Rocaton

INSIGHTS

Returns Wanted!
Opportunities in Private Middle Market Lending

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Executive Summary

* Massive monetary stimulus both in the US and overseas has flooded public credit markets with liquidity and driven down interest rates. Public fixed income sectors offer historically low yields to investors today.
* A concomitant focus on liquidity by investors and bond market rigidities has shut out smaller sized corporate issuers from public bond issuance.
* Outside of the public capital markets, capital formation is much more challenged as (i) traditional providers of credit to small and medium sized businesses have significantly pared their middle market lending activities in the face of economic uncertainty and changes to risk-based capital requirements and (ii) Collateralized Loan Obligation (CLO) issuance has contracted.
* These forces have produced a bifurcation in lending markets, with yields on private middle market lending activities at significantly higher levels than those available for investors in public high yield bonds from issuers of comparable credit quality.
* Given the secular nature of the changes to the financial system and an impending maturity wall for existing middle market credit, the supply and demand dynamics underpinning this market bifurcation are likely to persist through the medium-term.
* A number of specialized investment funds designed to capitalize on this phenomenon are being raised in the private market by high quality and experienced investment managers.
* **Rocaton believes that investors seeking attractive risk-adjusted yields in fixed income markets and are willing to accept some illiquidity should consider the addition of private middle market lending to their portfolios as a means of improving overall portfolio return.**
* **An allocation to private middle market lending could be made (a) within an investor’s fixed income portfolio in exchange for conventional high yield, (b) within an investors private equity bucket as a lower returning but lower risk illiquid fund idea or (c) within an “opportunistic” allocation.**

