US ROUNDTABLE

From left to right: Vipul Shah, Nick Cleary, Randy Schwimmer, Greg Robbins, Chris Flynn, Art Penn, Mike McGonigle

Getting creative

In discussion with seven US private debt managers, **Anastasia Donde** finds that players who would normally be rivals are becoming increasingly creative on how they work with each other and banks, as well as sponsors and borrowers.

Banks exiting mid-market lending and the long-anticipated rise in interest rates are themes that have been bandied about for so long that it often prompts a yawn from private debt managers.

However, a change in the way lenders are approaching these issues is rekindling interest.

On interest rates, many point out that the (small) impending rate rise is already priced into the market.

The looming turn in the US credit cycle is also in danger of becoming a worn-out topic. From a distressed perspective, the late-stage credit cycle means too few opportunities. For performing lenders, it signals a glut of plenty combined with higher risk; any deal can get done and the market is getting overheated.

In response, the lenders at *PDI*'s US roundtable are getting strategic around working with one another on club deals, spreading out their exposure across multiple products, venturing into new sectors and finding their own edge that will see them through any stage of the cycle.

Golub Capital, which has historically worked primarily on sponsored deals, recently hired a senior executive to work on non-sponsored sourcing. THL Credit's Chris Flynn says his firm frequently sells the senior slice of one-stop loans to banks or brings them in on the revolver. Audax's Mike McGonigle recently accommodated a client's request by establishing a BDC for just that investor.

The atmosphere around the roundtable, hosted at Golub Capital's offices in New York, was more collegial than competitive. Of course, these lenders, and others in the industry, have a vested interest in the success of private debt as an asset class, so they need to work with one other to make sure deal-making is sound, not getting creative in unwarranted ways.

Q How do you think GE Capital's exit is affecting the lending business?

Greg Robbins: It's certainly created an opportunity for us. We [Golub Capital] have hired some terrific people from GE and won some deals that we may not have otherwise. I think this is a smart purchase for CPPIB. They're going to be a big player in the market with strong financial backing.

Longer term, it's pretty clear that their cost of capital is going up so the playing field will be more level. But ultimately, I don't think spreads are going to increase just because CPP/GE has a higher funding cost. It'll also be interesting to see what their model will be on a go forward basis – will it be an underwrite-to-hold approach, an underwrite to syndicate mandate or something in-between?

Mike McGonigle: I think it's positive for the lending environment. You're trading one smart, well-financed owner for another smart, well-financed owner.

Randy Schwimmer: It shined a bright light on the regulatory issue: non-banks versus banks. The crown jewel of middle-market lending going to a non-US non-regulated entity says it all.

Q Speaking of which, how do you think continued regulatory pressures on banks will impact your business going forward?

Chris Flynn: We've strategically repositioned our portfolio over the last two years to invest in more secured paper, and that's primarily about filling that void created by the banks contracting in this space. I think the trend is in the early stages. You could see a long runway of alternative lenders satisfying the needs of lower middle-market borrowers.

Nick Cleary: And it's not just the middle market, bank regulatory change is creating opportunities in high-quality infrastructure lending here and globally. I do think media around banks exiting lending has been overhyped. Basel III is coming, but banks are not going to quit lending. These are still profitable businesses for banks. A number of the Basel III requirements start to bite next year with full implementation not until 2019. This means we're still at the early stages of seeing the impacts and opportunities.

So far we've seen the largest opportunity due to changes in bank regulation in the secondary channel, but it's cyclical. It's a nice opportunistic play but it rarely supports sustainable long-term deal flow because banks are adapting.

There is a lot of misunderstanding on what's going to happen in the bank space. And the institutional capital coming in is still quite new which means we're all finding our roles in the market. There are many transactions that are good examples of how bank and institutional capital are evolving to deliver innovative and valued debt solutions; hybrids of clubbed lending, underwriting, construction and splitting out the short term or revolving facilities from the longer-term core debt funding that institutions are well suited to.

CF: To clarify my point, I don't think the banking sector is going away. It's just going to get redefined and probably have a smaller role in middle-market lending.

Going forward, we plan on working in tandem with the banks. It's a different relationship than it was historically, but it can create a good risk-adjusted return for both parties when done right.

Art Penn: The regulatory changes that banks now have on leveraged lending and debt to EBITDA multiples have been helpful in keeping a lid on leverage. I don't think any of us here are doing six times plus leverage. That said, the leveraged lending guidance forces banks to look at themselves and others and ask, "Do we really want to do this deal?"

