Inside the Middle Market



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State of Middle Market Financing in the U.S.

A year has passed since we completed our first survey of middle market capital providers. The malaise in the credit market has lingered, and the impact of a recessionary economy and troubled financial sector is extending the tight credit conditions. While not immune to the credit dislocation, the middle market has been more forgiving than the large cap market, and deals are still getting done.

For this edition, we contacted debt and equity providers to the middle market, including senior and mezzanine lenders and private equity sponsors, to gain insight on the financing markets and the appetite for deal making. We confirmed that despite the recent credit turmoil, interest in quality middle market companies remains strong. And the sentiment is that if you have the capital, it is a good time to be doing deals. For lenders, deals are structured and priced better. For private equity, some say this environment should be one of the greatest for putting money to work. There is caution in the statement, as all eyes are squarely on the health of the economy.

Following the conclusion of our interviews, the unprecedented events in the financial sector have further constrained the credit markets. As such, we plan to complete another update in December to revisit topics covered here.

PARTICIPATING FIRMS

Allied Capital Corporation
American Capital, Ltd.
Banc of America Capital Solutions LLC
Bridge Finance Group
Burdale Capital Finance, Inc. (Bank of Ireland)
Charter One Bank (Royal Bank of Scotland)
Churchill Financial LLC
CIVC Partners
Dymas Capital Management, LLC
Fifth Third Structured Finance Group
GE Antares Capital
GMAC Commercial Finance
Goldman Sachs Specialty Lending Group, L.P.
Golub Capital
Gryphon Investors
Linsalata Capital Partners
Madison Capital Funding LLC
Midwest Mezzanine Funds
Nautic Partners
Northstar Capital, LLC
Prairie Capital
Transition Capital Partners LP
Wells Fargo Foothill

State of Middle Market Financing in the U.S.

Buyout and mezzanine fund raising reached a record high in 2007—the same year that a weakening economy and turmoil in the financial markets sent leveraged buyouts in a tailspin. The overhang in capital has left investors in search of places to put money to work, which can be challenging as credit has tightened and lender scrutiny has never been greater. Defensive sectors have become even more of a draw in the face of economic uncertainty, and with senior debt financing in short supply, both lenders and financial sponsors are picking their spots carefully.

For the owners of middle market businesses, today's 'perfect storm,' as it has often been referred, has created one of the more difficult operating environments in history. Against a backdrop of mounting obstacles—unprecedented energy and commodity price inflation, slowing growth, and tighter credit markets—business owners are challenged to maintain growth and preserve margin.

Consumers are facing declining wealth from all fronts. Everyday staples like food and gasoline have reached new highs, and little relief is in sight. The effect of $4/gallon gas symbolizes a change in lifestyle for many consumers—the impacts of which many believe have not even begun to materialize in terms of the flow-through to the economy.

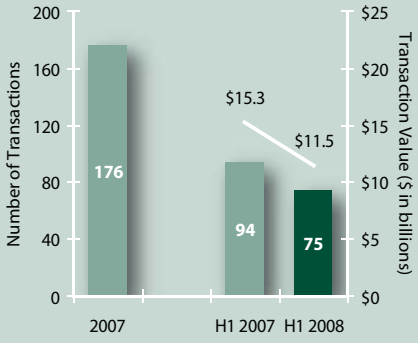
It comes as no surprise that economic uncertainty and the reduced access to debt capital have impacted deal flow even in the middle market. We are working harder to get deals done. Financing is harder to come by and is more expensive. Reduced leverage is forcing sponsors to be more creative in structuring deals. In this market, it is not just about adding leverage to get returns; it is about creating value in the companies that you own.

But there is good news. In the lower middle market, credit is still available, and deals are getting done. And for middle market companies that fit the right profile, there are many hungry buyers.

Historical Middle Market LBO Activity

Quarterly LBO Activity

Half Year Comparison



Disclosed transactions with values between $25 million and $500 million
Source: Thomson Financial.



State of Middle Market Financing in the U.S.

Finding capital

Capital is tighter. The number of active participants in the senior lending market has shrunk, and across the board, senior lenders are more cautious and structures are more conservative. Even still, some respondents tell us that capital may be becoming more available. "Lenders are being more selective, but capital has bounced back," Eric Bacon, a senior managing director at Linsalata Capital Partners, told us. And senior lenders that may have been on the sidelines six months ago are "selectively" returning to the market. "Middle market deals are still getting financed in the current environment. Most of the trouble in the lending community has been centered on very large banks and hedge funds that have not been a primary capital source in the middle market. Local and regional banks, SBICs, and asset-based finance companies, which have been key lenders to the middle market, have not been greatly affected by the crisis so far," offered Dan Patterson, Chairman and CEO of Transition Capital Partners.