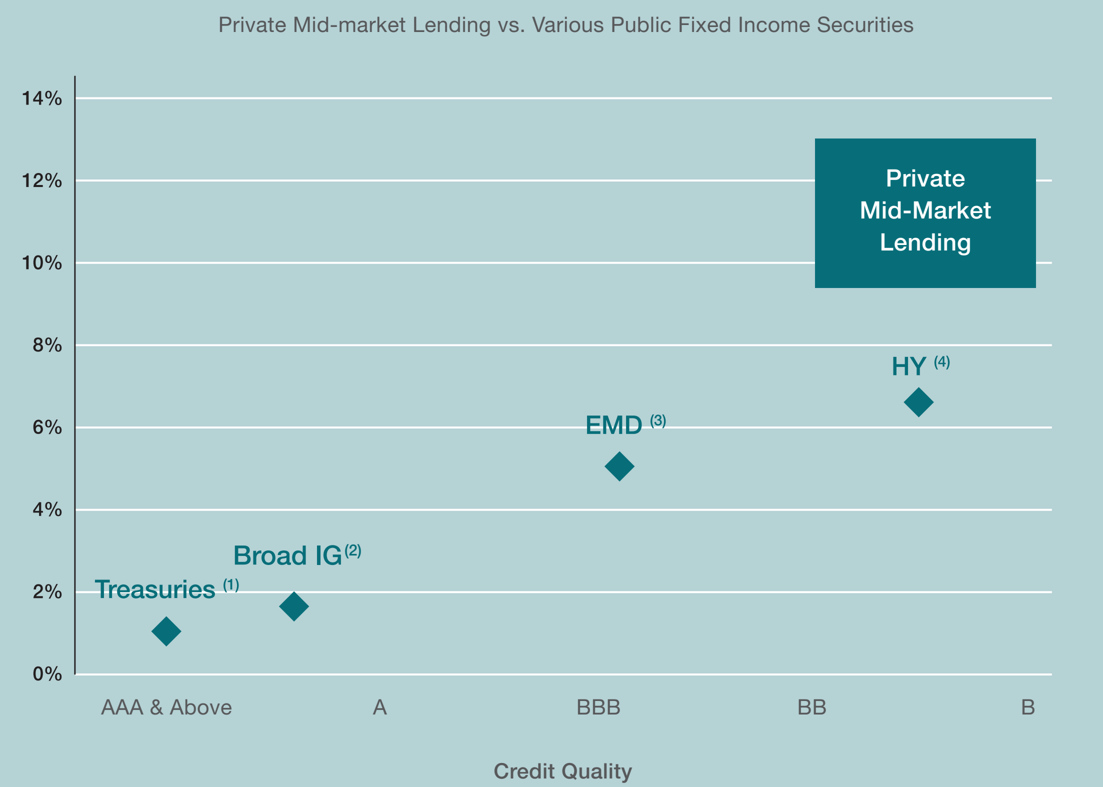
Introduction

Four years after the turmoil of the 2008 credit crisis, continued political and economic malaise has forced monetary policymakers to prolong and enhance their stimulus of capital markets. Yet, as successive waves of monetary stimulus have caused market participants across the board to pursue risky assets in pursuit of yield, a specific set of structural forces at work in the market for corporate credit has caused a bifurcation in the cost of capital for large versus small and medium sized creditors. Currently, the cost of credit for small and medium sized corporate borrowers in the private market is up to 4-5% higher than for large issuers of comparable credit quality issuing publicly traded bonds. For investors with an ability to accept illiquidity, strategies designed to capitalize on this lending opportunity offer an attractive premium over public bond markets. In this paper, we will lay out the options available for investors seeking to participate in private middle market lending. We then turn to a brief exploration of the forces that have created these conditions and why they are likely to persist for some time.

THE OPPORTUNITY: PRIVATE MIDDLE MARKET LENDING

Generally, the result of the forces affecting the supply and demand of financing for middle market corporates has been to increase the cost of credit for those firms[1]. Charts 1 displays current yield levels in varying qualities of publicly traded fixed income instruments, while Chart 2 displays the range of portfolio yields seen in our sampling of some of the largest publicly traded vehicles engaged in private middle market lending, known as Business Development Corporations or "BDCs"[2]. This 10-14% range is 4-8% higher than the current Yield-to-Worst on the Barclays US Corporate HY Index of 6.37% (unadjusted for credit quality differences).

Chart 1:
The Opportunity



Source: (1) Barclays US Treasury Index, YTW, (2) Barclays US Aggregate Bond Index, YTW, (3) JPMorgan EMBI Blended index yield, (4) Barclays US Corporate HY Index, YTW; all as of December 2012

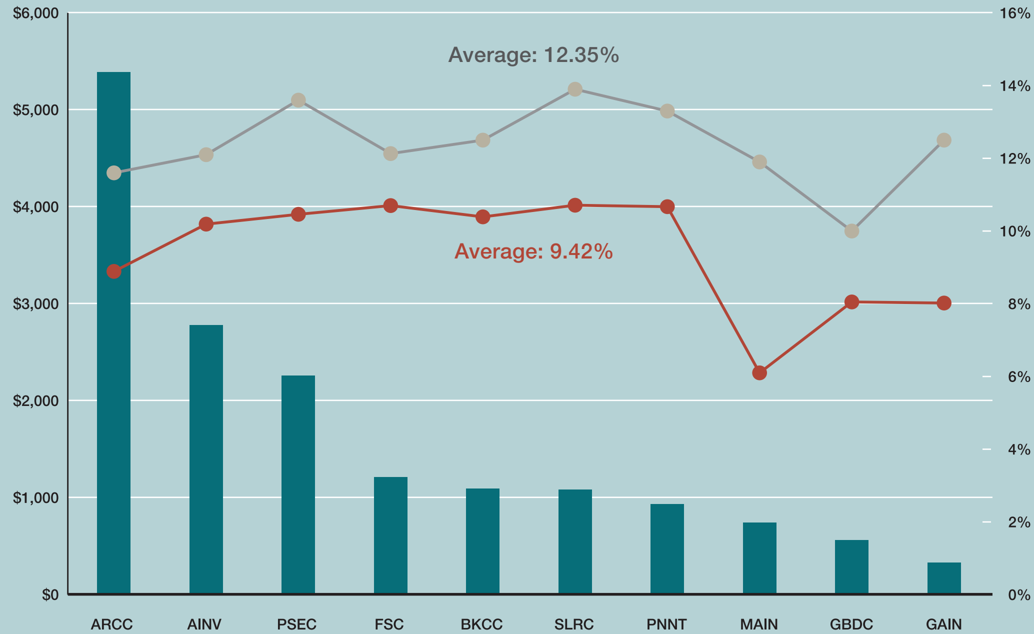
[1] While the "middle market" is broadly considered to include firms with between $5 million and $1 billion in annual revenues, the term's meaning is narrower in the context of the private lending market. Managers vary in how they define their opportunity set (EBITDA, enterprise value, and overall capital structure constraints), but generally target firms with EBITDA of $15 – $100 million and / or capital needs of $50 – $500 million. Such firms are of enough scale to justify their research efforts but are too small to effectively access the traditional bond and bank loan markets.

