



Middle Market

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

November 2014

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& Company

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Scarcity and Abundance

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M&A activity is on the rise but still lags the growth in liquidity. Flexibility is a point of differentiation in a frothy lending environment.

Where's the Peak?

Page 25

Structures are back to 2007 levels with loosening observed in all segments as sponsors play across markets. Wary lenders are eyeing a cycle peak.

Outlook

Page 32

Ample liquidity is expected to help support M&A activity and foster a continued aggressive posture in 2015. Rising interest rates might be the offset and bring balance.

A large image showing several interlocking puzzle pieces arranged on a background of a US dollar bill. The puzzle pieces are cut out from the bill, and the word 'Insider' is written in large, white, sans-serif font across the center of the puzzle.

Insider

Inside the Middle Market is published by Brown Gibbons Lang & Company, a leading independent investment bank serving middle market companies throughout the U.S. and internationally.



Participating Firms

Abacus Finance Group, LLC
Babson Capital Management, LLC
Bank of America Merrill Lynch
BMO Capital Markets
BNY Mellon-Alcentra Mezzanine Partners
CapitalSource
CIT Group
Citizens Financial Group
Crescent Direct Lending
Crystal Financial
F.N.B. Capital Partners
Fifth Street Asset Management
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Garrison Investment Group
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Gladstone Capital
GSAM Private Credit Group
Kayne Senior Credit Fund
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Northstar Capital, LLC
NXT Capital, LLC
ORIX Leveraged Finance
PNC Business Credit
PNC Mezzanine Capital
THL Credit
Triangle Capital
US Bank
Varagon Capital Partners
Wells Fargo Capital Finance





Highlights

DEAL FLOW	<ul style="list-style-type: none"> • M&A has replaced opportunistic refi and recap activity, but deal volume still lags the growth in liquidity. • Lenders are increasingly focusing on smaller deals as competition in the large market has intensified. • Corporate buyers are back in the market and actively participating in middle market auctions. • Cyclical are making a return as companies continue to take advantage of favorable market conditions.
CAPACITY	<ul style="list-style-type: none"> • The lending environment remains frothy. New partnerships underscore growing institutional interest in middle market direct lending. • While institution- and deal-dependent, regulated entities are exhibiting a higher degree of selectivity and a preference for more conservative deal structures. • Yields are challenged at all ends of the market, requiring lenders to be creative in how they structure transactions. Flexibility is critical in delivering value for sponsors. • Lenders continue to lower their EBITDA minimums in search of deal flow.
COMPANY PERFORMANCE	<ul style="list-style-type: none"> • Revenue growth in middle market companies is outperforming the broader market, with smaller firms seeing the largest gains. • Organic growth remains muted, which is accelerating the pursuit of acquisition opportunities. • Sectors cited for above-average growth include technology, energy, healthcare, food and beverage, and branded consumer products.
VALUATION	<ul style="list-style-type: none"> • Purchase price multiples are following in lock-step with leverage multiples, evidenced by a full turn of EBITDA multiple expansion over the last 12 months with widening across all industries. • Investor appetite is broad, and multiple inflation spans across industries and EBITDA size. • Growth and safety are themes driving premium valuations in the current environment.
TERMS AND STRUCTURE	<ul style="list-style-type: none"> • Leverage multiples have expanded by a half to a full turn because of competitive dynamics. Total leverage of 6 times is the new 5 on large market transactions. • Unitranche has seen the greatest spread compression, with pricing down roughly 100 basis points from a year ago. Lenders are using leverage as a point of differentiation. • First lien senior is stabilizing at L+450 (plus or minus 50 basis points). • Structures are back to 2007 levels with pressure felt in all segments as sponsors play across markets.
OUTLOOK	<ul style="list-style-type: none"> • 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 credit markets are active, and lender appetite is high. We are back at leverage peaks, tight pricing, and aggressive terms, said survey respondents—so it continues to be a borrower-friendly and seller-friendly environment. “Lenders’ portfolios are performing well, and that enables them to be a little bit more aggressive on the deployment side because they’re not distracted by issues that may impact their view on underwriting,” offered Scott Carpenter, a managing director and head of originations at Crescent Direct Lending.

The supply/demand imbalance lingers, leaving many lenders dissatisfied with volumes. According to Thomson Reuters LPC’s *4Q14 Middle Market Outlook*, 70 percent of survey respondents were unable to meet their lending goals. “Lenders are probably not happy with what they are able to put to work because it is so competitive. There are more lenders entering the market.

There are growing loan and fee budgets for everybody,” remarked Scott Reeds, a managing director at Citizens Financial Group. “Deal activity is picking up, but maybe not quite at the same pace as the growth in liquidity.” “If you’re not more aggressive today than you were yesterday, then you’re not doing deals,” said David Gaito, a region manager at PNC Business Credit. “I think partnership lending is still out there, but it’s getting challenged by the market.”

“We are trying to balance where we are willing to be aggressive to win,” offered Dan Letizia, a director at THL Credit. “We are still looking to grow the portfolio but making sure we are doing it with the right credits and the right economics.”

“Because the multiples are so high right now everybody’s become a seller, and it’s difficult to book new business as quick as existing business is being sold,” offered Steve Kuhn, a managing director at Fifth Third Bank Structured Finance. “Incumbents have ruled the day,” Gaito added. “If they like a credit, they are doing

everything in their power to keep it.” Brian Schneider, a partner at Northstar Capital added, “Incumbent banks are fiercely defending their portfolios. They are desperately trying to hang on to assets. If they’re comfortable with a credit and the deal requires them to take out the mezzanine or provide more senior, they’ll aggressively defend it.”

“We are probably at one of the more aggressive peaks that I can remember in a long time,” Kuhn said. “Companies are being purchased for very high multiples, and lending multiples are very full.” “It is a pretty dynamic market. There is a record amount of private equity capital waiting to be deployed, and corporate buyers are back in the market and very active,” commented Brent Burgess, the chief investment officer at Triangle Capital. “No one is knowingly doing foolish things, but everybody is very nervous. For the last year and half, the debate has been, is this as bad as it was in 2007? Now the data is pretty clear. It is worse.”

Deal Flow

If 2013 was the year of the refi and the recap, 2014 has been much more M&A driven, surveyed lenders agree. Leverage levels and pricing are more supportive to deals. The combination of aggressive buyers and more accommodating leverage conditions is facilitating ‘good but not great’ deal flow, with most lenders speaking to an increase in M&A activity that was measurable but slower than expected. “I think everyone got used to the latter part of 2012 and expected that to be the new norm,” said Ted Thorp, managing director and co-head at ORIX Leveraged Finance. “Transaction volumes across the board—whether new LBOs, dividend recaps, or core acquisition financings—remain down relative to historical norms.”

The year for some lenders was choppy with ebbs and flows driven by periods of volatility. Pipelines are up for some and weak for others. While the period beginning in August and continuing into Labor Day was one of the busiest market participants can remember,

“We are probably at one of the more aggressive peaks that I can remember in a long time. Companies are being purchased for very high multiples, and lending multiples are full.”

—Steve Kuhn

*Fifth Third Bank
Structured
Finance*



deal flow in the second half of the year has so far been disappointing. Sponsored new money issuances were weak in the third quarter leaving lenders focused on the amount of supply—hoping the M&A pipeline improves.

The observable uptick in M&A includes more family-owned, privately-held businesses and corporate carve outs, lenders said. Increased private equity exits are also fueling activity as sponsors take advantage of frothy debt markets. “It is not just the availability of financing, it is the attractiveness of the terms and pricing,” observed Tim Clifford, chief executive officer at Abacus Finance. “I think a lot of sponsors are looking at this as a great time to be selling businesses,” added Steve Robinson at GE Antares. “We are seeing a lot of companies in our portfolio being sold right now.”

“We have seen a very substantial increase in transaction activity. Deal flow is up a good 50-60 percent over last year, primarily driven by new change of control transactions,” said Robert Radway, chief executive officer at NXT Capital. “This contrasts with the comparable period last year, when roughly that same percentage was refinances and recaps.” “Driving deal activity has been a combination of both new platform deals for sponsors and confidence of unsponsored managers to raise growth capital,” commented Scott Turco at GSAM Private Credit Group. “Both sponsored and unsponsored companies are taking advantage of an active middle market lending environment.”

Lenders also spoke of a material increase in add-on activity. For Abacus Finance, add-on activity has almost equaled the volume of platforms, according to Tim Clifford. “Private equity firms are increasingly employing a buy-and-build strategy, and our recent deals and pipeline reflects that,” said Clifford. “We have also seen a lot of our portfolio companies making tuck-in acquisitions which is increasing the facility size to accommodate that type of activity,” confirmed Katie Jones, a managing director at BMO Capital Markets. Scott Carpenter at Crescent Direct Lending added, “While

add-on acquisitions are oftentimes part of the playbook for private equity firms in order to create value, there is an even greater sense of urgency in this market because you hope to acquire those smaller add-ons at lower multiples so they are accretive on day one.”

Abundant liquidity and an improving economy are expected to provide the foundation for a continued healthy M&A environment. Most lenders are holding on to the promise of strong deal flow in 4Q14, with positive momentum carrying over into 1Q15, supported by purportedly healthy banker pipelines.

Quality

The market remains bifurcated with a clear delineation between the “haves” and “have nots”. “You have the good credits and the bad credits,” offered Fred Buffone, managing director and the head of capital markets at Fifth Street Asset Management. “A lot of the marginal credits that were getting done earlier in the year are now not getting done, so those are getting pulled or they are being flexed wider. The really good credits that are the darlings that are well-priced and well-structured are getting oversubscribed. If anything, they are flexing down.”

Companies are continuing to take advantage of market conditions, with the prospect of higher multiples bringing more marginal credits to the fore. “The current environment is bringing more borrowers to the market,” commented Turco. “It is creating more transactions involving businesses that in other markets would not be sellers or would not look to refinance their existing capital structures.” “There seems to be a number of businesses trying to squeeze through the environment as favorable as it exists today,” added Bob Marcotte, the president and executive managing director of Gladstone Capital. “Many of those are challenged credits that are seeking the opportunity to recast and deal with maturities or pricing levels that are higher.”

Scott Turco at GSAM Private Credit Group added, “I look at quality in three ways:

“Private equity firms are increasingly employing a buy-and-build strategy.”

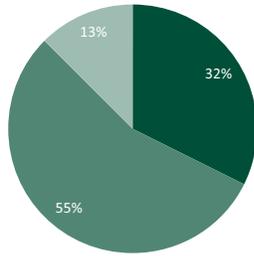
*—Tim Clifford
Abacus Finance*



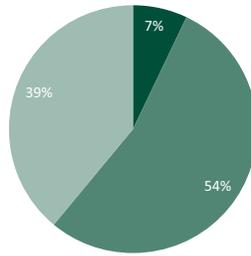
The Deals

Share of the Middle Market - First Half 2014

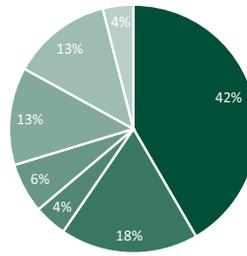
Deal Flow



Capital Investment



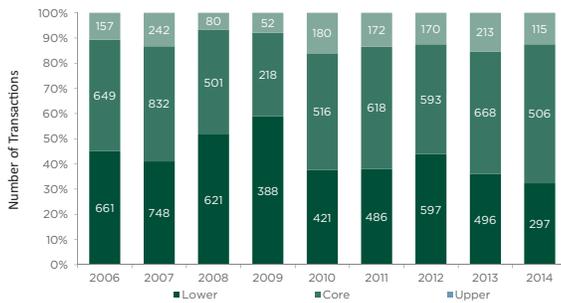
Industry



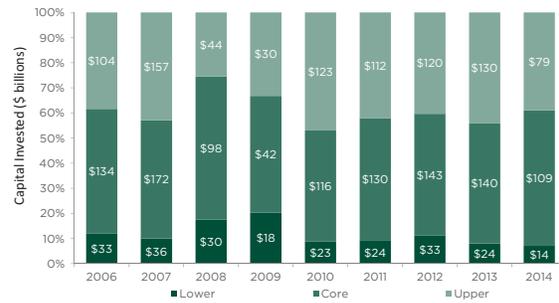
- Business Products and Services (B2B)
- Consumer Products and Services (B2C)
- Energy
- Financial Services
- Healthcare
- Information Technology
- Materials & Resources

- The Lower Middle Market \$25M-\$100M
- The Core Middle Market \$100M-\$500M
- The Upper Middle Market \$500M-\$1B

Deal Flow by Year



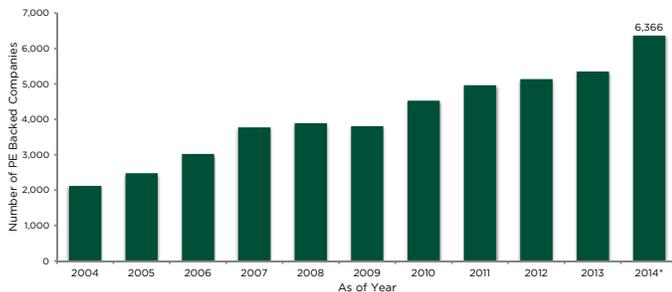
Capital Investment by Year



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

The Overhang

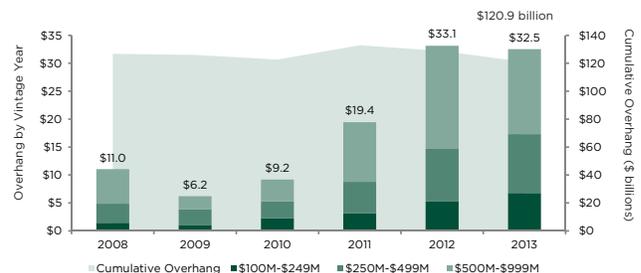
Middle Market Company Inventory



* As of September 30, 2014

Source: PitchBook.