> "Good companies are attracting a ton of attention. People want to put money out."
>
> —Mike Foster
> Midwest Mezzanine Funds

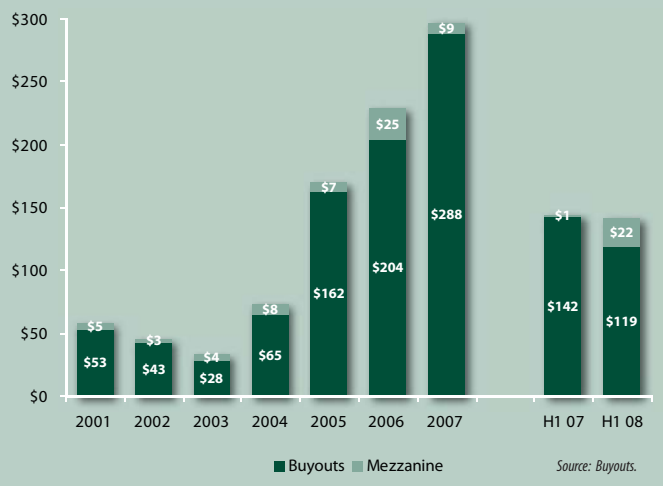
"Last man standing"

There are senior lenders that will always have the capital. "It does matter who your lender is," said Trevor Clark, a senior managing director at Madison Capital Funding. "It matters whether your lender will be in the market in good times and in bad." Speaking out on participants in the senior lending market, Andy Steuerman, a senior managing director at Golub Capital, commented, "If you look at the field of active senior lenders, where you may have had 12-15 a year ago, it is more like 5 or 6 today. I would argue that the middle market is efficient as is and doesn't require any more players. Private equity firms have always had their preferred group of "go-to" lenders, and they are leveraging those relationships, particularly in this environment." Joe Romic, a principal in the Sponsor Finance Group at American Capital, Ltd., commented, "The long-term market players are still around. The stronger, "core" lead agents are still there. What have changed are the participants." Sponsors say they are going deep in a shallow market.

Sponsors that have aligned themselves with lenders are not finding difficulty in financing transactions. "It is about working with long-term lending relationships and achieving a desired comfort level. It is a 'they know us, we know them' partnership," commented Keith Yamada, a partner at CIVC Partners. And some choose not to maximize leverage in deals, and so are not credit constrained. By taking on more modest leverage, sponsors avoid being exposed to closing risk if they cannot get the senior debt funded. "We have not heard or felt a tremendous amount of distress in the market. Since last summer, we have not fielded any S.O.S. calls from sponsors. For plain "vanilla" deals, we have not had one sponsor call us and say that they can't get financing," commented Mr. Steuerman. "It does not feel like a total liquidity crunch," one sponsor told us.

A number of middle market lenders are benefiting from the credit dislocation. Randy Schwimmer, head of capital markets at Churchill Financial (Churchill), told us, "We have seen nothing but continued deal flow. If I look at our current portfolio, a higher percentage of the loan volume was transacted post credit crunch. So, our competitive position dramatically improved during the period. And our appetite continues to be strong." Churchill has become more selective about hold sizes. While the average hold size for credits in the portfolio is currently under $10 million, Churchill will hold up to $25 million if the lead agent in a transaction.

"Our current appetite for the middle market continues to remain bullish. Our historic focus on sound credit structures has allowed us to maintain and have available capital enabling us to take advantage of the current conditions in the market," said Randy Abrahams, CEO of Bridge Finance Group (Bridge). Bridge offers specialized expertise in asset-based and SBA/USDA loans across numerous industries, including an expertise in healthcare financing, and provides product solutions for acquisition financing and growth capital, working capital needs, turnarounds, and restructurings.



Robust fund raising over the last few years has left a large overhang of capital that needs to be put to work. With the slowdown in the transaction environment, private equity groups are feeling pressure to identify and execute transactions to deploy the excess capital.

State of Middle Market Financing in the U.S.

Finding capital

Bringing liquidity

Some lenders are increasing hold sizes to bring liquidity to the market. Steve Robinson, a managing director at GE Antares Capital, told us, "We are taking down larger hold sizes for strong companies." GE's average hold size is now closer to $50 million, which is up from $35 million a year ago. "We can still write a $40 million check on the occasion that it makes sense for a deal to clear," Mr. Clark added.

Active players, through one-loan financing products, are filling a void in the senior market.

> "Good companies can get financed and sold in today's market."
>
> —Steve Robinson
> GE Antares Capital

The market response has been favorable since GE Commercial Finance and Allied Capital (GE/Allied) launched a $3.6 billion unitranche loan fund last December. The new vehicle has provided a significant benefit to private equity firms and corporate clients who have not been able to get senior debt, stretch senior, or one-stop financing from one provider who will hold the entire loan without adding syndication/flex provisions, according to Mike Miller, a managing director at Allied Capital. "The unitranche has filled a void where commercial banks, CLOs, and investment banks have exited the market, and the ability to underwrite and provide a loan at 3x to 4x on a senior basis or 5x on a one-stop basis has almost evaporated," said Mr. Miller. GE/Allied has closed seven transactions in the fund representing total loan commitments of over $695 million. "We are able to look at the market from several vantage points and offer clients a variety of financing options for their deals. The unitranche opened up a lot of opportunities. In our view, the market opportunities may be phenomenal in light of recent market events," Mr. Miller told us.

Golub has seen strong interest in one-loan financings offered through the firm's GOLD product and is on pace to match or surpass the $350 million in loan volume it closed last year. "It is not uncommon for us to write a $40 million check and underwrite the entire facility," Mr. Steuerman told us. Golub's average financing is $30 to $40 million for GOLD facilities. Golub's sponsor loan volume is up significantly over last year. Through the first half of 2008, the firm backed sponsor deals with $500 million in loans versus $400 million for the first half of 2007. "We can do more business than we do. We are trying to lend in very high-quality deals." Golub launched a syndication desk in early 2008 with the intent to underwrite a senior facilities up to $150 million—with the firm holding as much as $50 million in a single facility on its balance sheet.

