# Inside the Middle Market



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## State of Middle Market Financing in the U.S.

Lenders say the world changed in August. Liquidity in the large middle market became impaired as the high yield and institutional term loan markets froze in reaction to the S&P U.S. credit rating downgrade, Eurozone crisis, and uncertain economic climate. Trickle down in the lower market has been evidenced in a heightened sense of caution, which has caused some lenders to take a more conservative view on businesses they finance. Across the market, spreads have widened between 25-150 basis points depending on risk profile and size but leverage levels have remained largely intact.

Recent market volatility has been driven in part by emotion rather than facts. While unemployment figures remain high, they have not gotten worse. Inflation has remained stable. The economic recovery has not been robust; however, recent positive trends show that real GDP rose in Q3 '11 at almost double the pace of the prior quarter with comparable growth forecasted for Q4 '11. Quarterly performance reviews from banks have been positive.

Comparing today's lender commentary to findings from our April survey, we identified several key themes which remain unchanged:

- There remains a continued focus on quality and intense scrutiny of companies and how they performed during the downturn.
- Leverage levels remain largely unchanged and are expected to stay higher for the best companies.
- Quality sells. A bifurcated M&A market is pushing up purchase multiples for the highest quality companies.

Surveyed lenders concur that the current market dislocation is not a call out to 2008. Lenders are open for business. While the number of active participants is not expanding, there is ample liquidity, particularly among banks and finance companies. Middle market businesses are performing well. Concerns of a double-dip remain in focus for many lenders; however, credit quality remains strong and portfolio performance trends do not suggest that we are in or headed toward another recession.

Lenders are waiting on stability. With stability, there will be deal flow and lenders ready to deploy capital in high quality transactions.

### PARTICIPATING FIRMS

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**Ares Capital Corporation**
**Babson Capital Management LLC**
**BB&T Capital Partners Mezzanine**
**CapitalSource**
**CapitalSouth Partners**
**Churchill Financial LLC**
**CIT Group**
**F.N.B. Capital Corporation**
**Fifth Street Capital**
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**GE Antares Capital**
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**PNC Mezzanine Capital**
**RBS Business Capital**
**RBS Citizens, N.A.**
**THL Credit**
**Triangle Capital**
**US Bank**
**Wells Fargo Bank, N.A.**

# State of Middle Market Financing in the U.S.

## CAPACITY

Events of August—the S&P U.S. credit rating downgrade, Eurozone crisis, mounting macroeconomic concerns, and jittery equity markets—have rendered the credit markets less liquid on balance. To borrow a phrase from one lender we surveyed, "The world changed." "A diminished appetite for risk impacted the stock market, bond market, and institutional term loan market, which all saw negative funds flows," commented Ira Kreft, a senior vice president at RBS Business Capital. "Following the upheaval in 2008 and 2009, investors have shown a greater tendency toward a flight to safety and lower risk much sooner at the first sign of trouble." The yo-yo affect of a volatile stock market has exacerbated the uncertainty.

The large middle market is feeling the most impact, where the pullback by a number of previously active players has had a pronounced impact on pricing. Senior spreads have risen sharply, and OIDs and Libor floors have increased. "That market is upside down," said Tom Gregory, a managing director at Maranon Capital. "We have seen larger deals price higher than the smaller deals, and that is out of context with any kind of historic relationship," Gregory added. "I would like to believe it is a short-term phenomenon and won't sustain. When and how that market stabilizes and comes back to normal pricing hinges on what happens in Europe."

### Not the best of times, not the worst of times

One lender called today's market "a microcosm based on economic data and headlines," which supports the opinion of several lenders we surveyed that we could be witnessing a short-term phenomenon. "The capital markets are functioning well," offered Randy Schwimmer, head of capital markets at Churchill Financial, contrasting today to times in recent history when the capital markets were constrained—fresh in everyone's mind is the financial crisis of 2008-2009 and going back to 2000-2002, a time period when no one could get more than 3x leverage, Schwimmer said. "Even though some of the signals that a challenge could be on its way or coming, I think things are moving very quickly," said Andy Steuerman, a senior managing director at Golub Capital. "Just as bad as they get, they can recover fast."

### Not a repeat of 2008

Comparing current market conditions to the 2008 crisis, Steve Robinson, a managing director at GE Antares Capital offered, "It is nothing like 2008 when everything just stopped. Deals are still going to get done. The market turned so quickly, it still seems too soon to say it has absolutely settled at this new equilibrium." Robert Radway, chief executive officer at NXT Capital added, "I don't think we are going to see the contraction in the amount of capital available for middle market transactions that we saw in late 2008 and throughout 2009. Clearly the last few months have been a wake-up call, and lenders are approaching transactions with a greater degree of discipline."

Lenders are open for business. There is capital available, but they are being selective in how it is deployed, respondents told us. "We have not experienced any lenders not continuing to participate in the market," commented Preston Walsh, a partner at PNC Mezzanine Capital. "If the senior cash flow lenders like an asset, they are going after it," said Brian Schneider, a partner at Northstar Capital. "We are not getting any messages to slow down lending. It is more a message of, 'Be cautious,'" said Scott Reeds, a managing director at RBS Citizens.

