

Why Buy Middle Market Loans? (Last in a series)

A long-time practitioner of middle market lending called us last week. "I've really enjoyed your stuff on middle market loans," she said. "So what does it all mean?"

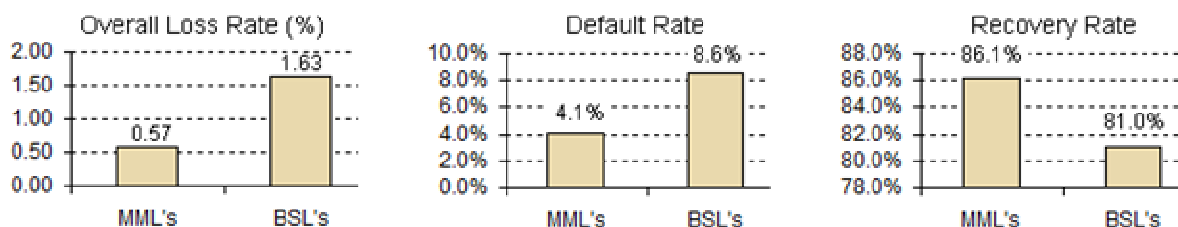
We understand the confusion. There seems to be a disconnect between the historic investor bias against smaller companies and deals, and evidence we've summarized in this space suggesting that expected losses for middle market loans are lower than for large, liquid ones.

In prior issues of OTL we've addressed four major misconceptions around the relative 'large versus small' value proposition:

Myth #1: Middle market loans (MML's) are less liquid than broadly syndicated loans (BSL's). This is the case only during times of 'normal' liquidity, but often because middle market lenders are more 'buy-and-holders' than traders.

Myth #2: Middle market companies are riskier than large cap ones. The problems of smaller companies are often easier to fix, and require less capital than mega-firm meltdowns. The loans themselves are less levered, and more 'constructively' structured. And issuers often have tighter 'borrower/lender' relationships.

Myth #3: Broadly syndicated loans show better recovery rates than middle market loans. In fact, S&P data shows default, loss, and recovery performance is better for middle market loans.



Source: S&P LCD, Credit Pro

Myth #4: Higher middle market spreads represent illiquidity premiums versus large caps. Institutional loan pricing and spreads are driven more by technical supply/demand issues such as high yield repayments and funds flows. Larger loans may alternatively be cheaper or dearer at times than middle market loans, depending on whether the market is extremely liquid or illiquid.

What our series has tried to show is not that middle market loans are always better investments than broadly syndicated loans, or that the default, loss, and recovery data we have presented are inarguable. Rather, we believe that middle market loans are often dismissed by otherwise savvy investors for reasons not always objectively examined and offer compelling risk/return dynamics when compared to liquid loans if managed correctly.

What is indisputable is that middle market credits as a class are not as transparent as those whose loans and bonds have been distributed to hundreds of institutional investors over many years. The level of tire-kicking required for an investor to appropriately assess the \$13 million EBITDA wing-nut manufacturer we discussed in our February 22 issue is several levels of magnitude deeper than someone looking to trade paper in Georgia Pacific.

But once that due diligence is done, augmented with focused, on-going credit monitoring, lenders are confident that a good middle market loan will perform as well as (or better!), be structured more conservatively, and priced better for the risk, than any broadly syndicated loan.

That's what it all means.

QUOTE OF THE WEEK

"There's no doubt about it, we're getting back to probably 2005, maybe 2006, levels of leverage. We're not at 2007 levels, but we're moving in that direction quickly."

- Bill Welnhofner, head of corporate restructuring, Robert W. Baird

CHART OF THE WEEK

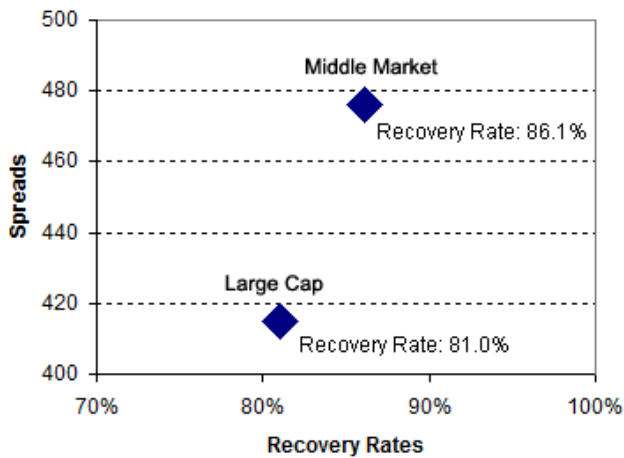
Premium Rewards

Today's average spreads favor middle market loans, with higher recoveries

LOAN STATS AT A GLANCE

A wrap-up of key financial metrics of the week, provided by:





