USA CHINA
INVESTMENTS GROUP
美中投资集团

中间市场高级和中级担保贷款调查

寻求投资回报的新机遇

机构投资者对大公司债和高回报债券市场非常熟悉，但是投资美国中间市场公司债却鲜有人知。

2008年信用危机之后贷款市场的一大特征是仅有很少的高级贷款资本可提供给中间市场公司。历史上，这些公司不能像更大型公司和流动性更高的借款方一样得到更大范围的债务资本，而且这些公司规模太小，不能通过公开市场的贷款共同基金或从机构贷款投资方获得资金。当前利率维持在较低水平，股市和信贷证券也已充分反应了实际价值，投资中间市场债市的机会则看起来极富潜力。

随着经济的发展，中间市场公司在寻求更多的贷款给公司的成长提供资金。这就意味着成熟的、经验丰富的贷方可以建立一个高质量的贷款组合，产生有吸引力的、有风险调控的回报。

回报的一部分是和中间市场贷款相关联的所谓的"非流动性溢价"，反应了机构投资者承认这类规模相对较小的贷款比更广泛的银团提供的贷款具有更低的流动性。起初，中间市场贷款的设计是"购买-持有"式的投资，并且要求对投资者进行高度的尽职调查。但是，资本结构中贷款的高级担保提供了下行风险保护。中间市场贷款浮动利率的本质减轻了利率风险，并且在利率上涨的环境提供更高的回报。

美中投资集团（USCI）开发了一套健全的投资流程，并拥有一支在结构化贷款和组建投资组合方面经验丰富的团队。这使我们可以很好地利用对资本的需求，尤其是由私募支持的公司对资本的需求，而我司在这个细分市场有着多年的投资经验。下面我们会展开介绍该战略，及其潜在的风险和回报。

美国中间市场公司贷款现状

在当下低利率环境下，所有信用投资都面临如何产生合理回报的挑战。最佳途径之一就是寻找更高回报的有价证券。但是这样也增加了风险。因此投资者就要被迫承担更高的信用风险来获取更好的收益吗？

通过在公开市场外进行私下协商交易提供资本，投资者有机会规避这样的期待。美国中间市场借方公司提供的高级担保就是为投资者带来更高回报，但同时不用降低信用质量，利率风险很小甚至几乎没有。

Middle market secured loans are currently estimated to generate yields of 9.5% to 10% and generally possess superior covenants and protections for investors resulting in extremely favorable risk-adjusted returns for this asset class.

中间市场担保贷款为投资者提供了信用投资的“三重冠”，包括：

■ 收益高于银团贷款

般低杠杆，高偿债能力比率

颁硬保守的交易条款和传统契约

It is worthwhile to consider the returns on middle market loans in contrast to other popular, publicly traded sub-asset classes. In the table of current asset yields available, middle market senior secured loans are estimated to provide yields in excess of those offered by high-yield bonds and broadly syndicated large corporate loans. USCI estimates that a diversified portfolio of senior loans made to high-quality, non-investment grade middle market companies currently generate an asset level gross yield of roughly 9.5% to 10% before equity incentives where available.

Asset Class	Index	Yield
Middle Market Senior Secured Loans	S&P LCD Middle Market Estimated Average	9.53%
High-Yield Bonds	S&P LCD High Yield (Average New Issue)	6.56%
Broadly Syndicated Large Corporate Loans	S&P LCD Large Market (Most ecent New Issue)	5.93%
Real Estate	NAREIT Global RE (YTD)	4.40%
Commodities	DJ UBS Commodity (1 Yr)	2.50%
Investment-Grade Bonds	Barclays Global Agg Corporate (YTW)	2.46%
Government Bonds	Barclays Global 7-10 Yr Treasury (YTW)	1.81%
Cash and Short Maturity Bonds	Barclays Global 1-3 Yr Treasury (YTW)	0.67%
Emerging Equity	MSCI EM (YTD)	0.60%
Developed Equity	MSCI World Net Return (YTD)	-1.79%

Note: Middle market loans represent first lien & second lien loans, institutional loans & pro rata loans. Data as of February 2016.

Source: S&P LCD for Middle Market, High Yield & Large Corporate; NAREIT, Barclays, MSCI and Dow Jones- UBS yield information.