[2] BDCs are publicly traded closed-end investment vehicles principally engaged in middle market financing that may qualify for tax exempt status by (i) fulfilling a variety of industry and geographic diversification requirements, (ii) limiting themselves to a 1:1 debt to equity leverage limitation, and (iii) paying out a minimum of 90% of their net investment income in dividends. These funds are typically managed by a privately held asset manager which collects a management and incentive fee. In this way, BDCs represent a good option for exposure to the middle market lending space for retail and other investors seeking current dividend income through individual stock selection in public equity markets.

Chart 2:
BDC Dividend and Weighted Average Portfolio Yields

Source: SNL Financial, Company press releases

Legend:
Total Assets
Dividend Yield (10/15/2012)
Weighted Average Portfolio Yield



For investors seeking actively managed investments, a number of specialized private partnerships designed to capitalize on this phenomenon are being raised in the private market by experienced investment managers. Investors can expect strategies to vary from a focus on senior secured loans to more subordinated instruments that may include preferred stock and occasionally warrants or other equity-like enhancements to securities. Origination strategies may also vary, with some funds focused on broad sourcing directly from middle market business relationships and others on providing financing for middle market private equity transactions or to special situations and distressed/rescue financing. Generally, fees resemble private equity vehicles, with management fees in the 1–2% range and performance fees of 15–20% subject to limited partner preferred returns ranging from 6–8% with catch-up provisions. Some of the funds being raised plan to use leverage, though at varying levels, and with some managers offering both levered and unlevered vehicles. One significant difference vis-à-vis private equity investments is the current income in the form of cash interest that gets distributed to limited partners, mitigating the j-curve effect experienced by investors in more equity oriented strategies. **Rocaton has met a number of investment managers who believe that they can consistently make loans to viable businesses that are between 2-3 times levered with expected returns in the 10–13% range[3] before considering fund level leverage. Rocaton anticipates that overall net IRRs to investors range from high single digits for unlevered funds and low to mid-teens for funds utilizing 1–2 turns of leverage.**

We now turn our attention to a brief exploration of the forces that have created these conditions in middle market corporate credit markets.

[3] 2-3 times levered refers to the total debt through the investment manager's debt exposure. In this case, total debt is 2-3 times annual EBITDA. In contrast, the public high yield market leverage largely ranges between 3-6 times levered for the BB/B rated portion of the market. See the risk section for comments on smaller company risk.