Middle Market Capital Overhang*



*Private equity funds of \$100 million - \$1.0 billion

* As of March 31, 2014.



Deal Flow

quality of the underlying business, the capital structure, and the documentation. Generally speaking, businesses have performed well and have appropriate leverage asks with reasonable underlying credit agreements. However, in some cases not only has the leverage ask increased, leaving a low margin of error for the companies, but you also have larger market structural items working their way down into the middle market, impairing the lenders downside protection. Fortunately, most middle market lenders have pushed back on those dynamics.”

“I would say quality overall is down,” remarked Robert Radway at NXT Capital. “There are a number of transactions that really shouldn’t command the kind of multiples either on a purchase basis or a lending basis that the market is currently providing.” “Those sponsors that have the appetite for more leverage are taking advantage of the current robust financing markets and pushing their leverage ask, in some cases, by more than one half turn greater than the same time last year,” commented Tom Aronson, managing director and head of originations at Monroe Capital. “The leverage requested by the private equity sponsors can be justified based on the current enterprise values; however, those companies will need to maintain their strong growth trajectory in order to support the requested debt levels.”

“We feel like we’re seeing decent quality companies. The issue is that those quality companies are trading for very high multiples, and they are garnering leverage that is at a level that approaches what we were seeing in 2006 and 2007,” commented Scott Reeds at Citizens Financial Group.

The M&A market continues to be driven by a combination of scarcity and abundance, indicated Steve Gurgovits, a managing partner at F.N.B. Capital Partners. “It’s a scarcity of attractive middle market businesses, and an abundance of debt financing available.” “The common theme

you hear about in auctions is, 50 packages went out and 40 term sheets came in. There is no shortage of interested parties on quality deals that come to the market,” said Steve Kuhn at Fifth Third Bank Structured Finance. “By the time you get a winner, you also have a large number of lenders that have seen the transaction with other buyers, so you have a long list of financing sources too.” “There certainly are not enough high quality deals to clear the market. For the really clean businesses above \$10 million of EBITDA, particularly those that haven’t cycled, people are being very aggressive. There are fewer of those right now.”

Lower Middle Market

Lenders are increasingly focusing on smaller deals as competition in the large market has intensified, identifying \$30 million of EBITDA as the mark where the market becomes ultra-aggressive. In the lower middle market, alternative lenders can offer more flexibility on amortization and other terms and are better able to compete against the banks. “Sponsor finance in the upper middle and broadly syndicated markets is overheated and somewhat commoditized right now,” commented Mitch Drucker, a managing director at Garrison Investment Group. “To alleviate the pricing pressures, we’re focused on the lower middle market where there is no CLO, mutual fund, or high yield markets to compete with. With banks constrained by regulatory oversight, we’re competing with a limited number of like-minded funds.”

Banks continue to be active on the basis that they can get better terms and tighter structures. “From a structuring standpoint, we like the additional protections,” commented Katie Jones at BMO Capital Markets. “During the first half of 2014, we saw a lot of activity in the sub \$10 million EBITDA space, especially relative to historical standards. A lot of it was from following our sponsors. We want to continue to support them, and so we follow them into the lower end of the middle market.”

“For the really clean businesses above \$10 million of EBITDA, particularly those that haven’t cycled, people are being very aggressive. There are fewer of those right now.”

*—Preston Walsh
PNC Mezzanine
Capital*



Sector

Broad investor and lender appetite is fueling increased deal flow across industries, from industrials to healthcare to consumer products and services. Information technology, healthcare, and energy services were cited among the most active given positive sector tailwinds. Manufacturing is seeing an uptick, benefiting from growth in the domestic economy.

Sectors that are draws and seeing increased activity:

- Information technology: software and IT consulting, particularly IT implementation
- Healthcare and healthcare IT
- Consumer: food and beverage; vitamins, minerals and supplements; particularly branded
- Energy
- Industrial products and services
- Test and measurement
- Water and infrastructure

The Affordable Care Act will continue to help demand in healthcare, a sector to which NXT Capital has been an active lender. “We tend to focus on companies that either because of their delivery model or because of innovation lower the cost of patient care,” said Robert Radway. “We like to see commercial pay or private pay be the dominant share of the revenue mix. There are many sectors that offer up that kind of payor mix, and with good tailwinds in healthcare in general, we are fairly bullish.”

Energy, broadly defined, includes companies that provide services to refineries or manufacturers of products that are used in oil and gas production. Within energy services, storage maintenance and construction, site preparation, and waste services were among the active areas cited. “The amount of capital that is getting invested into the energy sector is staggering, and the backlog of development acreage suggests it could continue for several years,” said Bob Marcotte at

Gladstone Capital. “Whether the recent dip in crude prices will disrupt the level of drilling activity is unclear.” Marcotte added, “As lenders, we are looking at what is the sustainable value of the business and what is a prudent level of leverage. Recent volatility is a reminder it is not your typical recurring cash flow-oriented business. I’m not sure that everybody’s necessarily viewing it that way.”

The outlook for U.S. manufacturing remains bright. Economic activity in the U.S. manufacturing sector expanded for the 16th consecutive month according to the September PMI reading, and the overall economy grew for the 64th consecutive month. Longer-term, the impact of low cost natural gas and re-shoring are forecasted to stimulate additional demand. Against this backdrop, appetite for acquisitions is increasing, creating a healthy transaction environment for sellers. “Domestic manufacturing is relatively strong. There have been examples where companies are bringing products back or are manufacturing here rather than immediately defaulting to Chinese production. We are seeing that in auto supply and in some of the fabrication-oriented businesses,” Marcotte said. “We see it in our portfolio and in some of the companies that are trading and looking for financing.” Brian Schneider at Northstar Capital added, “We are seeing a bigger mix of manufacturing businesses. There has been a resurgence in highly specialized manufacturing coming back to the U.S. and Mexico.”

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*—Brian Schneider
Northstar Capital*

“Industrial manufacturing is improving. Regulatory driven (e.g., pollution control, emissions control) and some fabrication and processing-oriented businesses are performing well,” Marcotte added. “Another area that has been incredibly active is metals fabrication particularly supporting aerospace. When you consider the strength of commercial aircraft backlogs and the sophistication of those businesses, it is an area that we expect to be relatively robust through the cycle. Technology is enhancing their ability to be more efficient. We are seeing well-run companies at the lower end of the market that are participating in this growth via plant expansion or acquisitions.”



Deal Flow

Challenged sectors

Defense and traditional media, print, and publications generally remain out of favor. “Government spending policy is difficult to predict, and the political element of defense spending makes it more challenging to underwrite,” said Robert Radway at NXT Capital. Government contracting is struggling as a result of sequestration and slowing orders. “Lowest price technically acceptable (LPTC) procurement is dictating how contracts are awarded. There is a natural topline and margin compression that is affecting those businesses,” said Bob Marcotte at Gladstone Capital.

“Because sellers’ expectations are now an 8 to 10 times purchase multiple, people are spending more time evaluating businesses that are either “scratch and dent” or involved in industries that may have been out of favor, in the hopes of getting back to that 6 to 8 times purchase multiple,” said Ted Thorp at ORIX Leveraged Finance. “Private equity firms are trying to find industries and businesses that will trade at a lower multiple because you cannot count on multiple expansion when you buy something for 10 times.”

“Even deals in sectors that might have been a complete non-starter post recession can probably get done in today’s environment,” said Katie Jones at BMO Capital Markets. “Because while it may be a non-starter for someone, there is enough capital on the risk return continuum that you can get your deal circled; it is typically a matter of price.” Sectors that historically have been out of vogue such as staffing, advertising, and corporate training right now are getting an audience, Jones indicated.

Cyclicals

Lenders speak to a broader range of cyclicals coming to market. Companies have demonstrated a good ability to manage costs and diversify platforms. Many that rebounded from their 2008 and 2009 troughs are starting to come back. Given

where we are in the cycle, more private equity firms and lenders are comfortable in supporting those profiles.

“There is a basic positive momentum that you can observe and to some degree underwrite, understanding what the bottom of the cycle looked like in a very ugly recession,” offered Radway. “Those are typically older companies in private equity portfolios; many were acquired in 2007 or earlier,” said Rich Jander, a managing director at Maranon Capital. “They’ve ridden through the cycle, and now it is time for the owners to get liquidity. We are seeing more of those pushing the market because they have to and because they can.”

Automotive deal volume has been strong. “Clearly you’ve seen a pretty substantial rebound,” commented Radway. “It is easier to underwrite auto. You are able to look back on what happened during the depths of the recession and

develop a perspective on the downside. There is more confidence to understand the risk.” Radway continued, “Auto is probably peaking or getting close to the peak, but will it drop off materially?”

Building products has really come back into favor in 2014. The sector has seen a substantial rebound from the trough of 2009. “Multifamily has been extraordinarily strong both in terms of performance as an asset class and in construction activity. That has driven the building products sector to rebound quite nicely,” Radway said. “We are seeing traditional single family construction and home improvement activity continuing to pick up. Nonresidential construction is also showing signs of recovery.”

“Cyclicals have fully recovered, by and large, so now would be a natural time to sell. Those that survived are better run companies, so they are more attractive assets,” said Brent Burgess at Triangle Capital. “However, we are much more cautious about investing in cyclical businesses than we would have been three years ago, particularly when you look at the valuations. These businesses are being purchased at 8x-10x and being

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*—Katie Jones
BMO Capital
Markets*



levered at 4.5x-5.5x. It is giving a lot of people pause, but it is not stopping the deals from getting done.” “There are more cyclical companies asking for a leverage profile that I would consider inappropriate,” said Robert Radway at NXT Capital. “I think lenders are making a mistake in financing those because the cycle will eventually turn, and you’ll have some economic headwinds that will be problematic.” “Lenders are taking a harder look at any of the businesses that do have cycle-related risk. We want to make sure we are inside a certain leverage multiple within 18 months if we can,” added Jeff Kilrea, a managing director at CIT Group.

“Everyone is acutely aware that we’re fairly long in the expansion,” said Preston Walsh, a partner at PNC Mezzanine Capital. “Most of the rebound growth has already occurred, so the question is, where do we go from here?” “You are seeing some pretty significant improvements in performance just within the last 12 to 24 months,” added Steve Gurgovits at F.N.B. Capital Partners. “As lenders, we always ask, ‘are we looking at the peak or is there a longer runway?’ The best approach is to be conservative in your analysis. People are not looking at opportunities with enough skepticism.”

“We are seeing some of the cyclical businesses trading on the perception that markets are going to continue to improve, whether it is building products, construction, or some equipment-related situations,” observed Bob Marcotte at Gladstone Capital. “I think it is a statement on the economic outlook and private equity’s positioning for what they expect 2015 and beyond to look like.”

Independent Sponsors Increasing Penetration

Lenders speak to an evolving independent sponsor community that as a group is becoming a meaningful participant in the middle market. “Independent sponsors are becoming an increasingly bigger segment of the market,” said Mike Foster, a senior managing director at Midwest Mezzanine

Funds. “A fund like ours can finance the mezzanine debt piece and write a meaningful equity check to help the sponsor get a deal done.” Foster continued, “They are professional investors, and they also have access to capital so they have become a credible buyer. Leverage isn’t typically going to be as aggressive because they don’t have a committed fund behind them. They tend to be lower levered and slightly lower value deals.” “We’re seeing a lot more activity from independent sponsors and family offices. They are looking for deal flow and becoming more aggressive,” Gurgovits said. “That group is very active in picking up companies that have experienced a failed auction process,” observed Ted Thorp at ORIX Leveraged Finance. “And so you have an ever-growing independent sponsor community that really did not exist to the same scale or scope that is emerging today.”

