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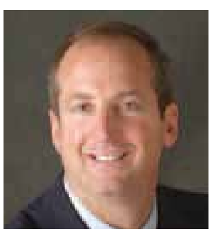
What Every Finance Professional and CFO Needs to Know Now and Into 2012

BY THEODORE L. KOENIG

Now that we have all lived through the credit crisis and are still around to talk about it, where do we go from here? What do finance professionals and CFOs need to know in order to navigate the U.S. financing and capital markets now and in 2012? Monroe Capital's Ted Koenig addresses three important areas of concern going forward.



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There are three questions that every one of us has thought about over the last several months: Where will liquidity come from and who will be providing it? How will deals get done post-credit crisis? What are the things that keep finance professionals and CFOs awake at night?

Whether you're a banker, finance professional, CFO or service provider, we all have a vested interest in the answers to these questions. This article highlights some relevant and interesting market trends in these areas.

News Flash: Banks Make Money by Not Lending

Ever wonder why banks do not have huge lending appetites right now? Consider this: Thomas Hoenig, president of the Federal Reserve Bank Kansas City, said recently that the Federal Reserve's policy of holding interest rates near zero is a subsidy for large banks that redistributes wealth from savers to debtors. Testifying before the House Subcommittee on Domestic Monetary Policy, Hoenig said banks can borrow at .25% and buy Treasury bonds that yield over 3%.

"It provides them a means to generate earnings and restore capital, but it also reflects a subsidy to their operations," Hoenig said. "It is not the Federal Reserve's job to pave the yield curve with guaranteed returns for any sector of the economy, and we should not be guaranteeing a return for Wall Street or any special interest group," Hoenig added. With a "risk-free" return of 3% leveraged at ten times, it is no wonder why banks today are not aggressively making new loans.

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The Middle-Market…The Place to Be

Private equity investors are increasingly focusing their efforts on middle-market companies. Investments in these companies demand less capital than larger deals and have greater flexibility when it comes to cashing out. This makes middle-market investing particularly attractive at a time when money remains tight and fundraising is challenging in the wake of the recession and global financial crunch. The statistics bear this out: middle-market deal volume is increasing, both in terms of the number of transactions and the dollar value of deals. (*See Figures 1 and 2.*)

One of the factors driving this growth in middle-market deal volume is the increasing number of flexible capital sources available — capital sources that have the ability to structure deals in a variety of ways that best suit the needs of middle-market companies to finance growth. Private capital providers can deliver structures that allow for greater free cash-flow generation due to lower amortization and cash interest requirements in exchange for PIK interest, equity warrants and success-based fees. This allows borrowers to partner with creative lenders that are better aligned with the goals of financing growth and long-term profitability while still benefiting from the lower cost of capital and tax advantages of traditional debt financing.

Fasten Your Seatbelts

Companies have been hoarding cash for more than two years; however, inflation is on the horizon and cash will have less value. With the economy slowly turning around, companies are spending on acquisitions designed to move their businesses forward rather than protecting them against the woes of a bad economy. Well-capitalized corporate buyers continue to seek growth, realization of synergies

