RSC Market Update - March 2017

Traveler Photo by ©4corners

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State of Debt Markets

Debt markets in Q1 have been robust and interest rates remain low compared to historical averages, but there is so much more to the story.

Interest rates are rising for the first time in a decade and that upward-sloping yield curve is impacting the markets in many ways. Rising interest rates are not borrower-friendly and it is one of many factors fueling a **refinancing boom in early 2017**. However, interest rates remain low and the debt markets are active. Investor capital continues to flow freely into non-bank debt funds of every class imaginable.

Opinions vary somewhat as to the global M - & - A outlook for 2017, but the general sentiment seems to be that 2017 will be a record-breaking year for middle market transactions. We tend to agree and that should lead to continued heavy activity in the debt markets. Obviously, the state of the economy will definitely be an influencing factor in the amount of transactions closed in 2017, which leads to the uncertainty surrounding a wave of public policy changes that are underway with a new administration in Washington. Possible tax cuts, reductions in regulations are pro-business and could be good for the economy, but they could also lead to inflation and more interest rate increases.

Anecdotes from the Capital Markets Desk:
Business Development Companies (BDC's) fall into two categories: with stronger and weaker capital positions
• Strong - Able to review new loan and investment opportunities on a "business as usual" basis. The merits of a particular deal are analyzed independently from the firm's overall loan portfolio. Underwriting is fairly robust and is being performed as a more traditional, risk-based assessment done on a deal-by-deal and deal-specific basis.
• Weak - Capital constrained given the choppiness in the capital markets and in a rising interest rate environment. They need to maximize yield on a per-deal basis and be very picky about new lending. Low levered, smaller transactions and lower yielding opportunities are simply not a good fit. These firms are unable to view new transactions independently of the rest of their loan portfolio and independently of the overall market backdrop.

Mezzanine Debt firms and SBIC: Mezzanine Debt firms, both SBIC and non-SBIC, are active in today's marketplace and have some distinct advantages and disadvantages.

Advantages of Mezzanine Debt firms:
- Move quickly
- Low or no amortization of term debt
- Can increase investment
- Often want to co-invest in equity

Disadvantages:
- Senior lender needs to provide a revolving line of credit
- Interest rates will be 11% -12%, plus enhancements to get above their IRR threshold
- May require a board seat
- May have pre-payment penalties through years 2 and 3

Growth in Private Credit Funds - Private credit funds continue to be one of the hot trends in the debt markets in 2017. As investor capital continues to steadily flow into credit-based products in search of higher yield, more and more private credit funds have continued to form. These funds have been viable alternatives for borrowers in all areas of the debt world. From asset-based to cash flow lending, lower middle market to upper middle market, from new acquisition to restructuring, these lenders are competitive and have plenty of capital to deploy. We will be exploring this asset class in much more detail over the coming months.

Capital Markets' Corner

We had the privilege of interviewing Jon Comeau. Jon is a VP of corporate finance at AvidBank in Palo Alto, CA.

What is the history of Avidbank?
JC: The bank was initially started as the Private Bank of the Peninsula in 2003. As the name suggests, the Bank was focused on the Private Banking market going after high net worth individuals in Palo Alto, Menlo Park, Atherton and part of the Bay Area. The Bank grew to a couple hundred million in assets but growth slowed from there. It is a highly competitive market and the bank did not have enough of a competitive differentiator. The bank ended up getting some new investors, board members, and executives which identified an opportunity for a small independent commercial bank. They used the Private Bank of the Peninsula as a De Novo platform to build a new commercial bank. The bank officially changed its name to Avidbank is 2011 to reflect the change in the business model. Additional capital was raised to support the growth. The bank has built out a great team of experienced bankers which has resulted in tremendous organic growth over the last few years. The bank just released its Q4 earnings and had 28% loan growth for FY 2016.

Can you give a description of your group at Avidbank? What types of lending do you do and what is the name of the group?
JC: I work for the Specialty Finance Division of the bank. The group can be split into three main product categories: (i) Asset Based Lending, (ii) Technology Lending, and (iii) Sponsor Finance Lending. The ABL products support sponsor backed and closely held businesses across the US. The tech lending products are similar to SVB, Comerica, Square 1, etc. and are utilized to provide working capital and growth capital to venture capital backed companies. The Sponsor Finance products provide cash flow based term loans to support sponsor led transactions (buyouts, refinancings, recapitalizations, etc.).

What is your sweet spot in terms of loan size and EBITDA for borrowers?
JC: Our sweet spot is for cash flow lending is businesses with $2-5MM EBITDA. For ABL and tech we work with companies that range from cash burning to highly profitable. Our hold size for loans is $10MM and we have the ability to do participations for up to $20MM.