“Leverage and terms are similar to 2007 levels. However, equity contributions have remained relatively high in part because of the higher purchase price multiples,” said Ira Kreft, a senior vice president at Bank of America Merrill Lynch. “These higher purchase price multiples have squeezed out some traditional middle market private equity sponsors and more value-oriented buyers. Sponsors have also been more open to a wider variety of financing options, including pairing ABL and various complementary capital providers, to be competitive.”

“Private equity sponsors are trying to find a way to see more deal flow,” Kreft continued. “Independent sponsors are finding some attractive and less broadly shopped opportunities, and they often need to partner with an equity provider. There are some mezzanine players who have a history of participating in these transactions; and, now, more private equity firms are embracing these partnerships. Sponsors have found certain traditional channels and approaches less productive in sourcing deals, and they are looking for new ways to find opportunities.”

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*—Bob Marcotte
Gladstone Capital*



Process

In a market where competition for assets is fierce and speed and certainty to close are paramount, timetables are accelerating and credit standards are being tested. Tweaks in the process are indicative of a hot market. Lenders shared their observations regarding the dynamics in sale processes today.

“With an M&A environment that is accelerating, there is more need for fully underwritten financing to support M&A processes. On the margin, terms continue to weaken both from an arranger’s and lender’s perspective and more in the benefit of the sponsor and issuer.”

Scott Reeds, Citizens Financial Group

“As the market has gotten more competitive, more lenders have been asked to provide commitments sooner and with fewer diligence outs. Those types of structures are appearing at the higher end of the middle market, typically above \$15 million of EBITDA where the bankers and sellers have more leverage over the process. We aren’t seeing that type of dynamic in the lower middle market.”

Pete Notter, Madison Capital Funding

“Bankers are running multiple parties to the finish line without exclusivity. Given the frothy market, many bidders are willing to go all the way to the finish line without exclusivity.”

Jeffrey Day, Madison Capital Funding

“We are seeing degradation in the quality of work that some lenders perform on transactions, where traditional due diligence requirements like quality of earnings reports, industry studies, and contractual terms of the lending arrangement seem to be soft. Lending standards are being relaxed to a point where we think it will create problems. It is not atypical given where we are in the cycle; that is what people do when they need to grow assets too aggressively.”

Robert Radway, NXT Capital

“Lenders today have to conform to what a buyer’s process looked like five years ago. It is ubiquitous now that lenders submit an indication of interest just to make it into the cutdown round. Process has also evolved for buyers to where more than one party is being required to do a full markup. Everything has gotten more formalized.”

Allan Allweiss, LBC Credit Partners

“We are seeing more situations where lenders are providing bridge unitranche financing. The loans suggest a one-stop financing, but in reality the lender has the ability to syndicate a first out piece post close. It is more like a bridge to a bifurcated structure than it is a one stop held through maturity.”

Scott Turco, GSAM Private Credit Group

“With an M&A environment that is accelerating, there is more need for fully underwritten financing to support M&A processes. On the margin, terms continue to weaken both from an arranger’s and lender’s perspective and more in the benefit of the sponsor.”

*—Scott Reeds
Citizens Financial Group*



“Lenders will be differentiated by their ability to deliver quickly and effectively.”

*—Michael Girondo
Varagon Capital Partners*

“You still have a lot of capital sitting on corporate balance sheets. If strategics want to own something, they are going to win an auction at the end of the day. We’ve lost a number of deals where a sponsor was convinced a deal was signed up, and then at the last hour, a strategic came in and swooped it away. That is very frustrating, and it’s still happening.”

Fred Buffone, Fifth Street Asset Management

“In some situations, process has changed considerably. In those situations, lenders are getting less information prior to being asked to submit committed financing proposals. Larger market credit terms (e.g, sunset provisions, pricing grids, etc.) are being pushed down to lower middle market term sheets. In more situations you are seeing borrowers, rather than choosing one party to provide exclusivity and working through credit agreements, bringing multiple parties along to the finish line. I think that will change in 2015 as middle market lenders continue to push back on these requests.”

Scott Turco, GSAM Private Credit Group

“Sponsors who don’t have an angle or a perceived angle are bowing out of processes very early. Because the market is so competitive, those sponsors with a perceived angle are keeping processes robust, and it often results in somebody having to overpay to win.”

Scott Reeds, Citizens Financial Group

“To potentially differentiate their bid, certain private equity groups and their limited partners are willing to initially finance platform company investments with all equity and refinance with a more traditional capital structure post-closing.”

Ted Thorp, ORIX Leveraged Finance

“Lenders need to be prepared for hard runs doing diligence alongside sponsors. Sponsors are facing increasing competition from other middle market sponsors, large sponsors moving down market, and strategic bidders. Lenders will be differentiated by their ability to deliver quickly and effectively.”

Michael Girondo, Varagon Capital Partners

“You have to go out the gate being prepared to be aggressive and competitive on terms, and you have to have a high degree of confidence as to your ability to deliver. You have to pick your spots and go for it based on your historical experience or the way a deal fits your underwriting model. If you can’t get a confident indication from the lender, sponsors have plenty of choice where to go.”

Robert Radway, NXT Capital



Capacity

BDC capital formation has been the biggest contributor to market liquidity, along with the proliferation of institutionally-funded asset management vehicles, said lenders in our survey. “Existing lenders are expanding their product offerings and new non-regulated lenders are entering the market and being aggressive with leverage and hold position. It continues to fuel a frothy lending environment and drives competition to a new level,” commented Jeff Kilrea at CIT Group.

New partnerships underscore growing institutional interest in middle market direct lending, such as the \$600 million venture between Solar Capital and PIMCO announced in September and Varagon Capital Partners (Varagon), launched in June with an initial \$1.5 billion investment commitment from American International Group (AIG). Varagon is an independent firm, backed by AIG and by certain partners and affiliates of Oak Hill Capital Management. “We’ve been a broken record for years in saying that institutional investors should be investing in private middle market credit,” commented Rich Jander at Maranon Capital. “When you see a group like PIMCO come into the market, it really adds the institutional “good housekeeping seal of approval.” The Solar Capital PIMCO venture will focus on unitranche loans to sponsored and nonsponsored companies with EBITDA of \$20 to \$50 million. Varagon will focus on first lien, second lien, unitranche, and mezzanine solutions primarily for sponsor-backed companies with between \$10 million and \$75 million of EBITDA.

“You have an enormous amount of lending capacity out there,” said Bob Erwin, a managing director at Babson Capital. “It feels like the desire on the part of the lending community to put assets to work has continued to accelerate throughout the year. People must be feeling immense pressure to put money to work. I don’t sense there is any slowdown.” “Everyone has raised money. They are willing to accept either higher risk or lower returns to deploy that capital,” commented Dan Letizia at THL Credit. “There has been a supply/demand imbalance for years.

Demand for debt has grown, but it continues to lag the growing supply.” “If you look at the beginning and end of any cycle, it usually starts and ends with the senior lenders. If they’re aggressive, then the rest of the buyout market is going to be aggressive,” Erwin added.

Regulatory restrictions continue to influence bank participation in leveraged lending. “There has been a clear movement on the part of the banks to more conservative deal structures,” said Robert Radway at NXT Capital. “The BDCs have grown in number, so there is a lot of capital coming from that part of the market. The finance companies have a fairly stable and what appears to be modestly growing market opportunity in comparison to years past. Said differently, banks have yielded a portion of the market to alternative lenders.”

BDCs

Lenders are largely dissatisfied with volumes and point to the ferocious appetite of BDCs as a primary cause for their discontent. “The real driver this year has been BDC formation. More BDCs have entered the market, and they continue to gain a significant amount of market share,” said Mark Tauber, a managing director at CapitalSource. BDCs are growing in number, ballooning more than four-fold since 2007 to over 60 today indicated Brent Burgess at Triangle Capital. They have been successful raising equity and are incentivized to put money to work. “BDCs as a group are taking an ever increasing piece of the pie and therefore have a greater distorting impact than certainly they would have had in the past,” Burgess said.

“The BDC model has many benefits including capital that is permanent. However, the investor does expect a certain dividend yield each quarter, and therefore there is an inherent “pressure” to put money to work in order to generate the necessary investment income,” commented Cheryl Carner, a managing director at Crystal Financial. “In a competitive market, many BDCs have to be aggressive in their deal structures in order to meet investor expectations.”

“It feels like the desire on the part of the lending community to put assets to work has continued to accelerate throughout the year. I don’t sense there is any slowdown.”

*—Bob Erwin
Babson Capital*



BDCs remain focused on providing the most flexibility they can to their borrowers, which will include one-stop unitranche as well as bifurcated unitranche and sub debt. “The larger BDCs are struggling to find enough new deal flow to offset runoff and are being very aggressive on pricing and terms for deals between \$75 million and \$200 million,” said Robert Radway at NXT Capital. “BDCs are a very relevant player when they can come to a sponsor and speak for the entire facility at 5x EBITDA. It gives the sponsor all the things they want—speed, flexibility, and certainty. That is very powerful,” remarked Jeff Kilrea at CIT Group. “Competition from BDCs is very tough,” remarked Katie Jones at BMO Capital Markets. “Their holds continue to increase. They are definitely stepping up and pushing on that 6x total leverage because they don’t have the same regulatory hurdles. They are taking deals down in one bite.”

“The biggest challenge in the BDC industry right now is the cost of capital. Very few BDCs are truly earning their cost of capital because of yield compression and statutory limits on leverage,” said Brent Burgess at Triangle Capital. “If the regulations change and BDCs are able to get incremental leverage and go up to 2:1, I think they are going to become not only a thorn in the side of mezzanine lenders but a bigger thorn to senior lenders as well,” offered Jeffrey Day, a director at Madison Capital Funding.

Banks

The middle market remains focused on OCC leverage restrictions and their impact on leveraged lending. The shakeout is still to be determined, lenders say, but there is enough capital to fill the void. Alternative lenders are standing by as banks concede market share in a growing shadow banking system.

Banks are aligning their talent and their capital in a way that conforms better to the new regulatory realities, surveyed lenders said, citing examples of institutions that have formally realigned some of their leveraged lending business units and minimized the role they’re playing in transactions. There has not been broad evidence of banks publicly backing away from the market, said the majority of survey respondents. If there has been a pullback, it is more evident in the larger banks where portfolio

scale, leverage levels, and regulatory concerns have been more pronounced, said some lenders. “We have successfully sold off senior loans at 2 turns of leverage to the smaller banks building their C&I books. That’s not the controversy,” said Bob Marcotte at Gladstone Capital. “It is the bigger deals (greater than \$10 million of EBITDA) where banks might have considered 3.5 to 4 turns or more of senior leverage where the regulator guidelines have begun to have some effect.” Day added, “There are certain institutions that are taking it more seriously than others. On the larger deals, banks are holding very little, or they end up just holding a revolver.”

“It is very hit or miss. Everyone expected to see a strict pullback because this was the second year of the SNC reviews in the post Leveraged Lending Guidelines era. Allegedly, the regulators were going to come in and rein in the banks. It is bank by bank dependent,” said Fred Buffone at Fifth Street Asset Management. “Basically, banks have one or two silver bullets a year. They are going to wait for the right deal that will be their one exception to justify to the regulators.” “As banks think about classifying a loan as a leveraged transaction, they are going to reserve those bullets for the game changers to their franchise, whether it is a name they want from a geography or industry focus that they are developing, or the economics and their role in a deal,” Jones said. “Because there is a more finite amount of capital, we are starting to see people really ration that more to things that really matter for them.”

Bank behavior has been inconsistent, varying institution by institution and deal by deal. However, there is a clear trend of banks becoming more selective in higher levered deals. “We are still in the early innings as banks react to the regulatory guidelines, but the theme that alternative lenders are taking on a bigger role is absolutely playing out,” commented Allan Allweiss at LBC Credit Partners. “It hasn’t impacted the market overall,” commented Ted Thorp at ORIX Leveraged Finance. “It may have moved a certain number of deals that were traditionally led by a commercial bank into one of the specialty finance companies or BDCs, but I do not believe that it is impacting whether a transaction does or does not get done.”

“We are still in the early innings as banks react to the regulatory guidelines, but the theme that alternative lenders are taking on a bigger role is absolutely playing out.”

*—Allan Allweiss
LBC Credit
Partners*



Capacity

Most banks now have policies and procedures in place to comply with the Leveraged Lending Guidelines, indicated Scott Reeds at Citizens Financial Group. “It does not mean that banks won’t do leveraged deals, because they will. It just means that they are being more strategic and selective, which, if you add it all up for all the banks, means there is less leveraged lending from the banks overall.” “The amount of dollars and number of deals that bank capital has supported continues to decline. That is a function not only of regulation but also other sources of non-regulated capital in the marketplace,” remarked Jeff Kilrea at CIT Group. “The BDCs, finance companies, and credit opportunity funds with private, long-term, patient capital can be very aggressive with hold positions and structures, but they get paid for the risk that they are taking. They are there to fill the void.”