RS: That's a good point. It draws a line in the sand that the banks can't go over without some real issues. And it's putting

NICK CLEARY

***Investment director, infrastructure debt,* Hastings Funds Management**

- Short-term lending at five to 10 years, long-term loans of up to 30 years;
- Deals in the $50 million - multi-billion dollar range;
- All sponsored transactions;
- Borrowers from $50 million - $1 billion EBITDA
- Opportunities: natural gas, wind farms, solar in the US, renewables in the US and globally;
- Energy is the biggest focus in the US.

ON GLOBAL OPPORTUNITIES:

"A lot of our activity in the last three years has been raising money in the US and investing it elsewhere, and we're increasingly bringing global capital into the US market these days as it grows.

"Globally, it's quite diverse. There is no one theme in our markets. In Europe and Australia, we see a broad cross sector in utilities, transport, power, airports, railroads, shipping and ports."

US ROUNDTABLE

CHRIS FLYNN

Co-chief executive officer, THL Credit

- Lower mid-market focused with typical company EBITDA in the $5 million-$50 million range, with sweet spot in the $10 million-$25 million range;
- $5 billion under management across direct lending and tradable credit, which includes a CLO platform;
- 15-20 deals per year;
- Primarily sponsor-focused in direct lending;
- Industry verticals: consumer healthcare out of Boston and Chicago, business and financial services out of New York, energy and industrials out of Houston and technology in Los Angeles;
- Avoids: infrastructure and real estate.

ON WORKING WITH SPONSORS:

"In a downside scenario, it's nice to have that sponsor that can control the board and potentially make tough changes that the entrepreneur is not willing to make."

the spotlight on the non-banks who still do. You can see it in the dampening effect on leverage.

MM: I agree. Historically, we defined the middle-market as companies with $10 million to $50 million of EBITDA. With some of these leverage lending guidelines, that definition is moving up. When companies get to a certain size, they'd normally access the broadly syndicated loan market and get refinanced out of our loans. It seems we're retaining our portfolio companies longer because there isn't that natural exit. We're also getting calls from private equity firms because their traditional bank lenders are incapable or nervous, from a regulatory standpoint, about providing incremental capital.

Vipul Shah: When you think about banking and the regulatory impact, a lot of folks think about Wall Street. But the regional banks are going through the same issue. On non-sponsored deals, these banks want to keep the relationship with the family or business that they've worked with for a long time. So other than being a revolver provider for people in this room, they're thinking about retaining the revolver and 10 other services and ensuring they have a friendly lending partner to provide what they used to. The buy-and-hold strategy works for the entrepreneur, but the buy-and-syndicate strategy introduces risk and they value the relationship. It's shining a light for entrepreneurs and managers that there are other sources of capital.

CF: One dynamic that has changed is the necessity to have multiple solutions for a capital raise. It's difficult if you're just a one-trick pony. Looking around the room, we all have flexibility with the capital we manage. We can do first lien, second lien, unitranche, etc. That didn't exist a few years ago. A lot of it is because as the banks have redefined their role, and has created an opportunity for some creative solutions, but you have to be able to execute across four or five potential securities.

RS: And that disintermediates a lot of the syndicated product. To the extent that Golub can hold a couple of hundred million per deal and just spread it out amongst other funds. They've done a great job in creating a virtual balance sheet and that's the next step. Instead of distributing it to outside investors, it's to inside investors.

Q: Do you have preferences for where in the capital structure you tend to invest?

AP: It all comes back to what sponsors and borrowers want. On the question of whether mezz is dead, there are quite a few sponsors we work with who like mezz and we're happy to provide it when it's a good risk-adjusted return. Some sponsors love unitranche, some love first lien or second lien. And the markets are open enough for all of us in this room to tailor the solution to their needs.

MM: We think mezzanine is alive and well. Junior capital ebbs and flows depending on where you are in the cycle. Our mezzanine team funded five transactions in the first half of the year, so we are still seeing ample demand from sponsors that like mezzanine. Some might be transaction-specific and not easy to find, but the need is still there.

Q: Where are we in the credit cycle?

RS: The seventh inning stretch. It's more of a rates cycle than an economic cycle. On the one hand, you can say we're in the sixth year of the recovery. But you can also say that the Fed has created an artificial environment by pumping liquidity into the market and not raising rates, so we won't know until we take the oxygen mask off the patient and see if it's still breathing.

GR: We are a lead lender to nearly 200 middle-market companies across a lot of different industries and the monthly numbers have been good. They're not gang busters, but for a lender, flat to slightly up is actually better. Overall, our watch list, as a percentage of our overall portfolio, is near record lows. So while leverage levels are high, it doesn't feel to us that we are at the precipice of the cliff.