Source: S&P LCD, Credit Pro

Stat of the Week:	1st Round	2nd Round	3rd Round
Percentage of upsets in the 2010 NCAA tournament	31%	38%	25%

	This Week	Last Week	One Year Ago
New Issue Loans (In Pipeline)	51	46	13
New Leveraged Loan Volume (In Pipeline)	\$20.09 Bn	\$18.87 Bn	\$2.07 Bn
Avg. Bid (LSTA 100 Index)	93.3	93.1	70.0
Avg. Spread (LSTA 100 Index; 3 yr Amortization)	499.0	506.4	1790.1
LIBOR (90 days)	0.29%	0.26%	1.23%
LSTA Index Returns (YTD)	4.15%	3.79%	8.17%
Middle Market Index Returns (YTD)	5.26%	4.64%	2.10%
Sr Debt/EBITDA (Mid Market; rolling 90 days)	3.0x	3.2x	3.3x
Debt/EBITDA (Mid Market; rolling 90 days)	3.6x	3.8x	4.1x
# of Defaults (LTM)	61	61	37
CLO share of Institutional Market (1)	46%	46%	39%

(1) New Issues for YTD 2010 and 2009

CHURCHILL SPOTLIGHT



This week we continue our conversation with **Jeff A. Golman, Vice-Chairman, Mesirow Financial**

[View part one](#)

Mesirow Financial is a diversified financial services firm headquartered in Chicago. Founded in 1937, Mesirow is a private company with over 1,200 employees in offices in the US and London.

OTL: How about some interesting growth sectors. Say, food and beverage?

Jeff Golman: There's always consumer demand in food and beverage, but it's so hard to get organic growth. It almost demands being acquisitive. The 'Better-For-You' (healthy living) space is one exception to the low single-digit growth outlook.

OTL: Do brands still rule?

JG: Brands take you only so far. After that, it's still the hard work of stand-out packaging, differentiating nutritional content, and superior marketing that makes the difference. Although nutrition isn't everything. The Cloverhill Bakery sale went pretty well, and that stuff (pastries) couldn't be worse for you! Lincoln Snacks, the Poppycock label, which was sold to ConAgra, is another example.

The Cloverhill Bakery sale went pretty well, and that stuff (pastries) couldn't be worse for you!

OTL: With the credit markets strengthening, will we see more PE buyers, vs. strategics?

JG: The strategic run will continue, but M&A activity has been improved by the new vitality of private equity. A good example is Senco. They make industrial staplers and fasteners. That deal had 'strategic buyer' written all over it. Illinois Tool Works, to use one name, would have been a natural fit. But PE bidders overwhelmed the process, and Wynnchurch ended up walking away with it.

OTL: Speaking of credit, how's the financing environment?

JG: It's getting easier. We have a list of 20-25 senior lending sources that seem to be active in the middle market. The right transactions certainly seem to attract plenty of banks. The Rohrer deal was a good example of that.

OTL: How about mezz?

JG: It's cheaper and plentiful. We're seeing pricing at 12% cash pay, plus 2-3% PIK interest. And no equity required.

MARKIT RECAP

An exclusive "On the Left" feature provided by:



Markit LCDX Nears Series-High Ahead of New Bullet

Markit LCDX On-the-Run



The Markit LCDX Series 14 index is set to roll on April 5th in synchronization with the launch of the new North American bullet LCDS contract. The contract is a welcome development for the market as participants expect the bullet maturity feature will overcome objections from many investors regarding valuation difficulties related to optional early termination and thus adding more liquidity.

To further promote liquidity in single name contracts, the index features a 250 bps coupon in line with the standard coupon for single names. The new index will see less reversioning and refinancing compared to prior series due to the removal of the optional early termination feature. Protection buyers will make a full first coupon payment starting from the previous IMM date prior to trade date. Tranches on the new index will roll a week later on April 12. Markit has written a primer on the new bullet LCDS contract, please contact otis.casey@markit.com for a complimentary copy.

The closing level from Friday was 104.27 which is up significantly from the beginning of the month at 101.98 and corresponds closely with the recovery in cash loan prices during March (in contrast to February). The Series high is 104.51 from January 11, 2010. New additions for Series 14 will be Dex Media West LLC, Charter Communications Operating, LLC and Idearc Inc. which will replace New Page Corporation, Getty Images, Inc. and Warner Chilcott Company, LLC.