Contrary to the headlines of woes in the banking sector, many of the respondents say that the large commercial banks have not pulled back from the leveraged lending market. Those that we polled are using capital more judiciously but are 'open for business' and are looking to grow loans. As the cost of capital has increased, banks are focusing on where to allocate capital and are demanding that it pays. Banks are taking a much harder look at relationship profitability. For new relationships, where they may have relied on the promise of cross-sell in the past, banks are demanding it now. Regional banks are not going outside their geographic footprint, several respondents said. It has to be a 'middle of the fairway' deal with the right sponsor, and the cross-sell opportunities have to be there. "Banks may be getting tighter on fees and covenants, but they are in this business for the long haul," said Mike Foster, a senior managing director at Midwest Mezzanine Funds.

While some U.S. banks may be capital constrained due to issues unrelated to leveraged lending, foreign banks are making a push in the middle market. Some have seen their deal flow increase while the credit market has contracted. And, for some, deal flow went from participation roles to lead arranged deals. "We are more open for business than the average Midwest bank," said David Beatty, a Vice President at Charter One Bank (Charter One), the U.S. middle market commercial banking arm of Royal Bank of Scotland. "We continue to be aggressive and focused in the middle market. While other banks may be having issues, we are continuing to do deals—an advantage right now in this market," said another Charter One lender.

New entrants may bring liquidity to the senior debt market. Tygris Commercial Finance Group (Tygris) launched in May 2008 and will provide senior secured cash flow, asset backed, and asset based credit facilities to middle market companies in targeted sectors. Tygris, backed by buyout firms Aquiline Capital Partners, New Mountain Capital, and TPG Capital, completed the largest initial capital raise ever in the U.S. commercial finance sector, raising $1.75 billion in equity commitments. There has also been recent news of other senior lending groups in formation. Next Capital, to be headed by former bankers from Merrill Lynch Capital, announced that it was looking to raise $1.0 billion in equity, with backing from JC Flowers & Co. LLC and Stone Point Capital LLC.

Mezzanine

Mezzanine had been sidelined during the second-lien phenomenon, which has resulted in an explosion in mezzanine funds that have pent up demand to use capital. Lenders say mezzanine is the easiest piece of the capital structure to fill out now.

With capital allocation and returns in focus, some lenders are doing more mezzanine than they had in the past. "Dollar for dollar," said Mr. Schwimmer, "we are closing as many mezzanine as senior deals right now." There are a large number of players, so lenders are in a more competitive state; however, most would say this is a very good time to be a mezzanine lender.



State of Middle Market Financing in the U.S.

Credit

Leverage

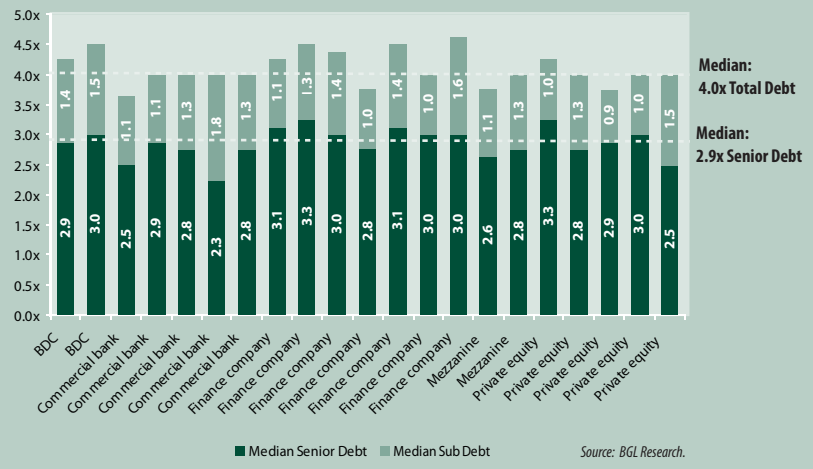
Debt multiples have declined 1 to 1 ½ turns of EBITDA from a year ago, with the median band on leverage coming in at 3x/4x for senior and total debt. For the plain "vanilla" middle market leveraged buyout transaction, the benchmark is ~3x for senior debt. Cyclical businesses may see slightly lower leverage at ~2.5x for senior debt, while exceptional businesses may tick up to ~3.5x. Each situation is company and sector specific. "We are seeing just as many deals with a two handle as we are a three handle for senior debt," said Trevor Clark at Madison Capital Funding. The Term B and second lien markets are still gone, so the gap is being filled with 1 to 1 ½ turns of mezzanine in the capital structure. Unitranche structures will have similar leverages of ~4.0x to ~4.5x total debt.

Some deals are getting more leverage in the current market, which is more the exception than the rule. It has to be for the right credit. "For the really strong, exceptional companies, total leverage can push towards 5x. This is the outside limit of leverage and is limited to only the highest quality transactions. Those deals will typically require more equity—at least 40% and up to 50%," commented Steve Robinson at GE Antares Capital. Counter-cyclical businesses or those with recession-resistant aspects to their business models, such as healthcare companies, have the potential to get slightly better terms.