The shortage of middle market capital supply

Middle market companies are often overlooked by traditional investors, yet it is a very large and growing asset class. If this sector was a stand-alone country, it would be the No. 4-ranked GDP in the world. Private U.S. middle market companies number about 350,000 and employ 32 million people. Typically, it is a sector of the U.S. economy that has been served by commercial banks and other traditional lenders. More recently, other capital providers such as specialty finance companies, structured-credit vehicles such as CLOs (collateralized loan obligations) and BDCs (business development companies), and private investment funds have begun to invest more actively in the middle market.

Since the credit crisis, increased capital requirements and regulatory burdens have led to improved competitive dynamics for non-traditional lenders. Large banks are constrained by regulatory reforms such Basel III and the Dodd-Frank Act. Many have also focused on more broadly syndicated, more liquid deals, while also providing fee-based services that require less capital. Finally, some large banks are still wrestling with legacy portfolios that create a drag on profitability and uncertainty, which has the effect of leading them toward larger, more liquid issues. Smaller regional banks are refocusing their efforts on loans within their geographic footprint. GE's announcement on April 9, 2015 of its intention to sell the majority of its GE Capital businesses – including its middle market lending business, one of the leading providers of senior loans to middle market companies – may further reduce the available supply of middle market senior debt capital.

However, while the middle market presents opportunities for non-traditional lenders, the ability for institutions to access senior loans to this attractive segment of the loan market has been more limited. While overall CLO issuance for broadly syndicated loans has rebounded over the past several years, few new vehicles have focused on middle market opportunities and the reinvestment periods for existing vehicles servicing this market are expiring. Public BDCs continue to be focused on loans that are more junior in the capital structure. Specialty finance companies are hampered by a mismatch between their assets and liabilities from providing middle market finance. Finally, most credit opportunity funds generally lack deep sourcing capabilities and tend to seek rescue finance or junior capital investments in special situations they believe will drive higher asset-level returns, rather than lending to higher quality companies.

The following regulatory reforms favor alternative capital providers to the middle market:

Basel III

W Updated risk-based capital weightings may require large banks to reserve more equity capital against leveraged loans

Dodd-Frank and CLO Risk Retention

W Risk retention (via Dodd-Frank) requires that a sponsor hold 5% of the face value of a securitization on its balance sheet

W Already in place in Europe (a factor in the zero CLO new issuance in Europe during 2012); U.S. to implement in 2016

W Favors middle market alternative lenders and larger securitized asset managers such as USCI

Volcker Rule

W Prevents banks from owning or sponsoring alternative investment firms

W May impact large banks' ability to make markets in CLO paper and provide warehouse facilities to CLOs

New FDIC, OCC, and Fed guidelines on bank leveraged lending

W Expands definition of "leveraged" loans[1] – could lead to higher loan servicing costs and interest costs for borrowers, making banks less competitive

W Expands definition of "criticized" loans[2] – these loans will have higher capital requirements

Source: Wells Fargo

1 To those with M&A related purpose and Debt/EBITDA >4.0x or Senior Debt >3.0x

2 To include loans to borrowers that cannot show the ability to amortize all senior debt or 50% of total debt in 5-7 years and loans to companies with total Debt/EBITDA > 6.0x

