opportunistic refinancings and dividend recaps have received less reception and saw a sharp decline in 3Q 2015. An atypical slowdown has been observed by some lenders heading into 4Q 2015, who speak to a weaker pipeline relative to past years where fourth quarters are traditionally robust. "We're not seeing the big year-end push that we've seen in the past," remarked Tom Aronson, managing director and head of originations at Monroe Capital.

Ira Kreft, a senior vice president at Bank of America Merrill Lynch, summarized, "Overall leveraged lending volume for the first three quarters of 2015 is down from the same period in 2014. These more subdued levels of activity are expected to continue for the foreseeable future. The impact of regulation and the leveraged lending guidelines have been felt in the market, reducing LBO and dividend recap activity and instilling more discipline in leveraged loans provided by regulated lenders. There has been a shift to more pro rata financing and a greater focus on better-rated loans. Meanwhile, recap and refinancing/recap volume has fallen. M&A lending volume has remained strong due to strategic acquirers tapping the market, while private equity volume has decreased."

The lower middle market (EBITDA below $10 million) has experienced little disruption, with deal flow remaining consistent throughout the year. "A lot of the volatility that is playing through the loan market is happening in the larger segment of the loan market—deals larger than $100 million," observed Rich Jander, a managing director at Maranon Capital. "Most of the drop off in volume has been in the upper middle market. But in the lower end of the market, we are still finding plenty of opportunity," concurred Chris Williams, a partner at Twin Brook Capital Partners. "We haven't seen as much of a fall off," offered Bob Marcotte, the president and executive managing director at Gladstone Capital. "The drop in buyout volume was from the larger transactions. While the lower market has been affected, there is still a fairly resilient flow of transactions in the lower middle market."

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>
> *—Rich Jander*
> *Maranon Capital*

Private Equity

Private Equity is Buying

Buy-and-build is the mantra of private equity firms to achieve target returns in today's elevated pricing environment. Lenders speak to a high level of add-on activity during the year. "Sponsor-backed strategics have been more active this year," Jander said. "It has

been a tough economy in terms of finding organic growth. In order to grow these businesses, you've got to find a lot of small tuck-ins to hopefully average down your purchase price multiple or grow your EBITDA to a larger level where you can get some multiple arbitrage." "Accretive add-ons are the easiest external path a private equity firm can pursue to add to these high-priced platforms," echoed Mike Klofas, a managing director at Babson Capital. "Our portfolio has benefited from significant growth related to financing add-on activity during 2015," remarked Scott Carpenter, managing director and head of originations at Crescent Direct Lending. "Given the high prices sponsors are paying for platforms, there is a greater urgency to executing strategic acquisitions. Often, the sponsor has identified and initiated discussions with potential add-on candidates simultaneous to their final diligence and the closing of their platform investment."

Private Equity is Selling

In the current elevated pricing environment, lenders say sponsors are selling more than they are buying. "High valuations are attractive for private equity firms, who are realizing on their investments," said Ira Kreft at Bank of America Merrill Lynch. "They are seeing these valuation levels," added Scott Reeds, managing director at Citizens Financial Group. "They don't want to enter at these valuation levels, but they would love to exit." "We are seeing a large number of sponsors as being net sellers," remarked Robert Radway, chief executive officer at NXT Capital. "When you are talking about purchase price multiples anywhere from 8x or 9x to 11x-12x or higher, you really have to be convinced about your investment thesis and your ability to significantly grow EBITDA. If you don't have that conviction, you're probably not going to play. And you have to be right for the returns to work. Sponsors are clearly sitting on the sidelines and being very selective."

Deal quality and lofty valuations are contributing to lower hit rates for sponsors and lenders. Private equity activity and volume is being negatively affected by high valuations and fewer quality companies, indicated Ira Kreft at Bank of America Merrill Lynch. "More aggressive strategic acquirers, lofty purchase price multiples and fewer quality deals are keeping many middle market private equity firms on the sidelines relative to new platform acquisitions," Kreft said. Rather, they are more focused on smaller add-on acquisitions for existing portfolio companies."

"The most disturbing trend to me is valuations on privately held businesses. In the lower end of the middle market, you tend to see more rational behavior, but we are seeing valuations for businesses with less than $5 million of EBITDA trading for 7-plus times," observed Steve Gurgovits, a managing partner at F.N.B. Capital Partners. "I hear from sponsors that they're seeing a lot of deals but losing a lot of auctions, mostly on valuations."

"We spend time with sponsors to support them, but the sponsors' hit rates are so low, it is a difficult allocation of time," remarked Preston Walsh, a partner at PNC Mezzanine Capital. "These are quality companies with attractive credit profiles of which there are fewer this year which drives up prices. Sponsors are uncertain if they are going to win and, if they win, it will be with maximum price and leverage."

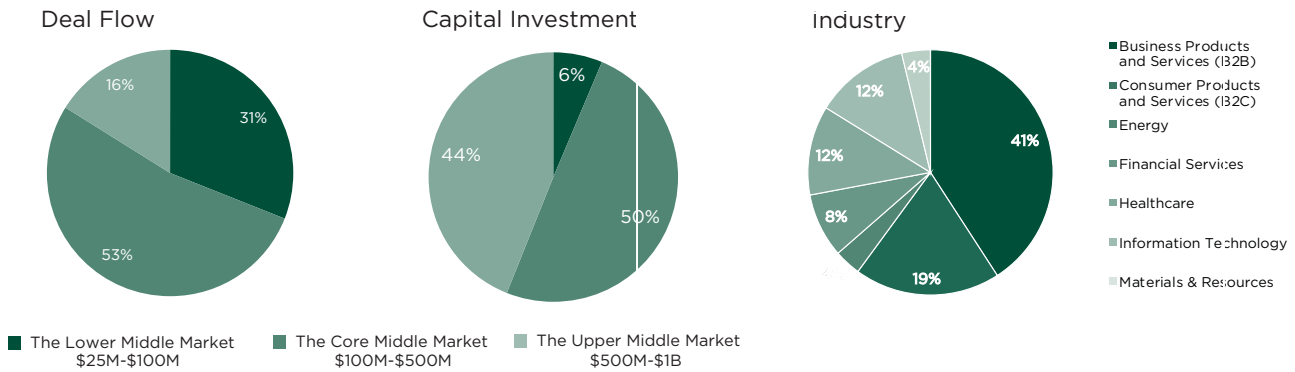
> *"I hear from sponsors that they're seeing a lot of deals but losing a lot of auctions, mostly on valuations."*
>
> *—Steve Gurgovits F.N.B. Capital Partners*

"There is more competition for deals. The GPs are not only competing with corporates that have cash, but they are competing against some of the larger cap funds that are coming down market," added Randy Schwimmer, a senior managing director at Churchill Asset Management. "The combination of those things is making the deal winning environment particularly challenging for them. Large family offices, a potential source of capital, are looking to put cash to work in private equity-style credit funds and be a factor in this space."

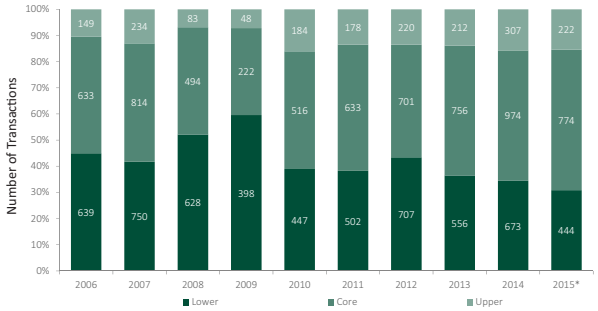
Gurgovits added, "Independent sponsors and family offices are the two emerging classes of buyers over the past 18 months that are driving the supply/demand imbalance because these groups bring more efficiency and more capital into the market, so your demand for deals starts to exceed your supply."

The Deals

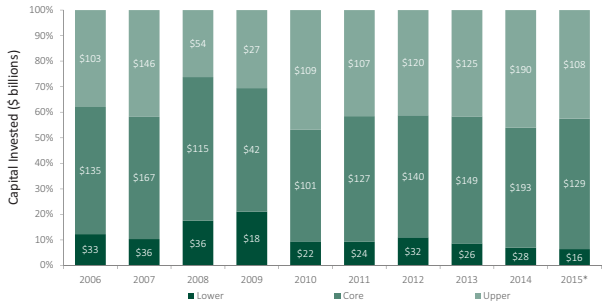
Share of the Middle Market - YTD 2015



Deal Flow by Year



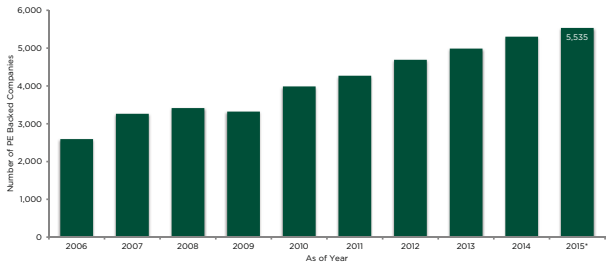
Capital Investment by Year



Deal counts and values reflect private equity buyout transaction activity only.

The Overhang

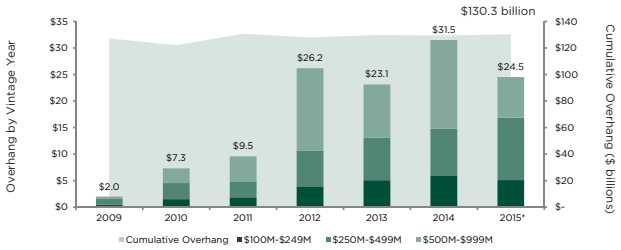
Middle Market Company Inventory



* As of September 30, 2015

Source: PitchBook.

Middle Market Capital Overhang



*Private equity funds of $100 million - $1.0 billion
* As of September 30, 2015.

Deal Flow

Quality

Lender responses were mixed when speaking to the quality of deal opportunities. Flight to quality is becoming more pronounced as lenders exhibit caution and scrutiny in the elongated economic recovery:

Mike Foster, Midwest Mezzanine Funds: "It definitely feels like you are in the later stages of a cycle. The good companies get bid up, but there are a lot of stories, turnarounds, and businesses that are trying to draft off of the market with all of the liquidity, hoping that somebody will overpay for their business."

Chris Williams, Twin Brook Capital Partners: "Quality is spotty. If you think about today's purchase price multiples, anybody who owns any type of asset is bringing it to market."

Robert Radway, NXT Capital: "Flow is in line with what you'd expect in the later stages of the cycle—more cyclical companies for which sponsors are asking full leverage."

Dan Letizia, THL Credit: "If it's a cyclical business, either the growth isn't there or you can't get comfortable with the sustainability of current performance. Structures are still aggressive for these deals just based on the overall supply and demand dynamics, but at leverage and pricing more appropriate for businesses operating at cyclical peak performance or in some cases starting to see a little bit of softness."

Fred Buffone, Fifth Street Asset Management: "The marginal deals or opportunistic refinancings and dividends are having a very challenging time getting done. The sweet spot right now is the plain vanilla company with no story, no noise, and minimal adjustments. Those are the ones that are in favor now. Middle market lenders have capital that they need to deploy. That is where they are looking to deploy their money right now."

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>
> *—Fred Buffone*
> *Fifth Street Asset Management*

Randy Schwimmer, Churchill Asset Management: "The market is bifurcated between the "haves"—quality credits with good sponsors that receive the best terms—and the "have nots." The latter are storied credits, cyclicals, and aggressive dividends. Those are seeing push back from the market, with higher spreads and tighter structures."

Brian Schneider, Northstar Capital: "Most private equity groups have been selling portfolio companies for the last three years, and we are starting to see the tougher assets being sold now."

Scott Carpenter, Crescent Direct Lending: "Our volume is up this year, but recent quality has been spotty. More recent trends include cyclical businesses and faster growing companies with relatively short operating histories. Healthcare and recurring revenue businesses have been popular throughout the year."

Scott Reeds, Citizens Financial Group: "We are seeing some nice businesses that are very financeable in today's market. But we have also declined a handful of tougher, storied deals where the sponsor and the company probably missed their window this year to get the deals done."

Rich Jander, Maranon Capital: Quality is still good. The issue we have to contend with more is structure. They are good companies but how much risk do you want to take in terms of the leverage you are willing to provide and how competitive the pricing is going to be.

Process

Processes continue to be demanding on sponsors and lenders alike. Capital surplus is fueling behaviors characteristic of a cycle peak, requiring sponsors to be very aggressive in how they pursue companies. Lenders speak to greater professionalization of processes even in the lower middle market, and almost every process is an auction. Timelines are contracting, and lenders are required to commit within a short time horizon.

"Sponsors are required to do more to differentiate themselves in order to win deals. Reps and warranties insurance is being increasingly used as a tool to differentiate, particularly in a competitive bidding process."
Mike Foster, Midwest Mezzanine Funds

"Clean deals are getting done quickly. "Story" deals continue to take longer driven by the credit review process."
Preston Walsh, PNC Mezzanine Capital

"What we hear back from sponsors is more packages get sent out, more groups are interested, and more groups are told the required range to be in for the purchase price."
Steve Kuhn, Fifth Third Bank Structured Finance

"We are seeing some deals getting retraded in terms of purchase price due to company-specific issues that may surface during a process. There are clearly some concerns about the economic environment, particularly the situation in China and what it means for the long-term competitiveness of U.S. companies. Activity in the energy sector is being dramatically reduced, whether it is fracking or oil and gas exploration and production, which is having a spillover effect on suppliers into that industry. It takes time for those issues to be fully recognized. It is clearly starting to show up."
Robert Radway, NXT Capital

"Processes constantly accelerate, and sponsors are being put under pressure to preempt auctions. It is not uncommon on almost every deal that a handful of bidders are required to spend money like they were going to be the winner. To be selected as a final three player, you have to perform all of your final diligence and mark up a purchase agreement and only one person wins. If there were more deals and less competition for good properties, you would have less frothy processes because there would be more choices."
Andy Steuerman, Golub Capital

"What we hear back from sponsors is more packages get sent out, more groups are interested, and more groups are told the required range to be in for the purchase price."

