Strength in connections

Three years after joining TIAA-owned Nuveen, Churchill Asset Management's president and CEO **Ken Kencel** and head of origination and capital markets **Randy Schwimmer** continue to make their mark by drawing on their deep industry roots and extensive network of relationships

Q How do you define your mid-market strategy today and has this changed?

Ken Kencel: We are focused primarily on providing senior and unitranche debt financing to private equity-backed middle market companies. We define the middle market as businesses with between $10 million and $100 million of EBITDA. But our core strength is in the traditional middle market. Those are companies with between $10 million and $50 million of EBITDA. This generally translates into credit facilities of between $50 million and $250 million, although in some cases we will go even higher, depending on the situation.

Separate from borrower size, the traditional middle market is distinguished from the larger middle market and the broadly syndicated loan (BSL) market by how lending groups are assembled. Our debt financings are almost exclusively arranged on a club basis, that is, sponsors typically select the lenders they want to deal with. Over the last 10 years, particularly through the recession, sponsors discovered that knowing who those lenders are, and how they behave in distressed situations, is critical to protecting the value of their investments. We have been doing this together as a management team now for 13 years through the ups and downs of the credit cycle. That includes at least one significant downturn. Our sponsor clients know us as being very constructive lenders, and have grown very comfortable with the way we support our relationships.

Ken Kencel

Fundamentally, we are a relationship-driven firm focused on delivering timely financing solutions for our private equity clients and superior investment performance for our investors.

Q How are deal terms, including pricing, leverage and covenants evolving in the current environment?

Randy Schwimmer: Leverage, defined as debt-to-EBITDA, is creeping up on average, though all-in pricing has been relatively stable in the middle market. This is in contrast to the BSL market where all-in spreads have contracted over the past year. In part this is driven by lower triple-A spreads for large cap CLOs, which still hold the lion's share of leveraged loans. Of course lower spreads are being offset by higher LIBOR rates; a trend we saw in the pre-crisis era.

With regard to covenants, there's no question there's been a general loosening of terms. But this trend is less dramatic at the lower end of the middle market where we play. It's also helpful that private equity sponsors are paying higher multiples of EBITDA for new businesses which translate to a very healthy 50 percent equity share of total capital.

Otherwise we are seeing a growing share of all-senior and unitranche financings from our private equity sponsor clients. The latter category, in particular, has proven to be an increasingly popular instrument for sponsors as they look to us to help them deliver the most competitive bids to win new buyouts.

Q How much of your investment portfolio is in unitranche?

KK: About 20 percent of our portfolio is unitranche. In the fourth quarter, we closed and committed nearly $1 billion, and unitranche represented roughly 30 percent of that. It has been running anywhere from 10 to 30 percent on a quarterly basis and on average it is 20 percent. We expect to grow our unitranche investment portfolio as this type of financing is becoming a preferred financing solution for our private equity clients.

Q Is your strategy exclusively focused on sponsored deals? Do you anticipate this will change?

KK: Our investment portfolio sits just shy of $3 billion today and is currently 100 percent private equity-backed companies. Today we have roughly 100 companies in our investment portfolio and that includes businesses controlled by over 60 middle market private equity firms. We work closely with virtually all of the leading private equity firms active in the middle market today and have very strong relationships with many of them that go back, in some cases, over a decade.

RS: Our strategy from the beginning has been to leverage those relationships to generate robust deal sourcing. Having a private


Randy Schwimmer

equity sponsor as an owner of our borrower is a basic tenet of our investing philosophy. Given the amount of capital they invest in platform companies, sponsors are highly motivated to help the company succeed. And they have the ability to invest additional capital to support the company for growth as well as support in tough times. Finally, their professional management tools enhance not just the value of their investment, but ours as well.

Having said that, there are always non-sponsored financing opportunities out there. The bar for those kinds of investments is much higher. At this point in the cycle, we have not seen the kind of deals that meet those criteria, but we'll continue to assess that strategically.

Q How would you account for the uptick in LP interest in the asset class in 2017 and do you expect this sustain into 2018?

KK: In 2017, there was $180 billion raised from institutions and high-net-worth investors for private credit. But if you look at the capital raised since 2013, it has been running consistently at between $100 and $150 billion per year. For the first quarter of this year, it was approximately $35 billion. That puts the current pace in line with what we have seen over the last five years. Several things are driving this. One is the overall hunt for yield. Investors tell us they are disappointed with returns on their fixed income portfolio, which is generally investment-grade oriented. But also, as Randy said, there's pressure on yields in the liquid credit market and value is harder to come by. At the same time, they are looking at their private equity fund investments and wondering whether the high purchase multiples being paid will hurt returns on that portfolio allocation.

The result is investors are looking for an alternative that provides consistent income with yields in the 6-10 percent range. In the alternative credit space, there's a broad spectrum of different strategies, ranging from the more traditional senior and unitranche debt that we do, to mezzanine and quasi-equity-like investments.

Ten years ago most institutions didn't have a formal allocation for private credit. Today more than half the institutions we meet with do. Most LPs are now very comfortable with private debt as an asset class. This, along with the recognition that banks are less active in the lending space, has spurred the jump in private credit fundraising.

Q What impact do you expect the Fed's recent rate hikes will likely have on this appetite?

KK: With LIBOR now up to 2 percent we have seen a strengthening of all-in yields for middle market loans. That despite some mild compression in spreads. LIBOR floors, set since the credit crisis at 1-2 percent, have largely become irrelevant. The overall yield on our portfolio remains at about 7 percent, which is attractive relative to both BSL and HY bond alternatives. If the Fed continues to tighten for the balance of this year and into 2019, we expect this relative value to remain. Being a floating rate instrument, after all, is one of the key attributes of our product. ■