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Five Questions With... Leonard M. Tannenbaum, CEO, Fifth Street Finance Corp.

This year is already off to a tepid start. As a lender, where do you think the debt markets are heading in 2009?

I am hopeful that new government stimulus programs will rouse a lot of lending. I think the best chance for the government to most quickly impact lending to the small and mid-market private equity world is through the SBA [Small Business Administration]. They have to encourage lending through the SBA. They need to find reputable, small-company lenders with good track records, and open up the government lending programs like SBIC [the Small Business Investment Company program] for us to be able to put money to work. Just putting money into the banks—which may or may not lend—won't bring the market back. We will lend. We want to lend. But if the government doesn't get the money down to the right hands, I think it may be 2010 before the market opens back up.

What's keeping Fifth Street Capital busiest today?

If you would have asked me two years ago, we would have been doing a lot of second-lien assets. Today, we're primarily doing first lien one-stops because the banks really have totally contracted, and are no longer lending to our industry. Our portfolio today is maybe 40 percent first-lien and 60 percent second-lien, and the trend is towards even more first-lien loans than that... Most of what we're doing is cash-flow lending.

If you're providing cash flow loans today then you must be really popular. How many of the deals that come your way do you actually end up financing?

I'll tell you a really interesting statistic. In 2008, for a full year, we closed on 100 percent of the term sheets that were signed, which is unheard of and probably will never happen

again. Our normal closure rate on a signed term sheet is about 50 percent. What happened last year was a consequence of better partnerships, proprietary lending, and less competition. We also are very careful about even issuing a term sheet, much less signing it. It used to be that you would see lenders issue term sheets as an indication of interest. Now you're seeing term sheets only if you really want to close the transaction.

What is the average senior debt to EBITDA ratio in LBOs you're seeing today, and what are the typical terms on that paper?

The banks are lending less than 2x EBITDA. We're typically lending through the capital structure, and in our history the average has been about 3.5x EBITDA. At our peak we were hitting 4x, but lately we've contracted down to between 3x and 3.5x. In terms of pricing, it's off the charts. We're doing first-lien structures with IRRs in the high teens—and those are for stable sponsor-backed companies with less than 4x total debt to EBITDA. If you would have told me that a couple of years ago I would have said you were nuts.

With 40 portfolio companies, what are you seeing in terms of EBITDA trends and company health?

For the most part, everything is stabilizing after the sharp declines last October and November. Clearly the best performing companies for us are the healthcare and healthcare services companies. Second to them, our niche manufacturing and infrastructure companies are doing ok. Burger King, and our other restaurants—because of their lower-end nature—are doing well. Even our health club chain, which falls at the lower end of that spectrum, is seeing a pick-up in memberships as people migrate from the higher end clubs to the lower end. But anything linked to the consumer is fairing the worst. But as we see the portfolio stabilize, we get encouraged again; barring another October.