—Steve Kuhn
Fifth Third Bank
Structured Finance Group

"We've seen a higher frequency of sponsors attempting to preempt an auction by providing a no-outs fully financed offer before the process runs its course. They feel they are smart on a business and have done enough diligence to convince their lenders. In some cases that approach has proven to be successful."
Robert Radway, NXT Capital

"The next element of flexibility sponsors are looking for is certainty from lenders. Sponsors are differentiating themselves by eliminating the financing-out in their offer letters and promising to close quickly. We are seeing more requests to provide fully committed letters, higher than in previous years."
Tim Clifford, Abacus Finance

"The most compelling advantage continues to be certainty of closing and certainty of execution, often times that is using one's balance sheet."
Jeff Kilrea, CIT Sponsor Finance

"We are seeing more situations where two or maybe even three bidders are going through the full diligence process— incurring significant costs on quality of earnings, industry studies, and all other third party diligence—knowing they may not ultimately be the buyer and they have not been granted exclusivity. Given the competitive dynamics, people are willing to do it. And lenders are running in parallel, in many cases providing committed financing to bolster sponsor bids with a higher certainty of closing."
Dan Letizia, THL Credit

"Market participants are arranging their own clubs earlier in a process, or pre-syndicating, to arrive at a collective proposal as a way to provide more certainty to sponsors. It is a tactic that lenders are using to more effectively compete with the unitranche. We've seen this trend in the marketplace and expect that it will probably continue into the foreseeable future."
Katie Jones, BMO Capital Markets

"We've seen a higher frequency of sponsors attempting to preempt an auction by providing a no-outs fully financed offer before the process runs its course."

—Robert Radway
NXT Capital

Capacity

The credit markets are open. Lenders exude a cautionary tone as volatility is tempering optimism and dictating discipline at this stage of the cycle. Volatility has been exacerbated by the Fed's indecision on rates. That has prompted persistent outflows from retail loan funds which, in turn, create upward pressure on broadly syndicated loan spreads, indicated Randy Schwimmer at Churchill Asset Management. "Some volatility has leaked into the middle market, causing more uncertainty on terms when deals are launched. Arrangers are trying to give themselves more wiggle room in case of another market shift." "Because of the uncertainty around the global economy and specifically interest rates, you are starting to see some degree of risk aversion," added Robert Radway at NXT Capital. "And that tends to filter down into the middle market over time, but it is not as quick or as pronounced as it is in the more liquid side of leveraged lending, whether it is high yield or broadly syndicated loans."

PERSPECTIVE: How has the recent market volatility and regulatory environment impacted lender participation and liquidity broadly?

Randy Schwimmer, Churchill Asset Management: Despite some environmental noise, it's still a very liquid market. Lenders are working hard to put money to work. Plenty of platforms are positioning themselves to grow. Overall tone continues to be good for good credits.

Robert Radway, NXT Capital: It is hard to judge because volume has been down overall. The latest market statistics through September suggest that overall middle market volume is down by about 30 percent year-over-year. The demand has declined. I think liquidity on the supply side has been constrained or shrunk, but it hasn't shown up yet because volume is off.

Katie Jones, BMO Capital Markets: We haven't seen as dramatic of a liquidity crunch in this current period of economic uncertainty and volatility, but if the volatility continues for a prolonged period and/or increases, then it is likely the next shoe to drop. The upper end of the lower middle market ($15-20 million EBITDA) would likely see more of an impact given the prevalence of BDCs and their need to access the equity markets to raise capital. The market below $10 million in EBITDA should not be as impacted, given the lower quantum of debt needed to clear a deal.

Scott Reeds, Citizens Financial Group: Liquidity depends on which part of the market an issuer is trying to access. The smaller, single-B broadly syndicated market is very challenged today, with a clear market of "haves" and "have nots", where good credits are getting done, albeit at a meaningfully higher price point than three months ago. The "have nots", which may be out of favor sectors or challenging stories, are struggling and sometimes price isn't enough to clear the deal. The middle market is more insulated than the broadly syndicated market. There are still a number of relationship-oriented middle market lenders that have plenty of capital and want to get deals done for sponsors they know and like. However, these lenders do have more opportunities presented to them by the challenges in the broadly syndicated market, causing these lenders to prioritize to the most advantageous relationship and economically beneficial deals.

> *"Despite some environmental noise, it's still a very liquid market. Overall tone continues to be good for good credits."*
>
> *—Randy Schwimmer Churchill Asset Management*

Bob Marcotte, Gladstone Capital: The late summer outflows from loan funds have caused a significant sell off in large-scale second lien loans. The stories of lenders getting hung with commitments that they've had to reprice and take losses on has only elevated credit concerns and provided strong incentives not to get too far out ahead of things. There is clearly limited availability at the top end of the market.

Scott Turco, GSAM Private Credit Group: The prevalence of hung deals has recently impacted the upper end of the middle market, particularly businesses on the cusp of either being underwritten or clubbed. You are starting to see the shift towards more clubbed deals, especially through the second lien.

Jeff Kilrea, CIT Sponsor Finance: The number of deals is down, but there is no shortage of capital to finance those opportunities. There is no shortage of capital providers.

Tom Aronson, Monroe Capital: There is adequate liquidity throughout the market.

A strong, well-structured transaction still gets plenty of competition, and that could be from $3 million of EBITDA on up.

Jeffrey Day, Madison Capital Funding: There is still plenty of capital. If lenders have pulled back, it is more because of regulatory constraints than capital constraints. By and large, it's still very competitive on every deal, which is why you are seeing such aggressive leverage and terms in the lower end of the middle market.

Fred Buffone, Fifth Street Asset Management: It still seems as if there is an adequate amount of capital for deals. For any given credit, it continues to be very competitive and you still see a lot of aggressiveness.

Allan Allweiss, LBC Credit Partners: There aren't too many lenders who are in retrenchment mode. It's a question of price discovery and leverage discovery. I suspect there has been a bit of a correction on both of those dimensions in aggregate.

Andy Steuerman, Golub Capital: If there is a liquidity bubble, it is not slowing anything down. If there is a good company for a well-known private equity firm, they're going to get a market deal.

Brian Schneider, Northstar Capital: There is virtually an unlimited supply of capital with the key restraints being companies available for sale and equally important a finite pool of people that have strong experience as a lender or a GP.

Mark Tauber, CapitalSource: The reality is, the middle market players are still buy and hold investors, so they are in it for the long haul. They don't have a trading mentality. They are making credit decisions based on historical track record and what they envision going forward and confidence in a specific sponsor.

BDCs

Capital constraints are influencing participation by BDCs, a group regarded as driving high leverage levels in the market. With equity prices under pressure, valuation issues are making raising additional capital difficult. "Clearly the credit environment has changed with the public BDCs trading below book value, so their ability to raise additional equity is restricted. For most BDCs, the only liquidity they have is when their existing loans repay," commented Brent Burgess, the chief investment officer at Triangle Capital. "A

PERSPECTIVE
Are we at a peak in the credit cycle?

"I think we are late in the credit cycle, but it is difficult to say whether we are in the 7th or 8th inning and whether we are going to go into extra innings. There certainly is no real concrete trigger event that you can point to or statistics that would suggest that we have a recession coming. You see softness, but it is inconsistent."
Robert Radway, NXT Capital

"I think the view is that we've peaked, particularly in the middle market, where you're hearing more that price is moving up and leverage is coming down. We've hit that threshold. I don't think lenders are necessarily being more conservative, but they're certainly not getting more aggressive."
Tom Aronson, Monroe Capital

"I think we're seeing a pause. I don't think the credit cycle is over yet, but leverage levels are too high. If we stay at these 5x/7x structures, it's like anything, something breaks. You start seeing credit problems emerge, which leads to lender consolidation."
Mark Tauber, CapitalSource

"I do feel like we're reaching a peak in the credit cycle because leverage hasn't gone up that dramatically from year to year. I do think the Fed needs to raise interest rates. They have put it off so long that now it's at a point where people are reading too much into it."
Preston Walsh, PNC Mezzanine Capital

"The consensus among lenders is that nobody wants to be a hero and really start reaching at this point in the cycle. The view of equity sponsors is that we are definitely at the top of the market heading down, and if you're going to sell, you need to be selling soon. I don't think anybody feels like there are boom times ahead. On the margin, there is more risk that things slide down than go up."
Mike Foster, Midwest Mezzanine Funds

"I think we are at a peak. Leverage levels aren't going higher. They are relatively steady."
Rich Jander, Maranon Capital

"Leverage is certainly closer to a peak than a trough. I don't think leverage is going to go much higher. We are seeing pricing start to move upwards as opposed to downwards."
Jeffrey Day, Madison Capital Funding

Capacity

number of BDCs are responding to these constraints by raising private funds or joint ventures with insurance companies. Those BDCs trading below book value who only have a public vehicle are at a disadvantage right now." "The status of public BDCs is definitely specific to the manager," remarked Rich Jander at Maranon Capital. "While the BDC class on average has traded below book, which is obviously a concern in terms of issuing new capital, the market is clearly increasingly distinguishing between tiers of managers in terms of performance."

"There has been less public BDC presence in the market in 2015 than there was in prior years. It has certainly created a bit more of an opportunity for nonregulated institutions with good capital," observed Allan Allweiss, a senior managing director at LBC Credit Partners. "There has always been a fair amount of capacity in the lending community to handle the deals even without the banks at the margin and less presence from the BDCs." "I still see the BDCs as being aggressive. They might not be lending to the magnitude that they were previously just because they might not have access to the capital," commented Jeff Kilrea, managing director and group head of CIT Sponsor Finance. "Some of the more formidable players were taking on outsized hold positions. I don't necessarily see that as much now, but I still see them as active."

"The pace of new investment pressure is nowhere near what it was. Other than a few of the private BDCs that continue to access the capital markets, the majority of the public BDCs are trading at discounts and largely rolling over and reinvesting liquidity events," observed Bob Marcotte at Gladstone Capital. "With less pressure to drive volume, we should see a more rational marketplace for the BDCs. That said, new institutional-backed funds are starting up. The question is how they are sourcing capital and whether they are going to have a broader impact on the marketplace."

"The class as a whole has been under pressure. The better performers will be able to continue to access the market for growth," added Randy Schwimmer at Churchill Asset Management. "The BDC market, as large as it is, is still relatively small compared to the overall leveraged loan market. While BDCs have gotten a fair degree of publicity, it still remains a relatively small part of the loan market, in part due to their yield requirements. They are going after higher yielding opportunities than are afforded by the 5-7 percent yields available in first-lien term loans."

With limited capital, BDCs are deploying it more judiciously. "If you look at the broad BDC universe, I think you've seen them get much more credit focused and much more disciplined about capital deployment in terms of yield and structure than they have been," Jander said. "The BDCs recognize there is a penalty if their portfolios are perceived to be of poor credit quality. The good ones are still able to access the capital markets. The bad ones are shut out." "The BDC investors and analysts have been favoring BDCs that have more of a senior debt orientation and secured orientation," Allweiss added. "For some of the larger players, unitranche is being emphasized more because they need to drive the kind of yield on new assets that ultimately will allow the valuation to improve to a point where they can issue additional equity," commented Robert Radway at NXT Capital.

> *"With less pressure to drive volume, we should see a more rational marketplace for the BDCs."*
>
> *—BobMarcotte*
> *Gladstone Capital*

Banks

Survey participants speak to the share shift favoring nonbank lending institutions, a gradual progression that has been accelerated by OCC leveraged lending guidelines. The impact is clearly manifesting itself in terms of the level of bank participation in the market and what terms and what structures they are willing to offer to borrowers, translating into lower leverage, high amortization, and a high degree of conservatism. "Broadly speaking, they are not in many respects offering what the market is prepared to offer, and so in that context the amount of capital or lending dollars available from banks has shrunk," Radway observed. "Banks are very limited in what they can buy right now. When they finally see a deal that fits their box and is squarely within the regulatory parameters, they are very aggressive. That is why you see such a wide divergence in pricing between institutional and bank pricing," added Fred Buffone, a managing director at Fifth

Street Asset Management. "Clearly regulation has an impact on bank lending appetite for some credits because they don't conform with the guidelines or in aggregate a bank is concerned about its profile relative to regulatory guidelines," remarked Allan Allweiss at LBC Credit Partners. "There are many instances in which banks will self-regulate or limit what they'll do because of their perception of what the regulatory regime is expecting of them."

As leverage multiples continue to increase, market participants are increasingly seeing the banks pull back given their limitations within the regulatory environment. Banks remain acutely focused on senior and total leverage and amortization. "Banks will generally try to be below a 3.5x/6x structure and need to see their deal fully amortize in 7 years," offered Rich Jander at Maranon Capital. "It is harder for commercial banks to do your typical 4x/6x deal, and as a result, you are seeing more demand for unitranche or one-stop financings that will go through 6 turns. That trend has continued through this recent market turbulence," said Scott Turco, an investment professional at GSAM Private Credit Group.

Broadly, banks are still in discovery mode as they interpret the guidelines and manage exposure. "Lenders may use different interpretations of the regulators leveraged lending guidance, which will impact the ability of any given commercial bank to do a specific deal, so the devil is in the details. However, broadly we are seeing a behavioral shift among commercial banks in terms of being able to participate in the more highly levered transactions," said Katie Jones, a managing director at BMO Capital Markets. "There is the literal interpretation and the "gray area" interpretation. The regulated lenders are doing both," added Jeff Kilrea at CIT Sponsor Finance. "Some are taking a more conservative approach, while others are playing around the edges a little bit. We are going to see what the regulators actually say when they come in for their quarterly or semiannual or annual audits." Kilrea continued, "I think the banks start to choke a little bit when leverage approaches north of 6x, regardless of the purchase price. That is just by virtue of the guidelines and the regulator's definition of what a leveraged loan is."

Everyone is picking their spots. "If you are a large bank with a diversified portfolio and significant ABL outstandings and your leveraged loan portfolio has performed well, you are probably going to continue to have some level of activity," commented Dan Letizia, a director at THL Credit. "There are other commercial banks that had a few more ripples or leveraged loans represented too much of their overall

PERSPECTIVE
Are we at a peak in the credit cycle?

