A **Q&A fireside chat** with CIO Ivelin Dimitrov of Fifth Street Asset Management

A Discussion:
The Middle Market

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With over a 16-year track record of lending to small and mid-sized companies, Fifth Street has become one of the leading lenders in the middle market with nearly $6 billion in assets under management and an award-winning origination platform. One of a handful of lenders with the ability to hold up to $250 million on its balance sheet, the firm now has over 300 private equity sponsor relationships and reviews over 1,000 investment opportunities per year.

At the forefront of it all is Chief Investment Officer, Ivelin Dimitrov, who has been with Fifth Street since 2005 and oversees the firm's credit underwriting, risk analysis and investment approvals. With so many sponsor-backed middle market opportunities crossing his desk, Ivelin has unique insight into the middle market lending environment. In this Q&A fireside chat, Ivelin shares his views on:

- How risk retention rules will impact the industry
- Middle market expectations for Q4 and 2015
- Purchase price and leverage multiples, pricing and covenant-lite loans
- The future of BDCs
- Fifth Street's recent platform expansion and where the firm is heading

Ivelin M. Dimitrov, CFA *is the Chief Investment Officer of Fifth Street Asset Management Inc. and Fifth Street Finance Corp., as well as Chief Executive Officer of Fifth Street Senior Floating Rate Corp. Mr. Dimitrov is a member of Fifth Street Finance Corp.'s and Fifth Street Senior Floating Rate Corp.'s Boards of Directors and Chairman of the Board of Directors of Healthcare Finance Group, LLC.*

Q: Each firm defines "middle market" a bit differently. What does Fifth Street consider middle market?

A: We have been middle market investors for over 16 years, during which time we have seen a number of participants come and go, definitions change and cycles go up and down. We operate in the traditional middle market space, which for us generally consists of companies with EBITDA of $15mm to $50mm. The financing solutions that we provide to the market consists primarily of senior stretch, unitranche and second lien loans, with sizes of $20mm to $300mm. The average EBITDA of a portfolio company is about $25mm.

Q: The widely anticipated risk retention rules for CLOs have finally gone into effect. What impact—if any—do you think they will have on middle market investing?

A: We view risk retention as a positive to our type of investment philosophy and orientation. The major goal of the regulation was to make sure that there is alignment of interests between those responsible for the management of the vehicles and the investor base. During the last downturn, we saw a number of market participants go out of business and lose money for their investors due to risky behavior focused on growing AUM to collect management fees. In our case, we have been significant investors in the vehicles we raise, and we expect to take advantage of the volatility in the CLO market by making opportunistic investments in the space.

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Q: Broad market conditions have softened this fall while stock market volatility has spiked. Have you noticed similar conditions in the middle market? How is middle market activity in the fourth quarter shaping up?

A: As one of a few traditional middle market origination platforms, we are generally sourcing, underwriting and holding the assets to maturity, which gives us a long term point of view on the market. A lot of times those transactions take 3-4 months to develop and move through our process, which gives us visibility on the upcoming quarter's activity. During the last few weeks of volatility, we saw certain transactions being pulled and borrowers relying less on the syndicated market. This works out well for our senior stretch and unitranche products, which provide our private equity clients with certainty of close and one partner with which to deal. We are seeing the same theme continue in the fourth quarter for the middle market, with a strong deal volume focused on a number of large one-stop transactions. We do see spreads widening over time, and we do believe interest rates are positioned to increase some time next year. We have been positioning the portfolio accordingly.

Q: Middle market fundraising is currently quite brisk. Many are touting better default and recovery rates, though some would argue that middle market credits just benefit from less perceived volatility. What are your thoughts?

A: In the middle market we need to be in control of our destiny, hence our platform's focus on first lien / senior secured investments, which have performed very well through periods of market volatility. We are also focusing the portfolio on defensive sectors such as healthcare, technology, and business services, which have historically helped us achieve above average default performance. Finally, to operate a middle market platform, you need to invest significantly in the origination, underwriting and portfolio management function. We have over 90 people with about half of them dedicated investment professionals, across locations around the country, so we have invested in building out the platform. We think we compare quite favorably against less established firms that say they are in the middle market but do not have the infrastructure to support the investment activities and may struggle during the next dislocation.

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Q: Do you have any new funds in the pipeline?

A: We have been actively fundraising for a number of initiatives. We have a Senior Loan Fund in the market with a mandate to invest in first lien opportunities, a number of SMAs in the works, and we also just closed our second joint venture with a long-time partner to invest in middle market loans.

Q: What is your current outlook for the middle market? Are you concerned about lofty leverage levels? Do you have any showstoppers in terms of underwriting criteria?

A: Operating in the middle market gives us some protection from the trends in the BSL space. The middle market is clubby, relationship-driven, with the same 4-5 platforms in the conversation on almost every deal. We support private equity sponsors that we have completed multiple deals with, over many cycles, which allows all of us to be on the same page as far as the appropriate leverage on a given transaction. Usually you would see the middle market in a similar leverage range, with potentially some outliers representing new shops, with a need to deploy capital, being more aggressive to win the deal. In the end, the sponsor community is quite rational and relationships usually prevail, as people have long memories and remember that we supported them through the last downturn and will be around to get them through the next one.