"Lenders have become more discerning, with a focus on larger, perceived as more stable, deals; however, leverage for middle market deals is still in abundance," commented Kevyn DeMartino, a managing director at Transition Capital Partners. A threshold of $10 million in EBITDA is indicating a dichotomy in the lending market, which is dictating leverage and pricing. Lenders are very cautious on companies that fall below this threshold given where we are in the cycle. The business risks, particularly barriers to entry and stickiness of customers, become more difficult to understand for smaller companies. And below this threshold, you lose capital availability because there is a smaller lending community willing to finance transactions of this size. Typically, the transactions will have a small deal premium, which equates to less leverage (no more than 3x/4x for senior/total debt) and higher pricing. If you introduce earnings volatility, 2x/3x is more the benchmark for leverage.

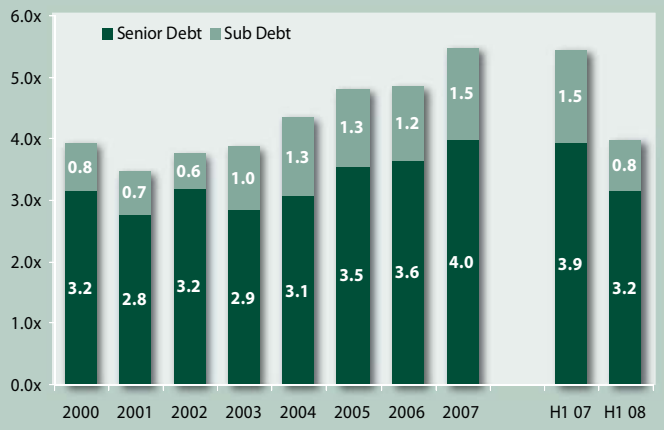
Survey of Capital Providers

Leverage Multiples (Debt to EBITDA)



Source: BGL Research.

Leverage Multiples (Debt to EBITDA)



Source: Standard & Poors LCD.

State of Middle Market Financing in the U.S.

Credit

Lenders are taking smaller "bite sizes" (average hold size ~$15 million) requiring sponsors to club out deals to more lenders. By the numbers, for a $45 million facility you may have two to three lenders in a club. The number jumps to ten-plus participants for a $200 million facility.

"For the right business, there are a handful of lenders able to fully underwrite with limited flex. Quality dictates in those situations," said Joe Romic at American Capital, Ltd. There must be visibility on how to sell down. Lenders say there are very few 'true' underwrites getting done. Typically you're seeing best-efforts syndications subject to broad flex language, exposing the sponsor to significant changes in structure and pricing. Pricing flex can change the deal economics by as much as 100 to 200 basis points. Upfront fees are back to 2-3%. For larger facilities, arrangers are forced to go wider to fill out a transaction, so pricing and upfront fees increase. The smallest player in the bank group can drive the most conservative terms to get the deal done.

> "Despite perverse negativity in the market, well run and well capitalized businesses will still be able to receive competitive terms from liquid banks."
>
> —Randy Abrahams
> Bridge Finance Group

Credit terms

Lenders are being held to task and are adhering to formal credit standards. "Right now, no one is going to stretch in terms. We're back to the good old days," said Randy Schwimmer at Churchill Financial. Now you see the 'full package' in terms of fees and covenants. Covenants are tighter (15% to 20% cushion cited), and term loan repayment is very important. Now you are seeing 10% to 15% amortization on term loans with a more manageable balloon at maturity, cited one lender. Excess cash flow recapture requirements have also tightened up. Pre-payment penalties were mentioned; given the recent market volatility, lenders are not interested in being refinanced out because the market shifts. Mention was also made to limitations on capital spending, including capex and permitted acquisitions.

> "There is good availability out there, but it comes at a price."
>
> —Randy Schwimmer
> Churchill Financial LLC

Pricing

Spreads are up on all debt tranches. Pricing on senior debt has increased more than 200 basis points from a year ago, with spreads seen ticking up to L+500 - 700 depending on the deal specifics. Lenders say L+500 is where most deals will clear if the facility requires going wide to fill out the transaction. Lower pricing may be available with a smaller bank group (~two lenders in club). Because of the mismatch in cost of capital, Libor floors are generally a requirement and are in the majority of deals now, with pricing at 3.0% to 3.5%.

Ample mezzanine capital is still available, so there has been less price appreciation. Mezzanine pricing is up 100 basis points from a year ago, with a 15% all-in return (12% coupon plus 2%-3% PIK) plus equity coinvest setting a floor. For a larger company ($20 to $25 million or more in EBITDA), you can see lower pricing. Mezzanine lenders say it is still hard to get warrants in sponsor deals.



State of Middle Market Financing in the U.S.

The bar is up

While market frothiness and an abundance of liquidity may have made it easier to overlook the underlying fundamentals of a company in years past, lenders are checking all of the boxes now. "Healthy discrimination" has meant that fewer companies are passing through the screening process. And the amount of time being devoted to due diligence is absolutely increasing. "Before, a sponsor may have focused on four or five aspects of a business to close the deal and accepted finding some dirt later. Now, good companies are still fetching higher multiples, but they have to be squeaky clean because the sponsor has to be exactly right at a higher valuation," said Brian Schneider, a principal at Northstar Capital.