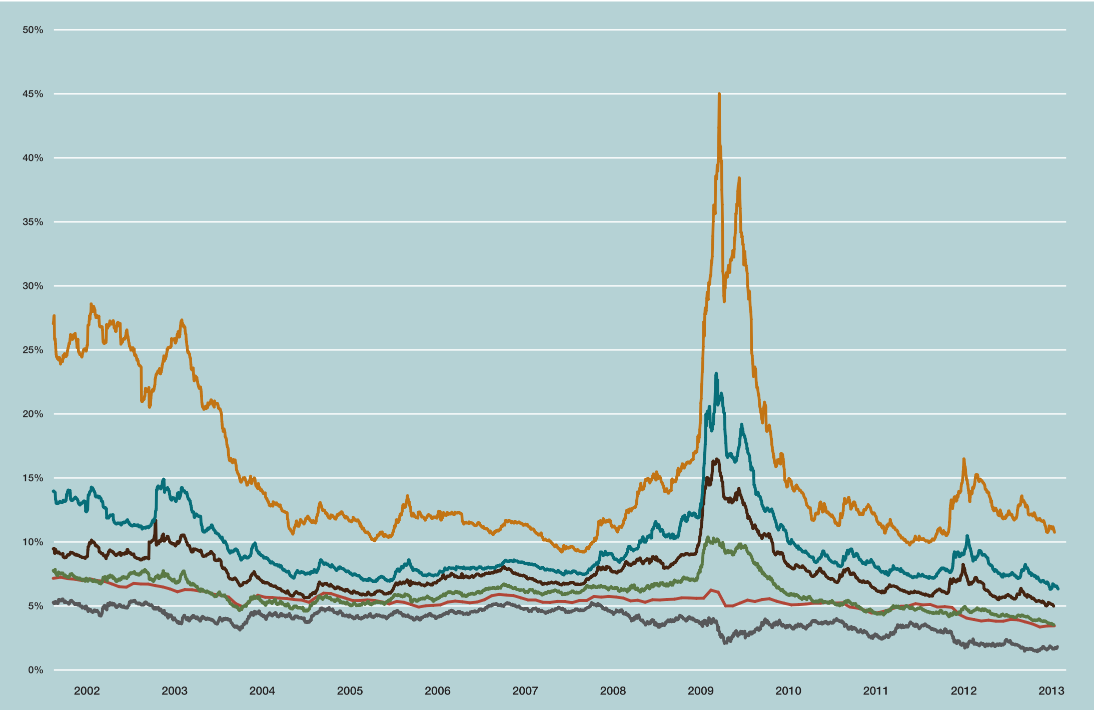
THE CONTEXT: MONETARY STIMULUS AND "RETURN FREE RISK":

Since the summer of 2007, the Federal Reserve has cut the Federal Funds rate from 5.25% to a target of 0%–0.25%. The Fed has also pursued additional measures of "quantitative easing" after reaching the zero interest rate boundary. The impact of these measures has been seen most obviously in fixed income markets as the Fed's buying activities have induced investors to search for yield in riskier but higher yielding segments of fixed income markets. As early as December 2008, Jim Grant famously referred to investments in U.S. Treasury bonds as "return free risk" . This label has largely born itself out given forward looking return expectations for high quality fixed income assets: the 10-Year Treasury note currently yields 1.6%, while the Barclays Aggregate Bond index currently yields 1.7%, even though U.S. inflation for the trailing twelve months has been 2.2%. Indeed, even in high yield corporate credit, yields are at or below their pre-crisis lows with the BAML US HY indices for BB and B credits yielding 4.9% and 6.2%, versus 6.5% and 7.2% in early to mid-2007 (see Chart 3).

Chart 3:
Yields at Varying Credit Qualities

Source: Federal Reserve Bank of St. Louis

Legend:
10 Year Treasury
AAA
BBB
BB
B
CCC



There is considerable debate as to the effectiveness of this monetary stimulus on the real economy, as growth and employment have stagnated in recent quarters and unused bank reserve balances held at the Federal Reserve have ballooned. Historically, one of the main transmission mechanisms for such loose monetary policy would have been lending to small and medium sized businesses by banks. As banks pass on lower funding rates to customers and increase the quantity of financing available, those businesses would theoretically benefit from a decrease in their cost of capital and greater availability of financing, facilitating greater levels of economic activity in the present. Yet, a variety of post-crisis regulatory and structural market developments have prevented this from coming to pass.

[4] Financial Times, December 4th, 2008, article "Return Free Risk".

A LENDER'S MARKET: DWINDLING SUPPLY IN THE MIDDLE MARKET

One likely reason for the lack of transmission of loose monetary policy into funding markets for middle market firms is the stiffening of bank capital rules that were made in response to the credit crisis. As shown in Chart 4, the Basel III rules developed by the Bank for International Settlements in the wake of the crisis mandate a large increase in the amount of capital required to be held by banks against loans of lower quality. As banks seek to adjust to the new capital rules, lending to riskier small and middle market firms has fallen. Banks have focused more on businesses requiring less capital such as mortgage loan origination.