“It will be interesting to see who steps in to fill that void and how big they step in as well,” observed Rich Jander at Maranon Capital. “We do think longer-term it will be a trend that definitely benefits the non-regulated institutions.” Zia Uddin, a managing director at Monroe Capital added, “The introduction of new lenders in the last 18 months is in anticipation that it’s going to be a bigger phenomenon.” “Even without the guidelines, BDCs and other alternative lenders have done a lot on their own to start taking share,” said Dan Letizia at THL Credit. “Alternative lenders are growing in number and check size and reducing their own cost of capital.” The fallout is creating a larger shadow banking system and with it, growth in the BDC and alternative credit asset classes.

Banks are demonstrating greater selectivity and being more aggressive for companies that are in their core commercial banking markets, key sponsor relationships, and industries where they have specialization. “Every bank approaches how they deal with the leverage guidelines differently,” Reeds said. “In general, they are adhering to them. Some banks have exceptions for certain types of customers or certain types of deals.”

Reeds added, “The way we were committing to leveraged loans three years ago is different today. Across the entire spectrum of leveraged deals, we look very sharply at what the debt paybacks are to make certain that we are not running afoul of the guidelines.” “There is a lot more scrutiny in our underwriting on repayment sources,” remarked Katie Jones at BMO Capital Markets. “We need to have the argument put together that even though the leverage might initially start high, there is a clear path forward on how to have a business derisk or deleverage in a shorter timeframe.” Steve Kuhn at Fifth Third Bank Structured Finance added, “We’ve seen a lot of influence on leverage, amortization, and fixed charge coverage as a result of the leveraged lending guidance. Generally speaking, as the markets have become more aggressive, the banks can’t move at the same pace that the market is moving.”

Compliance with leverage tests is directing bank participation in deals. “A debt to EBITDA leverage ratio of 6.0 times seems to be a true ceiling for banks—sometimes even 5.0 times,” said Jones. “We are seeing that in banks that we are selling to.” “We have to be sensitive to all these new ratios. It is just another level of diligence that we have to do, and some loans we are just precluded from doing,” commented Kilrea. “Right now, we are all new to this, and we just have our toe in the water. We are trying to figure out how it is going to impact us long-term.” For the best clients and the best relationships, the regulated institutions are still willing to do almost whatever it takes to win the transaction and maintain the relationship, said some lenders. “If that means four and a half by six structures, regulated entities will bring such transactions to market,” said Ted Thorp at ORIX Leveraged Finance.

Below certain leverage thresholds banks continue to be active. “Where we are seeing less participation by the banks is when leverage exceeds the levels that they have internally identified as HLT guidelines or the regulators have come in to restrict. Although, I have still seen banks selectively participate in highly levered transactions and seem to be able to do so pretty effectively,” said Pete

“If leveraged lending is a real business, banks are staying in. The deals that are north of 6.0 times total leverage will probably come under some scrutiny, but you manage your book accordingly to that.”

*—Mark Tauber
CapitalSource*



Notter, a director at Madison Capital Funding. “I think it was a lot of headline risk. If leveraged lending is a real business, they are staying in,” remarked Mark Tauber at CapitalSource. “The deals that are north of 6.0 times total leverage will probably come under some scrutiny, but you manage your book accordingly to that.”

“These Leveraged Lending Guidelines need to be industry dependent because not every industry is cut the same,” said Fred Buffone at Fifth Street Asset Management. “A software business can support more leverage than a deep cyclical industrial. You could overlever a deep cyclical industrial and still be well within the guidelines.”

Fitch Ratings cited a modest pullback in leveraged lending at U.S. banks in the third quarter. Debt underwriting revenues at four of the five largest U.S. investment banks declined in 3Q14, attributed in part to reduced leveraged lending according to comments made in third quarter earnings calls.

Comments made by regulators at the Loan Syndications and Trading Association’s (LSTA) annual conference this October may be signaling greater flexibility with leveraged lending guidance, according to Thomson Reuters LPC, which reported that the 6.0 times debt-to-EBITDA leverage ratio is not a hard line when considering compliance with federal leveraged lending guidance. “Six times is not a bright line that we use,” said Darrin Benhart, deputy comptroller for Credit and Market Risk at the OCC, speaking to attendees at the LSTA conference. “It is something that when leverage exceeds that, you are probably going to have some additional scrutiny and some additional attention.” The market is anxiously awaiting results of Shared National Credits (SNC) Review conducted in the spring of 2014.

“During the first half of the year, there was a clear shift by banks participating in the middle market from a leveraged lending standpoint. No question about it,” commented Robert Radway at NXT Capital. “As the application of the guidelines by the regulators has become clearer, banks are becoming more confident about what they are doing. We are now seeing some banks coming back and being more aggressive.”

Lower Middle Market

Liquidity in the lower middle market is very healthy. Lenders say there is no shortage of competition, and the trend of the larger middle market lenders dipping into the lower half of the market continues. “We’ve

seen evidence over the last year of lenders formulating strategies to attack the space that had previously not been participating there,” commented Pete Notter at Madison Capital Funding. “That is a function of reduced competition and healthier structures and economics for deals of that size range.”

“Private equity has experienced a lot of change over the years with many new groups forming. We have added resources to be sure we are seeing as many lending opportunities as possible—particularly among groups we have not historically covered as effectively,” commented Steve Robinson at GE Antares. “As a long time lender to the middle market, we understand successful credit selection is highly correlated to the breadth of your deal flow.”

Golub Capital announced in late 2012 a targeted effort to serve lower middle market sponsors who focus on companies with EBITDA of \$5 to \$10 million. Madison Capital launched its Micro-Cap initiative in March 2012, lowering its EBITDA minimum to \$3.5 million.

“There is not a part of the capital structure that lacks liquidity,” remarked David Gaito at PNC Business Credit. “The lower middle market might be the fiercest lending space today. You’ve had BDCs and finance companies enter the market. Regional banks are looking for yield and putting out a lot of liquidity.”

“We’ve seen a movement of lenders toward bringing their minimums down,” offered Allan Allweiss at LBC Credit Partners. “There is a slightly more favorable lending profile for the smaller businesses from the lenders’ perspective, but that is because there is inherently more risk at the lower end of the market.” “We are seeing a lot of larger sponsors dipping down and doing less than \$10 million platform deals in the hopes of buying and building. As a result of that, they are soliciting leverage feedback from the lenders that they are used to dealing with. Those lenders are following the sponsors down market,” commented Scott Turco at GSAM Private Credit Group. “The larger market lenders are looking at it as, over the long-term, this credit will grow through acquisitions and organically, so the underlying credit agreement is built to both support the existing business but also the larger business so that when the company goes to make acquisitions it is not being refinanced, it is just increasing its existing credit facility to a size more consistent with that lenders typical hold size.”



Capacity

"I think everyone is shifting down," said Jeffrey Day at Madison Capital Funding. "The lenders that used to have a hard line at \$15 million of EBITDA are now willing to consider \$10 million. Some that had a hard line at \$10 million are willing to go below \$10 million. I think everyone is asset hungry, and they are looking for an opportunity to deploy capital into good businesses."

"Part of our rationale for targeting businesses as low as \$5 million of EBITDA is that there is less competition. However, in a market where there is still a lot of overhang at every level of the capital structure and more money to be put to work than there are deals to be done, it has gotten competitive everywhere," commented Dan Letizia at THL Credit. "We are seeing more sophisticated processes for the \$5 million and sub \$5 million EBITDA businesses that never used to get that kind of professionalism attached to them."

"We see the lower end of the market to be as competitive as anywhere else," said Scott Reeds at Citizens Financial Group. "The lower end of the market is really setting up for the finance companies and unitranche guys to win those deals." Scott Turco at GSAM Private Credit Group added, "We are seeing more private credit funds, SBICs, and BDCs trying to finance the entire debt package."

"Given all of the money that has been raised, the unitranche lenders have become much more aggressive. They are going into markets they might not have in the past. Time will tell how a number of these lenders react when defaults increase," observed Mike Foster at Midwest Mezzanine Funds.

"The one stop is a vehicle of choice for most smaller sponsors," commented Bob Marcotte at Gladstone Capital. "Most small sponsors are having a tough time sourcing deals and dealing with the competitive dynamics. If they find a deal that they can lock up at a price they are happy with, in many instances they are chomping at the bit to get it closed and having a simple execution structure is better. Basis points

are important but consistency and predictability are even more."

Optionality

Given current market dynamics, lenders are required to be more creative and increasingly are pursuing alliances to identify deal opportunities. "It's brutally competitive across the board," commented Cheryl Carner at Crystal Financial. "I think that debt has unfortunately become very commoditized, and so that makes it very challenging for everyone to compete. It requires lenders to try and be that much more creative in terms of how they can structure transactions to differentiate themselves."

Optionality is the theme in a market where there are many different ways in which lenders are thinking about solving for financing problems or needs, indicated Allan Allweiss at LBC Credit Partners. "Lenders bring ideas to

the issuer or the sponsor and then let them guide the market toward what is working best," Allweiss said. "There have been periods over the past year or two when it was clear what financing solution was the most advantageous. Now it's more varied. In many situations, one or two different types of solutions rise to the top." "Deal flexibility is absolutely critical in delivering value for sponsors," added Michael Girondo at Varagon Capital Partners. "Sponsors want lenders that can offer multiple capital structures. They want to have people that can get them over the finish line."

"There is a real proliferation of different sources of capital and different structures. And everybody is trying to figure out how to compete," offered Brent Burgess at Triangle Capital. "It is not just senior plus mezzanine versus unitranche, which was the theme in 2011 and 2012. Now you have senior stretch and split collateral deals. All of it is to the benefit of the issuer because leverage is going up and cost of capital is going down."

Yields are challenged at all ends of the market. As unitranche pricing has come down, BDCs are bringing in first out partners to be more competitive and maintain dividend

"There is a real proliferation of different sources of capital and different structures. And everybody is trying to figure out how to compete."

*—Brent Burgess
Triangle Capital*



yields. “You are starting to see a lot of partnering,” said Fred Buffone at Fifth Street Asset Management. “It is becoming very collegial for funds like us to work with banks as their junior capital providers. They turn to us to derisk and not have to underwrite the second lien or take a non-amortizing B loan.” Buffone continued, “I predict that we can potentially see a comeback of the old-style Term A and B structures.”

“We have a lot of flexibility and are able to react quickly and provide creative solutions. The first out last out structure is an attractive structure for banks to participate in, depending on the leverage profile,” added Buffone. “Banks are looking to syndicate more, so more distribution versus hold, or just like us, trying to get creative to get a deal done,” said Dan Letizia at THL Credit. “That means coming up with a complete solution which includes a partner for the balance of the capital structure. Just like a BDC needs a partner to blend down to a cheaper cost of capital, a bank needs a partner to help them get that last dollar of leverage.”

“Ultimately, sponsors need to execute their business plans to create value,” commented Scott Carpenter at Crescent Direct Lending. “In today’s market with sponsors paying higher multiples, there can be a greater sense of urgency to executing accretive acquisitions. Slightly lower cost of capital is not going to drive returns. Sponsors require structural flexibility including low amortization structures and accordion features along with certainty to close.”

Mezzanine

Mezzanine volume is declining as unitranche, second lien, and stretch senior are becoming more prevalent. Second lien is encroaching on mezzanine in the larger market. The existence of more aggressive unitranche financing has also impacted mezzanine lenders’ capacity as there are more deals going unitranche than had been previously. In the lower half of the middle market, the willingness of senior lenders to provide stretch and one-stop financing is increasing, and as a result, the ability for mezzanine lenders to play an active role in those deals is decreasing.

“Generally, you are seeing a mix of mezzanine and second lien between \$15 million and \$25 million of EBITDA,” offered Scott Reeds at Citizens Financial Group. “You are seeing mostly second lien at \$25 million to \$50 million, and you are seeing all second lien above \$50 million. In the smaller end of the market, stretch senior and one-stop facilities are becoming more prevalent and a very credible alternative to use of any type of junior capital.”

“BDCs have created a fundamental shift in the size and scope of the traditional mezzanine market,” offered Bob Marcotte at Gladstone Capital. “The way the mezzanine lenders are deploying capital is by taking deep enterprise value risks and/or buying large equity co-investments. In many cases they are essentially doing minority recaps.” “As leverage multiples have crept ever higher and competition for mezzanine capital has increased, that layer of the capital structure has really been mispriced right now,” said Ted Thorp at ORIX Leveraged Finance. “Investors are not being compensated for the risk that they are taking on, given the level of leverage through the mezzanine debt relative to historical enterprise valuations.”

“Mezzanine goes in and out of favor more because it is an expensive option,” said Letizia. “The BDCs and other alternative lenders are getting comfortable with more than senior risk at what is still a relatively cheap borrowing cost. Unitranche pricing is coming down and blending to the first and second lien. You also have lenders in the mix that are doing more than traditional senior risk—senior stretch—and those are getting priced pretty aggressively.”