Q: What is Fifth Street's average leverage multiple?

A: Given our senior focus, the average leverage multiple across the platform is in the low 4s.

Q: Do you see leverage multiples going any higher or are they topped out?

A: We definitely see leverage multiples going higher in the middle market, and most likely in the BSL space as well. Part of that dynamic is driven by conservative leverage lending guidelines and part of it from availability of credit lines.

Q: Frothy market conditions and covenant-lite volume tend to go hand-in-hand. Yet, some middle market lenders draw a line in the sand when it comes to covenant-lite. What about Fifth Street?

A: We do not believe that the covenant-lite product has a place in the middle market, given the size of companies and structure of credit facilities.

Q: In terms of pricing, do you expect middle market yields to rise, drop or remain flat? Why?

A: We believe spreads have stabilized and have started to widen in certain cases, all dependent on the credit quality of the underlying borrower.

Q: What is your forecast for middle market activity next year? What kinds of deals will drive business in 2015?

A: Given some of the pressures that banks and other traditional lending providers are going through, the middle market space has consolidated around a number of providers – Fifth Street being one of them – that have the capital and relationships to provide creative financing solutions to the sponsor community. We are seeing a lot of opportunities within our senior, senior stretch and unitranche products. The private equity clients we do business with value the relationship, certainty of close and partnership approach we bring to the table and we believe this will continue in 2015.

Q: Purchase-price multiples have reached record levels. How is this affecting LBOs?

A: LBO volumes have been increasing in our core market. We feel our clients and partners in the private equity community are exercising discipline and prudence in respect to investment and leverage decisions.

Q: Turning back to BDCs, legislation is currently pending that would alleviate restrictions on BDC's 1:1 leverage, allowing them to lever up to 2:1. The legislation also covers the types of investments BDCs can make. In your opinion, will the SEC enact some form of changes next year?

A: There are certain aspects of the proposed legislation of which we are supportive, and other points that run counterintuitive to our conservative philosophy of not piling leverage on risky assets. We are running a conservative portfolio focused on first lien assets, so we are in position to react to whatever shape or form the final legislation takes.

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Q: Would loosening BDC's leverage restrictions go far enough in terms of leveling the playing field among banks and CLOs, which generally leverage up to 8x and 10x, respectively?

A: It all depends on the asset class. BDCs are permanent capital vehicles that have the mandate to invest up and down the capital structure. It would be inappropriate, in our view, to lever a mezzanine-focused BDC at more than 1:1. That being said, as operators of structured vehicles ourselves, we believe there is a time and place to utilize prudent leverage to enhance returns for our investors.

Q: What will the BDC market look like in five year's time?

A: BDCs as an asset class have really grown to fill a void in the marketplace left by banks which are hurting by the leverage lending guidelines, hedge funds that blew up through the last downturn and CLO shops that have had difficulty coping with risk retention. We think the asset class will continue to grow and evolve with new participants entering the market enticed by the attractiveness of private debt. We believe Fifth Street is well-positioned to gain share in this environment, given our track record, access to distribution channels, as well as our conservative underwriting philosophy and emphasis on discipline.

Q: According to many lenders, the middle market is less exposed to broader volatility. Yet, with equity playing a crucial role in BDC fundraising, won't BDCs introduce more volatility if they play a bigger role? During the 2008 credit crisis, weren't a majority of BDCs effectively shut down due to an inability to raise new equity?

A: We went public with FSC during the summer of 2008 and continued investing all through the crisis. The relationships we built during that time, delivering certainty of close and strong financial solutions to our private equity partners, are the cornerstone of our reputation and our origination business today. We believe we are well-positioned to capitalize on market volatility going forward, given our stable, permanent capital base, diversified lending sources and access to multiple distribution channels.

Q: Looking ahead, what is the biggest challenge facing Fifth Street?

A: We have grown over our 16-year history by emphasizing a culture of transparency, discipline and being honest as well as delivering returns to investors. To continue to deliver, we need to continue building on that culture, attracting quality individuals that share the same values. The recruiting process at Fifth Street takes a long time as we are trying to make sure we are aligned with our candidates on multiple levels – from the investment point of view as well as culturally. However, once you are part of the Fifth Street family, you are usually around for a long time, as seen by the tenure of our senior professionals. We need to continue building and emphasizing that culture in order to remain successful.

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ABOUT US

Fifth Street Asset Management Inc. (NASDAQ:FSAM) is a rapidly growing credit-focused asset manager. The firm has nearly $6 billion of assets under management across two publicly-traded business development companies, Fifth Street Finance Corp. (NASDAQ:FSC) and Fifth Street Senior Floating Rate Corp. (NASDAQ:FSFR), as well as multiple private investment vehicles. The Fifth Street platform provides innovative and customized financing solutions to small and mid-sized businesses across the capital structure through complementary investment vehicles and co-investment capabilities. With a 16-year track record focused on disciplined credit investing across multiple economic cycles, the company is led by a seasoned management team that has issued billions of dollars in public equity, private capital and public debt securities. Fifth Street's national origination strategy, proven track record and established platform are supported by approximately 90 professionals across locations in Greenwich, Chicago, Palo Alto and Dallas.

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