Chart 4:
Basel III Increases in Capital Requirements by Loan Quality

Source: Oliver Wyman

Legend:
Basel II
Basel III

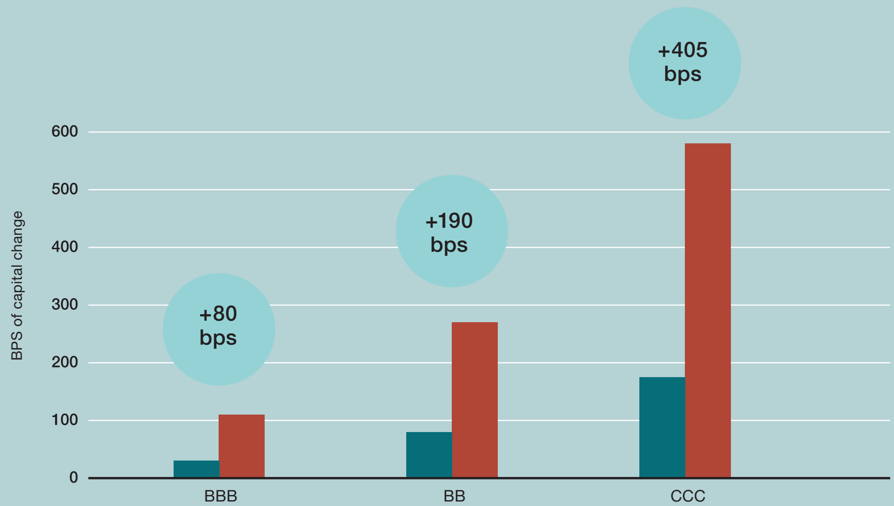
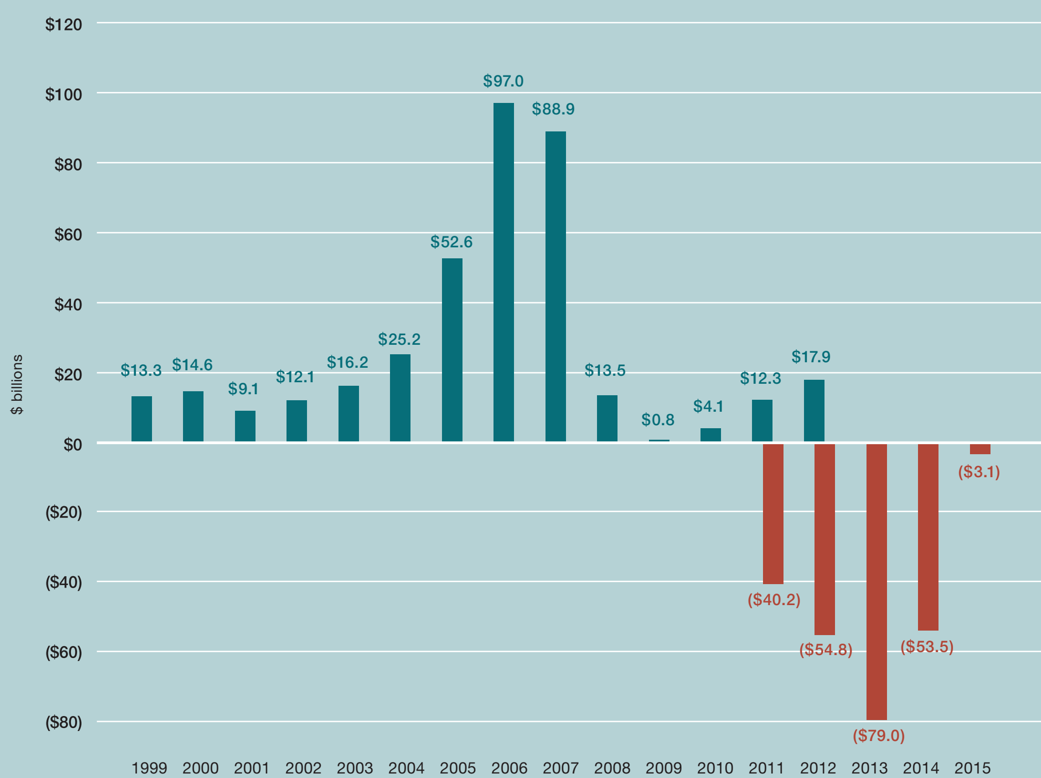