“Mezzanine in this market is a little bit nichier,” commented Rich Jander at Maranon Capital. “That means we are looking at slightly smaller opportunities than we historically did. We are also thinking harder about non-traditional opportunities, so participating alongside independent sponsors and management teams or in ESOP transactions. We have always said our model enables us to pivot effectively to generate deal flow in any market.”

“It depends on the sponsor and the type of business. Some businesses don’t lend themselves to unitranche or the sponsor wants to have a permanent tranche of junior capital that is non-amortizing,” added Mike Foster at Midwest Mezzanine Funds. “To some degree, if you can adjust your strategy, you do it without compromising structure and really taking undue risk. We are expanding our focus on independent sponsor transactions where there is probably more opportunity to mold the capital structure.”

“There is always going to be a subset of sponsors that wants to have traditional two-party transactions of senior and mezzanine,” echoed Jander. “With average purchase multiples creeping up, we are optimistic that there will be more demand going forward for mezzanine relative to unitranche. We are seeing the two-party structure offer modestly more leverage and a blended cost of capital that is competitive or slightly more attractive to unitranche.”



Company Performance

Middle market companies continue to prove their resiliency and are benefiting from positive economic tailwinds. Findings from the National Center for the Middle Market's 3Q 2014 *Middle Market Indicator* revealed that 68 percent of middle market companies (annual revenue between \$10 million and \$1 billion) reported positive revenue growth for the past 12 months. Other notable findings from the survey:

- Revenue growth is outperforming the broader market. Mean total revenue growth for middle market companies was 7.5 percent year-over-year through 3Q14 versus 5.5 percent for the S&P 500 over the same period.
- Smaller middle market firms are driving the surge in revenue growth, reporting an 8.9 percent increase year-over-year through 3Q14.
- Sixty-four percent of middle market executives expect revenue to increase in the next 12 months.

Lenders in our survey report that portfolio credit quality is good, and loan losses are at record lows. Company performance has been stable with revenues growing in line with the economy. We asked survey participants to share their observations on company growth:

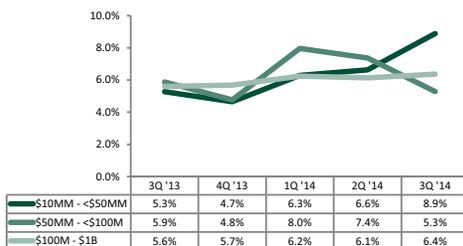
“Roughly half of the companies that are being presented to us are experiencing revenue and EBITDA growth,” commented Allan Allweiss at LBC Credit Partners. “Companies involved in technology, energy services, healthcare services, and some areas of business services are seeing a higher level of growth than the general C&I businesses.”

“Broader trends are positive. You are now starting to see some organic growth, and tuck-in acquisitions are providing some cost savings and synergies,” offered Fred Buffone at Fifth Street Asset Management. “Long gone are the days of acquiring a company and squeezing out every last cost, because that has already been done over the past couple of years.” “You just can’t rely on reduced SG&A to increase your EBITDA any more. You need to get revenue growth, and that is really hard to come by. It is still very choppy,” observed Mike Foster at Midwest Mezzanine Funds. “I think it has been tough in middle market businesses to grow organically, and so we are seeing businesses grow through acquisitions,” added Rich Jander at Maranon Capital.

“Organic growth remains a huge differentiator. There is probably more single-digit growth now organically,” said Katie Jones at BMO Capital Markets. “If you find properties that do have that double-digit growth, then that really sparks a lot of interest.”

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

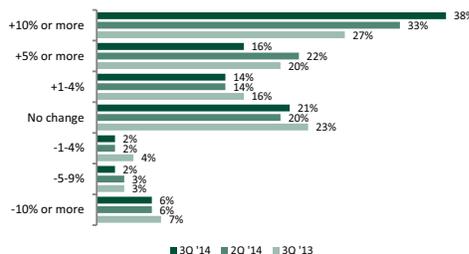
Revenue Growth by Segment



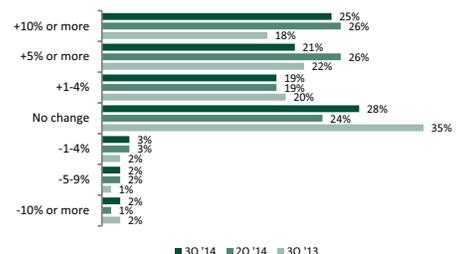
Source: National Center for the Middle Market.

Revenue Performance

Last 12 Months



Next 12 Months





Among the industries cited for above-average growth are technology (networking, software, SaaS, or cloud services), oilfield services and energy, healthcare, food and beverage, and branded consumer products.

“Industrial companies are growing at decent rates given where we are in the economy right now,” said Scott Reeds at Citizens Financial Group. “Many of these businesses cut costs in the downturn, so as the revenues start to accelerate, they are able to grow EBITDA at a higher rate. They are growing reasonably well and still generating high enterprise values.” Pete Notter at Madison Capital Funding added, “In general, the cyclical businesses have performed nicely over the past 12 to 24 months. Those companies are in the fifth year of the growth cycle, so you are seeing the effects of an improved economy and the tailwinds in the end markets that these companies serve.”

Lenders are intensely focused on the direction of the economy and interest rates. “I think people should be acutely focused on that today,” commented Scott Turco at GSAM Private Credit Group. “There is greater emphasis on underlying input costs of businesses. Having gone through a recent cycle, you have more guidance as to where a business can go from a revenue and margin perspective, so you at least have something to work with in terms of a trough.” “Most middle market businesses are not growing at very high rates. They are leaner, better businesses than they were in 2007 because it is a much more competitive environment,” said Brent Burgess at Triangle Capital. “We are more concerned about our returns than we are losing money because we believe that we are investing in stronger, healthier companies.”

“With the high leverage levels that are being placed on companies today, lenders are more acutely sensitive to customer concentration and any cyclical of a business. You don’t need much of a downdraft in operating performance to overburden certain highly-levered capital structures,” commented Ted Thorp at ORIX Leveraged Finance.

“Leverage growth has certainly outpaced the underlying performance of businesses,” said Dan Letizia at THL Credit. “We are probably getting closer to a point where there is greater uncertainty as to how long that sustains.”

“Leverage growth has certainly outpaced the underlying performance of businesses. We are probably getting closer to a point where there is greater uncertainty as to how long that sustains.”

*—Dan Letizia
THL Credit*



Valuation

Scarcity and abundance are themes driving today's seller's market. Surplus liquidity across every level of the capital structure, from senior debt to subordinated debt to equity, is still chasing too few deals, creating a hyper competitive market for quality assets and driving up purchase multiples. Broad investor appetite spans across industries and EBITDA size, with plentiful and flexible capital providing cheap currency to finance acquisitions.

Purchase price multiples are following in lock-step with leverage multiples, exhibiting a continuing upward trend throughout the course of the year. Lenders estimate a full turn of EBITDA multiple expansion over the last 12 months with widening across all industries. "Valuations are robust and will continue to remain robust until the credit markets tighten," offered Ted Thorp at ORIX Leveraged Finance. "It's a triffecta of plentiful debt, plentiful equity, and low deal volume which results in high purchase multiples. And if you have growth, it's even more appealing and people are willing to stretch on valuation." "It is an across the board phenomenon. If a company commanded 5x historically, it is now commanding maybe 7x. If it commanded 7x, it is now 9x," offered Robert Radway at NXT Capital. "There has been a sizable shift in terms of overall valuations, driven in part by where we are in the economic cycle. There is more expected growth, and people are able and willing to pay up for that. The financing environment is dramatically more accommodating than it was two or three years ago. And private equity groups have a lot of dry powder, so there is the desire and need to put money to work."

The drivers of premium valuations haven't changed—recurring revenue, high free cash flow conversion, diversification—businesses that have demonstrated growth through the cycle and have longer term track records to underwrite historical financials. "Businesses that have solid fundamental credit characteristics are commanding higher leverage multiples which is then driving purchase price," commented Scott

Turco at GSAM Private Credit Group. Businesses that are considered to be a high value-add, highly defensible, and have high barriers to entry are trading at the high multiples. "Anything that shows downside risk protection, lenders are willing to put more leverage on those than in the past. And the sponsors are willing to equitize in hopes of doing tuck-in acquisitions," added Brian Schneider at Northstar Capital.

"The non-cyclical quality businesses are trading for the premium multiples," commented Preston Walsh at PNC Mezzanine Capital. "People are looking for some kind of downside protection because they are concerned about when the next downturn will occur." Mike Foster at Midwest Mezzanine Funds commented, "The businesses that have recurring revenue, low customer turnover, and low capex are very hot. They tend to get a better reception and a higher valuation." Foster added, "They are viewed as more "safe" deals. If you're in the mode of trying to get capital deployed, there is a greater willingness to accept slightly lower returns for that security."

The market remains bifurcated with the "haves" and "have nots", a theme that has been observed for the last couple of years, indicated Schneider. "It is still this barbell notion in that a good company will be valued at a 7.5x multiple or higher. There is not a lot in that 5x-7.5x range." "For the "A" quality credits above \$10 million of EBITDA, you are seeing deals being valued in the double-digit multiples," offered Pete Notter at Madison Capital Funding.

"We are seeing eye-popping multiples," remarked Brent Burgess at Triangle Capital. "Some of them we understand because it may be a great business. Some others we are just shaking our heads." "For the businesses that appear to be so desired by the potential universe of buyers, we've seen purchase prices that are really extraordinary," added Allan Allweiss at LBC Credit Partners. "We've seen a few processes where the businesses

"There has been a sizable shift in terms of overall valuations, driven in part by where we are in the economic cycle. There is more expected growth, and people are able and willing to pay up for that."

*—Robert Radway
NXT Capital*



traded in the mid-teens.” Katie Jones at BMO Capital Markets added, “A quality property is going to trade for high single digits across all industries. We are generally seeing multiples of 8x-10x even in the lower end of the market.”

Reporting on the broader market (EBITDA of less than \$50 million), S&P Leveraged Commentary & Data cited a median EBITDA multiple of 10.1x through the October year-to-date period—up from 8.8x in 2013. Senior debt multiples rose to 5.2x—up from 4.5x in 2013. The median EBITDA multiple in 3Q14 was 11x.

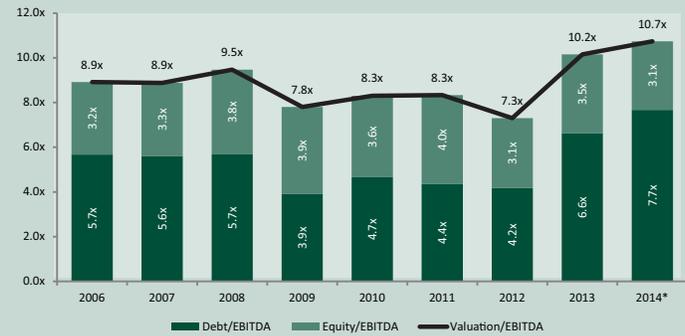
Private Equity’s Struggle

Sponsors are feeling the frustration of an elevated pricing environment. “It’s the combination of tremendous amounts of debt capital with a plethora of private equity funds competing for the same asset,” commented Ted Thorp at ORIX Leveraged Finance. “Some sponsors have found that their strategy of not overlevering businesses has resulted in losing a lot of auctions for businesses that they really liked and wished that they had bought,” commented Dan Letizia at THL Credit. “They do not want to overburden the business to the detriment of their invested equity dollars, but they need to be more aggressive than they were a couple of years ago.”

“Multiples have absolutely taken off. We are regularly seeing very nice businesses bid for north of 10x,” said Scott Reeds at Citizens Financial Group. “Even industrial companies that have some cyclical and capital intensity to them are getting bid up in the 8x-10x range. If they really want an asset, sponsors would probably admit they are overpaying to win.”

“A lot of sponsors are showing restraint and not participating at these elevated valuations. Sponsors are saying, I can’t make the returns work at 9x or 10x EBITDA,” observed Robert Radway at NXT Capital. “The sponsors paying 9x or 10x for

Middle Market Median EBITDA Multiples



*as of 6/30/14. Source: PitchBook.

businesses usually have some sort of angle. They may have had success with a past investment in a particular sector, they have an operating partner that has certain insights, or they have an existing portfolio company and can cut out expenses with add-on acquisitions,” added Jeff Kilrea at CIT Group. “If they are just launching a new platform, I think they are more diligent.”

“Valuations are robust and will continue to remain robust until the credit markets tighten. It’s a trifecta of plentiful debt, plentiful equity, and low deal volume which results in high purchase multiples.”

