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In the middle of an LBO uptick

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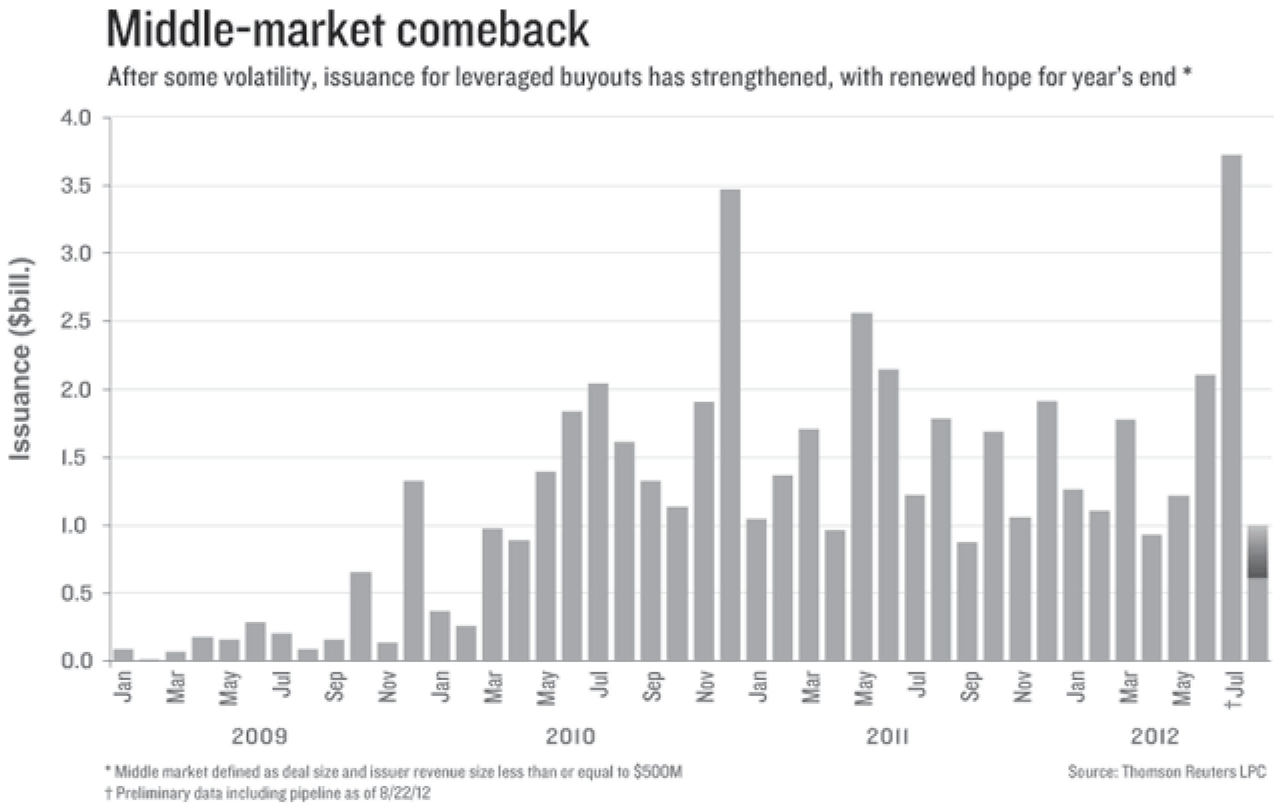
Over the past several months, investors have been plunging into riskier assets -- everything from high-yield bonds to less liquid assets like middle-market loans. That's because many of them, loaded with cash, have been struggling to balance the desire to earn higher yields with the realities of a market hobbled by economic uncertainty and rock-bottom interest rates.

That's spurred institutional investors, collateralized loan obligation managers, pension funds and others to pour money into the surging new issuance of high-yield and subordinated debt -- paper that carries much higher risk than senior-rated corporate debt and Treasuries. In August, U.S. issuers raised a monthly record of $28 billion in junk bonds. U.S. corporate subordinated issuance had soared to $14.7 billion through mid-August this year, according to **Dealogic** -- 3 times the volume for the same time last year and the highest since 2007. A chunk of this money has been spent on refinancing more expensive debt, dividends and leveraged buyouts.

"Risk seems to be on the rise again. There's a lot of money chasing opportunities, and that's feeding a lot of LBO, recap and dividend activity," says Scott Humphrey, group head of U.S. M&A at BMO Capital Markets in Chicago.

In particular, the middle market has become a target for those searching for yield. In July, middle-market LBO-related issuance soared to $3.8 billion (see chart below), the highest monthly level since June 2007, when volume was $4.2 billion, according to **Thomson Reuters**. In all, 19 publicly disclosed deals were completed, ranging from $33 million to $485 million. The biggest buyout loans for deals that were backed by private equity sponsors included $485 million for **US Renal Care Inc.**, $480 million for **Pinnacle Holdco Sarl** and $405 million for **Roto Acquisition Corp.**

Although LBO activity for the first half of 2012 has lagged behind that of last year (deal activity has generally tracked issuance), some believe the July spike is a sign the market has come back to life. While August activity fell back, lenders for larger middle-market and smaller-tier companies say the month is usually quiet and that pipelines have been building.