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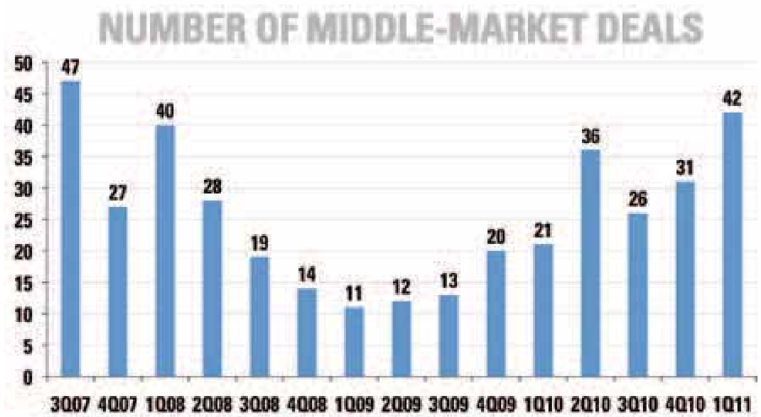
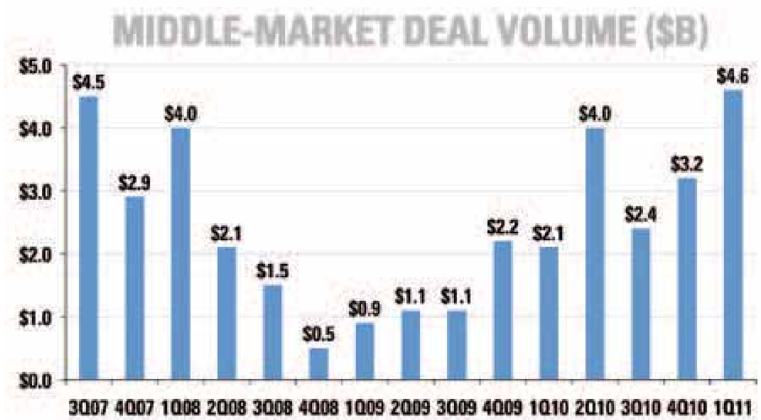
and diversification through strategic acquisitions that expand their footprint and product offerings.

The current U.S. private equity overhang (dry powder) stands at $477 billion. Since 2003, private equity fundraising has been driven not by the supply of private equity investments but rather by limited partner demand for private equity investments. This disconnect provides a partial explanation of the current overhang. Over the last decade, $1.5 trillion was raised by private equity firms, with follow-on funds raising nearly double the amount of their predecessor funds while consistently surpassing fundraising targets. In addition, a third of all funds since 2001 were raised by first-time fund managers, allowing limited partners to diversify their holdings as their allocations expanded.

The current overhang is unsustainable — given the nature of private equity fund structures, firms will lose the ability to invest this capital once their investment period runs out. At today's deal flow pace, it would take around five years to invest the current overhang, which means that private equity firms must start investing now at a much higher rate if they want to invest their full fund (and collect the fees and carry on those remaining commitments). These private equity firms will try their hardest to put this capital to use, which should result in a plethora of M&A activity.





Game Changer: Unitranche Debt Gains Significant Traction

Unitranche debt provides borrowers with the benefits of flexible capital and a more efficient lending process that increases the speed with which borrowers can execute deals. Unitranche lending has become a common method of financing middle-market companies, and many private equity firms and lenders prefer unitranche debt over the conventional capital structure involving a senior debt provider and a mezzanine debt provider.

There are fewer parties to deal with, no intercreditor agreement issues among lenders and one set of rules and regulations for the company. Rather than having a separate interest rate for senior and mezzanine debt, the unitranche structure employs a single blended rate that averages out the cost of the two forms of capital. The simplicity of working with a single party can also help close deals quicker, an attractive characteristic for firms that value ease of execution and speed. In recent months, our firm's clients have increasingly been requesting the unitranche product with over 50% of our financings involving unitranche debt.

SBA: A Popular Partner for PE, Lenders

At a time when fundraising has significantly decreased and it's been harder overall for private equity firms to raise new funds, the Small Business Administration (SBA) has stepped up to the plate. The SBA's growth capital program, which invests in mezzanine and growth capital, increased its lending by 23% in fiscal year 2010, providing a record $1.59 billion to investors backing small businesses. Last year saw the highest volume in the 50-year history of the SBA's Small Business Investment Company (SBIC) debenture program.

As the administration has fended off accusations that small business was ignored amid the bailouts — be it the Troubled Asset Relief Program or the Temporary Liquidity Guarantee Program — the SBA has been quietly putting capital to work directly into small businesses via the SBIC. "It costs the taxpayers zero and we are expecting the program to continue to grow in 2011," according to Sean Greene, an associate administrator for investment and senior adviser for innovation at the SBA.