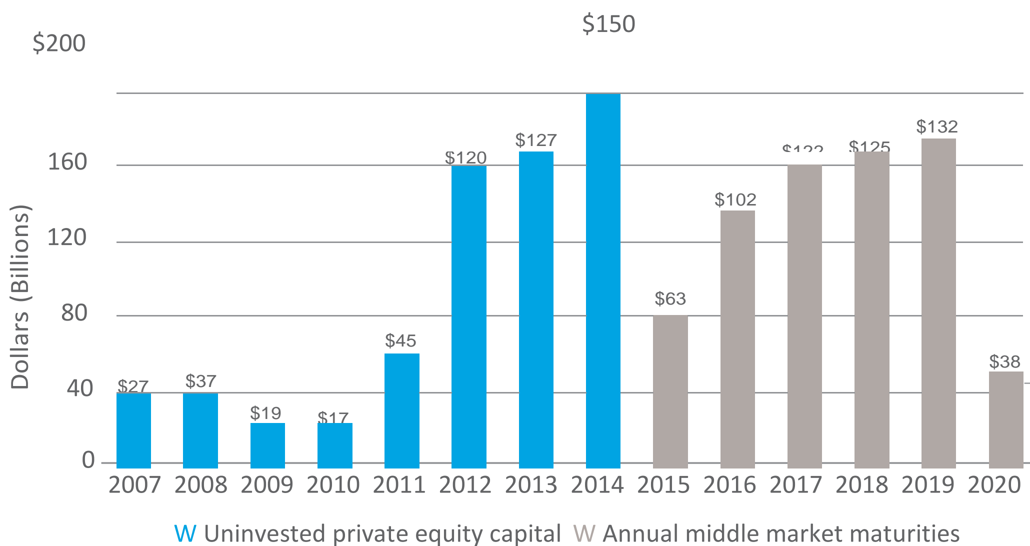
The growing demand for capital

On the demand side, things are similarly stacked in favor of capital providers. Dislocation in capital markets and the changes to the supply side, as previously outlined, have generally reduced the credit available to middle market companies. Importantly, as of the end of 2014, private equity firms have $535 billion in uninvested private equity capital available for investment. They will be highly motivated to deploy these funds before the end of their investment periods. At a typical capitalization of 40% equity, this translates into over $800 billion in new loan demand over the next several years.

In addition, there is a significant need for refinancing of existing loans made to middle market companies. The $583 billion of middle market loans coming due between 2015 and 2020 will provide a steady flow of attractive opportunities for well-positioned lenders with deep and longstanding sponsor and market relationships. All of this adds up to a very favorable environment for lenders with a steady source of capital, and an experienced investment team that can correctly assess the opportunity set.

The market for leveraged loans to support the activities of middle market private equity firms is likely to remain vibrant for many years with over $1.3 trillion in projected new loan demand - all at a time when the number of providers of loans to middle market companies is contracting.

Uninvested private equity capital by vintage & middle market loan maturities



W 2007 – 2014 private equity capital to deploy: $535 billion, driving $800+ billion of fi need

W 2015 – 2020 middle market maturities: $583 billion

W Projected new financing need in excess of $1.3 trillion

Source: Uninvested PE Capital from Pitch book, as of Q2 2014; Total Middle Market Maturities (sponsored and non-sponsored) from Thompson Reuters LPC, as of Q4 2014

In addition to “new money” middle market buyouts, starting in 2016 over $100 billion in current middle market loans per annum will become due thus providing an attractive opportunity to deploy capital in support of refinancing transactions.

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Key investment considerations

The supply and demand arguments and current yields for middle market loans are compelling. Yet no investment is without risk. Some of these risks are the same as for any loan; others are specific to this sub-asset class. Below we identify five critical areas of risk for middle market loans, and strategies to mitigate those risks:

Our senior investment team has deep experience in evaluating key risks of middle market loans with a primary focus on credit risk and preservation of capital.

Credit

Risk: Default by borrower

Mitigation: Robust investment process and experienced team

Structuring

Risk: Poor execution of loan documentation and structure

Mitigation: Robust investment process, tighter covenant packages and experienced team

Spread Volatility

Risk: Reduction in price of the loan

Mitigation: Less of a factor given that middle market loans are generally not actively traded. Middle market loans that do trade have exhibited lower volatility than their broadly syndicated counterparts

Illiquidity

Risk: Inability to sell the loan

Mitigation: Assuming that the investor can assume this risk, and that assets and liabilities are matched, this risk is addressed and investors should be compensated for it

Interest Rates

Risk: Reduction in price due to increase in interest rates

Mitigation: Middle market loans are generally floating rate securities, thus mitigating rate risk

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The “buy-and-hold” origination model

For many reasons, including the risks that have been detailed above, middle market loans are often more conservatively structured than broadly syndicated loans, with stronger covenant packages, lower leverage and better interest coverage. So how do they compare in terms of performance?

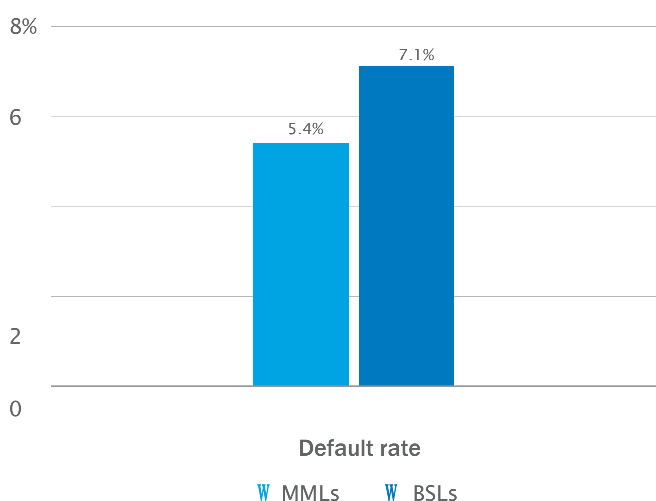
Interestingly, historical performance data suggests that middle market loans (MMLs) exhibit less risk, as measured by default and loss rates, than the closest comparable investment option, which is non-investment-grade, broadly syndicated loans (BSLs). Historical default and loss rates through the market downturn for each loan type are outlined in the chart below.