For many, the middle market offers a compelling yield alternative and a place to spend investment money. In the M&A market, U.S. acquisition levels have fallen this year to $532 million through mid-August, compared with $1 billion for all of 2011, according to Dealogic. Investors such as collateralized loan obligations are becoming more active, though traditionally they've favored more liquid, rated paper. Most middle-market loans are B, BB or unrated and rarely trade in secondary debt markets. But they're also attractive because they pay premiums of 25 to 75 basis points over loans for large corporates to compensate for less liquidity. In fact, interest in middle-market loans has been so intense that this premium disappeared the first half of this year, according to **Standard & Poor's**. Spreads have since widened, though they remain 10 basis points tighter than historic levels. Issuers can thank investors like managers of CLO portfolios.

"CLO managers are delving into the middle market. They generally prefer liquidity but are more willing to give some up because they want to put money to work," says Jeffrey Cohen, co-head of U.S. loan capital markets at **Credit Suisse Group** in New York. In the first half of 2012, Credit Suisse was the top underwriter for U.S. institutional large middle-market issues, with a total of 16 deals worth $3.3 billion. Cohen says the market is ripe for more in months ahead. "I think we'll see significant issuance. Investors are really hungry for new paper right now. And issuers have been successful raising new paper."

He also notes that there's more wiggle room to negotiate valuations privately. "In the middle market, the vast majority doesn't involve public markets. That's enabled more activity in the middle market. In the larger, more complex deals, sponsors have had a harder time with valuations. Public markets are not being viewed as cheap right now, so that's reduced opportunities there for sponsors."

Others remain cautious, not surprising considering how many wrong-footed calls there have been over the past two years for M&A and LBO revivals. "I think we'll be kind of sideways for the next nine months. Between Europe and a fiscal cliff and U.S. presidential elections, I don't think there's any significant catalyst for a move up," BMO's Humphrey says. BMO Capital, a unit of **Bank of Montreal**, was the 12th-most-active bookrunner in the first half of this year for U.S. large middle-market institutional loans, facilitating three deals worth $287 million.

Generally speaking, it's tough to get a true handle on overall LBO activity at any given time because so many deals are done in the private market and not disclosed -- especially among companies that do $10 million to $100 million deals.

Those who provide a specialty finance loan known as a unitranche, which mixes senior and subordinated debt into one tranche with a blended price, report a tremendous pickup in the pace of bite-size LBOs. Ted Koenig, president of **Monroe Capital LLC**, has been one of the most active unitranche lenders, along with a handful of other players that include **General Electric Co.** Monroe Capital is a private investment firm in Chicago that focuses on lower-tier middle-market deals for companies with $3 million to $30 million in Ebitda. In July, Koenig says he closed four deals worth $100 million, his busiest month in five years. Over the past 12 months he's done a total of 14 deals ranging in size from $10 million to $150 million. And he says a lot more are on the way, with 20 deals currently in his pipeline.

"August is a hard month to use as a proxy, so throw that out of the mix," he notes. "We had our busiest July ever in the last five years in terms of funding new business. Our pipeline is strong and is going to get stronger." In the past two years, his group has ramped up unitranche activity. Typically, middle-market LBOs are funded using a mix of loans that can include first- and second-lien loans, mezzanine debt and term loans. Koenig says more private equity firms are turning to this type of funding because it's faster to arrange than traditional financing -- a unitranche can be sewn up within 30 days -- and saves time and money by streamlining documentation. This kind of financing is gaining popularity among smaller companies that lack access to other funding sources such as high yield.

Because the unitranche market is private, it's difficult to gauge volume. But those who track middle-market lending say it's growing. "We don't know the size, but we're running into it more and more. Some middle-market lenders are forming partnerships with funds to offer more unitranche loans," says one data tracker. "When we're talking to lenders, they're saying it's huge."

Providers say this lending option has gained traction in the past year as buyout firms unloaded smaller portfolio companies. "These loans weren't always popular, but today there's a shortage of good companies for sale," Koenig says. "For every company showing up [on the auction block], there are seven or eight PE companies that want to buy. So those that come with credible financing -- those are the guys who will win the transaction."

The investor base for unitranche loans consists chiefly of hedge fund managers, non-CLO money managers and business development corporations. CLOs avoid this part of the market because it's too small.

Lenders say they expect CLOs and other institutions to remain more focused on the larger tier of the middle market, where deal size ranges from around $200 million to $1 billion. Many of these yield-hungry buyers are becoming more open to new opportunities and risk than in the past.

"I think the strong appetite of portfolio managers on the loan side is driving more aggressive structures from a leverage standpoint, covenants and use of proceeds," Cohen says. If this appetite continues, that should spell good news for middle-market companies and sponsors that have been impatiently biding their time for conditions to turn.