*—Ted Thorp
ORIX Leveraged Finance*

Strategics are starting to spend their cash stores on assets in the middle market and “... winning more processes than they were a year ago,” observed Thorp. “I wouldn’t say the majority of our transactions are being lost to strategics, but we do seem to see that occurring a bit more frequently as of late.”

Seller’s Market

A perceived frothy market is drawing would-be sellers looking to cash-in on favorable conditions. “Purchase price multiples are so attractive now for quality businesses that it is bound to bring out sellers,” said Brent Burgess at Triangle Capital. “An 8x multiple almost seems like a cheap valuation. We almost never see anything less than 7x now.” Burgess added, “We are seeing multiples that we just think are crazy, even for a \$1 to \$5 million EBITDA business.” “It is clearly



Valuation

a seller's market. Multiples are quite full," commented Robert Radway at NXT Capital. "Availability of financing is high. It is probably as aggressive and as accommodating as it's been since the credit crisis. If you're a seller and you see those factors, now is the time to try to realize value and people are."

"It's just a very competitive, frothy market. Even in scenarios where you have what may not be the most pristine, perfect company, there is still a ton of appetite for those types of deals too. I guess the best seat at the table is to be a seller," said Cheryl Carner at Crystal Financial.

Growth

Companies showing some organic growth are garnering higher multiples—a universal response among lenders.

"The commonality is buyers are searching for growth. If the competitive bidding process is going to drive sponsors to pay 8 times or more for a company, they want growth to support debt and presumably grow into your valuation," offered Bob Marcotte at Gladstone Capital. "Growth is an important offset to the high real cost of capital of more leveraged debt structures. Without it, it's very difficult to achieve a sponsor's equity appreciation targets."

"We see some multiples that are just jaw-dropping—high-growth companies with \$5 to \$10 million of EBITDA trading for double digits," remarked Bob Erwin at Babson Capital. "I think some sponsors are saying, 'I can't make the traditional LBO model work when a metal bender is going to trade for 7 or 8 times. I can't get that multiple arbitrage anymore, so why not go for a high grower?'"

High growth sectors like technology, energy, healthcare, and business services continue to lure investors. SaaS platforms within IT have been particularly well received in the buyout community. Food and beverage and branded consumer products are also showing growth, which is reflected in higher multiples.

"Sponsors are much more focused on the value creation plan. How am I going to execute on growing this business?" said Dan Letizia at THL Credit. "It is not about the historical growth of a business. It is about the strategic angle the sponsor has on growth that can be achieved going forward with their new ideas, their new people," said Brian Schneider at Northstar Capital. "The valuations are based more on the achievable potential with what they can do with the business."

"There is always somebody who has some particular angle that enables them to pay a half to a full turn more than everybody else around the table," said Burgess. "We've been partnered with sponsors on deals who thought they had a great angle, and they still lose the deal because someone else has an even better angle."

"Because there is a lot of capital, sponsors are willing to pay more, but they are being a lot more accountable for what they are bringing to the table with regards to growth," Schneider added.

"A lot of businesses are being used as platforms, and so if you have to pay 10-plus times, but you can go out and make add-on acquisitions and acquire some smaller businesses for 4x-6x over time and blend your multiple down, I think you are certainly seeing that happen," added Scott Reeds at Citizens Financial Group.

"The commonality is buyers are searching for growth. If the competitive bidding process is going to drive sponsors to pay 8 times or more for a company, they want growth to support debt and presumably grow into your valuation."

*—Bob Marcotte
Gladstone Capital*



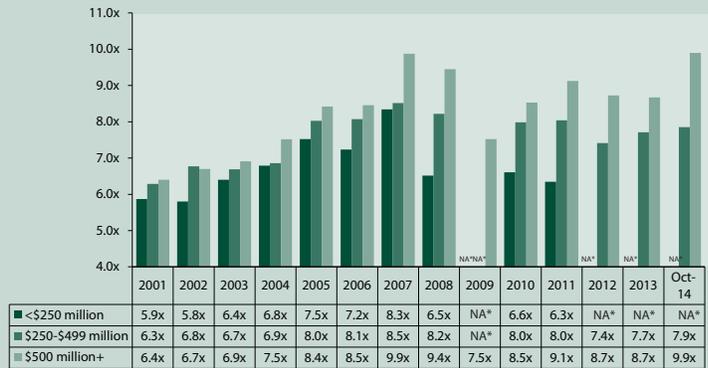
Lower Middle Market

Inflation has been observed even in the lower market. “It used to be that 5x or 6x was the standard multiple. Now it is 7x or more,” said Bob Marcotte at Gladstone Capital. Pete Notter at Madison Capital Funding added, “I have seen very few deals of any quality trade for less than 7x in 2014. The median multiple is clearly 7.5x or higher.” Notter added, “I have seen examples of portfolio companies making add-on acquisitions that are \$2 to \$3 million of EBITDA, and those companies are trading for between 7x and 8x EBITDA. Depending on the situation and the end market, there is still an aggressive valuation dynamic there. There have been selective examples of sub \$10 million EBITDA businesses trading for double-digit multiples, which are more the exception, but they are happening.”

“You are seeing higher valuations across the board,” said Tim Clifford at Abacus Finance. With the availability of cheap financing, purchase price multiples are pushing up to record highs.” Clifford added, “We’ve seen many deals where 8x is the lowest multiple or you have to either be at 8x to get a management meeting. Those are high multiples for smaller EBITDA businesses.”

Purchase Price Multiples in Middle Market LBO Transactions

EBITDA Valuation Multiples by Transaction Size



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

Source: Standard & Poors LCO.

“You are seeing higher valuations across the board. With the availability of cheap financing, purchase price multiples are pushing up to record highs.”

*—Tim Clifford
Abacus Finance*



Terms and Structure

Volume of capital and low interest rates are driving leverage higher. Yields are challenged at all ends of the market.

Highlights:

- Unitranche has seen the greatest spread compression, with pricing down roughly 100 basis points from a year ago. Lenders are using leverage as a point of differentiation.
- First lien senior has not seen as much compression, stabilizing at L+450 (plus or minus 50 basis points)
- Leverage creep of a half to a full turn because of competitive dynamics. Total leverage of 6 times is the new 5 on large market transactions.

Lenders shared their observations on pricing and leverage:

“Structures are back to 2007 levels, which marked the end of that cycle,” said Scott Reeds at Citizens Financial Group. “Every time we think we are at a peak in this credit cycle, we continue to migrate toward more aggressive behavior. The environment is getting extremely competitive and extremely aggressive which makes it hard to win deals.”

There is a slightly bigger bifurcation in the market for leverage, said participants in our survey. Lenders are trying to be defensive by going after the bigger, perceived to be better credits, and in those situations, are being very aggressive and leverage is getting pushed. It is offset by the credits, due to cyclicity, customer concentration, or smaller size, which receive lower attachment points.

Banks have tighter boxes and more adherence to standards. “Non-regulated institutions don’t have to play by those rules,” said Katie Jones at BMO Capital Markets. “Eventually the market will level set because you are not going to have people doing deals that are off-market.

If you are subjected to clearing them from a syndication standpoint, you are not going to be able to completely subsidize that off your balance sheet.”

“As leverage multiples are moving up, lenders seem to be picking their spots to be aggressive,” said Tom Aronson at Monroe Capital. “Private equity sponsors are able to increase their purchase multiples as lenders get more aggressive. Industry professionals are starting to ask whether we have hit the peak of the cycle.” “Lenders can rationalize higher leverage multiples based on increasing enterprise values and the stronger fixed charges associated with our current low interest rate environment. Time will tell whether today’s purchase price multiples truly reflect enterprise value or whether we’re at the top of the market,” commented Scott Carpenter at Crescent Direct Lending.

“Private equity sponsors are able to increase their purchase multiples as lenders get more aggressive. Industry professionals are starting to ask whether we have hit the peak of the cycle.”

*—Tom Aronson
Monroe Capital*

Middle market lenders remain disciplined and credit-focused. “We still think there is essential balance in the market. We’ve seen firming on pricing and terms,” said Allan Allweiss at LBC Credit Partners. “There is always a limit to how far the market can go, particularly if a credit has any need for multiple lending parties.” Allweiss continued, “Yes, we are competing with more lenders in most deals; however, we are not lending in a significantly stretched way or having to do unnatural things with respect to pricing.” “Our approach is to try and find opportunities where we can deploy capital and not be at leverage levels that we know are at a peak, particularly for middle market companies that we anticipate would be challenged in a downturn,” said Cheryl Carner at Crystal Financial. Jeffrey Day at Madison Capital Funding added, “We continue to be disciplined on credit and have been willing to walk over a quarter turn of leverage or 25 basis points of price.”

EBITDA below \$10 million

- Deals tend to have a modest pricing premium because of their size, and typically structures are getting done with an incremental amount of senior leverage.



- More deals are being closed with one lender and often structured as senior stretch and one-stop facilities.
- Pricing is wide, in the low L+300's to mid L+400's, based on the credit profile of the borrower. If in the L+300's, there may not be a material premium (25 basis points); if in the L+400's, the spread widens (50-75 basis points).
- The leverage profile is reduced by half a turn as you get closer to \$5 million of EBITDA.
- All-senior execution can look like 3x-3.25x; pricing L+450 up to L+600.
- Senior stretch execution can look like 3.5x-4.25x. Leverage is typically a half turn higher and priced at a slight premium (-25-50 basis points) to straight senior.
- A finance company execution (split senior mezzanine structure) can look like 3x-3.5x senior by 4x-4.5x total. Senior pricing L+450-550 with a Libor floor of 1 percent.
- Below \$5 million of EBITDA, the leverage profile can look like 2x-2.5x senior and 3.25x-3.5x total.
- A bank execution will be priced at L+300-450 with no Libor floor. Senior leverage will typically not exceed 3x.
- Maximum leverage on a unitranche execution is 4x. Average leverage is 3.5x-3.75x. Pricing L+750-800. Libor floor of 1.0-1.5 percent.

EBITDA between \$10 million and \$25 million

- Leverage profile of 3.25x-4x senior/4.75x-5.5x total. 4x/5x is common.
- Pricing L+425-475, Libor floor of 1 percent, OID of 1.0-1.5 points.
- Stretch senior up to 4.5x leverage, average is 3x-3.5x; L+500-550, 1 percent Libor, OID of 1.0-2.0 points.

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 above \$25 million

- Leverage profile of 3.5x-4.25x senior/5x-6x+ total
- 4x/6x is common
- Pricing L+425-450, Libor floor of 1 percent, OID of 1.0-1.5 points.

At EBITDA breakpoints of \$25 million and \$40 million there is a greater distinction in leverage and terms. Total leverage of 6x is not unusual for companies with EBITDA of \$20 million, said survey respondents.

Unitranche

Leverage and pricing is wide depending on the credit profile of the borrower.

- Leverage profile of 5x-6x for business with good growth and attractive margins.
- Leverage profile of 3.5x-4.25x for business with cyclical and/or less predictable margins or earnings growth.
- Pricing L550-800, Libor floor of 1 percent.
- For the more storied businesses with lower attachment points, blended pricing is 8-9 percent.

On large transactions (EBITDA of \$20 million or more), lenders have seen the leverage on unitranche structures match or potentially exceed that of a senior mezzanine structure. Those are structured to have a first out and last out piece.

Mezzanine

Mezzanine leverage is 1 to 2 turns, determined by how aggressive the senior lender wants to be and how aggressive the sponsor wants to push total leverage. Mezzanine lenders are not deterred by a six handle, said survey respondents.

Mezzanine is facing increased competition from unitranche and second lien. In addition, because it has been difficult for private equity groups to deploy capital, sponsors are asking for more senior debt and writing bigger equity checks. Competition has forced mezzanine lenders to be more creative, with some starting to do more unitranche to compete with BDCs. Mezzanine lenders have also had to be even more sensitive on price. "Historically, we'd never see a grid on mezzanine financing. We've seen that now," said a senior lender in our survey. "Most of the time where I am hearing sponsors talking about unitranche, they are trying to pressure the

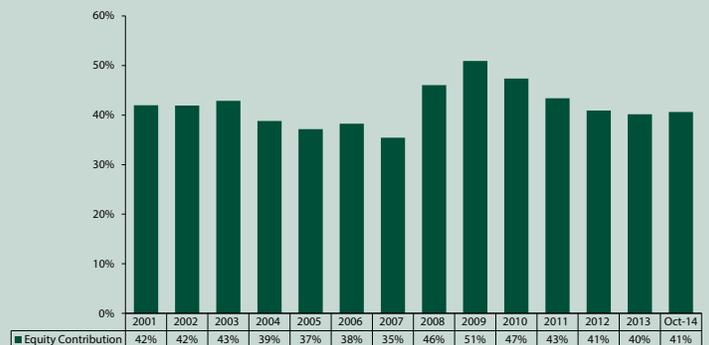
Acquisition Financing Trends

Leverage



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

Equity Contribution





mezzanine or senior lender on getting lower pricing. To some degree it is working,” said a mezzanine lender in our survey.