To Randy's point, it's six years into the recovery, we're certainly being cautious. We're almost exclusively focused on the top part of the capital structure and working with repeat sponsors and borrowers.

NC: When we look across our business globally and back over the 20-plus years Hastings has been in infrastructure, it's hard to find a comparable situation to use as a guide.

In Australia the economy is generally fine, rates are still declining and the growth in the Asia/commodity cycle has slowed yet the foundations remain quite robust. In the US the pain was taken early and swiftly, as seen in the real estate market and overall leverage in the private side of the economy. Today the US appears to be stabilising and recovering, albeit it hampered by a lack of political consensus, inefficient bureaucracy and chronic under investment in infrastructure. Europe and the UK are different again.

We are not seeing any uniform pattern to credit quality across sectors or markets. Credit cycles are inevitable but experience, a global perspective and locally agile investment teams can avoid bubbles and quickly capture opportunities are invaluable in today's investment climate.

AP: I agree that we are fairly deep into the credit cycle. The biggest area of stress and opportunity right now is obviously energy. We might be in a capitulation phase at this point, where inevitably, there is a lot of money to be made on the upside.

VS: If you look at the mid-2000s relative to now, I don't think we're anywhere near historical leverage levels when the cost of capital was much higher and free cash flow was much tighter.

RS: We've all been doing underwriting for a long time and we always say: "What if?" Whether we're going to get another cycle in three months or three years? Will it look like '08-'09, 2001 or 1998? How does it affect the credit that I'm looking at? In many cases, you actually have a track record of these businesses to see how they did. If they motored through the most recent recession without a hitch, that's a good indicator.

Somebody once said that nothing good happens over six times leverage. And that needs to be addressed better if we're in the seventh inning versus the third inning.

NC: Another part to the credit cycle is liquidity. There is a lot of liquidity out there. Today with low rates and liquidity, capital is very cheap and this can mask weak performance and credit risks. It may end up being a game of musical chairs, and when the availability of liquidity ceases and rates increase some sectors may see credit events emerge quickly due to liquidity risks or materially higher capital costs that were not necessarily seen in the underlying assessments.

The other half to this is the new

MIKE MCGONIGLE

Managing director, Audax Group

- The senior secured business, which McGonigle runs, invests primarily in term loans of midmarket private equity sponsored buyouts;
- Invests primarily in first lien senior secured loans, but the firm as a whole invests in mezzanine and second lien via a separate group/funds;
- Industry generalists, but avoiding sectors like retail, restaurants, fashion/apparel and energy;
- lends up to $40 million as a partner with banks and other agents in transactions ranging between $50 million to $300 million;
- $10 million-$75 million EBITDA companies.

ON SPONSORED VS UNSPONSORED:

"We actually think the non-sponsored space is attractive. There are firms out there that do it very well. But given our lineage as a private equity firm, we don't think the non-sponsor side plays to our strengths well, nor do we think we can do it in large volumes, so the focus right now is on the sponsor side."

US ROUNDTABLE

ART PENN

Founder and managing partner, PennantPark

- Invests up and down the capital structure in first lien senior secured debt, unitranche, second lien and mezzanine;
- Majority sponsor-backed transactions;
- $2 billion in assets mostly in two BDCs and some private funds;
- Sector expertise in energy and gaming;
- Avoids fashion, start-up tech companies;

ON ENERGY

"We continue to believe that energy might be a particularly attractive opportunity as we get to the kind of capitulation phase in the market. When we do these deals, we have management teams, consultants and experts that we rely on."

liquidity from non-bank lenders which can reduce risk via greater diversity of funding and, importantly, longer tenor debt capital that provides borrowers time to adjust. However, it's unclear to me how much of this new investor capital is going to stay in the long-term as rates kick up and 5 to 10 percent returns can be achieved in liquid, lower risk assets.

MM: The whole world is awash in liquidity, we focus on the middle-market, so we're not as susceptible as large-cap names are to capital market conditions. That colours our thinking as we put money into a company. We view it as a lending relationship, not a tradable security.

GR: The BDC market is a great place to put illiquid assets. It's permanent capital. It's tightly controlled in terms of leverage limitations, so it can withstand losses more easily.

VS: Given what happened in '07-'08, people are much more apprehensive about taking fast money. On the non-sponsor side, where you had hedge funds which were more active with entrepreneurs, people say, "Look what happened!" Those stories travel much faster and they're fresh on people's minds.