-Otis Casey
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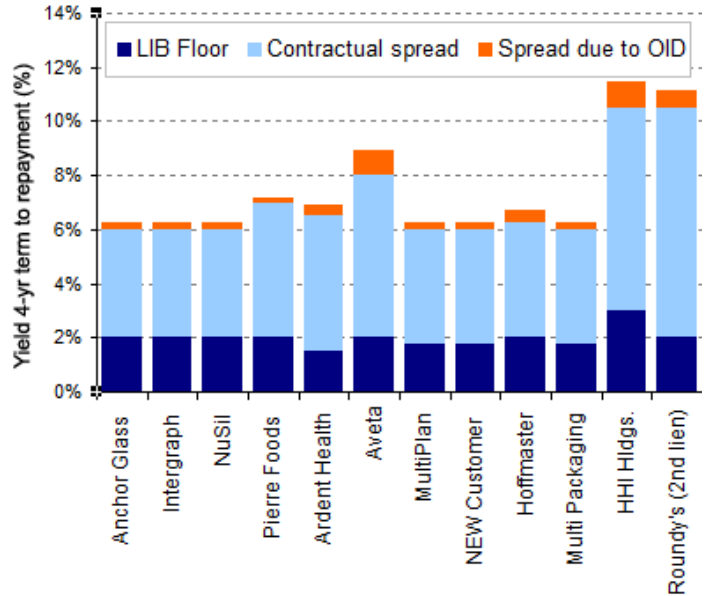
OTL: What's been your biggest surprise over the last couple years?

JG: Given the shock the markets were in after Lehman failed, I'm surprised how quickly things have come back. But it's not back to where it was in 2007. Leverage is still fairly conservative. And PE sponsors still need to put up 40-50% equity to get deals done.

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Dividend recaps popular in 1Q10 but market remains selective



Source: Thomson Reuters LPC

Amid limited dealflow, dividend recapitalizations for leveraged issuers are becoming increasingly palatable to asset seeking lenders. Still, the desirability and success of such deals remains selective.

Investor confidence is focused on sponsor commitment to the company, the amount of leverage being used to finance the dividend and the perceived ability of the company to generate cash flow irrespective of the dividend.

As such, investor appetite will differ from deal to deal. NuSil Technologies, for instance, offered good growth prospects and was oversubscribed. The deal offered a yield of 6.28%, well below the median of 6.48% for dividend deals in 1Q10. In contrast, HHI Holdings was in market for a while despite offering a rich yield of 11.45%

Sources say the fact that an auto-related company was seeking a dividend was fairly aggressive despite increased market liquidity. There was also an ABL component to the deal, making it potentially riskier for first-lien holders not participating in the ABL tranche.

Other dividend deals are also testing the market's appetite for risk. Roundy's launched a second-lien piece that offers a yield of 11.13%. Though Roundy's sponsor has consistently been paying itself a dividend, sources say lenders are more concerned about the leverage of roughly 5 times through the second-lien tranche.

For more loan market trends, dial into LPC's MM Webinar on 4/15/10 at www.loanpricing.com/LPC_webinars.html

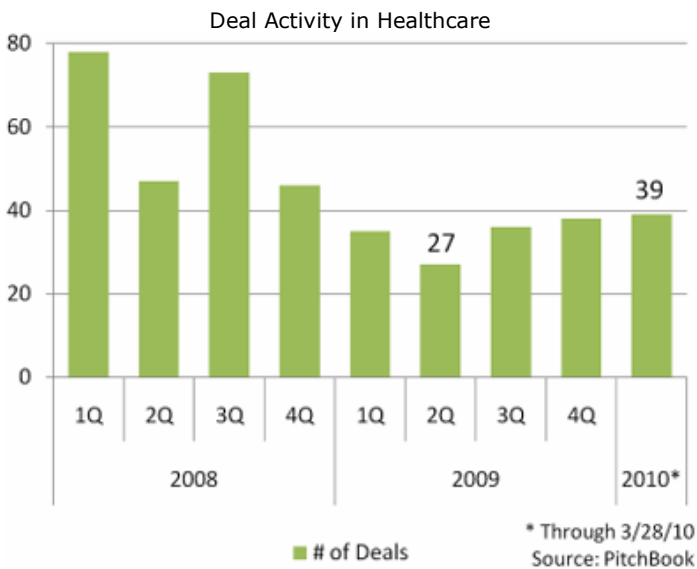
-Diana Diquez
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THE PULSE OF PRIVATE EQUITY

Trends & Analysis covering all aspects of the private equity industry



What Does the Healthcare Bill Mean for PE?



With the recent passage of the Patient Protection and Affordable Care Act, and the upcoming signing of The Reconciliation Act of 2010 by President Obama, it seems appropriate to spotlight private equity's recent involvement in the healthcare sector.

Such substantial change in the sector opens the door for opportunistic investment as well as innovative management and restructuring over the next few years. Whether we will see the private equity industry taking up the challenge en masse, however, will be unclear until businesses settle in to the new system of regulations, tax breaks and mandates.

Overall, activity in the sector has risen steadily since its 2Q 2009 nadir, and, with a few days left in the quarter, it appears the sector will break the 40-deal mark for the first time in over 18 months. The median deal amount rose to \$126 million, and deal activity in the sector accounted for 14% of total PE deal flow for the first quarter of 2010.