Mezzanine pricing has come in at least 100 to 150 basis points over the last year and now is 11-12 percent cash and 1-2 percent PIK. As modeled returns have been coming down, sponsors are keenly sensitive to maintaining an appropriate delta between mezzanine and equity. “If the equity return is modeling to 18 percent, a sponsor is not going to tolerate mezzanine modeling to 14 or 15 percent,” was the response of one mezzanine lender. “The two biggest battles that we’re fighting right now are on price and repayments,” offered Bob Erwin at Babson Capital. “The whole market seems to have ratcheted down. Right now, it feels like a race to the bottom.”

- Private equity groups with proven track records are able to secure lower cost mezzanine provided they are willing to offer more of a co-invest.
- Co-invests are becoming harder to get and the amounts are getting smaller.
- Warrants are still available in independent sponsor and management buyout transactions.

Second Lien

Second lien is pricing 200 to 300 basis points wide of the senior. Second lien pricing remains robust in the broadly syndicated market, L+700-800 with a 1 percent Libor floor. Pricing is wider in the club market, L+750-900 with a 1 percent Libor floor, OID of 1.5-2.0 points.

EBITDA of \$20 million is typically the floor on second lien although it is getting done for smaller deals.

Equity

Sponsor equity contribution remains healthy, with 30-40 percent still the norm for middle market leveraged buyout transactions. As you move up in transaction size, equity is closer to 30 percent.

Terms

Sponsors are trying to drive large cap terms into the middle market and middle market terms into the lower middle market, said lenders in our survey. “Lenders are close to the limit on leverage and can’t go a lot lower on the cost of capital, so now it is a race to the bottom,” commented Brent Burgess at Triangle Capital. “What is the last lever to pull? Structure is really being pressured now.” Katie Jones at BMO Capital Markets added, “Lenders who play across the size spectrum and follow sponsors across markets see more deterioration as it relates to the quality of the overall credit package as sponsors seek consistency independent of the size of the deal. The entire package, by and large, has widened out.”

Larger companies get the benefits of higher leverage, better structural terms, and lower pricing. “You are seeing a lot of “big boy” terms creeping into the lower end of the middle market,” commented Scott Reeds at

Citizens Financial Group. “My sense is as EBITDA approaches \$25 million, you stair step up from a leverage, terms, and pricing perspective and then again at \$50 million.” “The level of EBITDA always gets lower and lower in a bull market of what the market is willing to accept,” added Fred Buffone at Fifth Street Asset Management.

Amortization

Lenders are seeing a lot of pushback on amortization, with 1 percent more the norm and the one provision that is seen coming down market the most. Borrowers are becoming more accustomed to one-stop facilities and asking for less amortization. The pushback is across the board. “I am seeing fewer processes pushed to 1 percent from 5 or 10 percent than I am seeing ones already at 1 percent being pushed to zero,” said Scott Turco at GSAM Private Credit Group.

Banks typically want a minimum of 5 percent amortization, but they will make exceptions for certain clients and certain deals. “Banks are finding ways to be competitive, but it is going to be on a very selective basis,” said Scott Reeds at Citizens

“The level of EBITDA always gets lower and lower in a bull market of what the market is willing to accept.”

*—Fred Buffone
Fifth Street Asset
Management*



Terms and Structure

Financial Group. “As leverage starts to approach 6 times, and finance companies are offering 1 percent amortization, banks have to be very selective on where they compete on those deals.” “Banks are still pretty rigid. They need to demonstrate to the regulators that a certain percentage of the loan can be paid in the first five years through cash flows,” commented Jeff Kilrea at CIT Group. “Banks will do 1 percent amortization. We try to make the argument that we’ll get the repayment from the excess cash flow recapture.” “If you are above \$25 million of EBITDA, 1 percent amortization tends to be the starting point,” said Katie Jones at BMO Capital Markets. “If you are below \$25 million, maybe we are successful with 2.5 percent, maybe 5 percent. Sponsors that play across the size spectrum, given the vast majority of their deals are at 1 percent, are going to expect that even if their business is \$10 million or \$15 million of EBITDA.”

“It is important now more than ever to stick to your discipline because there are situations where lenders are agreeing to looser terms on these smaller deals,” commented Scott Turco at GSAM Private Credit Group. “Obviously, it hasn’t been convention previously in the lower middle market, but it is happening today. As a result, we may lose transactions but continue to be focused on staying disciplined, especially in those smaller businesses.”

“The groups that are not panicky with putting out capital still have a disciplined fixed amortization,” contends Brian Schneider at Northstar Capital.

Covenants

Fewer covenants and looser cushions are appearing with increasing frequency in today’s credit agreements said lenders in our survey. Borrower-friendly and much loathed cov-lite is pushing further down market but middle market lenders are pushing back. The threshold typically approaches the \$50 million EBITDA market, survey respondents said, however, single

covenant or cov-lite structures are even pushing on \$25 million. “\$50 million seems to be about the level where people are focusing on doing cov-lite transactions,” offered Steve Robinson at GE Antares. “It was \$75 million with exceptions. Now it is \$50 million with exceptions getting below \$50 million.” “Cov-lite is pushing very aggressively on the upper end of the middle market,” remarked Jones. “Businesses with EBITDA of \$30 to \$60 million are now accessing cov-lite where historically that was reserved for companies above \$100 million of EBITDA. That has not made its presence in the lower end of the middle market.” “The middle market is still very disciplined and will not do cov-lite deals. That is something that has held true, and I think every middle market participant believes in and will not give up,” commented Fred Buffone at Fifth Street Asset Management. “They would rather compromise on price or leverage before they will compromise on credit quality or covenants.”

“Lenders who play across the size spectrum and follow sponsors across markets see more deterioration as it relates to the quality of the overall credit package as sponsors seek consistency independent of the size of the deal.”

*—Katie Jones
BMO Capital
Markets*

Occasionally lenders will agree to fewer covenants—3 reduced to 2 or 2 to 1—but it is more the exception. Robert Radway at NXT Capital offered, “Typically you’d see a total leverage covenant, a fixed charge covenant, and a limitation on capex. You’re probably seeing a lot of deals being done with one or two of those as opposed to all three.” “We have to have at least one covenant. We try to get at least leverage and fixed charge,” added Jeffrey Day at Madison Capital Funding.

Universally, covenant cushions are widening, from 20-25 percent to 30-35 percent. In the lower middle market, most sponsors are looking for 25-30 percent cushions as opposed to the traditional 15-20 percent. “The larger the deal, the bigger the cushions,” Radway offered. “We are seeing the relaxation much more at \$25 million or more of EBITDA.”

All of the large market terms—builder baskets, equity cures, incremental facilities, and MFN pricing—are trying to come down market. “The ‘goodie basket’ is a lot more fulsome



to our clients, and that includes things like restricted payments, dividends, accordions, permitted acquisitions, and permitted investments,” said Katie Jones at BMO Capital Markets. “All of your negative and positive covenants have a lot more flexibility and availability to them relative to historical standards.”

Some terms are being accepted and some are pushing back. The shift is gradual. “As larger sponsors have moved into middle market deals, you absolutely have seen some of the larger market terms try to push down into the middle market,” said Jeffrey Day at Madison Capital Funding. “We try and resist where we can, but if you are dealing with larger sponsors that are moving down into our market to make acquisitions, they are accustomed to getting these terms.” Lenders indicated that pressure is being felt as far down as \$15 million of EBITDA. “As the market has gotten busier with new M&A activity, those firms are regressing back to their normal ecosystems, so that is creating less pressure and leaves the middle market free to transact on its more traditional types of terms,” added Rich Jander at Maranon Capital.

The lower middle market hasn’t seen a significant shift to loosening credit standards this year, indicated Pete Notter at Madison Capital Funding. “We are not seeing a lot of new “watering down” of documentation terms or structure,” Notter said.

Holds

Hold size continues to be a differentiator and a key variable in how lenders compete for the lead left mandate. Growing institutional interest in the middle market has enabled prominent middle market lenders to take on additional third party capital which has increased their hold size. “It is kind of an arm’s race among the senior lenders to be able to speak for larger holds,” said Dan Letizia at THL Credit. “That has been a basis for who is going to agent a deal.”

“The evolution in our business of real scale and the ability to use that to compete for transactions has probably been one of the

most interesting developments that we’ve seen take shape over the last year,” said Rich Jander at Maranon Capital. “There are lenders that have created a hold capacity that is substantial, whether it is holding all the exposure directly on the balance sheet or having captive syndication through asset management vehicles. Either way, people are competing on hold size,” commented Robert Radway at NXT Capital. “It is one of the biggest phenomena impacting our market,” added Michael Girondo at Varagon Capital Partners. “A number of lenders have been successful in raising capital to increase their deal size dramatically. The number of lenders that can take down an entire capital structure is a multiple of what it was five years ago.” “For the larger unitranche deals, you see some of the larger BDCs taking down \$200 million on a single name,” observed Radway. “Increasingly, sponsors are taking the single lender option. I think it is proving compelling,” Girondo added. Varagon has a typical hold size of \$20 to \$100 million.

“Everybody gets to a similar leverage point, and it really comes down to how much can you hold,” commented Scott Reeds at Citizens Financial Group. “When leverage is at elevated levels like it is today, the non-regulated entities can hold a lot more.”

Bank hold sizes remain stable to lower as they comply with Leveraged Lending Guidelines (LLG). Banks have finite capacity for leveraged loans so they are being smarter and more strategic about how they allocate capital, indicated Reeds. “Generally speaking, banks aren’t taking large hold positions, but there are always exceptions,” he said. “Banks have been pretty disciplined around hold positions. Depending on the bank, you can see holds from \$15 million on the very low end to \$30 to \$35 million in the traditional middle market (EBITDA of \$15 to \$25 million), but certainly not beyond that,” said Robert Radway at NXT Capital. “It is having the ability to either layoff exposure to captive distribution or to have the ability to affect a syndication. Our bank competitors are not competing on hold positions.”

“The evolution in our business of real scale and the ability to use that to compete for transactions has probably been one of the most interesting developments that we’ve seen take shape over the last year.”

*—Rich Jander
Maranon Capital*



Terms and Structure

“In the nonsponsored world, we are continuing to see very large hold sizes. Banks have a lot of capital, and they are looking to provide tickets of \$40 to \$60 million. We see a lot more capital available coming out of traditional commercial banks,” said Katie Jones at BMO Capital Markets. “Finance companies and institutional investors are more active players in the sponsored business. There we are continuing to see large holds because the CLO market is so white hot.” Jones continued, “This compares to the banks who are less aggressive in the sponsored business than they historically had been because of the regulatory guidelines.”

“The name of the game is being able to take down most or the entire facility with limited to no flex so that there is certainty to close and a seamless underwriting process for the sponsor. That is what they’re looking for,” offered Mark Tauber at CapitalSource. Tauber indicated that most lenders can speak to holds of \$20 to \$25 million. High holds can start at \$40 million and tap on \$100 million or more in certain situations.

“Hold sizes are going up for two primary reasons,” observed Scott Turco at GSAM Private Credit Group. “As the market has become more competitive, lenders have increased their hold sizes in credits that they have greater conviction in; they want to deploy more dollars in a won and known credit. And because of the perceived strength of the credit markets, people are willing to take on more syndication risk.” Turco continued, “I think more lenders are structuring credit agreements to allow for the ability to grow outstandings through acquisitions. Their thought process being: where it is a competitive situation involving a known credit, we would rather support those acquisitions ourselves than to sell down that position.” “Lenders are willing to take big bite sizes to win a deal, in the form of an underwrite or an ultimate hold,” commented Dan Letizia at THL Credit. “There are situations where you want to hold more because you like the credit and

you are looking to build your book of assets. For the larger deals, it has always been a differentiator.”

Underwriting

Underwriting is less prevalent in today’s robust credit environment, said most lenders. Facility size, nature of the auction process, and the degree of certainty that the sponsor wants to present from a financing standpoint are determining factors. “If it is a really tight timeframe and the sponsors can’t have financing contingencies as part of their final bid, that is where we are seeing bid requests for underwritten transactions. Otherwise they are trying to club deals up themselves if they can,” said Jeffrey Day at Madison Capital Funding. “The line of demarcation gets very gray because of the liquidity. You can do a small syndicated deal or you can do a large club deal. I think they are both on the table,” said Scott Reeds at Citizens

Financial Group. “The finance companies and BDCs would prefer club arrangements because they are focused on deploying assets, whereas banks prefer more of a syndicated market where they can hold but hold isn’t necessarily the deciding factor.”

“The middle market is still a club market,” observed Radway. “By and large, 60-70 percent of the deal might be spoken for based on the hold capacity of two, possibly three lenders. The sponsor typically tries to put together a club of two or three lenders to get a deal done without having to pay for a fully underwritten deal.” Radway continued, “Instead of a single lender speaking for a \$100-\$150 million commitment, you might have two lenders speaking for \$75 million. That is more prevalent than a single lender underwriting a larger deal and then syndicating the exposure concurrent with close or post-close.”