Our focus now is to really understand our partner so that regardless of what happens in the broad market, we have transparency and alignment of interests.

NC: Transparency and understanding are also important. We spend a lot of time explaining our business to our clients and issuers to improve transparency and better align our clients with investment opportunities, and vice versa. Should an

GREG ROBBINS

Managing director, Golub Capital

- Mainly sponsored deals;
- Focuses on one-stops and senior loans lately;
- Often works with repeat sponsors and borrowers with 250 PE firm relationships;
- Averages 60+ transactions per year, though ahead of that target for 2015;
- Closed 43 transactions in the first half of 2015 out of more than 1,200 opportunities giving a hit rate of less than 4 percent;
- Likes: resilient, cash-flow generating predictable businesses that have a strong second way out i.e. a strategic buyer would want to buy;
- Three industry verticals: healthcare, software and specialty retail/restaurant;
- Avoids: highly cyclical businesses such as auto, homebuilding and energy.

ON WORKING WITH SPONSORS:

"You have a partner here where if things aren't going well, they can change the direction of the business, they can change management, invest more capital, set a new vision or cut the capex programme. There are many things they can do that can improve our position in the capital structure as a lender. But it's certainly a more competitive product when working with sponsors. They're smart, they pit us against our competitors. They like to beat us up on terms and pricing."

TIAA-CREF Asset Management is pleased to announce the launch of Churchill Asset Management LLC, a new majority-owned affiliate focused on originating, underwriting and managing senior loan investments, primarily in U.S. middle-market companies.

TIAA CREF

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For more information on TIAA-CREF Asset Management, please contact Jennifer Pedigo, CFA at **Jennifer.Pedigo@tiaa-cref.org**.

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US ROUNDTABLE

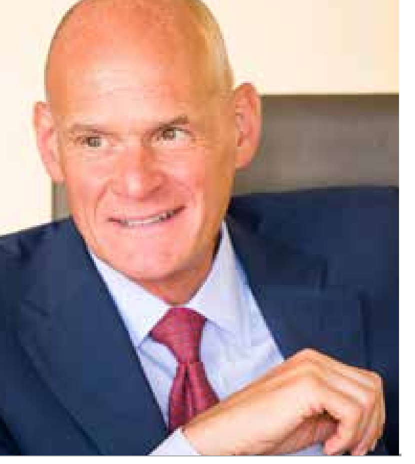
RANDY SCHWIMMER

Head of origination and capital markets, Churchill Asset Management

- Mostly sponsored deals;
- Industry generalists. Typical deals are spread across a mix of assets including manufacturing, distribution, recurring-revenue software companies or business services;
- Avoids: heavy cyclicals or anything that requires specialty lending expertise, like oil & gas, drilling, gaming, fashion-driven apparel;
- Six deals completed this year since the firm was re-launched under TIAA-CREF in April;
- Initially managing about $300 million of TIAA-CREF capital.

ON THE SPONSORED CHANNEL PREFERENCE:

"The way we look at it is: we like to see adult supervision with our sponsors, so it's not just capital but also thoughtful leadership on policies and procedures and upgrading management teams."



event happen, this means everyone has a better handle on when to worry or act promptly and when not to.

Q Where are you seeing the most interest among investors? What are the challenges to raising funds?

GR: Insurance companies and pension funds have definitely been active in the space. With rates virtually at zero for years, the traditional fixed-income solution is broken. The 60/40 mix between equities and bonds that used to generate a 7 to 8 percent return worked for a long time, but it doesn't anymore, so institutions are being forced to evaluate alternatives. Middle-market lending is one of them.

CF: Where the conversation becomes a little more interesting, if you go back and look at traditional LP allocations, is fixed-income or alternatives. Where we play in direct lending — the 9 to 11 percent net return — the yield works for fixed-income but the lockup doesn't. For alternatives, the yield is too low, but the lockups were acceptable, so you were in that no man's land.

Now, what we've seen more is investors carving out room in that alternatives bucket to do some longer-dated fixed-income. As long as they've created a basket for it, it's a much easier conversation.

RS: In a way, the recession was the best thing to happen to the asset class because these companies motored through and investors could look back at the track record and say it performed as advertised. Smaller like-minded lenders and a small group of banks or finance companies can actually help the borrowers motor through a recession. Rather than having one eye on the door from a liquidity perspective, we're actually buy-and-hold investors and that's helped educate everyone on how it's different to bonds or broadly syndicated loans.