"We generally view the current market conditions as being at or very close to a peak, just given the comparisons with the previous cycle and where leverage multiples and coverages topped out. They're very consistent with the prior cycle."
Pete Notter, Madison Capital Funding

"We view the current valuation and credit markets as at or near a peak. For now, concerns over the global economy and interest rates have not had a material impact on access to capital in the lower middle market as they have on the broadly syndicated credit markets. Also, sponsor and lender portfolios are performing. As with any cycle, mainstream investors will gravitate towards more defensible businesses and recurring revenue models the further we get into the cycle."
Scott Carpenter, Crescent Direct Lending

"It certainly feels like we're at or near a peak in the credit cycle. It has been five or six years since the recession. We are seeing growth in the economy, but it is not sufficient to even get the Fed to raise interest rates yet. We are in a highly leveraged, modest growth situation right now."
Scott Reeds, Citizens Financial Group

"If I thought a recession was imminent, I would we say we were at a peak. However, I think the economy is going to keep puttering along, not with a lot of growth but also not flat lining either. Because of that, leverage is going to remain where it is for awhile."
Steve Robinson, Antares Capital

"I think the general sentiment, this year more than last year, is that we are closer to the peak. On new deals, there is an expectation of enterprise value contraction through the investment period just based on market factors, not necessarily company-specific ones. So there is more pressure on structuring appropriately and investing with the right partners where you have faith in how they are going to react if a company starts moving sideways."
Dan Letizia, THL Credit

"We are probably more in a rate cycle now than a credit cycle. With the Fed having kept rates so low for so long, we won't really know where we are in the credit cycle until the oxygen mask comes off and we see if the patient continues to breathe on its own."
Randy Schwimmer, Churchill Asset Management

Capacity

portfolio, so there may be more pressure on them to shrink that."

"I don't think there has been a material shift one way or the other. Each bank handles the sponsor business differently. Some banks are choosing to play only in leveraged sponsor deals in certain industry sectors or with specific sponsors they know well. Some banks have chosen to really not play in leveraged sponsor transactions, and they are committing to corporate deals in an aggressive manner," remarked Scott Reeds, a managing director at Citizens Financial Group. "Banks are not like finance companies and will be more selective and targeted given the regulatory environment and where we are in the economic cycle."

"Banks have very strong and well-capitalized balance sheets as opposed to the BDCs, especially in the lower end of the middle market," commented Katie Jones at BMO Capital Markets. "At some point, if they cannot access the equity markets, the business models will be under pressure. Banks should not feel that pain to the same degree. As a result, if BDCs are on the sideline to some degree, it should take some of the heat out of the market from what is currently in the favor of issuers and move it back to investors."

Regional banks continue to be active and are exhibiting no discernable change in appetite levels, said surveyed lenders. "Regional banks remain active as long as the sponsor isn't trying to create too aggressive a package," observed Randy Schwimmer at Churchill Asset Management. "The Fed is serious on constraining leverage over 6x," added Bob Marcotte at Gladstone Capital. "However, the impact appears to be affecting the largest buyouts for the most part. The smaller regional or specialized banks are not as constrained. The smaller deals are garnering less attention because they are not part of the shared credit reviews." Steve Kuhn, a managing director at Fifth Third Bank Structured Finance, shared, "I am not seeing that regional banks are less aggressive or pulling back. What I am seeing is that nonbank competitors have gotten more aggressive on leverage and amortization which makes the bank product less competitive." "When leverage gets beyond 3x they tend to fall off. It is about price versus leverage versus flexibility," remarked Tim Clifford, chief executive officer at Abacus Finance. "The majority of our deals have banks in them just because of the size of the companies," remarked Mike Foster, a senior managing director at Midwest Mezzanine Funds. "They tend to be significantly more aggressive with existing customers. If it is a new name, the threshold becomes pretty high. A lot of these deals are getting done with incumbent banks because that falls in a different basket than a new deal."

"Broadly, we are seeing a behavioral shift among commercial banks in terms of being able to participate in the more highly levered transactions."

—Katie Jones
BMO Capital Markets

Institutional Interest in Private Middle Market Credit Grows

The competitive landscape is evolving with several partnerships announced during the last twelve months. The most notable was the sale of GE's sponsor business to Canada Pension Plan Investment Board (CPP), announced this April. With the dissolution of the GE/Ares SSLP, new partnerships were forged, including Ares Capital and Varagon Capital Partners, announced in June, forming a new joint venture called the Senior Direct Lending Program (SDLP).

Surveyed lenders indicate there has been no immediate pricing impact as a result of the transaction and expect the new Antares will have a broader mandate to deploy capital in the first 12-18 months under its new ownership:

"The market anticipated there would be some disruption because Antares represented such a significant share. Instead, those of us who partner with them found the transition to be quite seamless. And there's been little change in deal terms as a result."
Randy Schwimmer, Churchill Asset Management

"Antares is very much in the market, and is working hard to protect the agencies they had when they were under the GE umbrella. With CPP, they are now perceived by the marketplace to have more flexibility not being part of a regulated entity and can provide their own one-stop where CPP can supply the junior capital and Antares can lead the first lien or senior capital."
Fred Buffone, Fifth Street Asset Management

"It is early in CPP's ownership to say too much, but so far we have experienced Antares being aggressive in their hold and leverage levels like they were under GE's ownership. We will be interested to see over time if their hold levels and cost of capital materially change."
Scott Reeds, Citizens Financial Group

"It [GE] was the largest player in the industry, and any time the highest volume participant in a given market exits, you will see an impact on pricing."
Scott Turco, GSAM Private Credit Group

"You have gone from a regulated entity under GE to a non-regulated entity under CPP. Antares dusted off the playbook they used 10 years ago and are really going to market with a similar type of calling. And they are doing it very well. That provides people with the market access that they've always had, but now it provides them the portfolio flexibility that they didn't necessarily have as a regulated institution.
Jeff Kilrea, CIT Sponsor Finance

"They have a broader mandate, and I think what people are seeing so far is that they are being more aggressive in certain situations today than they were pre-transaction."
Dan Letizia, THL Credit

Steve Robinson, a managing director at Antares Capital, commented on the transaction: "We stayed very active throughout the sale process and never really skipped a beat in terms of our activity level. As a nonregulated entity, we will have the ability to be more aggressive than we were in the past for certain credits that we like. Of course, we still have to structure to the market, but it does give us a little more flexibility which will help going forward. We will have more appetite to structure and hold junior capital. And we are actively financing healthcare-related transactions, which is something we were doing when we were at Antares prior to GE's ownership. We previously had been precluded from participating in healthcare deals because GE had a vertical."

Robinson continued, "Our mandate is the same. I think our holds will be consistent with, or even higher, than we were in the past. The cost of capital is generally pretty consistent. We were a significant player in the market before, and we'll continue to be a significant player."

In April 2015, TIAA-CREF launched Churchill Asset Management in a move to increase its participation in private middle market credit. "TIAA-CREF has an existing credit business and was looking for a team with a track record in the middle market to fit into their overall private credit strategy," Randy Schwimmer told us. The Churchill senior management team has been together for almost a decade. The partnership will augment TIAA-CREF's senior debt capabilities. "It is a terrific partnership because the firm has significant LP relationships with private equity sponsors, particularly in the middle market. From an origination standpoint, that has given us a real tailwind starting off over the last seven months." "Schwimmer continued, "Non-bank lenders have begun to fill the vacuum left by banks that have stepped back from making loans to the middle market due to regulatory or balance sheet pressures. This is particularly true among more levered companies where there has been the most scrutiny."

In September 2014, Angelo Gordon & Co. launched Twin Brook Capital Partners, led by a deep bench of former Madison Capital executives, which has been in fund raising mode since October 2014. It was reported earlier this month that Twin Brook is expecting its final close in early January, should exceed its target, and is expecting to have around $1.5 billion in available capital. By year-end, Twin Brook expects to tally 16 closed transactions (including 11 as agent or co-lead arranger) representing about $365 million of commitments. Commenting on the timing of Twin Brook's entry, Partner Chris Williams, commented," There is a lot of disruption in the market in a number of different shops. Banks are pulling back with all of their regulatory issues, and there is a general dislocation among some of the longer-term players which has created a lot of opportunity. Lenders are focusing internally more than they are externally which has been good for us because they have taken their eye off the private equity sponsor. There is a desire out there for a stable and consistent player to come into the market."

Capacity

EBITDA Thresholds

Lender minimum EBITDA thresholds continue to blur given competitive dynamics, however, $10 million appears to the line where structure and pricing are more borrower-friendly. "There is definitely a bifurcation at that $10 million EBITDA level," remarked Randy Schwimmer at Churchill Asset Management. "Sponsored deals will still get more leverage and tighter pricing, but less than the over-$10 million crowd." "$10 million is a bright red line. We hear it from sponsors, and we hear it from other banks we call on when we are syndicating deals," said Chris Williams at Twin Brook Capital Partners. Scott Carpenter at Crescent Direct Lending, commented, "The $10-15 million EBITDA market has gotten more aggressive. In today's market, at $10 million+ of EBITDA you may not see a consistent relative value compared to the pricing and structure of broadly syndicated middle market credits."

"There has been a lot of compression in the market, meaning terms, pricing, and structures are increasingly very similar across the EBITDA size spectrum, and the compression continues to become more striking. Breakpoints are much less dramatic. $5 million seems to be the real break point," offered Brent Burgess at Triangle Capital. "It doesn't feel like there is a lot of push on the debt side to get more aggressive. Maybe that is why you are seeing the blurring of the boundaries. People don't want to get more aggressive in the market they're in but they're willing to move down market and bring some of the same terms or similar terms."

Broadly, smaller companies tend to see more conservative structures, particularly below $10 million. However, as new SBIC funds are formed and oriented to the unitranche product for the $3-7 million EBITDA segment, the lower middle market is seeing more competition. "In the lower middle market, the delineation is at $5 million, which used to be above $10 million," commented Tim Clifford at Abacus Finance.

Ira Kreft at Bank of America Merrill Lynch summarized, "The sub $10 million market has benefitted as nonbank lenders have moved down market. Tranche B and unitranche providers have expanded the credit available to middle market companies. In combination with asset-based lending facilities, such lending structures have provided an attractive alternative to traditional bank cash flow loans for middle market companies. As the EBITDA size increases, middle market companies have more options. The institutional

LENDER NEWS

In 2015, Angelo Gordon & Co. launched Twin Brook Capital Partners (Twin Brook), a finance company focused on providing cash-flow based financing solutions for the middle market private equity community. Twin Brook's flexible product suite allows for tailored financing solutions for leveraged buyouts, recapitalizations, add-on acquisitions, growth capital, and other situations for companies that typically have EBITDA between $3 and $50 million. The direct lending team, led by Trevor Clark and Chris Williams (the original founders of Madison Capital Funding), consists of a cohesive group of highly experienced, dedicated professionals who have successfully worked together throughout their careers at leading middle market lending institutions. Over the course of their careers, the team has successfully closed over 1,100 transactions with 200+ different middle market private equity firms.

Chris Williams
Partner

What has been the reception of the Twin Brook platform amongst the private equity community?

The overall reception to our new platform has been extremely positive. Since our team fully came together in May of this year, we have seen almost 300 transaction opportunities from over 120 different private equity groups. We have committed ~$300 million of capital since May. Furthermore, our large capital base has allowed us to take sizeable hold levels and positioned us well to play a leadership role as Administrative Agent for several of these transactions.

What differentiates the Twin Brook platform from other middle market firms?

We would highlight our highly experienced team and our ability to execute on a timely and consistent basis. Rich Christensen, Dave Gibson, and Grant Haggard each bring over 20+ years of relevant middle market lending experience. Private equity firms appreciate interacting with highly experienced individuals who have closed transactions across a wide range of varying industries. Being able to identify key credit issues early on in a transaction along with moving a deal process along timely and efficiently are important traits in our model.

Can you comment on the timing of Twin Brook's entry in to the market. What are your views on demand for private credit?

We've seen rapid change in the middle market lending landscape and a real need for the type of alternative financing solutions we provide. Private credit is taking share as more traditional lending sources continue to have a low appetite for risk and the high yield market isn't open to most of these companies.

term loan and high yield debt markets are generally open to companies with $50 million or more in EBITDA, and depending on market conditions, $100 million or more. But these alternative structures provide a very viable alternative."

Unitranche

The unitranche market is evolving and here to stay:

"Hand in hand with popularity of the unitranche has been the ability of players to finance larger deals under that structure," commented Randy Schwimmer at Churchill Asset Management. "If you are one lender providing one document, your ability to hold more of that paper greatly enhances your competitiveness."

Katie Jones at BMO Capital Markets, added, "Unitranche continues to be a very real competitive alternative to traditional financing. Unitranche players have shown a higher willingness to put out more unfunded capital, principally in the form of revolvers that historically was one of the weak spots of that product. Unitranche will play all the way from a senior stretch (3.75x – 4.5x) up to what would otherwise be a first lien/second lien or first lien/mezzanine structure to 5.5x-6.5x. Pricing has tightened due to competitive dynamics and is nearing the blended rate of first lien/second lien as opposed to historically being a bit wider."

"Because the competition is so strong for first out or senior debt, we have mainly focused on the junior capital component of the capital structure," offered Brian Schneider, a managing partner at Northstar Capital. "We see the unitranche market drifting toward higher risk assets, meaning: 1) the asset has a higher risk profile or 2) the asset is one that you have to pay up for so you need high leverage on it. Most of the sponsors that we work with aren't taking the higher leverage."

"We have done a number of bifurcated unitranche transactions. I think we will continue to see demand for that product because of the convenience that it provides for the borrower," said Scott Turco at GSAM Private Credit Group.

"There is an abundance of participants for the last-out in a bifurcated unitranche transaction. The challenge is anything beyond our own balance sheet from a first-out standpoint," Jones added. "This is a younger market so there is not the same level of transparency amongst the agreement among lenders (AAL). Bringing participants into a syndication is more difficult because there isn't a readily available market, and the work that goes into getting the deal across the finish line can be very challenging."

Mezzanine

The mezzanine market has continued to contract as unitranche and second lien have taken share, requiring most traditional mezzanine lenders to get creative to get deals done in the market environment over the past few years. PNC Mezzanine Capital conducts an annual survey on the state of the mezzanine market. The 2015 findings "...revealed a real shrinkage in terms of the lenders who say they still do mezzanine. Traditional mezzanine lenders were focused on smaller deals," said Preston Walsh at PNC Mezzanine Capital. Mezzanine lenders are seeing more opportunities below $20 million of EBITDA. "Above that, there are so many options now," Walsh added. "A number of mezzanine lenders have migrated to structured equity types of transactions in order to get their volume and returns," said Allan Allweiss at LBC Credit Partners. "We also see some providing second lien and other products to increase their opportunity set because there haven't been enough opportunities."