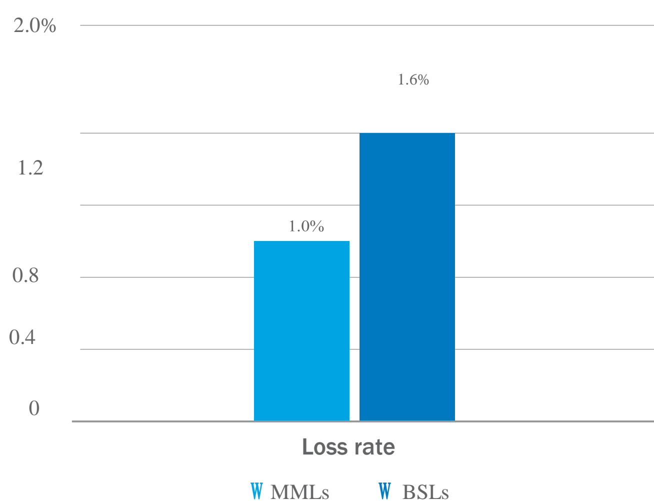
Given the perception that smaller generally means riskier, is there a reason that middle market loans perform better in the downside case than their large-cap brethren? The answer is fairly straightforward. The typical investor in a broadly syndicated loan can (during normal market environments) trade out of the loan if their view of the credit changes. Thus, the mentality of such a buyer will tend to be that of a trader with the instinct to move paper quickly, not a buy-and-hold investor. In contrast to this “moving business” model, middle market lenders are in the “storage business.” They hold the risk on their balance sheets. This dynamic creates a strong incentive for middle market lenders to conduct deep due diligence before making a loan and to be very thoughtful about the terms of the loans they make.

Because of the long-term nature of the holding, middle market lenders prefer a strong senior secured position in the capital structure, which provides a significant element of downside protection. Because size of the facility or loan is smaller, the lender group operates like a “club” and is thus more effective should restructuring be necessary. A club can negotiate tighter covenants, allow less leverage and insist on a lower loan-to-value ratio than larger, more broadly syndicated loans. Middle market lenders generally require shorter maturities and higher amortization, and avoid riskier large deal debt characteristics such as PIK (payments-in-kind) or covenant-lite structures. In addition, they demand a higher proportion of sponsor equity (40% and up) and expect more equity support should the company become troubled. It is this conservative loan structuring that contributes to the better overall performance of middle market private lending

The case for middle market loans: why has this asset class exhibited better performance in a downside scenario?

Middle market and broadly syndicated loan performance through the downturn, 1995 – 2011





Source: S&P LCD; MMLs include total facility sizes of less than $200MM and BSLs denote total facility sizes of greater than or equal to $200MM. Overall loss rates are calculated as follows: (Default Rate * (1 – Recovery Rate)). Default Rate reflects the number of defaulted deals divided by the total loans made during the period.

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Beyond senior debt

Many investors in search of yield also consider instruments that sit farther down in the capital structure of middle market companies, such as public high-yield and private mezzanine debt. These credit instruments offer higher returns as a result of additional risk and can provide a bump in yield. Yet investors need to understand that default rates on high-yield and mezzanine debt are higher than on senior debt. Several other risk factors need to be considered. Credit risk rises farther down the capital structure. Sometimes, depending on the macroeconomic and credit picture at the time of issuance, a capital structure may be either more aggressive or conservative. Investors need to be even more aware of the risk-return characteristics of the paper they are buying. And finally, unlike senior debt, junior debt is often fixed-rate, making it more susceptible to the risk of interest rate increases.

A sweet spot in middle market lending

At USCI, we believe that the risks associated with senior secured lending to middle market companies are further mitigated by focusing on loans made to companies backed by private equity sponsors. The logic behind why private equity backed deals are safer than non-sponsored and "rescue finance" type loans is illustrated in the table below. Some of the key reasons are that private equity sponsors provide additional transparency around financials, offer professional guidance to the company, and, in a downside scenario, good private equity firms stand ready to inject their companies with additional capital.