The reaction to the recessionary economy and credit dislocation has ever more been a flight to quality. Several of the survey respondents expressed concern about the reduced quality of M&A opportunities coming to market. Sponsors and lenders are looking for bullet-proof business models, and the hot buttons, some of which may be portfolio driven, will differentiate between the 'A' and 'B' quality company and ultimately drive the market's view of the acceptability of a credit. There is a higher bar you need to get over to achieve decent leverage.

We're back to fundamental credit. Unless you really understand the dynamics of how a business operates—how the company fits into the economy both on a macro and a micro basis, how you can improve the operations, and how you can increase value—nothing else really matters.

Hot Buttons

Economy

Economic uncertainty is top of mind, and lenders are sensitive to how companies are performing through the downturn. There is more forward thinking about where a company is in the business and economic cycle, which includes more analysis of a true severe downside case to a business. "Entering into a transaction today, we have better visibility on company performance. Now we have the benefit of seeing how a company is performing in the slowing economy. We can address issues like margin compression with management head on," said Trevor Clark at Madison Capital Funding.

> "In a good or a bad market, an excellent company is going to get a strong multiple, and a less desirable company will get the relative value that it deserves."
>
> —Mike Miller
> Allied Capital Corporation

Financial performance

Visibility of earnings. There is a greater focus on the sustainability of current earnings, and appropriately so. Lenders want high visibility of earnings over the next 12 to 18 months. They are looking closely at historical performance and anomalies to assess stability of earnings. And for forward earnings, lenders want to see rational growth plans. For businesses that have had very rapid growth over the past two to three years, there is quite a bit of discussion around what is the appropriate level upon which to lend, one sponsor told us.

Run rate. Lenders are closely monitoring interim financial performance to ensure that numbers are holding up during a process.

Cash flows. Lenders want businesses with low capex and low working capital requirements. There is more focus on cash flow multiples than in the peak of the market, and businesses that have high maintenance capex requirements have become tougher deals now. "Businesses with a high capex burden can't delever; there is no debt paydown capacity in those deals," offered one lender.

Scale. Larger scale means greater stability, and more lenders want to go upstream now, one sponsor offered. Generally speaking, more lenders have raised their LBO threshold to $10 million in EBITDA as a preferred minimum cutoff, which is up from $5 million two years ago.

Customer and geographic diversification. Stickiness of customers and geographic footprint are even more in focus.



State of Middle Market Financing in the U.S.

The bar is up

The right industry

Industries that have a defensive feel, strong underlying fundamentals, and modest tailwinds are generating more interest. Sponsors tell us that some lenders won't even take the call for certain sectors, dubbing them "do not lend" or "toxic" industries.

Lenders are keen on sponsor experience in an industry vertical, particularly for the more specialized sectors such as healthcare, with the sponsor's track record in terms of number and success of deals in the sector a key measure. Sponsors are focusing on opportunities where they have clear operating angles and where they will have the opportunity to drive incremental growth through add-on acquisitions.

> "It's a great time to be selling a company in the right industry."
>
> —Mike Foster
> Midwest Mezzanine Funds

Sector Focus

More attractive

Aerospace & Defense
- Eyes on the election

Business Services
- Outsourcing plays or cost saving thesis around business model
- Education services
- Environmental services

Consumer Staples
- "Needs" versus "wants" based

Food & Beverage
- Some respondents say they are taking an 'eyes wide open' approach on food. Typically viewed as a defensive play, the sector is facing headwinds from cost inflation and a recessionary economy that is driving changes in consumer food spending behaviors, which cloud the visibility of earnings.

Healthcare
- Several cited robust activity and quality of deal flow relative to other sectors
- Caution on reimbursement risk

Energy / Natural Resources
- Infrastructure very active
- Significant recent deal flow in oil services, lender appetite may be getting "full"
- Alternative energy – some funding uncertainty
- Construction-related seeing choppy revenues
- Caution on run up in commodity prices and sustainability of earnings

Logistics

Technology
- Software companies with technology barriers to entry

Green
- Themes are good; need to rationalize real opportunities
- "Legitimately" green– green trends core to base business, i.e., not new technology or transformational story

Less attractive

Automotive

Consumer Facing
- "Wants" versus "needs" based
- Consumer discretionary bearish

Housing and Related
- Some respondents said that we may be nearing the time when building products may be in vogue again.

Industrial
- Cyclicality and susceptibility to commodity price volatility
- Raw material prices have reached new highs
- Tailwind of strong exports driven by a weak dollar. Perception that advantage will go away when the dollar strengthens
- Capex intensive – lenders point out that there is less liquidity in the market to do large capital projects in the current environment

Real Estate

Retail



State of Middle Market Financing in the U.S.