> *"The consensus among lenders is that nobody wants to be a hero and really start reaching at this point in the cycle."*
>
> *—Mike Foster*
> *Midwest Mezzanine Funds*

Deal scarcity has crowded out traditional mezzanine funds from financing opportunities in more ways than one. As strategic activity plays an ever increasing role in private equity buy-and-build strategies (more than 50 percent of leveraged transactions are being done in add-ons as opposed to platforms), mezzanine lenders are playing less of a financing role. "As opposed to buying 10 platform companies in the portfolio, they may only buy 5 or 6 but then do twice the number of add-ons," commented Mike Foster at Midwest Mezzanine Funds. "Usually, they are financing that add-on activity with more senior debt. Because the platform company isn't as large, they're typically not using the more traditional senior mezzanine structure."

Capacity

Private equity sponsors are more challenged to deploy capital, a function of the growing capital overhang and the competitive market. "Sponsors are not finding as many opportunities to get dollars out the door, so they often are putting in the mezzanine themselves. It is an opportunity for them to deploy capital and get some amount of current income back for their investors. They have the flexibility with their own capital to structure it the way they want," Foster said. Scott Carpenter at Crescent Direct Lending added, "There is an increasing number of sponsor LP's that have an interest in mezzanine co-invest opportunities. We are often asked to propose both a unitranche and also a senior stretch structure to accommodate this possibility."

2015 was an above-average year for Midwest Mezzanine, according to Foster, who said the firm is seeing opportunity with an emerging class of buyers—the independent sponsor. "It is a combination of really focusing on the sourcing over the last 18 months and the type of deals that we're doing." An underserved market by certain segments of the lending population, independent sponsors are seeing support from SBIC funds like Midwest Mezzanine. "Independent sponsors typically don't bring a significant amount of capital so they are reliant on investors like us to provide more equity than we would if we were working with a traditional sponsor. Because we can allocate more equity than we had in previous funds, it gives us an opportunity to invest more." Mike Foster continued, "Nothing is proprietary, but independent sponsors tend to be closer to the deals, which typically are not as heavily shopped, so the valuations can be more reasonable." Steve Gurgovits at F.N.B. Capital Partners added, "We are really focused on deals with independent sponsor groups that bring some operating experience and some capital to the table. In these situations we have a little more flexibility in how we structure a deal, and we usually have the opportunity to co-invest in the equity to get a deal done."

Mezzanine executions have ticked up, an outgrowth of efficient bank cash flow solutions and relatively inexpensive mezzanine, said some lenders. "We have anecdotally seen mezzanine participants as being active," commented Scott Turco at GSAM Private Credit Group. "We've seen them be competitive against highly levered bifurcated unitranche solutions, particularly in terms of their cash PIK mix and mechanics, as well as their unique relationship with the company, senior lenders, or private equity GP."

Despite the growing popularity of the unitranche product, there are still some sponsors that like the patient capital that mezzanine offers, which continues to generate steady deal flow. "Pretty consistently there is $5 billion of mezzanine that gets deployed in our market every year," remarked Rich Jander at Maranon Capital.

As purchase price multiples have increased, the senior/mezzanine structure has been more competitive, creating opportunities in the lower middle market, Jander indicated. "We've seen sponsors elect mezzanine in a traditional structure over a unitranche because they can get more leverage even though the pricing blend may be slightly higher," offered Jander. "Banks are more willing to compete on price, so if you can put together a traditional first lien and mezzanine deal, the first lien pricing can be pretty competitive. You can get to a leverage level that will be slightly higher by a quarter turn or more than the unitranche will be. Sponsors are finding that to be attractive."

> *"Portfolios are blending towards lower risk structures. It is largely a function of where we are in the credit cycle."*
>
> *—Dan Letizia*
> *THL Credit*

"A $10 million EBITDA company doesn't have the same options as a $40 million company that can get a first lien/second lien execution. That is really where we are headed," Jander continued. "The suppliers of unitranche capital who are largely BDCs have issues of their own right now in terms of capital availability and yield, so all of these factors are converging. Mezzanine for middle market deals is really vibrant."

Maranon Capital is having one of its best years of mezzanine capital deployment in the history of the firm. "I don't think we are an anomaly. I think there are a lot of mezzanine opportunities right now." "The thing that we keep hanging our hat on is our long-term relationships with like-minded sponsors, who don't necessarily want to take every last nickel of leverage to make a deal work," remarked Bob Erwin, a managing director at Babson Capital. "They

are going to grow their businesses through organic growth or through acquisitions. They are going to try to buy right which is tougher nowadays, but they aren't really looking to financially engineer their businesses through hot money."

Pricing

Current mezzanine pricing metrics are 10-12 percent coupon and 1.0–2.0 percent PIK. Given that the senior banks are much cheaper, there is a fair bit of pressure on the cash interest, lenders said. "Twelve percent had always been the golden rule in mezzanine," remarked Mike Klofas at Babson Capital. "Eleven percent cash pay seems to be the new rule." However, there has been some firming with the volatility in the broader market. "It feels like it definitely firmed up to 12 percent," commented Brent Burgess at Triangle Capital. "For a while it felt like 12 percent wasn't winning anything, and you had to go south of that. That seems to have changed."

Co-invest opportunities are still available but getting more competitive with more participation by LPs. "We are being a lot more selective in terms of how we are looking at the equity co-investments," said Mike Klofas at Babson Capital. "With double-digit purchase price multiples, it is hard to see multiple arbitrage in a positive way in those types of deals."

Second Lien

Second lien continues to push farther down market and is becoming more prevalent in the lower end of the middle market, for companies with EBITDA as low as $10-15 million lenders said. "Second lien used to be more prevalent in service businesses with high recurring revenue. It is becoming more industry agnostic, so you will see second lien as readily in an industrials company as you would in a technology or software company," offered Katie Jones at BMO Capital Markets.

"Second lien seems to be the junior capital of choice although it is the hardest piece of capital to raise in today's environment," observed Scott Reeds at Citizens Financial Group. "We've seen pricing increase more on second lien to the levels of mezzanine debt." BDCs that were active second lien investors are having difficulty raising capital in the current market, which is creating a shortage of lenders and driving up yields. "While first lien pricing has widened out materially, the spread between first lien second lien has increased more than previous market norms. Given how hard second lien is to raise in the market, most sponsors are privately placing second lien with LPs and other close relationships to reduce any syndication risk," Reeds added.

PERSPECTIVE

Are lenders moving up the capital structure given where we are in the economic cycle?

"Portfolios are blending towards lower risk structures. It is largely a function of where we are in the credit cycle. To be in a more secured structure or in the dollar one position, you will be better prepared to weather whatever storm is coming. It is the ongoing balance of managing risk reward and maintaining the level of returns that your investors are seeking."
Dan Letizia, THL Credit

"In periods of volatility, you tend to have a risk-off trade so people move up the capital structure. We are still selectively doing second lien and mezzanine, but as a percent of our portfolio, it is more weighted toward first lien and unitranche today. "
Fred Buffone, Fifth Street Asset Management

"Absolutely. More BDCs are focusing on senior and unitranche and shying away from second lien. Second lien spreads are widening not only because of broader macroeconomic concerns but because there are not as many participants, especially in the lower end of the middle market, due to the perceived risk and their longer-term view of where we are in the economic cycle."
Katie Jones, BMO Capital Markets

"We have been for the past six months or more. No question. Our portfolio is showing a noticeable increase in straight senior debt transactions versus either stretch or unitranche transactions."
Robert Radway, NXT Capital

"No question more seniority is preferable. The unitranche is the all-senior solution that gives lenders the comfort and yield they need, while also delivering certainty of execution to the sponsor."
Randy Schwimmer, Churchill Asset Management

Company Performance

Findings from the *3Q 2015 Middle Market Indicator* released National Center for the Middle Market (NCMM) revealed a resounding 7 in 10 middle market companies are reporting year-over-year revenue growth. The middle market continues to outperform the S&P 500, reporting 7 percent revenue growth in 3Q 2015 versus 4.7 percent for the S&P 500. Market segmentation highlighted the following trends:

- The largest middle market firms (revenues between $100 million and $1 billion) experienced the biggest gains averaging 8.3 percent growth year-over-year
- The core middle market (revenues between $50 and $100 million) experienced slower growth at 5.4 percent

Anticipated revenue growth is at the lowest level measured in the past year, according to the NCMM Middle Market Index, which forecasts revenue growth to tick down to 4.1 percent over the next 12 months.

Growth Remains Elusive

Unless a company is operating in a growing industry, organic growth is hard to come by. "Companies are not getting a lot of help from the economy, so in order to grow, they have to make an acquisition or gain market share," observed Preston Walsh at PNC Mezzanine Capital. "We are coaching our companies to keep their costs under control."

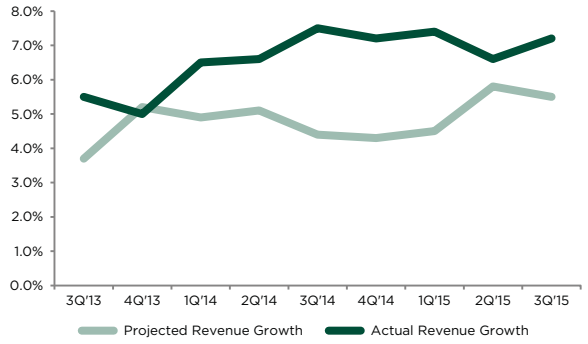
"We haven't had the economic boom in this recovery. Manufacturing hasn't really gained a lot of traction despite a lot of reshoring back to the U.S. The housing market has recovered but is still way under the last peak. With commodity prices down across the board, there is a deflationary feel to the market which has kept the Fed in check," commented Steve Gurgovits at F.N.B. Capital Partners. "I think we all just deserve 6 to 12 months of euphoria from a fiscal boom where maybe things do overheat for rational reasons, but that type of scenario seems very far off right now."

"There is not a lot of growth in most sectors. The only way to generate growth is to take share, and everybody is trying to do that. That is a fundamental headwind," said Allan Allweiss at LBC Credit Partners. "It is a combination of uncertainty around interest rates and certain market driven volatility, in the case of commodity prices, that has created some headwinds for middle market companies, in an environment where there is nothing that is creating a significant tailwind."

"Overall, the growth in middle market businesses is flat. In many cases, companies performance is lagging EBITDA adjustments or the growth expectations of some of the sponsors," indicated Bob Marcotte at Gladstone Capital. "Free cash flow cushion is not as robust. Covenants will get tighter, and market exuberance has given way to a more sanguine view of performance and challenges

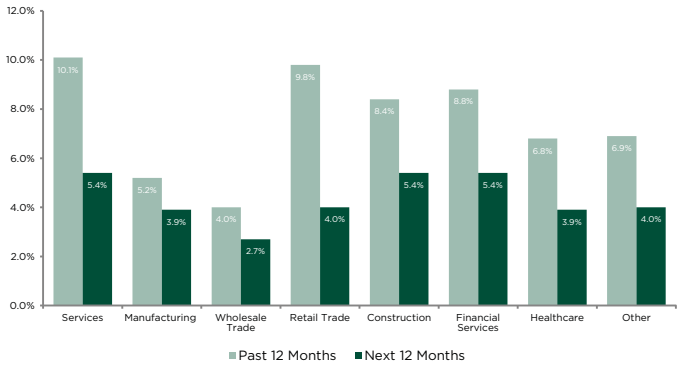
U.S. Middle Market Companies - Recent and Expected Growth

Revenue Performance versus Forecast



Source: National Center for the Middle Market.

Revenue Growth by Industry



Source: National Center for the Middle Market from Dun & Bradstreet.

of growth in light of the broader market volatility and uncertainties in the marketplace."

"This year, we are seeing more companies projecting growth to be flat or tick down through the end of the year and into 2016. There is no indication of a catalyst for robust growth in 2016, and we are seeing it manifest both in performance and in forecast," added Allan Allweiss at LBC Credit Partners. "The growth cases we are getting from our private equity clients are probably more conservative than they were a year ago," commented Dan Letizia at THL Credit.

"In order to grow, companies have spent more time and energy on building effective sales teams: putting in CRM systems, hiring strong sales managers, changing the way they do business," observed Brian Schneider at Northstar Capital. "It is no longer an option to do business the old way."

Sectors Seeing Above-Average Growth

- Healthcare/Healthcare Services
- Technology/Software
- Consumer Products
- Tech-Enabled Business Services
- Business Services
- Engineered Services (compliance, safety orientation)
- Subscription-Based Services and Training

Credit Quality

Portfolio credit quality is strong with lenders reporting solid company performance across most sectors. Overall, trends in revenue and EBITDA growth are positive, however, there are signs that growth may be slowing. Default risk remains low.

"Portfolio credit quality is generally strong across the banking industry, evidenced by low loan charge-off and delinquency rates," offered Ira Kreft at Bank of America Merrill Lynch. "Certain sectors such as energy and metals have been more challenged as falling commodity prices have had a negative impact on borrowers' cash flows, and companies supplying into heavy truck, mining, and construction equipment have been impacted as well."

"If companies are struggling, it is not a reflection of the fundamentals of the U.S. economy. The overall health of the U.S. economy is strong despite sector-specific issues in energy, commodities, infrastructure, and some areas in agriculture," added Schneider. "Our portfolio is the strongest it's been in a long time."

Lender Hot Buttons

Lenders are becoming more skeptical given where we are in the economic cycle and are factoring into their approach:

"Everybody is interested but reacting more to real time events as opposed to building in negative or positive expectations. I think there is a real focus on fundamentals to understand cost and profitability drivers for businesses and the risks that could negatively impact them," said Allan Allweiss at LBC Credit Partners.

"We are looking at downside modeling scenarios a little bit more closely."

—Jeffrey Day
Madison Capital Funding

"We are looking at downside modeling scenarios a little bit more closely," remarked Jeffrey Day, a managing director at Madison Capital Funding. "We've put more leverage on some of these businesses in the last couple of years than we have in the past. It is something that our chief credit officer and chief underwriting officer are very focused on. With rising interest rates and potentially some softness, you could definitely see free cash flow tighten rather dramatically."