SBICs are privately owned and managed investment firms that are licensed and regulated by the SBA. SBICs use a combination of funds raised from traditional limited partners and the SBA to make equity and mezzanine capital investments in small businesses. There are currently more than 300 SBICs with more than $16 billion in capital under management.

Bank Loan Funds: Popularity With Investors Creates White Hot High-Yield Market

Year-to-date June 30, mutual funds have registered inflows of more than $20 billion into leveraged loans, already surpassing the $18 billion in total inflows recorded in all of 2010, according to Lipper FMI. The outlook for credit is positive, buoyed by strong corporate earnings and low default rates. A new crop of floating rate funds are aiming to take advantage of robust demand for bank loans as investors seek mid-single digit returns and protection against an eventual rise in interest rates. At least eight mutual funds that will invest primarily in senior floating rate bank loans have launched this year or are preparing to launch, according to SEC filings.

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Bank loans are loans made to non-investment grade large corporate borrowers. Expectations of a future rise in interest rates, combined with a positive outlook for U.S. corporate credit, have raised the profile of bank loans among both institutional and retail investors. The floating rate aspect makes bank loans a natural hedge against rising interest rates and inflation. Examples of major investment management firms launching floating rate funds include:

- *Credit Suisse Floating High Rate High Income Fund* was re-launched to reflect a shift in investment strategy, which emphasizes floating-rate bank loans;
- *PIMCO Senior Floating Rate Fund* is an open-end mutual fund that was launched in July 2011;
- *Nuveen Short Duration Credit Opportunities Fund* invests in below investment grade adjustable rate corporate debt instruments;
- *Prudential Floating Rate Income Fund* launched in April 2011;
- *GSO Capital Partners*, the credit platform of The Blackstone Group, is preparing to launch its third closed-end senior loan fund;
- *Babson Capital Management* announced it will launch a global closed-end fund to invest in floating rate assets, including secured loans;
- *KKR Asset Management* is raising a global closed-end fund to invest in fixed-income securities, including loans and high-yield bonds.

All of these funds will be competing for large market, broadly syndicated loan investments and high-yield bonds, making this a very crowded space.

Investors are lining up, both for CLOs' senior-most tranches and for the equity piece, as the economics of investing in a CLO improve over time.

Senior Secured Direct Lending: An Attractive Investment

Senior secured direct lending represents an attractive investment opportunity in the current market environment. This is driven by the imbalance between low supply of capital for middle-market corporate borrowers and high demand from these companies. The dearth of available credit from traditional bank lenders in the middle-market space (as opposed to the large market space) has created a favorable environment for investors.

Funds with both capital to invest and the proper investment structure can utilize strong credit skills to seek returns in the high single digits and perhaps more. This is accomplished by investing in a diversified portfolio of self-originated, senior secured corporate loans. The senior secured nature of the investment offers downside protection to the investor. The returns in this segment of the market are at a significant spread to those available to investors focused on the large liquid credit names in bank loan funds.

This investment opportunity is consistent with Monroe Capital's view that investors with a long-term horizon and the ability to invest in longer lock-up vehicles can benefit from a premium that accrues to illiquid and more complex investments. This investment can be utilized in the context of an opportunistic credit allocation, a client's hedge fund sleeve or within a broader fixed income portfolio.

From the perspective of a borrower, senior secured financing is attractive because it does not require the company to give up significant equity ownership or control of their business. Instead, the loan is backed by collateral such as property, plant, equipment, inventory and receivables. Access to credit by the borrower is a function of the nature of such collateral, the amount of free cash flow generated, the health of their business, as well as the type of business and, to a significant extent, the current condition of the capital markets.

Private Equity Investing: More Difficult This Decade Than Last 30 Years

If we look at the period from 1981 to 2000, the overall market maintained an upward trajectory and the use of leverage made perfect sense during that time. In 1981, debt created returns because we were operating in a high inflation environment, with interest rates that only moved lower for the next ten years. In a sense, you could buy a business with absolutely no growth, leverage it with 90% plus debt, watch inflation grow by 10% and triple your money. That was the story of the 1980s.