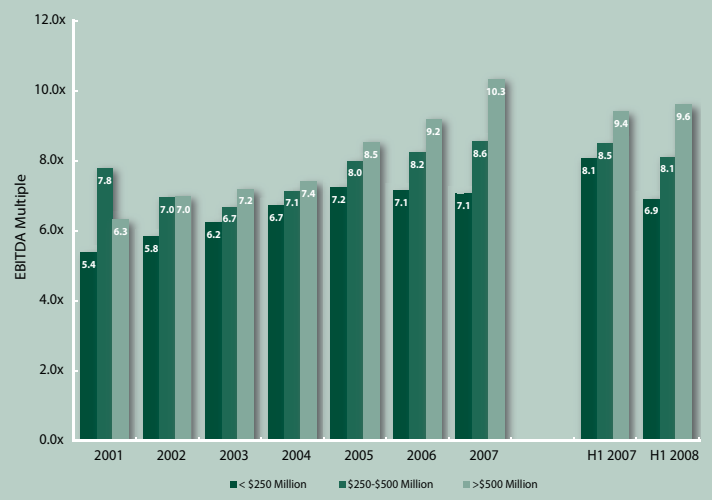
Valuation

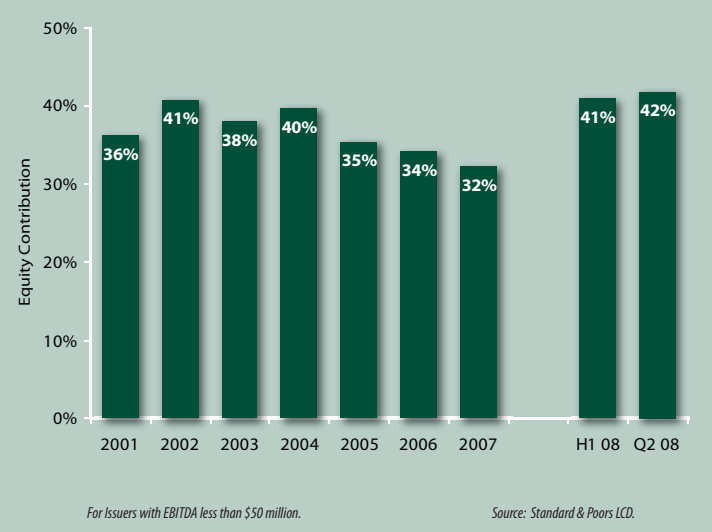
The flight to quality is driving a bifurcated market, where a premium for perceived scarcity value is pushing up purchase multiples. One sponsor referred to it as a barbell effect, saying that on one end there is an observed feeding frenzy in the current market for the highest quality companies. On the other end, there is a flow of deals coming to market involving either underperforming or lesser quality companies that are attracting low valuations, leaving fewer opportunities 'in the middle.'

"The better companies with lower risk profiles are valuable assets right now. Buyers are willing to pay higher multiples for these businesses—not the irrational multiples we once saw, but still high single-digit multiples for very good companies," offered Keith Yamada at CIVC Partners. Several of the respondents in our survey cited EBITDA multiples north of 8x for really attractive businesses, and a few spoke of multiples of 10x or more. "For quality companies, there has been a slower capitulation on price even in the slower economic environment. We are seeing 8x/9x EBITDA valuations that are not necessarily limited to companies in high-growth industries—they are businesses with good earnings visibility, strong management teams, and credible forward plans," said Patrick Fallon, a partner at Gryphon Partners.

Respondents say leverage contraction has made its way into purchase price multiples, though not meaningfully. The decline is more evident for companies below $10 million in EBITDA. Because smaller companies garner less leverage in the current market, it is more difficult to pay full multiples for those businesses.

Because purchase price multiples have stayed firm relative to overall leverage multiples, it means that more equity is going into deals to make them happen. Average sponsor equity contribution has topped 40 percent—which is the minimum now—though most respondents commented on the continuing trend of 50% or more equity going into deals. Just 12 to 24 months ago, that percentage would have been closer to 25% to 30%, which is out of the question now. Sponsors are writing bigger equity checks, in part as a reaction to the market but also to be pre-emptive for certain opportunities. Sponsors are willing to accept slightly lower returns for a good, sound investment to sleep at night, one lender commented.







State of Middle Market Financing in the U.S.

Getting to the finish line

Early reads

Investment bankers are soliciting reads on lender appetite before marketing deals to gain insight on the depth of the debt pool to fund a transaction. And in turn, lenders are talking before meeting with sponsors.

Lenders need to get a lot more comfortable with the investment thesis and the transaction, so sponsors are involving them early in the process. In this environment, it matters who your lending partners are, and sponsors are extracting value from their long-term relationships, looking for early reads on new deal opportunities. "We can obtain quick, honest, direct reads upfront on whether an opportunity is likely to be in a lender's wheelhouse, and if there are issues, whether the lender can get comfortable with the transaction," offered Patrick Fallon at Gryphon Investors.

clubbing deals

More sponsors are wearing syndication and arranger hats than in the recent past and are doing more of the legwork upfront to line up the senior debt—if not the whole bank group, then three to four lenders to reduce flex. Sponsors want to ensure that the same lenders are there at "take off" and at "landing." "Generally speaking, we have to work a lot harder to cluge together club deals and are spending more time and effort on orchestrating the bank group," said Mr. Fallon. If sponsors have to involve lenders that they may have had less exposure to in the past, it adds another degree of complexity to the deal. It matters who is in the syndicate or bank group and the history and interaction between the lenders, particularly if something should go awry.

Creative structuring

With overall middle market M&A volume down, excess capital is chasing fewer quality deals, which is driving highly competitive processes. Sponsors are under pressure to put money to work, so they are pushing the envelope on equity with the intention of refinancing at a later point in time. "Good companies are attracting tremendous private equity interest. Sponsors will be willing to over-equitize those deals to maintain a reasonable pace of capital deployment over the next few years," Mr. Fallon told us. Some are putting forth all-equity capital structures to differentiate themselves in processes—taking the financing contingency out of the proposal altogether.