"On every deal, we look at the recession EBITDA run rate and where it is today to see how much debt capacity the company could service in a downturn," offered Steve Kuhn at Fifth Third Bank Structured Finance. "It is more of a concern today because for most of the companies we look at, the EBITDA has never been higher.

Company Performance

We do have that conversation now more than we used to."

"You need to apply some rigor when you are thinking about the companies and how they are going to perform in the next cycle. And that is part of the conversation about leverage. We know these companies are going to cycle. How levered do we want to have them when we go into that cycle," said Rich Jander at Maranon Capital.

"For every new deal we look at, we talk about the likely profile in different alternatives for a downturn and try to make sure we build structures that can withstand those. We've always done that," said Allan Allweiss at LBC Credit Partners. "I do think we are probably more focused on that today than if we felt like we were in the early innings."

Lenders are approaching cyclicals with more caution. Anything that has an industrial, cyclical, or heavy capex component is receiving more scrutiny:

"The benefit of experience is crucial when lending to cyclical businesses. We are typically able to review borrower financials dating back to the prior recession to determine how relevant past experience is likely to be in determining future performance. More conservative capital structures can address some level of anticipated borrower cyclicality," added Scott Carpenter at Crescent Direct Lending.

"Companies that serve the capital goods, mining, and commodity industries are challenged right now. Anything in oil & gas is having a really tough time. So, you have a number of very selective mini recessions in a few industries," commented Preston Walsh at PNC Mezzanine Capital. "There is more sensitivity there. You want to address that with less leverage. For us, it is making sure we're staying within historical parameters." "We are mindful of the oversupply or price deflation that is occurring within the commodity sectors," indicated Bob Marcotte at Gladstone Capital. "There is definitely some anecdotal impact beginning to roll through industrial businesses in the face of this global commodity softness."

"There has been an increase in deal flow in cyclicals (building products, automotive, construction) over the last 12 months. Along with that, there is certainly increasing sensitivity to cyclical forces in that subset, especially as you get into year 6 and 7 of a non-cyclical environment," observed Pete Notter, a director at Madison Capital Funding.

Commodity-driven sectors are seeing the most weakness with market participants searching for a bottom. Energy has seen a significant change in lender appetite, said survey participants, and for some lenders there is almost no appetite.

"I think we are beginning to move in the direction of a bottom. Even the largest players in the energy services space are continuing to ratchet down spend or pricing, so you are going to continue to have softness well into 2016," Marcotte offered. Marcotte continued, "A significant number of these service-related businesses are fundamental to the development and sustainability of fracking technology. It may not be as cost-effective today in many places, but it is not going to go away. The energy operators that see that longer-term view recognize that fracking is getting more cost-effective and are focusing on highest return opportunities. They are buying in to the industry and effectively deleveraging and averaging down their investment to be in a much stronger position as things stabilize and grow."

> *"Companies that serve the capital goods, mining, and commodity industries are challenged right now. Anything in oil & gas is having a really tough time. You have a number of very selective mini recessions in a few industries."*
>
> *—Preston Walsh*
> *PNC Mezzanine Capital*

"Energy deals have never been a natural for cash flow leverage structures. As a percentage of middle market deal flow, it is usually not a big number," remarked Katie Jones at BMO Capital Markets. "Energy is affecting our companies more in the form of their customers, and as a result we are seeing some revenue softness."

"Building products is probably one where there are still some years of legs left in the housing recovery before another peak," said Dan Letizia at THL Credit. "It is a function of underwriting to what is a sustainable level given the catch up that needed to happen. It is an example of where today's performance may not be indicative of a normalized level or where you can comfortably de-risk through principal repayment over an investment period."

"We are willing to still lend to those sectors. I think most lenders are," offered Allan Allweiss at LBC Credit Partners. "You look for businesses that have the right moats around them and the right value drivers. We are still able to find some really attractive value propositions." "I think lenders are more cautiously looking at the cyclical industries or the higher valuation/higher leverage industries, and there probably is a shift toward the more recession-resistant, safer industries," remarked Fred Buffone at Fifth Street Asset Management. "Those deals are still getting done, but I think the universe is slightly smaller today."

"I think it really comes down to, is this is a good story, does the enterprise value warrant leverage, how did the company perform in the last cycle, regardless of industry?" commented Andy Steuerman, head of middle market lending at Golub Capital. "If you have a good story and the credit attributes hang together, I think all deals in all industries are getting done. It just depends on the leverage, market position, and sustainability."

"Lenders are more cautiously looking at the cyclical industries or the higher valuation/ higher leverage industries, and there probably is a shift toward the more recession-resistant, safer industries."

—Fred Buffone
Fifth Street Asset Management

Valuation

Valuation multiples remain elevated, with inflation observed across the size spectrum, said the majority of participants in our survey. Flight to quality still prevails fueling a bifurcation of the "haves" and "have nots" as asset selectivity is playing a greater role in financing.

Survey participants speak to a continuing supply/demand imbalance, fueled by a growing overhang of private equity capital, leaving funds to aggressively compete with each other for limited quality deal opportunities. Strategic buyers are taking an even more active role in and winning middle market auctions, contributing to multiple expansion.

"Inflated purchase prices are across the board and being fueled by capital surplus rather than fundamental business growth outlook," commented Brian Schneider at Northstar Capital. "We are seeing several deals executed at 8x and levered at 5x. This is the new normal." "Whether it is a good business or a bad business, or whether it is growing or not, it is getting a turn or two turns more than it would in a more normalized environment," added Dan Letizia at THL Credit. "We used to say 6 is the new 5," Schneider added. "8 is the new 7 today. The only bump in the capital supply road will be sector-specific. Otherwise, we don't see any changes over the next several years."

"In today's frothy market, it is not uncommon for sponsors to pay 10x for a business that may have traded for 8x a few years ago. Sponsor models that anticipate a reduced exit multiple appear to be more commonplace," said Scott Carpenter at Crescent Direct Lending. "We've been seeing valuations in the 9x-11x range for the good quality credits—the more predictable revenue streams, the strong margins, the meaningful market shares. You talk to sponsors who you believe are disciplined buyers, and they'd say it is the cost of entry," said Jeff Kilrea at CIT Sponsor Finance. "Lenders are financing part of that. If there is a slight multiple accretion, the lenders are going to give you that incremental leverage."

"Part of the reason people are bidding up valuations is because the cost of capital is so low. If you are paying 8x, 9x, or 10x, you are going to be talking about a double-digit growth business to ever make any kind of return," commented Mike Foster at Midwest Mezzanine Funds. "At some level you are capped out even in the upper market on the amount of leverage, so every additional turn of leverage is all coming out of equity. There is a difficult argument in most businesses today to suggest you can find double digit-growth. If interest rates go up, that argument loses less and less validity."

"Inflated purchase prices are across the board and being fueled by capital surplus rather than fundamental business growth outlook."

—Brian Schneider
Northstar Capital

Quality

Bifurcation

Asset selectivity is pushing higher given where we are in the economic cycle, with the bifurcation observed last year even more pronounced today said some lenders. And while there is not a concerted shift, defensive plays are more attractive in the current environment. "Anything that looks like it might be recession-resistant is getting a lot of attention and trading for higher multiples right now," offered Preston Walsh at PNC Mezzanine Capital.

"Because of the deal scarcity, people are falling over themselves for the really attractive credits. The ones with issues take more time and are not seeing the same type of multiple expansion," Walsh added. "The net result is an overall multiple increase, but it is very incremental, and it is oriented around the companies that are viewed as the most attractive." Carpenter commented, "We aren't seeing many lower middle market businesses trading for less than 7-7.5x unless there is a cyclical or "story" aspect to the business. This is 1-2x higher than a few years ago."

"There is a bifurcation," added Pete Notter, a director at Madison Capital Funding. "You're seeing the really strong niche players in favored sectors (tech-enabled business services, for example) that have strong growth potential commanding peak valuations. And everybody else falls in line underneath that."

"I don't think it is a barbell as much as a continuum," observed Allan Allweiss at LBC Capital Partners. "On the right hand side you might have some healthcare, TMT, certain consumer products businesses, and on the left you might have commodity and automotive. In the middle will be the vast number of industrials, distribution, and business services. They'll range the spectrum between largely 4x and 8x. The majority of businesses trade in the middle of that range."

Defining Quality

Lenders cited key value drivers that influence premium valuations in today's market:

- Recurring revenue, visibility
- Subscription-based, repeatable revenues
- Predictable growth story
- Stability of cash flow
- Performance in the last recession
- Favored industry
- Barriers to entry
- Platform with ability to grow through acquisition

"To achieve a premium valuation, a business needs to have the right fundamentals - they have the right moat around them, sustainable and strong EBITDA margins, and a way to grow the business. Generally you are not going to pay 10x-12x for a business to cut costs; you are going to pay 10x-12x for a business that's going to grow," Allweiss said.

"To get close to the 10x or above, you need to have it all," added Brent Burgess at Triangle Capital. "You need to have recurring revenue, higher margins, and good growth. For those companies where you can "check all the boxes", the auctions are really aggressive. We have seen some deals where multiples are well north of 10x, and that is typically because there is above-average growth and a lot of white space."

PERSPECTIVE
Are valuations at a peak?

Rich Jander, Maranon Capital: Everybody knows valuations are sky high, and a lot of the reason is because interest rates are so low. Even a slight increase in rates has to have an impact at some point on valuations or the equity investors are going to continue to take lower returns. Something has to give.

Andy Steuerman, Golub Capital: It feels like it, but the price of the next deal always surprises me. There aren't many deals that we are looking at where the multiples aren't at least 9x and most of them are above 10x. We can all use some more deals. That would cure a lot of issues.

Scott Reeds, Citizens Financial Group: It feels like a peak. Leverage levels haven't materially changed. Valuation levels remain consistent with where they've been over the course of the year at elevated levels with a lot of our sponsors frustrated and looking for a catalyst that will change that.

Tim Clifford, Abacus Finance: It feels like we are at a peak. Any good company is going to trade for 8x or more. When you talk to sponsors, the number one complaint they have is valuation, and it is the main reason they drop out of a process.

Steve Gurgovits, F.N.B. Capital Partners: We've been trending higher and certainly nearing a peak, but there is really no impetus to bring multiples down. We talk internally about what's driving multiple inflation. I'm more concerned about what's going to cool it down. Hopefully some rationality can enter the market through some minor dislocation of some kind or perhaps even just a Fed rate increase. The economy has to speed up or valuations have to come down. You cannot just rely on cost takeouts or an effective roll-up strategy to create value when buying a business at such a high multiple.

Fred Buffone, Fifth Street Asset Management: The cost of capital is not going down. When you have a ceiling on leverage, there is probably going to be a ceiling in purchase price. If the economy remains stable and there is not a drastic increase in supply, we should probably have a stabilization in purchase price multiples for the next couple of quarters.

Mark Tauber, CapitalSource: I don't think valuations will go much higher. The Fed is going to raise interest rates, which is going to lead to tighter coverages and make it more expensive to buy these companies. Valuations and leverage are at a peak right now.

Randy Schwimmer, Churchill Asset Management: We are certainly at a plateau. There is still more private equity capital than there are deals. It's hard to see valuations going that much higher, but with so much dry powder available, sponsors will keep multiples from heading down anytime soon.

Allan Allweiss, LBC Credit Partners: In certain sectors, we were definitely for much of the year close to a peak. Some of those—consumer products, technology, TMT across the board, some healthcare—were likely near as high as could be justified for financial buyers. Strategic buyers have a whole different pricing hurdle because of the inherent benefits they can reap from the efficiencies of putting businesses together. Since there has been more strategic participation in the market, that is part of what the financial buyers have had to compete with. It's hard to make that go away.

Valuation

Industry

Multiples are very dependent on the business and the industry. Technology-driven business services or recurring revenue software companies were frequently cited, where higher growth rates justify higher valuations. Healthcare remains of high interest among sponsors, driven by three variables: stable reimbursement rates, growing demand, and diversified customers, which support a predictable revenue model.

Growth is a draw of technology-based businesses, with SaaS models frequently cited by lenders. "We see many of these companies as being industry disruptive, so they are garnering higher debt and purchase price multiples," commented Tom Aronson at Monroe Capital. "Software deals are very aggressively priced today, consequently you will see some very high debt multiples as well," offered Chris Williams at Twin Brook Capital Partners. "We see purchase price multiples for SaaS models regularly above 10x." "Any type of subscription-based, highly predictable and preferably growing (but not necessarily a requirement) business that has sustainable revenue that is coming from a large, diversified group of customers such as a software company commands a very high premium," added Robert Radway at NXT Capital.

Sectors in Favor:

- Tech-enabled business services
- Software/IT
- Healthcare services
- Healthcare IT
- Quality industrial businesses with high barriers to entry
- Aerospace
- Branded consumer products (ability for upstart brands to take market share and grow rapidly)
- Food and beverage

All are viewed as defensible sectors with attractive growth characteristics.

Sectors out of Favor:

- Energy
- Agriculture
- Education
- Infrastructure

Cyclicals almost by definition will have a lower multiple and less competition, said lenders, but still can attract healthy multiples in the current environment. "We are seeing spreads on what I would consider some of these more cyclical businesses, they are reminiscent of 2007/2008," said Mike Foster at Midwest Mezzanine Capital. "Two years ago you wouldn't have gotten these multiples." "I would say in a vacuum, there should be a pretty healthy delta between the cyclical industrial businesses and the less cyclical, less industrial businesses, but it's fairly compressed right now," added Pete Notter at Madison Capital Funding.

> *"We are mindful that things are pretty frothy, and there will be a cycle. It is just a matter of when."*
>
> *—Katie Jones BMO Capital Markets*

"It is not necessarily sectors as much as it is credit themes. We are mindful that things are pretty frothy, and there will be a cycle. It is just a matter of when," said Katie Jones at BMO Capital Markets. "One of the first things that we evaluate is how companies performed in the last cycle. How vulnerable are they– do they have supplier concentrations, customer concentrations, who has the pricing power? If it's healthcare, have there been reimbursement cuts? So, it is gaining a better understanding of the drivers of the business and global themes that may affect them."