-Joel Stimson
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Deal	Arranger	Sponsor	Facility (1) (\$MM's)	EBITDA (4) (\$MM's)	Leverage	Spread	LIBOR Floor	OID	Rating
24 HR Fitness	JPM, Deutsch, Wells	Forstmann Little	\$675	NA	NA	NA	NA	NA	B/B2 (corp)
Affinion	BAML, CS	Apollo	\$1,000	NA	NA	350	150-175	98.5-99	B2/B-
Aquilex	MS	Teachers Merchant Bank	\$235	NA	NA	400	150	99	B/B2 (corp)
Ardent Health (div) (3)	BAML, Barclays, GE	Welsh, Carson	\$325	\$133	2.45X/3.15X	500	150	98	B/B2 (corp)
Aveta	BAML, Citi, Jefferies	Straus Group	\$360	NA	1.3x	600	200	97	B (Current)
BioScrip	Jefferies	Non sponsored	\$150	\$73	1.3x/4.1x	400	200	NA	NA
CHI Overhead Door	GE	JLL	\$100	NA	NA	550	200	98	NA
CKE Restaurants	BAML, Barclays	TH Lee	\$450	\$153	4.5x	NA	NA	NA	NA
Custom Building Prods.	BAML	Kelso	\$320	\$86	3.4x	400	175	99	NA
Global Tel Link	Credit Suisse, UBS	Veritas Capital	\$245	\$106	2.3x/3.9x	400	200	98.5-99	B/B2
Harden Healthcare	GE, KKR Cap., JPM	Capstar Partners	\$145	NA	NA	550	300	NA	NA
HHI (div)	BAML, Credit Suisse	KPS, MC	\$380	\$102	3.7x	750	250-300	97	B+/B2
Hoffmaster	CS	Kohlberg & Co.	\$280	NA	4.9x	425	NA	NA	NA
Multi Pack. Solns (div)	Wells Fargo, UBS	Irving Place Capital, Jefferson Cap	\$245	NA	3.6x/3.9x	425	175	99	B/B2 (current)
Munder Capital	CS	Crestview Partners	\$85	\$35	2.3x	400	200	98	BB (est.)
NEW Cust Serv (div) (2)	BAML, Barclays, DB	Berkshire Partners	\$700	NA	5.5x/5.5x	425	175	99	NA
Open Mobile	SunTrust, MS	MC Venture, Columbia Cap, Leap	\$175	NA	NA	400-425	200	98.6-99	NA
Ozburn-Hessey (2)	BAML	Welsh, Carson	\$385	NA	4.7x/5.8x	550	200	98	Ba3/B
Preferred Maramount	GE	Swander Pace Capital	\$95	\$28	2.3x/3.5x	550	200	98	NA
Pretium Packaging	Madison, Dymas	Castle Harlan	\$83	\$33	2.4x/3.8x	600	200	NA	NA
Prime Healthcare	RBC	Non sponsored	\$290	\$179	1.4x	400-525	200	99	B2 (corp)
Provo Craft	BAML	BAML Capital	\$170	\$52	2.3x/3.6x	600	200	97	B/B2
RCN	SunTrust, GE, SG	ABRY Partners	\$730	\$182	4.0x	NA	NA	NA	B1 (current)
Sarnova	GE, Bol	Water Street Healthcare Partners	\$175	\$40	3.0x/4.25x	475	150	98.5	B/B2 (corp)
Shearers Foods	Jefferies	Mistral Equity Ptnrs.	\$140	\$45	2.6x/4.0x	475	200	98	NA
Sheridan Prodn. Ptnrs.	UBS	Warburg Pincus	\$700	NA	2.6x	450	NA	NA	NA
Skilled Healthcare	CS, BAML, Barclays	Onex Corp	\$430	NA	3.1x/4.2x	350-375	175	99	B+/B2 (corp)
Wyle Laboratories	Barclays, JPM	Court Square Capital	\$120	\$60	1.5x/4.4x	400	200	98.5	B+/B2 (corp)
Average			\$289	\$87	3.15x/3.9x	492	193	98	
(1) Senior only	(2) Includes 101 soft call (3) Includes 102 soft call	(4) May be estimate based on leverage	(div) = dividend	NA=Not Available	New Deal				

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The Churchill Financial Group, headquartered in New York, is a leading commercial finance and asset management company with over \$2 billion of committed capital to support its financing activities and over \$3.5 billion of assets under management.

Established February 2006 with the goal of building and developing a preeminent commercial finance business, Churchill Financial focuses on lending to and investing in middle market companies that are backed by leading private equity firms and other investors. Churchill Financial is comprised of three complementary operating businesses: Churchill Financial Middle Market Finance, Churchill Capital Mezzanine Finance and Churchill Pacific Asset Management.

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