

Lead Left Spotlight - Stephen Boyko



This week we chat with Stephen Boyko of [Proskauer](#). Steve is a partner in the firm's corporate department and co-head of the private credit and finance groups. He represents one of the largest client rosters in the industry, including an array of specialty finance companies, private debt funds, and BDCs.

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The Lead Left: Steve, thanks for joining us again. We spoke in April to review 1Q trends. You recently came out with your first half survey [\[link\]](#). What's activity been like?

Stephen Boyko: Activity remains strong as we move into vacation season. For example, last Friday afternoon I got four new transactions. And we had eight new deals overall by the end of the day. So there does seem to be a fair amount of M&A activity going on.

It's very competitive. We are witnessing a constant loosening of pricing and terms. In auction deals, we are seeing 3-5 sponsors competing for the deal, and each are bringing 3-5 lenders to the table. The vast majority of deals that we are doing are sponsor-backed. Only 20% is non-sponsored, direct-to-borrower deals. And roughly 70% of our transactions relate to acquisitions.

TLL: Have you seen much of a change from the first quarter? Any surprises?

SB: There have been a few surprises. We weren't surprised that spreads are going lower. We were surprised that there has been so much activity in the healthcare space, given all the uncertainty surrounding healthcare reform. We thought lenders would be picking their spots. But 25% of our deals have been healthcare-related, which is somewhat surprising.

TLL: Within healthcare what subsectors are you seeing?

SB: In the past we've seen lab deals and some physician roll-ups in anesthesiology, urgent care, and emergency room space. While we are still seeing some physician roll-ups, we've also seeing a fair bit of healthcare technology deals.

TLL: Any other first half surprises?

SB: We hear in the market that there is a lot of cov-lite. In the direct space, the vast majority of mid-market issuers (\$40

million of ebitda or less) are not cov-lite. This is especially the case when they are financed by direct lenders. Interestingly, even the direct lenders who are offering the most aggressive terms want covenants when they hold a good chunk of the deal.

TLL: How do your stats break that down?

SB: We did 73 deals in the first half, and only 16% of them were cov-lite. This was the case even though 39% of our deals had greater than \$50 million in ebitda, with the balance spread being across the mid-market. We are also continuing to see step-downs on covenants. 78% of our transactions had at least 5 step downs!

TLL: What percent of your deals were "principal investing" vs "syndicated"?

SB: The vast majority is principal, in which the lender is holding a significant piece of the capital structure. It's mostly senior debt; only 20% of our deal flow is either 2nd lien or mezzanine.

TLL: Have you seen continued deterioration in structures?

SB: It really has continued, things like wider baskets and flexibility in incremental debt baskets. Also free and clear baskets. However, we have seen tightening in a few deal terms. For example, cash flow sweeps. Some lenders are keeping step-downs at lower levels of leverage. In 2016, the first step-down point occurred at 3.9 times leverage. For the first half of this year, that number is 3.5 times- half a turn lower.

For transactions between \$25-50 million ebitda, the excess cash flow sweep step-down occurred at 3.1 times. For deals over \$50 million ebitda the sweep stepped down at 4 times. That really bucked the trend.

We've also seen a little tightening in restricted payments. That ratio for dividends for issuers between \$25-50 million ebitda was 3.3x, with leverage coming down from initial levels of 5 or 6 times.

For the greater than \$50 million ebitda companies the ratio was 4.8 times – a big jump. The middle market space is requiring significant deleveraging before allowing dividends.

Another trend deals with starter baskets. The rule of thumb is allowing a basket equal to one quarter turn of leverage. That ratio pretty much held last year. For the first half of this year, it crept down to 20%.

TLL: *You represent mostly lenders, correct? So I'm sure you're being asked for some pretty stretchy stuff by sponsors.*

SB: Yes. Sponsors are asking for more and more room on incremental debt, such as free and clear baskets. If the deal has closing leverage of 5.5 times, they are looking for a free and clear basket of an additional half turn to full turn of leverage (i.e. 6.5 times). Depending on the deal dynamics, this will typically settle around a half to three-quarters of a turn of additional leverage.

TLL: *Where do you see total leverage ratios going?*

SB: We did presentation with Lincoln International recently to discuss our data and their data for the first half of the year. It was a great event. We had about 200 lenders and sponsors in the room. Our data on leverage showed a decrease, on average, by 0.3 turns to 4.8x for the first half. Lincoln's leverage number for the approximately 1,000 companies in their database was about the same- 4.7x. We scratched our heads and triple-checked our numbers (we always double-check). But they were correct. We think it's because a large proportion of our clients are finding more off-the-run credits to complement the higher leverage deals they are doing for top-tier sponsors. While we close lots of deals with leverage at 5, 6 and 7 times, we also close a good number of deals with 2, 3 and 4 times leverage, which drags the average down. With that said, competition for deals remains intense and we anticipate that leverage will likely trend higher as we go further into the year.

TLL: *What about pricing? What kind of trend are you seeing?*

SB: Pricing is down across all product types and EBITDA bands. We believe that two factors are contributing to this – competition (for sure) and the increase in lower cost capital available to our clients. Most of our clients have raised senior funds, which allow them to compete directly with banks. The big change in the market is that direct lenders now are offering two financing solutions to borrowers - a senior-only solution and a complete capital structure solution

TLL: *What percent of deals were unitranche?*

SB: 44% were either 1st lien or unitranche.

TLL: *How do you define unitranche?*

SB: We classify by leverage. Once you're over 4.25x or 4.5x, that's really unitranche.

TLL: *I noticed in your data that the prevalence of non-bifurcated unitranche structures is continuing.*

SB: Yes, 76% are straight unitranches (no bifurcation). There's such an appetite for product, clients will hold the whole thing. Also direct lenders have raised lower cost capital so they can keep the entire tranche rather than having to sell off the first out tranche to meet their hurdles.

TLL: *So Steve, what kind of market are you predicting for the 2nd half? More of the same?*

SB: It does feel like more of the same. The market is very competitive. You always see a number of folks competing for the same deal. This drives down pricing and results in looser terms. While markets are strong, there's still not an abundance of deals. And there's a ton of cash looking to be deployed.

With that said, we do see clients picking their spots on terms. For the right credits, clients will take a beating on the pricing as long as they get the terms they are looking for. It's possible some tightening will happen, but I wouldn't bet on it in the near term

TLL: *How about my favorite topic: ebitda adjustments?*

SB: We are seeing adjustments everywhere, not just for top-tier issuers. Our lender clients are paying attention to add-backs, but the trend is not good. There's also not a uniform approach. We are tracking add- backs by type and deal size. It's one of the 200 data points we collect on each deal. We are starting to see trends by EBITDA size with fewer and looser EBITDA caps as EBITDA increases.

In the traditional middle market, non-recurring items such as a plant catching fire or a staff downsizing, we're seeing a little loosening on terms. For run-rate synergies – giving credit for expected expense reductions - lenders are a bit more conservative.

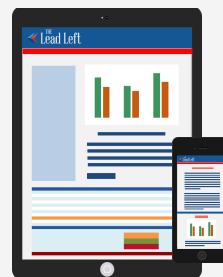
TLL: *So Steve, last April we talked about the Trump effect. Any updates?*

SB: The status quo is fine for the capital markets. We know that lots of items are being discussed, such as rolling back Dodd-Frank and increasing BDC leverage. Who knows what will actually get passed.

But we do know is that the chance of taxes and regulations increasing appear to be very small. This is good for the market.

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Churchill Asset Management's exclusive capital market's publication, *The Lead Left* reviews deals and trends with a unique focus on the mid-market space and is read by thousands of influential industry participants.



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