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Leveraged Capital

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Q&A Middle-Market Yield Premium Returns After 4Q Inversion, Says Fifth Street's Buffone

Leverage could top 6 times for certain middle-market transactions, says **Fred Buffone**, head of capital markets at **Fifth Street Asset Management**, which has over $6 billion of AUM. He spoke with Bloomberg Brief's Kelly Blessing on March 17.

Q: How do you define middle market?

A: Broadly speaking, as companies with Ebitda of $10 million to $50 million. That's not to say we won't selectively look at companies a little smaller or a little larger, but that tends to be our sweet spot.

Q: How are things in the middle market today versus the large-cap market?

A: Because you have a smaller buyer base for middle-market club transactions, there's a lot less price and yield volatility. But it also can be slower to react. After the sharp selloff in the large-cap market in the fourth quarter, yields on broadly syndicated loans were actually slightly wider than middle-market yields for a short time. With deal flow very light on both sides, we've seen a quick rebound in large-cap pricing, and the spread premium is now getting back to normal.

Q: How are fundamentals right now?

A: You're still seeing Ebitda growth across the spectrum, though it's a little slower than in the last couple of years. The strengthening dollar is making it a bit tougher for exports, but most middle-market companies are more domestic-focused and don't have much in the way of exports. Fifth Street has very little energy exposure, so we don't expect much impact to our portfolio.

Q: Where is leverage going?

A: After ticking up for most of last year, leverage in both the large-cap market and the middle market came down slightly in the fourth quarter. The six times leverage cap and the 50 percent amortization rules are holding down leverage for banks under regulatory oversight. Non-bank lenders don't have that same concern. A sector with more cyclicality and more capex may warrant a maximum leverage multiple of about five times, while a business services or software company that has high recurring revenues or contracts could easily see leverage of six times or higher.

Q: Do you see defaults ticking up?

A: If the default rate rises more quickly in the middle market than in the broadly syndicated market, it's generally because the middle market has covenants, whereas the majority of the broader market does not. Middle-market deals tend to have lower leverage and better pricing to compensate for their smaller size and illiquidity. The diligence process that direct lenders put into a middle-market company is extensive. We go into a transaction expecting that we'll buy and hold. It's not a trading mentality.

Q: What sectors are attractive?

A: Two of the largest sectors that we focus on are health care and technology. We employ credit experts who spend the vast majority of their time just underwriting those sectors. We also like them because they tend to be less cyclical. They have better recurring revenues and profitability because of the dynamics and tailwinds of the industries. We tend to avoid the deeper cyclicals, particularly the ones that have higher capex. We also tend to avoid businesses that have commodity-driven pricing.

Q: What do you expect in terms of issuance this year?

A: Broadly speaking, we're probably going to be at or slightly below the levels of 2014. The year is off to a very slow start. With the reset at the end of 2014, leverage levels retreated and the market became a little more selective. Capital is available, but it's getting harder for sponsors to justify paying what sellers are asking, so M&A activity is down.

Q: What are the biggest risks in middle-market lending?

A: Since these are smaller credits, there's not going to be liquidity there to exit a particular credit if it's not going well. That's why we spend a lot of extra time on the diligence and underwriting side.

Q: What part of the capital structure do you prefer?

A: Three of our four main funds primarily invest in in first-lien debt. Our larger BDC, Fifth Street Finance Corp., is over 80 percent invested in senior secured loans, but that vehicle also invests in the junior part of the capital structure, such as unitranche, second-lien and mezzanine.

Q: Is it hard to raise equity right now?

A: BDCs that are trading below book value need shareholder approval to issue equity. Fifth Street has publicly stated that we do not intend to issue equity at either BDC below book value. However, we have availability under our credit lines and we're constantly getting money back from refinancings, so we always have opportunities to invest in both BDCs.

Q: Why did you do a CLO now?

A: As a direct lender, we have many sponsor relationships, so we've always had the opportunity to invest in the traditional senior part of the capital structure. But we didn't always have an appropriate vehicle to do so. That's why we diversified with our senior floating-rate BDC, and now the CLO. We also have a second warehouse that we're ramping.

AT A GLANCE

Grew up: Philadelphia suburbs

Lives now: Rye, New York

Hobbies: Golf, hockey and soccer

Favorite book: The Lord of the Rings

Favorite music: Classic rock

Favorite movie: Shawshank Redemption

Favorite vacation spot: Anguilla (honeymoon spot)

Best investment advice: Stick to your basic strategy and don't chase momentum