“As the market has become more competitive, lenders have increased their hold sizes in credits that they have greater conviction in. And because of the perceived strength of the credit markets, people are willing to take on more syndication risk.”

—Scott Turco
GSAM Private
Credit Group



Outlook

“No better, no worse” is the outlook of most lenders when asked about the prospects for 2015. As long as the economy continues to show modest improvement, businesses should continue to grow at acceptable levels. Lenders will need to deploy assets and invest capital, with most anticipating a frothy environment as the supply/demand imbalance persists. “I don’t think the inflow of capital will change. I don’t anticipate a material spike in defaults because the economy seems to be improving,” offered Preston Walsh at PNC Mezzanine Capital. “We are keeping a close eye on inflation, interest rates, and the state of the economy—whether we actually have some sustainable growth.”

On Interest Rates

Lenders are factoring a rising interest rate environment into their underwriting analysis. While rising rates will have a direct impact on valuations and borrowing costs, with interest rates so low, most market participants do not anticipate a material effect in 2015.

“We are watching pretty closely what happens with interest rates. As those start to tick up, and we think they will tick up modestly beginning in 2015, we will be looking at what impact that has in the market on spreads and floors.”

Rich Jander, Maranon Capital

“A 25 to 50 basis point increase in Fed Funds will not make much of a difference. However, if you saw a more dramatic shift in monetary policy, there is no question it is going to have an impact.”

Robert Radway, NXT Capital

“Fed unwinding should have a dampening effect on the markets. The Fed is trying to pull back its stimulus and hoping that does not cause the economy to tip into a recession.”

Brent Burgess, Triangle Capital

“Interest rates can move pretty quickly up or down. If that is a gradual, controlled situation, then I think it would be positive for the macro economy.”

Steve Gurgovits, F.N.B. Capital Partners

On Liquidity

“We are watching the interplay between new capital formation and forced exit or forced moderation as a result of regulation.”

Rich Jander, Maranon Capital

“I think banks will be pulling back and being more conservative. It hasn’t happened yet, but I think it will happen.”

Steve Robinson, GE Antares

“The broader market will be more susceptible to volatility because a lot of the liquidity is coming from retail mutual funds. CLO issuance continues to be strong in the middle market. However, if that changes, you are going to see some more tightening as it relates to capital deployment.

We are in a hypersensitive environment right now as it relates to the amount of scrutiny on banks and the sensitivity given what happened in the last downturn. Ongoing reviews, whether it be the Fed or OCC, are going to start to dictate behavior. There will probably be a ripple effect through the broader market. In the lower end of the market, because there is so much capital from finance companies and investors, there clearly will be a lag.”

Katie Jones, BMO Capital Markets

“We are watching the interplay between new capital formation and forced exit or forced moderation as a result of regulation.”

*—Rich Jander
Maranon Capital*



“Clearly the liquidity that is continuing to come into the senior market is robust. There have been a lot of BDCs that have created side car vehicles that are dedicated towards the senior secured marketplace. The outflow of the traditional leverage funds and commercial bank regulatory constraints are going to be picked up by these leveraged funding vehicles.”

“Yield and terms continue to be attractive on unitranche and second lien loans relative to high yield alternatives. This spread premium is going to continue to attract investors and fuel capital formation on the part of BDCs. Today, private BDCs are continuing to access capital at a pretty healthy pace; however, public issuance will be less pronounced with many BDCs trading below net book value with some of the recent dislocations in the investor bases. Unless there is a fundamental break in the credit quality, leverage availability, or flow of funds, it is still an attractive place to invest relative to the alternatives.

Bob Marcotte, Gladstone Capital

“I don’t see anything that is going to materially change the supply or the demand. The caveat is if BDCs are able to get more leverage, which will bring more supply of first lien senior debt capital into the market.”

Jeffrey Day, Madison Capital Funding

On Leverage & Pricing

“Through the BDC Modernization Act, BDCs are trying to enact legislation to increase their leverage and lower their overall cost of capital. If they are successful, BDCs are going to be borrowing more, and that is going to give them the ability to compete at lower prices. Other players will respond by trying to figure out ways to put more leverage in their structures or lower their cost of capital. You could still see another wave down in terms of pricing.”

Brent Burgess, Triangle Capital

“We are probably close to the peak of the cycle and entering a period of relative stability but one that is still quite aggressive. There might be some further deterioration from a lender’s point of view but not much.”

Robert Radway, NXT Capital

“You have seen a period of significant deployment for lenders over 2013 and 2014 with very few underlying credit issues. If you have an uptick in the default rate of some of these highly levered balance sheets, then you will have less overall credit deployment. I would expect to see less aggressive lending terms and more conservative capital structures in 2015, which could translate into lower purchase multiples, which would ultimately be a positive for both middle market lenders and private equity groups deploying capital into that environment.”

Scott Turco, GSAM Private Credit Group

“Independent of changes in interest rates, I think we are in for a benign pricing and leverage environment. If interest rates begin to walk their way up, we will all have to think about whom that impacts in the market and how we reflect that in our lending practice.”

Allan Allweiss, LBC Credit Partners

“I don’t see the market getting much more aggressive from where it is today. There will be some kind of trigger to a return of a supply and demand balance—rising interest rates; economic stagnation, either domestically or globally; political unrest—that gives lenders pause. For deals that you’re closing today, it is just a question of, are you derisking before that happens?”

Dan Letizia, THL Credit

“There is still too much capital chasing too few quality assets. As we move into next year, to the extent we can continue to moderate the supply/demand imbalance, that will have a muting effect on valuations and leverage. If you have more deal flow, people will be more selective, and that will lead to more reasonable multiples across the board.”

Pete Notter, Madison Capital Funding

“If you have more deal flow, people will be more selective, and that will lead to more reasonable multiples across the board.”

*—Pete Notter
Madison Capital
Funding*



Outlook

“Leverage levels are currently very aggressive. Most people believe that the U.S. economy is doing fine and has some modest room to grow. As a result, leverage levels could continue to creep up in 2015, but likely not by very much. If interest rates start to rise, the actual cash flows that businesses can support will be more challenged unless spreads contract. That should provide somewhat of a balance to overall leverage level escalation.”

Scott Reeds, Citizens Financial Group

“As we move into the fourth quarter and into 2015, we might be entering a firming period in terms of pricing. We don’t expect to see too much more push on leverage multiples given where we are today. It will be interesting to see whether alternative pricing structures such as PIK toggle features surface as a point of differentiation to win mandates.”

Rich Jander, Maranon Capital

“We are already at peak leverage, so it is hard to imagine leverage getting much higher. If leverage and pricing remain at current levels, we are probably looking at more measured growth next year given that we are not being adequately compensated for the risk.”

Jeffrey Day, Madison Capital Funding

“I think you could see leverage creep another quarter to a half turn higher during 2015. Interest coverage is much better, especially compared to 2007 levels. I think it would be unlikely to see pricing drop below 400 over Libor meaningfully.”

Michael Girondo, Varagon Capital Partners

“You’ve had two or three years of very aggressive lending. Looking at historical metrics, we are at or worse than the previous peak. Once you start seeing an uptick in default rates, lenders will start becoming a little more conservative.”

Mike Foster, Midwest Mezzanine Funds

“The closer we get to the perceived cycle, the more you are going to see rationalization with leverage. Pricing has been relatively stable, give or take 50 basis points, for the last 24 months. I don’t see a dramatic uptick within that 50 basis point window.”

Jeff Kilrea, CIT Group

“From a leverage standpoint, I don’t see the market getting significantly more aggressive in 2015 than they are right now. At the same time, I don’t see lenders pulling back significantly. There is still a substantial amount of capital available to finance transactions.”

Ira Kreft, Bank of America Merrill Lynch

On M&A Activity

Overall sentiment is positive, with lenders predicting an M&A driven market in 2015. All indications point to a busy fourth quarter and a building 1Q15 pipeline. The fundamental drivers that have been in place—namely a healthy economy, eager buyers, and accommodative financing markets— should they maintain, will continue to support healthy deal volume next year. However, lenders contend there is no catalyst to materially drive more M&A.

“I think the market is going to stay strong at least for the next 12 months. There is enough liquidity to keep our market aggressive and that will help to support M&A activity.”

Steve Robinson, GE Antares

“The last surge of good quality, privately-held companies to come to market was back in 2012 with the capital gains changes. Given low interest rates, elevated valuations, and an improved growth outlook, you have the healthiest flow of quality companies coming to market in quite some time. You still have fundamental growth demands on the part of strategics and a lot of capital to put to work by private equity, which is a good foundation for continued M&A activity.”

Bob Marcotte, Gladstone Capital

“The closer we get to the perceived cycle, the more you are going to see rationalization with leverage.”

*—Jeff Kilrea
CIT Group*



"I think people generally perceive this to be a good environment for exits. There are a lot of family-owned or closely-held businesses that every year are going to rotate into a generational transfer."

Allan Allweiss, LBC Credit Partners

"We have been talking for a couple of years now about the overhang of private equity-backed portfolio companies. We started to see that inventory chip away in 2014. The businesses that have been climbing out of the recession are now on an upswing and saleable today. We think that trend will continue to perpetuate.

"Strategics are finally entering back into the market. They are letting go of the cash they have been accumulating and actively participating in some of these middle market auctions. There have been many more instances this year where a transaction that was auctioned to middle market private equity has ultimately gone to a pure strategic buyer. We have seen an increase in that type of activity."

Rich Jander, Maranon Capital

"If purchase prices remain at current high levels, family and sponsor owned businesses will continue to come to market. It also has a lot to do with financing multiples, which may be impacted by default rates. Assuming no portfolio issues, lenders are likely to stay on the current course."

Al Ricchio, Kayne Senior Credit Fund

"I would expect a continuation of today's healthy M&A environment. There remains an overhang of private equity capital, leverage is readily available on competitive terms, and seller valuation expectations are being met. Overall, it continues to be a market conducive to transacting."

Scott Carpenter, Crescent Direct Lending

"If you're a seller, right now is probably as good as it gets in this cycle. There is a lot more downside to holding on than there is upside. That is going to push more people toward the exit sign over the next 12 months."

Mike Foster, Midwest Mezzanine Funds

"I think there is more activity to come. Clearly, we are still at a relatively low level of overall middle market M&A activity by comparison to 2005 and 2006. I would estimate roughly a 10-15 percent increase in volume over 2014. A number of factors will drive market activity higher, namely continued economic growth and the maturity of portfolio companies that sponsors want to exit and need to exit."

Robert Radway, NXT Capital

"I would expect M&A volume to increase next year, and we should see more sectors participating in the leveraged buyout market. It could be more of a picker's market which will allow lenders to be more selective. If deal flow from the last 12 to 18 months is any gauge, lenders will need to sharpen their pencils because most deals will have a story."

Mark Tauber, CapitalSource

"M&A activity in the lower middle market is extremely competitive right now, and sponsors realize that they won't win on purchase price alone. They will look to have an 'edge' in the process, and that often means looking to lenders for committed financing to improve their chances."

Tim Clifford, Abacus Finance

"If you're a seller, right now is probably as good as it gets in this cycle. There is a lot more downside to holding on than there is upside. That is going to push more people toward the exit sign over the next 12 months."

*—Mike Foster
Midwest
Mezzanine Funds*



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Representative Transactions:

 — obtained financing provided by — and 	 — recapitalized by — 	 — has received a minority investment from — 	H.J. Heinz Lofts Phase I — acquired by — Recapitalization/Joint Venture 	 — recapitalized by —
ENVIRONMENTAL SERVICES	E-COMMERCE	HEALTHCARE	REAL ESTATE	METALS
 — acquired by — 	 — a division of — — acquired by — 	 — acquired by — — a portfolio company of — 	 — acquired — 	 — acquired by —
RETAIL SERVICES	HEALTHCARE	PLASTICS & PACKAGING	HEALTHCARE	BUSINESS SERVICES
 — acquired by — — a portfolio company of — 	 — a portfolio company of — — acquired by — 	 — acquired by — 	 — acquired by — — a portfolio company of — 	Obtained Financing for Construction of the Aloft Hotel in Beachwood, Ohio — provided by — and Private Equity Investor
HEALTHCARE	METALS	BUSINESS SERVICES	ENVIRONMENTAL SERVICES	REAL ESTATE
 acquired the Wisconsin whey processing operations of a wholly owned subsidiary of 	 — acquired by — 	Senior Management of acquired the outstanding stock controlled by non-management shareholders with financing provided by and 	 — acquired by — 	 — acquired by —
CONSUMER	INDUSTRIALS	RETAIL SERVICES	INDUSTRIALS	RETAIL SERVICES

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