Size

While size has always been a differentiator, multiple expansion has taken place at all EBITDA levels. Irrespective of size, it is credit-driven, said lenders, with small companies (defined as below $10 million of EBITDA) able to attract full multiples. Are multiples of 8-plus times attainable for a smaller business? "No question," said Tim Clifford at Abacus Finance. "For the higher quality companies with high margins, it is going to be 8x or more." "If you have a recurring revenue model and you have demonstrated historical and projected growth, it is not uncommon to see high single digit up to 10x valuations for companies in the $5-15 million EBITDA size range, with the cyclical or industrial companies tending to trade to a slight discount to that. As you get further up the size spectrum, it's fairly common to see companies with those profiles trade for 10-plus times," added Pete Notter at Madison Capital Funding.

"Strategics are active and private equity investors are active," said Brian Schneider at Northstar Capital. "There are a lot of buyers in the market right now, and that is driving up price for smaller deals." "I don't think we've really seen anything trade under 7x, other than energy, storied credits, or smaller commercial businesses," added Bob Marcotte at Gladstone Capital.

"There is a difference between the smaller middle market ($5-15 million of EBITDA) and the larger companies," observed Randy Schwimmer at Churchill Asset Management. "The former is still seeing valuations in the single-digit range."

Leverage

The sectors garnering high purchase price multiples are the same ones attracting high leverage multiples. Lenders are financing the multiple accretion.

"It's just crazy valuations. There are cyclical businesses trading for double-digit multiples, which honestly is just shocking. Businesses that used to be 7x to 8x are trading for 9x to 10x times. It just seems like double-digit multiples are more of the norm than the exception in this market," said Jeffrey Day at Madison Capital Funding. "Much of the reason leverage is so high is because lenders are looking at a 35-40 percent loan-to-value, but are those values really realistic when the next cycle comes? Will you be able to sell that business for 10-plus times? I think the answer is probably no, so I think in many cases we're fooling ourselves with a loan-to-value argument."

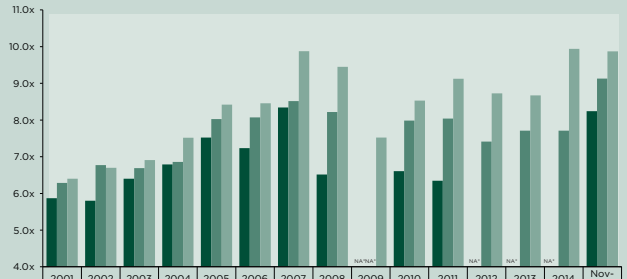
"If you are a recurring cash flow software subscription-oriented business, you are going to get very cheap senior capital. And the result is, it is going to inflate the multiple that the business would likely trade at. Conversely, if you are dealing with a Tier II auto parts supplier or an industrial manufacturer, by definition you are going to have a lower leverage attachment point, and compress the price that the sponsor is willing to pay to make that deal work," commented Marcotte. "Elevated leverage is a tough call for a sponsor as the business may not support the need to achieve their desired returns."

"Any good company is going to trade for 8x or more. When you talk to sponsors, the number one complaint they have is valuation, and it is the main reason they drop out of a process."

—Tim Clifford
Abacus Finance

Purchase Price Multiples in Middle Market LBO Transactions

EBITDA Valuation Multiples by Transaction Size



	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	Nov-15
<$250 million	5.9x	5.8x	6.4x	6.8x	7.5x	7.2x	8.3x	6.5x	NA*	6.6x	6.3x	NA*	NA*	NA*	8.2x
$250-$499 million	6.3x	6.8x	6.7x	6.9x	8.0x	8.1x	8.5x	8.2x	NA*	8.0x	8.0x	7.4x	7.7x	7.7x	9.1x
$500 million+	6.4x	6.7x	6.9x	7.5x	8.4x	8.5x	9.9x	9.4x	7.5x	8.5x	9.1x	8.7x	8.7x	9.9x	9.9x

*NOTE: Data not reported due to limited number of observations for period.

Source: Standard & Poors LCD.

Valuation

Strategics

The wild card in today's competitive auctions are corporates, who are keeping private equity buyers on their toes. Corporate buyers are eager to make acquisitions and accelerate growth beyond just organic means. Armed with strong balance sheets and quantifiable synergies, they are demonstrating success displacing private equity in competitive auctions and keeping purchase price multiples at current elevated levels.

"Strategics are winning the lion's share of auction processes if they want to," commented Scott Reeds at Citizens Financial Group. "Sponsors are having a hard time winning deals, and in certain circumstances, they are finding ways to stretch to win. They have to pay up to own these businesses."

"What has absolutely continued to put so much push behind these elevated multiples are the corporates. Their balance sheets are in pristine condition. They are able to buy the company at a different basis because they are looking at it not as a sole platform but as a strategic add-on. The scope of the diligence is going to be different, and the conditions around the purchase are going to be different, so they are able to move through a process with a lot more speed and efficiency," remarked Katie Jones at BMO Capital Markets. "That has been a theme that has continued to be prevalent over the past year or two. All of the corporate issuers are very interested in making acquisitions."

"We definitely have seen outlier valuations that come through strategic transactions."

—Pete Notter
Madison Capital Funding

"In a low GDP environment, companies are looking beyond organic growth to enhance value. Acquisitions are part of the answer," observed Randy Schwimmer at Churchill Asset Management. "Corporates with cash are driving valuations as much as sponsors. And scale can create premium valuations." "Strategics have a very cheap cost of capital, heady growth objectives, and a great deal more pricing flexibility," added Bob Marcotte at Gladstone Capital. "We've seen significantly greater premiums than 1x-2x when companies are able to attract strategics."

Size is becoming less of a determinant, as strategics are actively pursuing acquisitions even in the lower middle market. "Strategics are much more active in buying now," said Tim Clifford at Abacus Finance. "We've had some anticipated runoff in our portfolio this year. In those situations, the companies were sold to strategics, as opposed to being sold to other sponsors. We've seen several deals go that way." Bob Erwin at Babson Capital added, "Three out of the four exits we had this year have been sales to strategic buyers. The strategics definitely seem to be a factor and are driving valuations even for the small companies."

"We have seen quite a bit of straight corporate strategic interest, and that has contributed to valuation multiple expansion," concurred Pete Notter at Madison Capital Funding. "Those companies naturally can afford to pay more because they recognize more synergies than financial buyers can. So we definitely have seen outlier valuations that come through strategic transactions."

Terms and Structure

Highlights:

- Volatility has not really impacted leverage levels.
- Leverage creep of ~1/4 to 1/2 turn
- Leverage is being driven by the nonbanks who are not governed by leveraged lending guidance, with highly levered transactions well above 5x EBITDA
- Firming of spreads across the board, 25-50 basis point upward bias across the market
- Spread widening is more pronounced in second lien
- Reduced Libor floors: 50-75 basis point floors in some deals
- Pullback on the most aggressive structures for cov-lite in the large market, a leading indicator

Leverage levels are mirroring the 2007 peak. Broadly, lenders characterize the current market by "6 is the new 5", with the majority of businesses getting leveraged between 5x and 6x. There are exceptions across the deal spectrum where smaller companies are also getting leveraged very high. Scott Reeds at Citizens Financial Group summarized the market, "In the broader market, very good companies are getting leveraged at 6x-7x. In the middle market, very good companies can attract 6x-6.5x. Below $25 million of EBITDA, leverage caps out around 5.5x—6x."

"It is still a very liquid and issuer friendly market no question about it," commented Randy Schwimmer at Churchill Asset Management. "Appetite for leverage, particularly in the non-bank world for better credits, remains robust."

Lenders are staying relatively disciplined in terms of the types of companies they're financing, Rich Jander at Maranon Capital told us. "They are not reaching for bad companies just to get yield. Conversations are more around what is the appropriate leverage level."

"Appetite for leverage, particularly in the non-bank world for better credits, remains robust."

—Randy Schwimmer

Churchill Asset Management

Flight to quality is surfacing in pricing and structure. "Broadly, you are seeing a flight to quality that manifests itself in higher relative leverage and lower pricing for what are perceived as higher quality credits," offered Scott Turco GSAM Private Credit Group. "The lower quality credits are gapping out both in terms of their pricing and lower leverage multiples. For the "A" quality credits below $25 million of EBITDA, pricing and leverage generally hasn't changed. However, for "B" or "C" quality credits, senior pricing has gapped out 50 basis points or more. Sub debt has probably gapped out 75 to 100 basis points."

Brent Burgess at Triangle Capital summarized: "For the highest quality companies we are seeing leverage go up to 6x. We're not seeing a lot of that leverage. If it is an "A+", it will get the 6x. If it is an "A", maybe it is 5.5x. If it is an "A-" or a "B", it is 5x. The senior leverage range is fairly tight, 3.5x-4.25x. Senior leverage is topping out at ~4.5x, and many times that is stretch senior."

Banks are adhering to regulatory restrictions on leverage. "The 6x total leverage ceiling is a big issue for banks, as is the 4x senior leverage ceiling. So you're seeing non-regulated lenders structure deals slightly north of 4x leverage because that makes it more difficult for the banks to compete," Burgess added.

Broadly, volatility has resulted in relatively little change in lender behavior or posture in the traditional middle market, said some lenders. "We are seeing deals in cyclical industries that we wouldn't finance getting leverage multiples that are prototypical of more stable credits with less sensitivity to economic cycles. For as long as that is occurring, people are not cutting back on their risk appetite," commented Robert Radway at NXT Capital.

Valuations are at or nearing a peak, which is driving leverage asks up. "Purchase price multiples are very high. If sponsors are paying up, they are pushing their lenders to get more leverage and most are getting the leverage

they are asking for," observed Tim Clifford at Abacus Finance.

Some lenders argue it is still a balanced market. "On the whole, I think it is a very segmented market," observed Allan Allweiss at LBC Credit Partners. "We see a lot of oppportunities to support people on an enterprise value basis at leverage multiples of 2.5x-3x and see a fair number where we are comfortable supporting borrowers at closer to 5x."

EBITDA below $10 million

- 1/4 to 1/2 turn reduction in total leverage
- Capping out at 5x total leverage
- $5 million is the line of demarcation for lenders, down from $10 million, where structure and pricing reset
- Increasing use of senior stretch and unitranche financing
- 50 basis point premium on pricing

Bank execution

- Senior and total leverage 2.5x/3.5x. Max leverage is 3x/4x depending on credit profile
- L+300-400 (+/- 50 basis points) without a floor
- Bank pricing typically 50 to 100 basis points less than institutional pricing

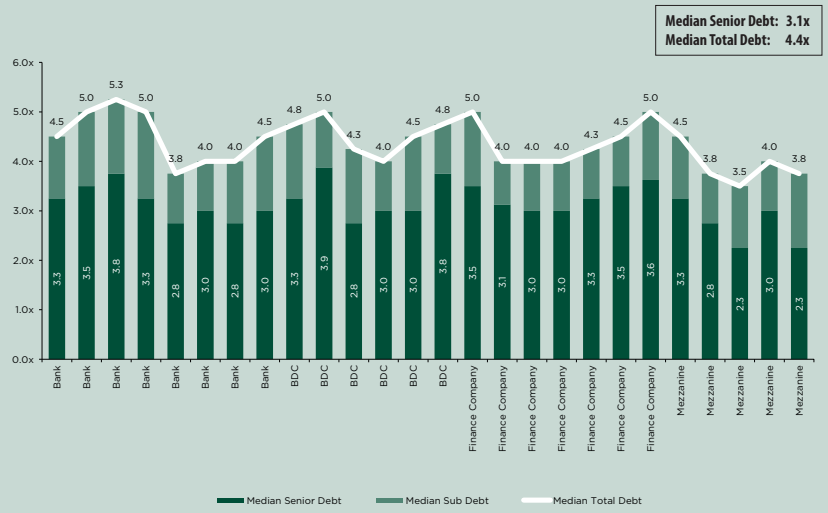
Nonbank execution

- Strike zone for most senior leverage is 2.75x-3.5x
- Total leverage 4x-5x
- Mezzanine is 1.25x – 1.5x
- Senior pricing L+475-525, 1% floor
- Seeing 75 basis point floors

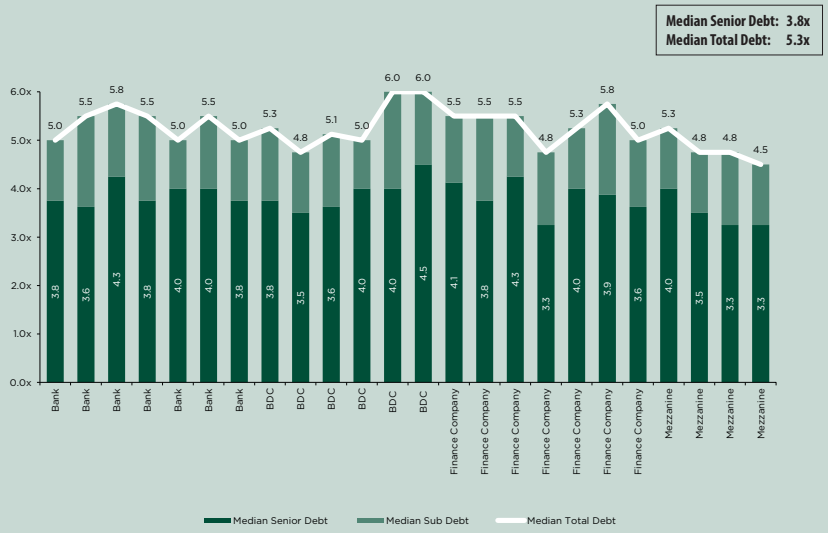
Survey of Capital Providers

Leverage Multiples (Debt to EBITDA)

EBITDA below $10 million



EBITDA between $10 million and $25 million



Source: BGL Research.

Terms and Structure

EBITDA below $10 million

Senior stretch

- Straight senior is 3.5x-3.75x
- Maximum leverage 4.25x-4.5x
- 50-75 basis points of additional pricing
- L+525-550 pricing, 1% floor

Unitranche

- 4.5–5x range (1/2 turn inside a mezz read)
- Full leverage, all-in 5x-5.25x; would have to be closer to $10 million of EBITDA than $7 million for high end of range
- L+800-850, 1% floor

Pricing below $10-15 million of EBITDA is going to be more consistent. Above $15 million, pricing is going to be moved by the broader markets and supply and demand dynamics.