CF: In a lower middle-market credit, you can actually sit around the table with all the constituents and call a plan to maximise stakeholder value. It's a substantially different conversation in a broadly syndicated transaction: you don't exactly know who your counterpart is, what type of vehicle they own it in or whether they actually purchased the debt at a discount.

VS: We are seeing investors at every size. There are institutions, especially small- and medium-sized ones that have goals to match their asset/liabilities. Then single family offices, multi-family offices, endowments and foundations have a need from a current income standpoint. So in these net, almost double digit yields, there is still a pretty significant demand, even if interest rates change.

Q How do you differentiate yourself from your peers?

RS: TIAA-CREF has significant investments as an LP in sponsor funds, so it's a great advantage to be at the table with sponsors as an LP. They'll go through their portfolio and say, "There is this deal we might do something with in the next few weeks and we'll give you a call."

We also have really good relationships with the lenders around this table. We're not going to be competing to lead deals in the foreseeable future, so we're going to be going to the Golubs and the THLs and Audaxes of the world, and saying, "Is there anything we can do to be helpful?" So being a trusted relationship is also critical.

GR: I think it is a combination of a number of factors including scale, size, longevity, a broad product suite with large buy and hold capabilities and a reputation for delivering consistent reliability. We're not beholden to M&A activity to drive deal flow; we get a lot of activity from our existing portfolio. The leveraged lending guidelines, some turmoil among our competitors and the hiring of some really terrific originators has led to growth, but we're remaining cautious and disciplined. This is not the time to be stretching for yield in our opinion.

VS: Our differentiation tends to be domain knowledge and expertise. We don't have a sponsor-coverage model as many of our competitors do. We're more likely to see an opportunity come from an industry expert or company itself and get involved very early in the due diligence process. For us, it's a combination of knowledge and relationships. On the non-sponsored side, the relationship factor and domain knowledge becomes almost a requirement. We are creating the quality of information that the sponsor would normally provide. Our team has an average of more than 20 years of research, entrepreneurship, operating and investment experience across the capital structure, which we believe makes for a strong partner.

AP: For us, part of the differentiation is the trusted long-term partnership we're building with sponsors and borrowers, our investors and our colleagues in the business. Additionally, track record is an important differentiator. People can see how we performed through the downturn, when the economy cycled down. The performance of the overall portfolio and how we handled and dealt with some of the inevitable bumps you have in this business are also differentiators. We're proud of that track record.

CF: Our go-to market strategy from an origination standpoint is focused on the infrastructure we've put in place over the last seven years and building out a five-office footprint. Lower middle-market credit is still a local game. Having offices in Texas, Chicago, New York, Boston and LA helps us find differentiated deal flow.

MM: We think our differentiation is being part of a firm that has private equity and mezzanine capabilities. We can leverage the mezzanine team's origination sourcing. We didn't need to build a separate debt origination team. We can also leverage the private equity industry and company knowledge. When we're looking at a software deal, we're on the phone with our PE colleagues who know the industry cold.

NC: In our debt business we're focusing more on deployment via client-tailored mandate solutions for large institutional clients that have been a great match for the opportunity because they can be agile and flexible relative to fund structures. We're gradually seeing more fund products making sense for investors as the infrastructure debt markets start to normalize and as the sector matures. The key product development questions are often risk/return profile and how long the fund tenor should be to align with the long term nature of the underlying investment opportunity.

Q What have been some of the challenges to your business lately? Is risk creeping up?

RS: It's not just about covenants, but cushions. The definition of EBITDA. When you see adjusted EBITDA and if your credit agreement goes on for a page and a half, you're in trouble.

What is the real EBITDA? That's an important question, because sponsors are clearly trying to stretch the envelope and justify the high purchase price multiple that they're paying. It's the lender's responsibility to be crystal clear about the definitions of cash flow, so even if cushions or covenants are a bit loose, you know the metrics being measured and how. ■

VIPUL SHAH

Managing director, Arrowpoint Partners

- Focuses on non-sponsored transactions, no specific target for those deals;
- Typically invests in $3 million to $75 million EBITDA businesses;
- Targets 10-12 deals per year;
- Industry verticals: technology, franchising, business services, industrials, healthcare;
- Newly formed direct lending platform under Arrowpoint Partners, which also manages CLOs, specialty credit, liquid fixed-income and equities;
- $8 billion under management overall.

ON THEIR NON-SPONSORED PREFERENCE:

"Our team is made up of former entrepreneurs, operators and private equity investors who have been managing credit for a long time and that lends itself to a network that brings about those type of non-sponsored opportunities."