Chart 5:
CLO Formations and Expirations

Source: S&P LCD

Legend:
CLO Issuance
Decrease in Reinvestment periods



Combined with decreased incentives to engage in middle market lending, commercial banks also face a changed secondary market for the loans they originate. Prior to the credit crisis, CLOs supported such lending activities by providing a market into which excess loans could be sold by underwriting institutions such as regional commercial banks. Chart 5 demonstrates both a dip in the level of CLO formation since pre-crisis years as well as the large dollar value of vehicles that will come to the end of their investment periods in coming years. While 2012 has been a record year for post-crisis CLO issuance, it remains unclear the extent to which this source of demand will return.

In aggregate, these developments in the banking industry have changed both the size and nature of the market in which small and medium sized firms must obtain loans. S&P data, shown in Charts 6 and 7, illustrates both that bank market share and overall volumes of middle market lending have decreased dramatically in recent years. Since 2002, the proportion of middle market leveraged loans newly issued by banks has decreased from approximately 70% to less than 25% in 2012. Further, in 2011 the level of middle market loan volume was down over 50% from 2007 and an additional 60% year over year in the first half of 2012. Thus, these trends have caused small and medium sized firms to increasingly confront a supply constrained market for financing.

Chart 6:
Share of Primary Middle Market Leverage Loans

Source: S&P LCD

Legend:
Banks
Non-banks

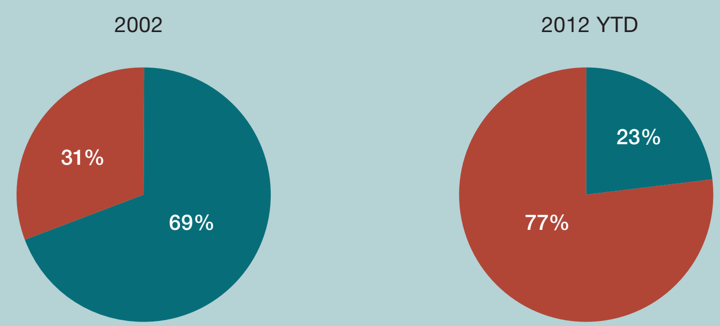
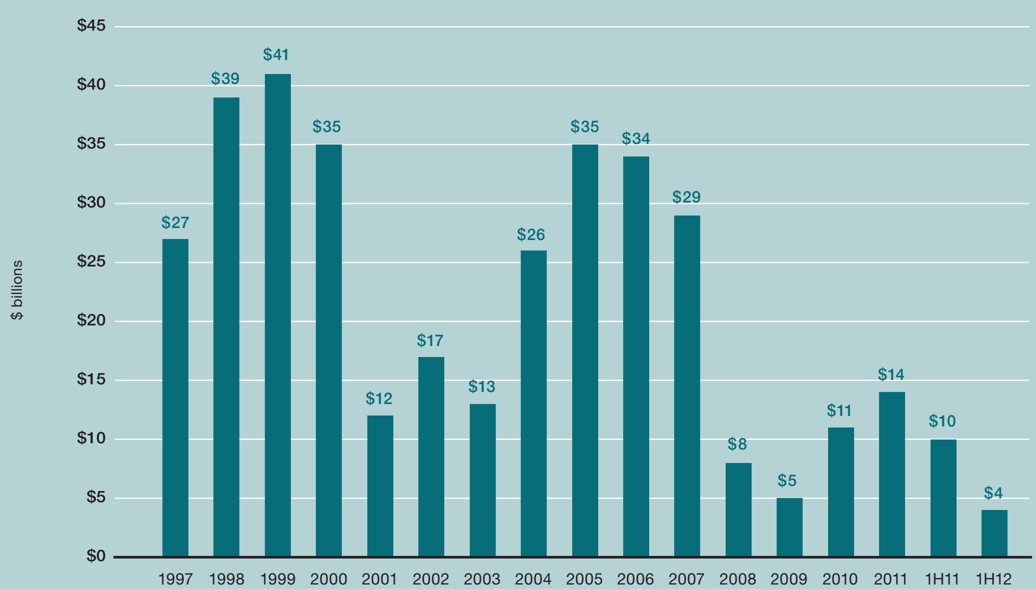