EBITDA between $10 million and $25 million

- Leverage up 1/4 to 1/2 turn
- Senior leverage 3.25-4x
- Total leverage 5x - 5.75x
- Mezzanine is 1.25x–1.5x
- Senior pricing L+425-475, 1% floor

Unitranche

- Leverage up to 5.5x-6x
- Pricing L+650-750, 1% floor

Lenders are seeing more 6 handles in the lower end of the middle market.

EBITDA above $25 million

- Leverage profile 4x-4.25/5.25x–5.5x (in some cases up to 6.5x total leverage)
- Senior pricing L+425-525, 1% floor
- Senior L400 +/- if banks only, no floor

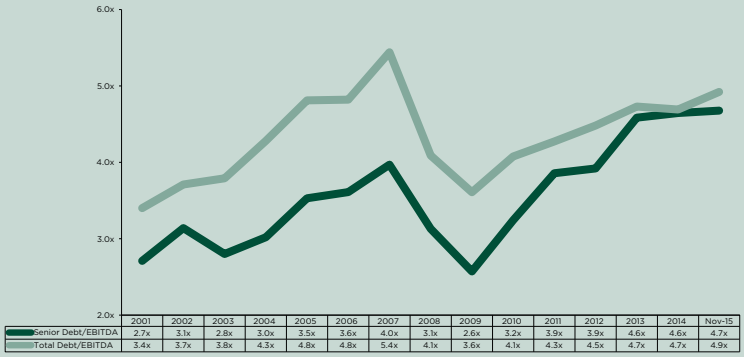
Stretch L+500-600, 1% floor

Unitranche

- Leverage generally 1/4 to 1/2 turn inside mezz read
- 5.5x – 6.5x total leverage
- L+600-700, 1% floor

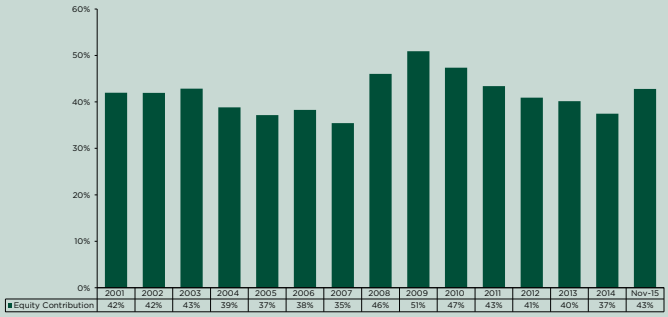
Acquisition Financing Trends

Leverage



Middle market enterprise values between $25 million and $500 million.
Source: Standard & Poors LCD.

Equity Contribution



Second lien

- EBITDA of $20-25 million is the typical breakpoint where structures transition over to second lien.
- Leverage 5.25x–5.5x
- Pricing L+850-1000, 1% floor
- Long-term trend has been between ~350 to 400 basis points wide of first lien.

Equity

Equity contributions are still strong at 35-40 percent. For smaller deals, lenders like to see 40-45 percent minimum equity checks.

"Minimum equity is going to be a key structure determinant," said Katie Jones at BMO Capital Markets. "In the middle market, we like to see 35 percent, sometimes even 40 percent." Jones continued, "Equity contribution is one very key differentiator as we compare today's market to prior hot markets. In 2007, 30 percent was the standard even for the lower middle market, even creeping to 25 percent. Minimum equity thresholds have still held up quite nicely. Investors have still been able to hold on to more reasonable capital structures, notwithstanding the fact that leverage has crept back up to those predecessor year levels."

Terms

Terms continue to be under pressure. Given the market volatility, terms are not getting any more aggressive but are not expected to get any less aggressive, said lenders in our survey.

Some terms that historically were more lender-friendly are getting more push back and getting much more aggressive. Lenders peg the EBITDA size at around $20-25 million where large market terms begin to surface:

- Free and clear baskets on incrementals
- Ratio debt on incrementals
- Starter baskets
- Available amount baskets
- Permitted investments
- Restricted payments
- Cov-lite was dipping below the "unofficial" $50-60 million EBITDA floor. With the recent volatility, that threshold has increased.

"Term compression was getting borderline egregious going into the summer months. We were seeing covenant cushions of 30-35 percent and wider," commented Fred Buffone at Fifth Street. "I think we will have some reversion back because of the recent volatility in the market. I would expect to see tighter cushions and an increase in covenants."

"Quality deals that are clubbed or syndicated are still getting done with relatively aggressive terms and leverage points," said Scott Reeds at Citizens Financial Group. "However, you are seeing investors across the spectrum not afraid to push back on certain of the most aggressive terms depending on the quality of the deal. In certain cases to get deals done, sponsors or the arrangers have to be flexible to make some changes to get them over the finish line right now."

> *"In today's market, terms are on the looser side than where they'd be in a normal range."*
>
> *—Andy Steuerman*
> *Golub Capital*

"I think if it's a really good deal that's sought after, it's going to go wide, and if it's a deal that is hard to get done, it's going to be tighter," remarked Andy Steuerman at Golub Capital. "In today's market, terms are on the looser side than where they'd be in a normal range."

Everything continues to push down, indicated Katie Jones at BMO Capital Markets. Terms that were reserved for companies with EBITDA of $50 million are now in the $25-50 million and the $25-50 million are now in the $15 million. Concepts that used to be reserved only for rated, distributed deals are very firmly in the middle market. "The higher end of the middle market ($25-50 million of EBITDA), has gotten so competitive for private equity firms to buy platforms, they now are spending more time in the lower end of the middle market, putting together

Terms and Structure

companies in the $10-15 million EBITDA size range. These are firms that tend to expect a certain set of terms. That is part of the reason you are seeing this trend," Jones said. "The other part is just this continued supply/demand imbalance. A lot of the middle market participants are sitting on a fair amount of liquidity and need to put money to work. When competing with the unitranche product, that is where terms continue to work in the favor of issuers, even as you are going to the lower end of the middle market, which has typically enjoyed tighter structures and stronger yields."

With amortization down as far as it could go, covenants were the target in 2015, with lenders seeing more pressure even moving down to $10 million of EBITDA. "Obviously the market is still pushing back and saying no. However, we are seeing some market participants get aggressive—maybe they really like the asset, the sponsor—and want to take the deal off the market," added Jones. "At the smaller end of the middle market, you don't have to syndicate so you can do whatever works for your own balance sheet. That is how those terms are getting papered."

In the traditional sponsored middle market ($100 million deal size and below), lenders remain disciplined. "For the most part, there is a discipline around covenant packages in the lower middle market (<$50 million EBITDA). There is increased flexibility influenced by market liquidity and middle market sponsors introducing larger market terms, but the overall discipline remains.," offered Scott Carpenter at Crescent Direct Lending.

- Covenant packages typically include 2 to 3 operating covenants, as opposed to 3 to 4. Most deals will have at least one covenant, probably 2 or 3.
- In senior-only executions, typically there is a leverage covenant. If a senior/mezzanine execution, there will be a senior and total leverage covenant and a fixed charge covenant. The minimum EBITDA covenant is the biggest give.
- Covenant cushions are wider: 20-25%, widening from 15-20%
- Asks for 1 percent amortization increasing
- Banks will typically require 7.5–12.5% annual amortization. Most aggressive is 2.5–5.0%
- Equity cures, builder baskets (Starting at $10 million EBITDA)
- Requests for capex lines and acquisition lines, committed or uncommitted

"In the sponsor finance business, almost everything goes out at 1 percent, and it is by and large size agnostic. The lowest the nonsponsored market has seen is 5 percent," remarked Katie Jones at BMO Capital Markets.

> *"Terms that at the margin were a little tighter historically became much more borrower-friendly in the past six to nine months or more. We've seen a slight rebalancing there."*
>
> *—Robert Radway*
> *NXT Capital*

"Smaller issuers are increasingly able to take advantage of sub 5 percent annual amortization whereas historically they hadn't been able to do so," said Pete Notter at Madison Capital Funding.

"Clearly covenants were eroding for a while. They have firmed a little bit," offered Robert Radway at NXT Capital. "Loan documentation became much more borrower-friendly. Whether it is default provisions and cure periods and cure rights, things that at the margin were a little tighter historically and became much more borrower-friendly in the past six to nine months or more. We've seen a slight rebalancing there."

Holds

Hold levels continue to rise, a development which lenders call an "arms race" in middle market lending, and remain a differentiating variable in how lenders are winning deals today. "If you want to win an agency, one way to differentiate yourself is to use your balance sheet. Provide your sponsor with a greater certainty of closing," commented Jeff Kilrea

at CIT Sponsor Finance. "You'd better have substantial hold capacity to win the lead left," added Robert Radway at NXT Capital. "Hold size continues to be a competitive differentiator," observed Dan Letizia at THL Credit. "The major change today is that there are more lenders willing to take large and growing bite sizes. Ultimately, it depends on the deal size and the type of execution the sponsor is looking for."

Through strategic relationships and growing balance sheets, the number of lenders looking to take on and hold higher positions has increased significantly over the last three years, according to Randy Schwimmer at Churchill Asset Management. "Back in 2011, arrangers could hold a $50 million check. Then it went to $75 million. Today a dozen or more providers can hold $100 million comfortably. Some are north of $200 million. It's all distributed among funds managed internally by that provider."

Large hold levels are serving to "disintermediate a lot of the syndicated product," Schwimmer highlighted in a U.S. roundtable conducted by *Private Debt Investor*. Successful lenders are creating virtual balance sheets which Schwimmer says is the next step. "Instead of distributing to outside investors, it's to inside investors. I've called it the cargo pants strategy. Lenders have created these multiple pockets to put capital in," Schwimmer said. "If you look at these unitranche providers, they are all trying to create multiple pockets of capital in order to do that. That is the biggest change in the market. It is the ability of these middle market arrangers to underwrite and hold more capital in larger financings themselves." Schwimmer cited Golub Capital, which has over a dozen different vehicles, among them CLOs, a BDC, and separate managed accounts with insurance companies. "So that is an enormous advantage."

"We have participated by developing significant hold capacity on our own, and our competitors have followed suit with great success in being able to speak for and take down very large holds. It makes a difference," commented Robert Radway at NXT Capital.

"We have created a competitive advantage where we play in our straight senior debt orientation." "We've raised significantly more capital over the last 24 months so our hold levels have expanded greatly. There's certainly an advantage to being able to hold more, and we've done everything to increase our hold limit," offered Tom Aronson at Monroe Capital.

"Players are absolutely trying to differentiate themselves based on scale," offered Rich Jander at Maranon Capital. "A big focus for us has been to build scale in our business." Jander added, "In the private credit space, you are absolutely starting to see the development of brands over the last decade. That has accelerated over the last couple of years as more institutional investors have gotten interested in private middle market credit. So now you are starting to see these brands attract more capital, and as they attract more capital, then hold size is increasing."

"Players are absolutely trying to differentiate themselves based on scale."

—Rich Jander Maranon Capital

Generally speaking, a facility size approaching $200 million will be more of an institutional execution, and there is sufficient appetite to underwrite in the current environment. Below that size, a club execution can be completed easily given lender depth in the market, said participants in our survey. "You are going to see bigger deals get done," commented Fred Buffone at Fifth Street. "You are seeing one-stops or club deals get done in excess of $300 to $500 million with one party."

Different lenders have different goals with their hold level. "In general, regulated entities are more balanced with their approach, holding enough to lead a transaction while attempting to manage those hold levels to reasonable levels. Finance companies and other institutional investors are generally more aggressive with their hold levels," commented Scott Reeds at Citizens Financial Group.

Outlook

"Steady as she goes" is the mindset of lenders looking out to 2016. Survey participants revealed a sentiment of cautious optimism, underscored by a positive outlook on the economy and the expectation of moderate growth. Uncertainty around the state of the global economy and interest rates is clouding visibility and feeding volatility, with geopolitical risks of primary concern.

Overall, 2016 will be business as usual. Nothing on the horizon signals a sea change. While most companies are still reporting profitability, lenders will be focused on managing the health of their portfolios, as portfolio performance will be critical. The market will remain competitive with lenders hoping for stable pricing and lower leverage. Higher selectivity will reign in this period of uncertainty.

"Our markets are going to remain focused on China and the other emerging markets, Europe, and industrial investment activity in the U.S. A lot of the volatility is also created by uncertainty over the strength of the U.S. economy overall and what that means for when the Fed starts raising rates and the pace of rate increases thereafter," commented Scott Reeds at Citizens Financial Group. "Until there is some more clear visibility around those issues, there is going to remain some volatility. Visibility on these issues should hopefully provide some continued tailwinds to our market and allow for some liquidity to re-enter the market."

"It is inevitable that there will be some type of a correction but the severity and timing is unknown," observed Scott Carpenter at Crescent Direct Lending. "The challenge in this market is to stick to your knitting and get paid for the risk you underwrite, whether it's credit, structure, or cyclicality."

"Institutionally, our view is that the current environment is very aggressive and overheated, and the risk return is not great in today's market. Having said that, we are enterprise value, relationship lenders, so we're going to continue to deploy capital every year, regardless of where market leverage and pricing are. We're going to pick and choose our spots, defend our credits, and try and avoid the potential landmines," said Jeffrey Day at Madison Capital Funding.

"I don't think the downturn will happen in 2016, but we're long in the business cycle."