Are most transactions sponsor-backed, involving a private equity firm with committed capital?
JC: We have a good mix of dedicated funds and fundless sponsors we work with. In the event there is no committed capital, we do have extra focus in our diligence around the LPs and sources of capital to both close the transaction and provide additional support down the road if necessary.

Do you do deals with mezzanine lenders and if so, will the bank allow 2nd liens in the capital structure?
JC: Yes, we work with mezzanine lenders and structure 1st lien 2nd lien deals. We take extra care in underwriting the company's ability to service total debt along with the total leverage and equity support since we are dealing with pretty small borrowers. However, for the right transaction and with the right partners, we do not mind working with mezzanine capital.

How long is your typical underwriting process and how many people are involved from beginning to end?
JC: From term sheet to closing is typically 4-6 weeks. A lot depends on the motivation of all parties and the speed in which we receive the needed diligence materials. We can execute quickly when the situation calls for it. We typically only have 1-2 people involved in both the term sheet and underwriting process. We focus on relationship banking and the individuals you work with up front will be the same people you work with for the life of the relationship.

What other ancillary services are offered by Avidbank that may be useful and attractive to portfolio companies of private equity firms?
JC: The Bank is focused on providing sophisticated deposit and credit products of larger banks with the relationship banking approach of a community bank. One of the biggest benefits we offer on the cash management side is a dedicated operations team where you can know an individual and get a hold of them direct vs calling a 1-800 number and having no idea who is on the other line. When I first started at Avidbank, I was shocked by how many calls I got from clients praising our operations team. Working at a bigger bank it is usually the opposite. Also, our ABL products are a great tool for lower mid-market portfolio companies. If there is a need to working capital or additional leverage we have a great and flexible product set and experienced bankers.

Thank you very much to Jon Comeau.

LevFin Insights

High-yield funds were sapped of $887 million in retail cash in the week, according to sources familiar with Lipper data. It's the first outflow in four weeks, but barely dents the inflows of $1.9 billion recorded over the prior three weeks.

Market sources also relay that this past week's outflow was all ETF-related, with roughly $1 billion of redemption from that segment filled back in by approximately $150 million of mutual fund inflows.

As for the year-to-date reading, it doesn't include the inflow three weeks ago, so it's just an inflow of $411 million.

Leveraged loan funds received a $548 million net inflow for the week, marking a contraction from the $1.3 billion inflow last week, but a 10th consecutive infusion to the asset class, for a net $10.6 billion inflow over that span. Market sources relay that there was barely any ETF influence this past week.

There have been a net $2.7 billion on inflows to leveraged loan funds this year.

Source: Matt Fuller

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LevFin Insights

AEA Investors has announced the final closing of a $1.025 billion fund targeting first-lien senior secured loans to middle market companies.

The fund, AEA Middle Market Debt Fund III, is the firm's fourth senior debt fund. Like the previous three vehicles, the new fund is leveraged, for total available capital of $1.025 billion.

The new deal closed in December and is by far the largest of AEA's senior debt funds. AEA's first, Middle Market Debt Fund I, closed in 2007 at $325 million; the 2011 fund at $410 million and the 2012 deal at $245 million.

Since 2007, the senior debt funds have invested an aggregate of $2.4 billion in more than 200 transactions. Typically, AEA's senior debt funds will invest $10 million to $50 million in any one transaction, to companies generating EBITDA of $10 million and up.

AEA also has platforms dedicated to private equity and mezzanine debt.

Source: Kelly Thompson

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Chart Of The Month

Fig. 4.1: Annual Global Private Equity Fundraising, 1996 - 2016

RECENT HIRES

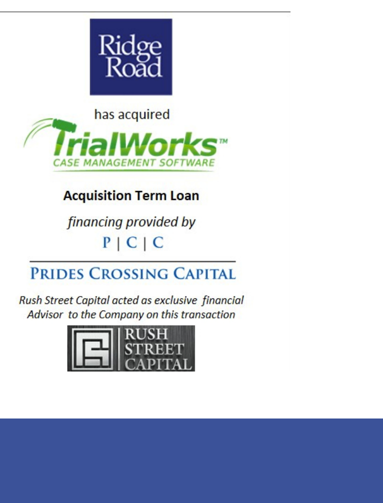
Rush Street Capital is pleased to announce our latest hires, Jeff Quinlan and Tirelo Morake

QUOTE OF THE WEEK

"It's not how much money you make, but how much money you keep, how hard it works for you, and how many generations you keep it for."
-Robert Kiyosaki

Middle Market Economic Outlook

RECENT TRANSACTIONS



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