Because senior debt financing is in shorter supply and there are more covenant and amortization issues to grapple with, sponsors are turning more to mezzanine weighted capital structures, where the senior component of the capital structure is actually smaller than the mezzanine. So, sponsors are looking at putting in capital structures that have two to three turns of mezzanine finance.

Buyer and seller expectations are coming more in line but are not totally there yet, respondents to our survey said. While there are still all-cash deals out there at very attractive valuations, the use of earn outs and seller notes, though not widespread, has been on the rise from a year ago. "Earn outs make sense given where we are in the economic cycle," one lender offered. Many view them as a very fair way to bridge gaps between buyer and seller value expectations.

> "The winners will take the closing risk out of the financing proposal."
>
> —John Tilson
> Brown Gibbons Lang & Company



State of Middle Market Financing in the U.S.

Looking ahead

The next twelve months give most lenders and sponsors pause. Most expect that 2009 will be a very challenging year.

Not a restructuring market...yet

Most of the survey respondents said that we are not in a restructuring market…yet. There is more "wiggle room" at this point in cycle, said one sponsor we interviewed, because deals were more loosely structured over the past two to three years. And banks are still working with borrowers.

If we officially entered recession in the beginning of 2008, the impact of the slowdown will now be coming into full swing, so we will begin to see softness in earnings. Sponsors said they are seeing more "good company, bad balance sheet"' transactions, though not in the number they would have expected by now. The companies are fundamentally sound but have inappropriate capital structures, which will make it difficult for those businesses to sustain growth. "There have been no widespread defaults in middle market leveraged loans. Everywhere we can feel it…we see it coming," said Mike Miller at Allied Capital. "Covenants are getting tight, and we're seeing more amendments, which is a leading indicator," added Steve Robinson at GE Antares Capital.

Credit will remain tight in the near-term

The majority of respondents see the credit market staying relatively consistent with today, unless continued negative news in the financial sector or a significant spike in default rates tighten lending standards further. "We have reached a relative bottom, but not an absolute bottom," commented Randy Schwimmer at Churchill Financial. We'll bounce along at this level for awhile." If the economy continues to deteriorate, we can expect further contraction in leverage multiples. There is room to come down, lenders said, citing the 2001-2003 timeframe when 2.5x/3.5x was the benchmark on leverage multiples. And while there may be some signs of easing, we will need to see sustained improvement in the economy before liquidity meaningfully returns to the lending market. Most believe that we are not likely to see marked improvement until the second half of 2009 at the earliest.

The credit dislocation is not expected to result in a permanent change to lending. "It's a cycle. Portfolios built in today's market are going to do very well and should generate nice returns, which will attract more capital. The influx of capital will lead to more aggressive lending decisions. Then a new cycle will begin," offered Keith Yamada at CIVC Partners. "The credit market that we're in now is not an anomaly or excessive from a historical point of view. Senior debt multiples were at two to three turns of EBITDA in previous years. We are really where we have been traditionally—getting back to sound structures in deals," said Scott Nielsen, a Vice President in the Structured Finance Group at Fifth Third.

Deal activity

All the signs suggest than 2009 will be another challenging year for M&A; however, several undercurrents are likely to bolster middle market deal making in the coming months:

Sponsors will need to continue to be aggressive acquirers due to a need to invest committed capital. "Sponsors are spending significant time and energy on portfolio company performance—looking to execute on add-on acquisitions, which typically have more attractive pricing than platform investments. If you can complete a number of these a year, it can be highly accretive," commented Patrick Fallon at Gryphon Investors. This is a great time for add-on acquisitions, sponsors said. Sponsors with platform investments are more educated on a market and can typically get better pricing for smaller, tuck-in acquisitions. According to *Buyouts*, over 40% of LBOs executed in the first half of 2008 were add-on acquisitions. This number compares to 15% for the comparable period in 2003, when market conditions echoed some of what we're seeing today. The need for sponsors to realize portfolio investments will also create deal flow.

Sellers may be more motivated to pursue a transaction today for strategic reasons. Those that are flexible to structure will be more successful executing transactions in the current environment.

> "Those who have the capital—senior debt through equity—are going to pick up some really great companies over the next 12-18 months."
>
> —Mike Miller
> Allied Capital Corporation



Looking ahead

Very strong companies in need of growth capital to finance an acquisition, plant expansion, or geographic expansion may not have the ability to borrow for that today and are looking for additional sources of equity. Sponsors commented on seeing more minority investment opportunities than six months ago. For sponsors, minority deals can be attractive; in many situations, they can pay a lower multiple to get a "seat at the table" and plan for the time when they can exit at a better multiple.

There will also be the companies that need to sell. Slowing growth and rising costs are driving fundamental business level changes that will continue to force small- to mid-tier players to consider strategic partnerships or possible exits. The 'need to sell' will also be driven by factors other than market conditions. Business owners seeking a liquidity event—a need to diversify their personal balance sheet or strengthen the company balance sheet—will create deal flow. Anticipation of higher capital gains taxes may also push more deals into the market.