In the 1990s, we had the greatest bull market of all time: from January 1990 to the end of 1999, you could leverage just about anything and post an attractive return. If you just levered the stock market, for example, you would have been a leading fund manager.

However, going into this decade of the 2010s, investors will have to navigate a choppy, up-and-down market and not rely on an upcycle to bail them out. With inflation at least checked for now, private equity fund managers are going to have to earn their stripes. It is now a full-fledged business as opposed to merely a form of finance.

ESOPs Will Gain in Popularity for M&A Transactions

Increasingly, closely held business owners are turning to employee stock ownership plans to create liquidity from their businesses. This is due partly to the changing M&A landscape after the recession, partly to the aging of Baby Boomer business owners and partly to recently improved designs for transactions involving employee stock ownership plans. From a tax perspective, an ESOP appeals to selling shareholders because the transaction can be structured to permanently avoid payment of capital gains taxes (if they are a C corporation at the time of the sale), while the company can receive large income tax deductions for the repayment of both principal and interest on the acquisition costs.

An ESOP is a friendly financial buyer created for the sole purpose of buying a shareholder's stock. The seller will dictate the amount of stock he or she wants to sell and the cash he or she wants to receive at closing. If senior debt does not provide enough up front liquidity, investment and mezzanine debt can be brought in. The most typical ESOP candidates are long-term businesses with consistent earnings. Often, when there are limited cash options from strategic or financial buyers, the ESOP creates the only available market. An ESOP can also be used as a tax-efficient strategy for one shareholder to buy out another.

CLOs Are Off Life Support and Viable Once Again

The pipeline for new collateralized loan obligation (CLO) deals stands now at $1.98 billion. So far this year, $7.6 billion in CLOs have been printed in the U.S., with the majority being CLOs backed by broadly syndicated loans. Around $4 billion in CLOs were issued in 2010, according to data from Citibank.

The U.S. CLO market has made a strong comeback this year after succumbing to a difficult credit crisis in 2009. Investors are lining up, both for CLOs' senior-most tranches and for the equity piece, as

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the economics of investing in a CLO improve over time. Returns to equity holders in new issue CLO deals this year are being marketed at 12% to 15%. And even though many CLO managers are reportedly financing a hefty part of the equity tranches on their own, market participants say that interest is coming in from various quarters such as insurance companies, banks and private equity funds.

Warning: The Fed is Watching

The Federal Reserve, which has come under heavy criticism for failing to spot the housing market bubble, is now paying close attention to run-ups in asset prices that could pose risks to financial stability. In early June, vice chairman Janet Yellen identified one of the markets the central bank is monitoring the most closely: leveraged loans.

In a speech given in Tokyo, Yellen said the Fed is concerned that the large amount of money investors are pouring into syndicated loans has contributed to a rapid increase in purchase prices that could result in imprudent lending. Yellen noted that strong demand from investors has allowed borrowers to bargain for more attractive loan terms, "especially given that many funds catering to retail and other unlevered investors have little choice but to immediately deploy invested funds." She cited as evidence "the re-emergence of deals that do not provide investors with the traditional protection of maintenance covenants — so-called covenant-lite structures — and of deals financing the distribution of dividends to equity holders, as well as a gradual increase in the levering of the underlying corporate assets by borrowers."

Yellen also noted that, prior to the financial crisis, lead arrangers of syndicated loans amassed significant pipelines of very large deals that they committed to finance. When investor interest waned, the banks were left with notable positions in "hung" deals, which resulted in substantial mark-to-market losses. When prices came under pressure, calls for additional collateral followed, leading in many cases to the sale of positions by banks and other market participants that put further pressure on valuations and started the cycle anew. It is speculated that if the Fed were to introduce regulation, it would most likely take the form of requirements that arrangers retain a portion of loans through maturity, so that if there is downside risk, particularly in the recovery mechanics of the loan, the banks or parties involved in the construction of the product would bear some of that risk. abfj

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