Chart 7:
Middle Market Loan Volume by Year

Source: S&P LCD



REFINANCE OR BUST: THE COMING MIDDLE MARKET MATURITY WALL

Having covered the broad trends affecting the supply of credit to the middle market, we now turn briefly to the question of demand. While the strength of economic recovery in the United States is far from clear at this juncture, what is evident is that a significant amount of debt owed by middle market firms will mature in coming years. Charts 8 and 9 below illustrate the proportions of loans and bonds owed by the middle market that will come due through 2019. These maturities provide relative comfort as to the healthy level of demand for credit in the middle market space that can be expected to persist through the medium term.

Chart 8:
Maturity of Levered Loans

Source: S&P LCD

Legend:
Tranche ≤ $1billion
Tranche ≥ $1billion

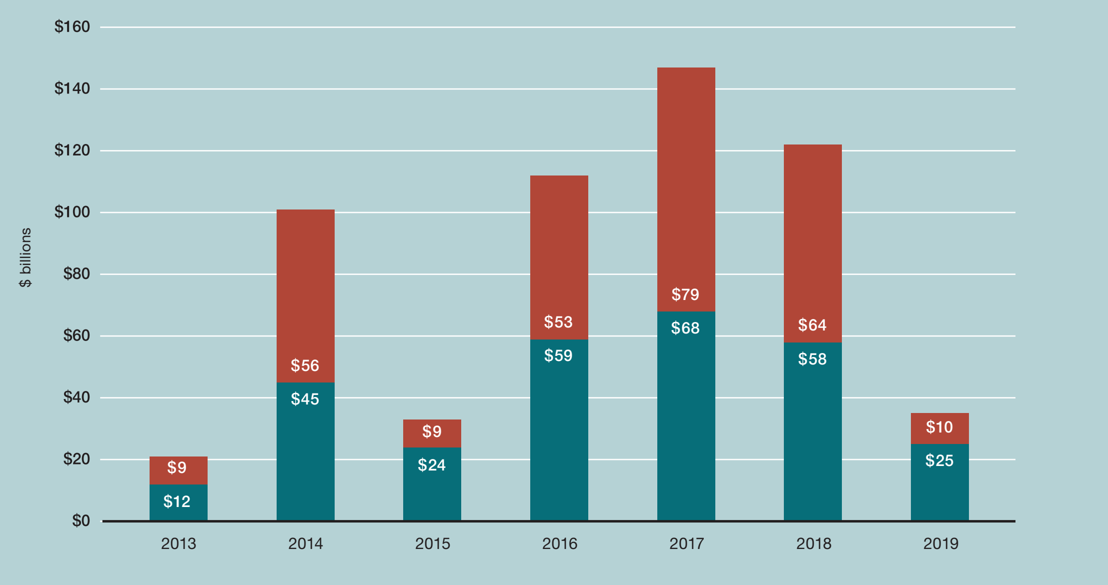
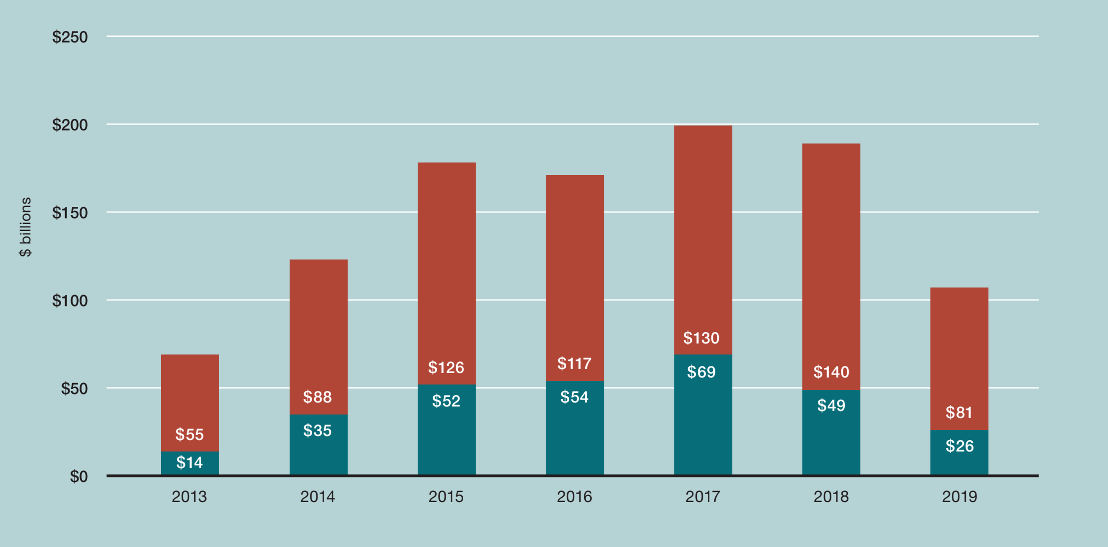