The reemergence of strategic buyers has fueled a more competitive M&A market for private equity. Strategic buyers have returned to the market and are bidding aggressively to win processes in which they are engaged. And several industry-shaping M&A transactions have been announced this year, suggesting that further consolidation is on the horizon. International buyers, now with greater purchasing power, may be taking the view that current market conditions present a buying opportunity for U.S. targets. Globalization will continue to fuel cross-border M&A activity in the current environment. It is expected that strategics, when they can acquire, will make up some of the shortfall from private equity.

A silver lining?

Deals in the middle market are still getting done, even if it is taking longer to get to the finish line. "There is a healthy appetite out there for solid middle market businesses," offered Tom Turmell, a principal at Golub Capital. Kevyn DeMartino at Transition Capital Partners, added, "Middle market deals are in the sweet spot in the current environment in that there exists many opportunities to find solid companies that can greatly benefit from additional management and capital resources. Given this, many more buyers—strategic and financial—are players in any given deal."

Premium valuations can and are being achieved in today's market. Great companies are attracting significant strategic and financial buyer interest, and because there are fewer of them, are garnering top of market prices. For companies of the highest quality, purchase price multiples have not contracted meaningfully, if at all, with valuations on par with those achieved in 2007.

Performance is sector driven, but on balance, respondents say middle market businesses are still faring well despite the softening economy. "Good companies have continued to perform in the face of macroeconomic events," said Trevor Clark at Madison Capital Funding. Respondents cite some pockets of weakness, but on the whole, portfolio companies are performing reasonably well through the downturn. "We are still seeing good, clean companies with solid prospects," said Patrick Fallon, at Gryphon Investors.

Sponsors have substantial dry powder to invest and are actively looking for quality deals. And the sentiment is that if you have the capital, it is a good time to be doing deals.

> "There should be tremendous opportunities for private equity coming out of this cycle. Active but selective acquirers and early consolidators in this market are going to do very well."
>
> —Keith Yamada
> CIVC Partners



State of Middle Market Financing in the U.S.

Perspective: Senior BGL bankers "sound off" on the current market environment

A flight to perceived quality is fueling a stark bifurcation in the market—a market starved for high-quality acquisition candidates. Great franchises ('A' quality companies) are commanding premium valuations, driven by a feeding frenzy of willing buyers. "Strong middle market companies are still attracting a lot of attention. Several of our in-market deals are oversubscribed at very high valuations, rivaling terms and structures that we saw in early 2007," said John Tilson, managing director and principal. Transactions with solid 'B' companies can still get done, although they are more difficult to navigate in the current environment and do require more creativity to get closed. Sponsors and lenders echo these observations.

> "Strong middle market companies are still attracting a lot of attention. Several of our in-market deals are oversubscribed at very high valuations, rivaling terms and structures that we saw in early 2007."

The large overhang of equity capital is driving highly competitive processes. Sponsors are opportunistically over-equitizing transactions—and in some cases proposing all-equity structures—illustrating how competitive the market is right now for strong, performing businesses.

Company performance has been solid. Well-positioned middle market companies are exhibiting demonstrable resilience through the downturn and are hitting their numbers. Scott Berlin, managing director and principal, commented, "Speaking to the companies that we are working with, we are not seeing a big drop off in performance. The businesses are showing growth and are demonstrating the ability to pass through cost increases to their customers."

We continue to see a healthy appetite for deal making in the middle market. However, the overriding 'proceed with caution' mindset has not gone unnoticed. Sponsors and lenders are much more cautious and diligence has become more rigorous, so deals are taking longer to close. "The current market dynamics play into our strengths on several fronts. Getting to the finish line requires flawless execution, which may be even more critical in an increasingly challenging market. Our senior level bankers proactively manage transactions from beginning to end to maintain momentum and competitiveness during the process," said managing director and principal, Andrew Petryk.

> "Getting to the finish line requires flawless execution, which may be even more critical in an increasingly challenging market."

"We have earned a reputation for working with companies that command premium valuations, and the market is perhaps even more competitive for these businesses right now. We are seeing this first hand. We are marketing businesses that have received broad interest that are bringing in very attractive valuations."

"We also leverage our deep industry knowledge and keen understanding of the capital markets to evaluate the strategic and financial viability of transaction partners for our clients' businesses, which is particularly important in tighter financing markets. And if it fits with the opportunity, our partnership in Global M&A gives us direct access to global buyers. International players may be less sensitive to the U.S. economy, and with greater purchasing power, see this as a buying opportunity, and so have increasingly become more active acquirers of U.S. businesses."



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Representative Transactions

Carl's Patio *has been acquired by an affiliate of* WBG Weinberg & Bell Group *with financing provided by* TriState Capital, The Private Bank

AIRNET (AMEX:ANS) *has been acquired by* Bayside Capital Opportunity Fund

Financial advisor and rendered a fairness opinion to the Board of Directors of AirNet Systems, Inc.

~H2O+™ *has been acquired by* CSW Private Equity Investments *and* Goldman Sachs

Quantum Foods *has obtained* **$75,000,000 Senior Secured Credit Facility** *provided by* Wells Fargo, Wells Fargo Foothill

ATP Engineered Rubber & Plastics Group *a portfolio company of* Apax Partners *with interest held by* GoldenTree Asset Management, LP, Fortress, BlackRock Kelso Capital *has been acquired by* Baird

TAD Metals, Inc. *has been acquired by* O'Neal

Avon Bearings *has been acquired by* Kaydon

jobs.ch *has been acquired by* **Tiger Global Management, LLC**

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