> Lenders to companies that are controlled by top-tier middle market private equity firms benefit from strong corporate governance and transparency, as well as potential economic support should a portfolio company need additional capital.

Sponsor-driven middle-market	Non sponsor-driven middle-market	Middle-market rescue lending
W Hundreds of transactions per year, driven by M&A and refinancings W Sponsor-backed companies have accounted for 65% of middle-market issuance since 1997 and nearly 80% since 2010. Performance of these deals has been tested over multiple credit cycles	W Fraction of the number of sponsor-driven transactions per year W Sole focus on this segment results in sporadic deal flow and lumpy position sizes W Performance of these deals has not been tested over a full credit cycle	W Deal flow driven by the default cycle W Deals extremely far between and extremely lumpy W Performance of these deals has not been tested over a full credit cycle
W Conservative structures: average senior leverage of 3.0x to 3.5x	W First lien loans are "stretch senior" and are deeper in the capital structure (estimated - 4.5x to 5x)	W Portfolio comprised of first lien loans that are very deep in the capital structure or second lien loans
W Typically defensive industries with strong cash flow generation	W Can include cyclical industries (automotive, retail, restaurants) avoided by most middle-market sponsors	W Borrowers have few/no alternatives for capital
W Strong equity sponsors ensure access to additional equity capital, there to support business, and provide active board oversight	W No financial sponsor	W Typically no financial sponsor or a sponsor that is unwilling to commit further capital due to capital impairment
W Typically lower LTV	W Typically higher LTV	W Typically highest LTV
W Exposure to economic cycles tends to be limited	W Tends to have increased exposure to economic cycles	W Tends to be very exposed economic cycles

Source: S&P LCD Q4 2014 High-End Middle Market Lending Review. Defined as issuers with <$50MM of EBITDA.

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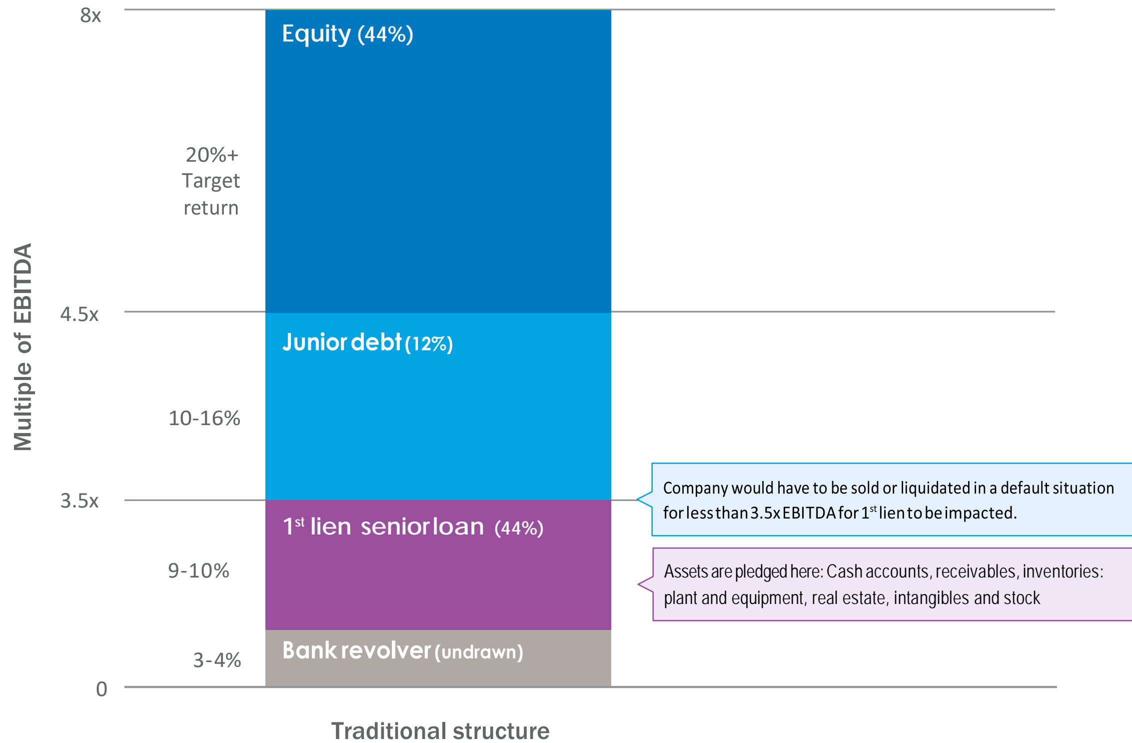
Middle market case study

Below is an example of the capital structure of a typical private equity backed middle market company. The diagram illustrates some of the positive attributes of lending to this type of borrower. The senior secured tranche is backed by a range of corporate assets and would not be impaired short of default. The equity investment by the private equity sponsor consists of $175 million and comprises 44% of the capital structure.