Chart 9:
Maturity of High Yield Bonds

Source: S&P LCD

Legend:
Tranche ≤ $1billion
Tranche ≥ $1billion



RISK AND CAVEATS:

* **Leverage**: Private lending funds deploy varying levels of leverage, magnifying both returns and risk. Rocaton believes moderate (0.0x-2.0x) leverage to be appropriate for private vehicles, depending on the level of risk assumed.
* **Cyclicality**: Small and middle market firms are particularly vulnerable to economic downturns; moreover, relatively inelastic bankruptcy / reorganization costs cause a higher proportion of value to be eroded in the event of a default. As such, Rocaton believes it is important to limit investments in private middle market lending to firms that have demonstrated an ability to construct broadly diversified portfolios and successfully operate and/or restructure firms in workout situations.
* **Origination and servicing costs**: The cost and complexity of sourcing, underwriting, and servicing small and middle market loans is substantial. Given the operational challenge this represents, Rocaton believes it is important to limit investing to managers that have established experience in sourcing and loan servicing operations.
* **Conflicts of interest**: Vehicles associated with private equity management companies present inherent conflicts of interest which should be thoroughly vetted. Incentive and decision making structures for investment professionals associated with the fund must ensure their independence from PE deal origination within the same management company for which financing may be needed.
* **Competition & underwriting standards**: While the current yields in private markets reflect a lack of supply relative to demand vis-à-vis the public bond markets for similar credit quality issuers of larger size, the market for private middle market lending is intensely competitive. Large proprietary platforms (GE Capital, Prudential Capital) as well a substantial number of non-bank platforms devoted to middle market lending actively compete for financing mandates from middle market firms. Investors should ensure managers have clear processes for the initial and ongoing evaluation of borrower credit quality, and should be cognizant of the corrosive effect of loose monetary conditions on underwriting standards in their monitoring efforts for investments in such funds.

CONCLUSION

Unprecedented levels of monetary stimulus intended to lower financing costs and stimulate the real economy has driven investors into risk assets and yields down to historically low levels. Yet, smaller issuers have increasingly been shut out of public high yield bond markets while banks and other financial institutions have become increasingly reluctant to lend to middle market borrowers as their own capital requirements increase the relative cost of such activities. This has elevated rates for middle market borrowers in private borrowing markets to 4–8% more than are available to investors in public bonds from issuers of comparable credit quality.

A number of firms are raising capital in private partnerships that plan to capitalize on this bifurcation in the credit markets by focusing their lending activities on the middle market space. Thus, while this increase in the cost of capital for middle market firms is genuinely worrisome for the nation's economic recovery, it presents an opportunity for investors seeking yield in today's ultra-low rate environment. **Rocaton believes that, for investors with the tolerance for long lock-up periods, the returns these investments strategies target represent a compelling risk-reward trade off and should be considered as a means to improve overall returns in the context of a well-diversified portfolio.**