—Preston Walsh
PNC Mezzanine Capital

On the Economy

"I don't think the downturn will happen in 2016, but we're long in the business cycle. We are another year closer to a downturn, and we are managing everything with that in mind."
Preston Walsh, PNC Mezzanine Capital

"We are much closer to the next cycle than we've been, so you will definitely see lenders being more cautious particularly now that we're starting to see some backup in the broader market. That tends to ultimately make its way down to the middle market. We are being more cautious and picking and choosing our spots, so I think we're probably not the only ones that are doing that."
Jeffrey Day, Madison Capital Funding

"You're always worried that it's later than you think. Most lenders think we're in the 7th inning or so. Hard to believe it's much beyond that with so much liquidity in the system."
Randy Schwimmer, Churchill Asset Management

"We all know that the only certainty is we are one day closer to the next downturn than we were yesterday. As a result, we are more cognizant from a portfolio construction perspective. Can we build a portfolio that isn't over concentrated in a particular industry? Are we picking what we think are market leaders within those industries, and are we levering them as prudently as we can? That is what we are really focused on, rather than trying to time the next cycle."
Rich Jander, Maranon Capital

"Most people think we are definitely past the 5th inning. The pessimists say the 8th or 9th. My view is we are probably in the 7th inning. It is an election year, so I think you are going to see continued growth and stability at least through the election. The question is what happens beyond the election and going into 2017."
Fred Buffone, Fifth Street Asset Management

"In the economy, there has been a deceleration of growth, and certain industries such as metals and mining and energy have been severely impacted by global factors. However, there is an expectation that growth will return in the second half of 2016. The challenge for lenders is selectivity in lending opportunities and appropriate structuring of credit facilities in anticipation of the next economic downturn. We have already observed more covenant violations and amendments occurring for middle market companies. While many of these companies may be in compliance with their fixed charge coverage covenant, they are having issues staying within their leverage covenant."
Ira Kreft, Bank of America Merrill Lynch

On Interest Rates

"While interest rate increases will make financing more expensive, it should not have a material impact on the market. The market has already priced in an increase at the December FOMC meeting, and we expect gradual rate increases in 2016."
Ira Kreft, Bank of America Merrill Lynch

"I think there is a natural assumption that leverage multiples will come under more pressure as the cost of capital increases for borrowers. I don't expect that we are going to see a big spike in the overall baseline rates, but I do think that as rates continue to tick up in 2016, you are going to begin to see pressure on leverage multiples. I don't think you can continue at peak leverage multiples in the face of slowly increasing interest rates."
Pete Notter, Madison Capital Funding

"While interest rate increases will make financing more expensive, it should not have a material impact on the market."

—Ira Kreft
Bank of America Merrill Lynch

"A Fed rate hike would be beneficial. It would take uncertainty off the table. It depends on what happens after the first hike. Are we "one and done" or "two and through?" The pace will probably be very deliberate."
Randy Schwimmer, Churchill Asset Management

"If the Fed starts to have some conviction around the direction of the economy—that it is sufficient to raise rates—I think it would be a good thing for the loan market. I think it will give people some confidence and should slow down some of this volatility."
Scott Reeds, Citizens Financial Group

"We don't anticipate any drastic moves by the Fed, but hopefully slight moves and/or signaling will impart more prudent capital structures. Generally speaking, people have some time to react to that and put out more assets that reflect a structure that has higher interest rates. We know rates are not going down."
Brian Schneider, Northstar Capital

On Liquidity

"The middle market will remain liquid, given the capital flowing into the space, regardless of rate hikes. 2016 appears bullish for both lenders and borrowers. That will continue as non-banks replace capacity being lost thanks to regulatory pressures on the banks."
Randy Schwimmer, Churchill Asset Management

"I haven't seen any examples of liquidity shortfalls in the market, and I don't expect to see those in the immediate term. I think that the current levels of market liquidity should be maintained for the foreseeable future."
Peter Notter, Madison Capital Funding

"It should still be a good lending market for 2016. Credit is available, but the impact of regulation is being felt as more discipline is instilled into lending to reduce the systematic risk to the banking system."
Ira Kreft, Bank of America Merrill Lynch

Outlook

"I think many of the nonbank lenders have raised significant capital and are in a good position for 2016. I don't think you'll see any significant slowdown from a financing standpoint in the upcoming year."
Tom Aronson, Monroe Capital

"If the volatility in the broader segment of the leveraged finance marketplace persists, it is certainly going to create some uncertainties for other providers of leveraged finance.

"The equity cost of capital of BDCs has gone up dramatically, which on average, is making them less competitive. If the cost of equity does not come down, and debt costs rise, I think the BDCs are going to be more challenged. In addition, there are a variety of BDCs that are facing investor pressure on their stock. How they perform and how they are perceived in the marketplace may affect capital availability."
Bob Marcotte, Gladstone Capital

"BDC leverage could go to 2:1 next year. I am not sure how profound an affect that will have, because I think BDCs will migrate to less expensive deals. It won't create much more demand to loan product in the markets they currently serve. I just think they'll go to a cheaper product and a little bit better asset quality."
Allan Allweiss, LBC Credit Partners

"There seems to be a lot of appetite for middle market debt. There are institutional investors interested in the asset class and are putting more money to work in this market than they did historically. So I don't see capital availability changing any time soon."
Dan Letizia, THL Credit

"Many of the nonbank lenders have raised significant capital and are in a good position for 2016. I don't think you'll see any significant slowdown from a financing standpoint in the upcoming year."

—Tom Aronson
Monroe Capital

"It will continue to be an arms race for managers in private middle market credit to build scale and brands. It is going to be a virtuous cycle. People are going to be able to attract capital because they have those brands. I think you will see more of a convergence around managers in the alternative space too. You will see private equity platforms look to build complementary platforms in private credit."
Rich Jander, Maranon Capital

On Leverage & Pricing

"I think we will continue to see reasonable spreads in line with historical norms for senior debt in the middle market. There has been a very constructive balance between supply and demand, where we see periods of aggressiveness and tightening. There has been and will continue to be a very constructive equilibrium for both buyers and sellers and for both lenders and issuers."
Randy Schwimmer, Churchill Asset Management

"The middle market will adjust up to maintain its relative position with the larger market. Right now that gap has narrowed or even gone negative and that doesn't persist. If anything, pricing may go up. I don't think leverage is going to go up or down."
Rich Jander, Maranon Capital

"Credit cycles are like pendulums. We currently appear to be near or at a peak regarding market leverage with a Fed influenced market resistance at the 6x level. Regarding pricing, the premium to broadly syndicated is currently thin by historical standards. Any material deterioration in portfolio credit quality has the potential to quickly impact market liquidity and therefore leverage and pricing. The lower middle market remains less efficient and has generated a premium to the broadly syndicated markets over time. Covenant packages are also more robust. We expect these trends to continue over the longer term."
Scott Carpenter, Crescent Direct Lending

"I don't expect things to get more aggressive, and on the margin, you might start to see a little tightening in pricing and leverage. There is recognition that we've hit the top, so there is no reason to be heroes and get more aggressive. You're just going to continue to try and find good companies, not give away the store on structure, and just accept the fact that pricing is still a little bit lower than it should be."
Mike Foster, Midwest Mezzanine Funds

"Leverage should come down. It should seek a more prudent level in a rising interest rate environment. Maybe pricing ticks up a little bit."
Jeff Kilrea, CIT Sponsor Finance

"I don't think we're going to see much erosion from a lender's point of view in pricing, but I don't see a dramatic change either on the upside. Similar leverage."
Robert Radway, NXT Capital

"I think leverage multiples are at their peak. If volatility in the broadly syndicated market persists, you could actually see pricing widen in the lower middle market over the next 12 months."
Chris Williams, Twin Brook Capital Partners

"I think we've hit the peak in leverage. If you look at the previous cycles, we've always peaked right around 6x total leverage depending on the sector. You won't see leverage going up as a result. I think we are going to be in this narrow range on pricing, leverage, and purchase price multiples. Absent any volatility and supply/demand imbalances, the middle market should be fairly stable with some periods of choppiness for the next couple of quarters."
Fred Buffone, Fifth Street Asset Management

"If the market slows down, you are going to continue to see slightly higher leverage and lower pricing for people to win deals. From a senior lender perspective, you are going to see the push to put more leverage on deals and to reduce pricing on deals."
Steve Kuhn, Fifth Third Bank Structured Finance

"With ample market liquidity, leverage and pricing should stay in the same range for high quality credits, maybe slightly more lender-friendly. Deals with hair will continue to have some combination of lower leverage, higher pricing, and tighter credit documents. These levers are pulled differently depending on lenders' varying yield thresholds and risk appetites, but late in the credit cycle we expect a greater focus on risk versus reward."
Dan Letizia, THL Credit

"Leverage will not change materially. The market still seems to be in a period of discovery in terms of where deals need to get priced. In the near term, it will settle at a slightly higher rate, and ultimately, the smaller middle market deals will creep up.
Steve Robinson, Antares Capital

On M&A Activity

"I think leverage multiples are at their peak. If volatility in the broadly syndicated market persists, you could actually see pricing widen in the lower middle market over the next 12 months."

—Chris Williams Twin Brook Capital Partners

Lenders are hesitant to forecast the direction of the M&A market as past predictions have fallen short of expectations. Absent a catalyst to materially change volume in either direction, the oversupply of capital is expected to keep pressure on structure and pricing.

"Middle market M&A activity will continue to be healthy through the early part of next year. Macro events tend to have a transitory effect. The appetite for yield on the part of investors and the search for financing outside of the bank market by borrowers have both come together in a very balanced way that is creating opportunities for everyone. That won't change any time soon."
Randy Schwimmer, Churchill Asset Management

Outlook

"Many sponsors took advantage of the hot markets we have seen for the past couple years. Others are looking for add-on acquisitions. If the debt markets settle down, that should present good conditions to bring out new sell-side opportunities in the first quarter. Sellers are talking about accessing the market and thinking about the conditions necessary in which they'll come out, which is a good leading indicator."
Katie Jones, BMO Capital Markets

"It seems like there are a lot more generalist-type deals in the market—automotive, chemicals, consumer products. I would expect more verticals to participate in the lending market next year. I think we'll see a renewed LBO market."
Mark Tauber, CapitalSource

"I am not calling the trough, but people are going to start looking for opportunities in the energy sector. Opportunity can be found in distressed or troubled areas."
Jeff Kilrea, CIT Sponsor Finance

"2016 will look a lot like 2015. I wouldn't be surprised to see moderately but not materially higher volume. So, if the market ends up having shrunk 30 percent this year, I would anticipate a rebound of 10-15 percent in 2016."
Robert Radway, NXT Capital

"You will see an uptick in deal volume as private equity firms continue to be pressured to put fresh capital to work in new platform deals. I think you will also continue to see larger corporate divestitures. The broader markets are rewarding pure play companies, which are attracting higher multiples. As a result, you are seeing some larger chemical and industrial companies sell off non-core assets which leads to greater middle market deal volume."
Scott Turco, GSAM Private Credit Group

"Absent a recession, the market is going to continue on as it has. It is going to be door-to-door guerilla warfare to find deals for the next five years. You will have to spend more time and energy sourcing deals, knock on a lot more doors, and meet a lot more people than you ever had to in the past."
Brian Schneider, Northstar Capital

"Strategic buyers will continue to be active in 2016. Organic growth has been modest for many companies. Corporate America has historically high levels of cash and credit is available at attractive terms. And, their ability to justify higher valuations because of their ability to take out expenses and effect synergies. Some privately-owned companies will come to market as sellers realize it is time to sell from a performance and economic cycle standpoint and as concerns about declining valuations set in. Lower valuations should propel increased activity for a number of private equity sponsors that prefer to acquire companies at multiples below 6x."
Ira Kreft, Bank of America Merrill Lynch

> *"I would expect more verticals to participate in the lending market next year. I think we'll see a renewed LBO market."*
>
> *—Mark Tauber*
> *CapitalSource*

"There will still be a lot of sponsors with money to put to work, and they're actively looking to do that. Obviously, if the economy does slow down, that will put a bit of a crimp on M&A activity because you will find more of a dislocation between buyers and sellers. As long as the loan market is stable, I think you could see an increase in recaps as sellers look to hold on to companies for another 12 to 24 months."
Steve Robinson, Antares Capital

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For questions about content and circulation, please contact Editor and Director of Research, Rebecca Dickenscheidt, at rdickenscheidt@bglco.com or 312-513-7476.

Global Leaders

Representative Transactions:

Profile — a portfolio company of — Mid Oaks Investments LLC — acquired by — Platte River Equity — Brown Gibbons Lang & Company
ENVIRONMENTAL SERVICES

GED Integrated Solutions — acquired by — ALTUS Capital Partners — Brown Gibbons Lang & Company
INDUSTRIALS

Celsis — acquired by — charles river — Brown Gibbons Lang & Company
HEALTHCARE

Ferragon Corporation — obtained financing provided by KeyBank, Comerica, Michigan Economic Development Corporation — Brown Gibbons Lang & Company Real Estate Advisors
REAL ESTATE

Hynes Industries — recapitalized by — Resilience Capital Partners — Brown Gibbons Lang & Company
METALS

EZ — acquired by — 7-Eleven — Brown Gibbons Lang & Company
RETAIL

Heritage Park — has partnered with — Texas Health Ventures Group — a joint venture between — United Surgical Partners International and Baylor Scott & White Health — Brown Gibbons Lang & Company
HEALTHCARE

Orthoplastics — acquired by — MedPlast — a portfolio company of — Baird Capital — Brown Gibbons Lang & Company
PLASTICS & PACKAGING

Fleming County Hospital — acquired by — LifePoint Health — Brown Gibbons Lang & Company
HEALTHCARE

TENEX Capital Management — acquired — Progressive Employer Management Company — Brown Gibbons Lang & Company
BUSINESS SERVICES

Premier Dermatology — has partnered with — Forefront Dermatology — a portfolio company of — Varsity Healthcare Partners — Brown Gibbons Lang & Company
HEALTHCARE

GLC Great Lakes Castings — a portfolio company of — Republic — acquired by — The Reserve Group — Brown Gibbons Lang & Company
METALS

Tempus — acquired by — Grupo Financiero Monex — Brown Gibbons Lang & Company
BUSINESS SERVICES

EORM Environmental, Health, Safety and Sustainability Consulting — acquired by — bsi. — Brown Gibbons Lang & Company
ENVIRONMENTAL SERVICES

Obtained Financing for Construction of the Aloft Hotel in Beachwood, Ohio — aloft — provided by — usbank and Private Equity Investor — Brown Gibbons Lang & Company
REAL ESTATE

emanuel gerualdo — acquired by — Jacob Ash Holdings, Inc. — Brown Gibbons Lang & Company — Meridian Capital
CONSUMER

STB Stahlhammer Bommern — acquired by — CAMCO Columbus McKinnon — Brown Gibbons Lang & Company
INDUSTRIALS

TERRArenewal Wastewater Residuals Division — a portfolio company of — Saw Mill Capital — acquired by — Management and McLarty — Brown Gibbons Lang & Company
ENVIRONMENTAL SERVICES

MACTek — acquired by — PEPPERL+FUCHS — Brown Gibbons Lang & Company
INDUSTRIALS

PERFECTFIT — a portfolio company of — The Anderson Group — acquired by — Cross River, LLC — a subsidiary of — Shanghai Shenda Co. Ltd. — Brown Gibbons Lang & Company
CONSUMER

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