Sample capital structure

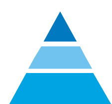


Borrower Profile:	Transaction metrics:
Enterprise value: $400	Total debt: $225 million
million Revenue value:	1st lien senior loan:$175M
$250 million EBITDA: $50	Junior debt: $50M
million	Senior leverage: 3.5x (LTV 44%)
Rating: B2	Total leverage: 4.5x (LTV 56%)
Moody's	Equity: $175 million (44%)
Industry:	
Industrial	

Source: S&P LCD; MMLs include total facility sizes of less than $200MM and BSLs denote total facility sizes of greater than or equal to $200MM. Default Rate reflects the number of defaulted deals divided by the total loans made during the period.

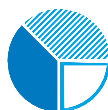
Constructing a top-tier middle market loan portfolio

To construct a portfolio of high-quality assets in this sub-asset class, experienced investors are guided by certain fundamental principles. For a successful middle market lending strategy, USCI has identified the following attributes:



Seniority

Invest in a core of senior secured first-lien and unitranche loans



Diversification

Maintain a highly diversified portfolio of loans to minimize single-deal risk

Quality

Focus on the traditional U.S. middle market. Invest alongside top private equity sponsors with significant "skin in the game". Avoid cyclical industries/ companies, those with start-up risk, customer concentration and certain other company risk factors

Prudent leverage

Seek to apply a modest level of fund-level leverage on these higher quality loans via a well-crafted financing vehicle, rather than lending to riskier companies or lending deeper in the capital structure

Key middle market loan characteristics

The criteria and metrics used by USCI in portfolio construction are summarized below. Important points to note are the number of lenders, typically two to 15, far fewer than a typical syndicate; the effective duration of the loans, often under four years; and the relatively small size of the loans, $5 million to $100 million.

Use of funds	Leveraged buyouts, acquisition financing, refinancing or recapitalization, organic growth initiatives
Maturity	3 to 5 years
Facility size	$5 to $100 million
EBITDA *(Earnings before interest, taxes, depreciation, and amortization)*	$5 to $50 million
Lenders per facility	1 to 5
Senior leverage multiples	Up to 4.5x
Unitanche leverage multiples	Up to 5.5x
Total leverage multiples	Up to 6.0x
Spread over libor	800 to 900 bps
LIBOR floors	1.0% to 1.5%
Upfront fees	0.5% to 2.0%

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Conclusion

USCI believes that an experienced investment team can potentially generate strong risk-adjusted returns by lending to middle market companies in the current market environment. A diversified portfolio of senior loans made to high-quality middle market companies currently has the potential to generate a 9% to 10% asset-level yield, representing a significant premium to public-market alternatives. Using modest amount leverage through a well-crafted credit facility, the return for this strategy has the potential to generate 12% to 15% net yield to investors.

As noted in detail above, the strategy:

- Compares favorably to public market credit and broadly syndicated debt strategies
- Has strong return potential relative to the risks, many of which can be mitigated
- Offers significant downside protection due to capital structure seniority, private equity sponsor backing, deep loan diligence
- Has a favorable supply/demand dynamic with structural imbalances that favor lenders and are unlikely to be corrected any time soon

About USAChina Investment Group

USAChina Investments Group LLC and its subsidiaries ("USCI") are a global merchant bank and investment management company who is a global leader in cross border foreign investment between China and America, utilizing proprietary financial technologies and important joint venture partnerships to accelerate the pace and accuracy of identifying and matching cross border partners, as well as increasing their probability of success and profitability.

USCI's financial products and services, as well as its GTIC is built to facilitate the mission critical transactional needs and support the success of the hundreds of Chinese businesses expanding to America each year. The GTIC offers growth capital and custom designed services to leading Chinese SMEs including foreign direct investment services, growth capital, IPO listing in America, business development and strategic partner networking support, university level executive training and mission critical professional and administrative services.