> "I am still convinced that even in the most difficult periods, the best companies will always be financed."
>
> —Andy Steuerman
> Golub Capital

"Deals are still clearing; it is more a matter of at what price versus what structure," said Mark Tauber, a managing director at CapitalSource. "When things were really gloomy in 2008, you saw leverage get chopped back considerably. I think lenders learned that if their leverage multiples are too conservative you completely shut down the market and there is not going to be any deal flow." Chris Williams, a senior managing director at Madison Capital Funding added, "You still have lenders that are ready to finance transactions, but it is going to be at their pricing. I don't think 25 basis points of pricing will ever move the needle in terms of whether a deal gets done, but just given how rapidly it has moved over the last couple of months, I think you have some sponsors scratching their heads saying, 'Where is this going to stop?'"

Company performance doesn't indicate a slowing economy, many lenders said. "You were starting to see the numbers decline in your portfolio companies in 2008. We are not seeing that," Reeds added.

### Trickle down

The uncertain macroeconomic environment has cast a haze over the financing markets, which some lenders say has resulted in a fairly dramatic change in market sentiment, impacting which middle market deals get done, how they are priced, and what leverage they can attract. Others say tightening has not appeared in a material way. "The correction has been more about pricing and less about leverage," Robinson said. "We have seen the larger deals price up at least 100 basis points and in some cases more than that. The middle market is more like 50-75 basis points. It is because of the buy and hold mentality of these investors in the middle market."

"The smaller the transaction, the more likely it can get done," Steuerman said. At a certain deal size, the financing needs change, and depending on the appetite and the acceptability of the company, it requires crossing over into a bigger process and tapping the institutional term loan market. "Lenders are having pointed conversations about economics and structure and are looking for the lowest common denominator," Steuerman added. Steuerman said it is fairly common to be having those conversations and looking to that market today.





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## CAPACITY

### Who is coming to the table?

While lenders say the senior cash flow lending market is "flat" given the lack of substantial new entrants or meaningful CLO formation, they say within the existing landscape, there is ample liquidity from banks and finance companies. Less liquidity has been available in the high yield, BDC, and institutional term loan market.

"I would say there is no real shortage of senior capital in today's marketplace," commented Jeffrey Kilrea, a managing director at CIT. "Your legacy 'old guard' lenders are all looking to and deploying meaningful amounts of capital using their balance sheets and various sidecar vehicles to both be competitive with each other and certainly take on larger exposures for internal profitability reasons." "Capital providers in the middle market are not driven for the most part by what is going on in the large cap market," said Randy Schwimmer at Churchill Financial. "All the mainstay lenders are focused on what they having been doing for a long time, which is financing good companies for their private equity clients." Those go-to lenders have demonstrated a consistency to stay in the market and act reasonably through difficult economic periods. Surveyed lenders say there are roughly five or six banks and the same number of finance companies that can credibly lead deals in the sponsor market today.

> "Everyone is tentative, but that hasn't changed their liquidity and need to originate assets."
>
> —Howard Widra
> Midcap Financial, LLC

### Banks

Banks are active and continue to be a good source of liquidity, most lenders said. They have seen little pullback going into Q4 '11. "Regional banks, the banks that have groups that are focused on specific industries, and banks that have sponsor platforms, are actively looking to deploy capital," said Scott Reeds at RBS Citizens. "Banks need to generate revenue, and they are still hungry," echoed said Jamie Lewis, a senior vice president at RBS Citizens. "If it is a well-structured transaction being sold into the bank market and there is a lot of regional appetite, those deals continue to get done." Jeff Hastings, a senior vice president at US Bank added, "If there is a good deal in the market, there are a lot of banks trying to participate in it because everyone is looking for commercial & industrial (C&I) loan growth."

Some surveyed lenders say banks are taking a more conservative stance in the current environment, indicating that the caution is not a function of reduced liquidity but of reduced risk appetite given the economic climate. There is more caution with credit committees, and banks are looking at deploying capital with a stronger eye toward risk reward.

Some lenders speak to the inconsistency of regional bank players in the senior cash flow lending market, with some operating from a finite pool of capital to fill for leveraged lending. The regulatory environment and new capital requirements are posing challenges and impacting profitability for some. "Some of the bigger regionals with liquidity are pretty eager," said Tom Gregory at Maranon Capital. "When you start getting smaller than that, there is just no depth." "There are a decent number of healthy regional banks that are working really hard to branch out from real estate," said Brent Burgess, chief investment officer at Triangle Capital. "They are not getting overly aggressive, but if there are assets in operating companies, they are going to try to figure out a way to lend."

### Business development companies

Before the market dislocation in August, BDCs were active, and lenders speak to their participation across senior, unitranche, and mezzanine opportunities. Lenders surveyed said they have seen BDCs actively competing through a unitranche product where they can get a higher yield for deploying their capital.

BDCs are now under pressure, and as a group, their public valuations are limiting capacity and access to capital. For BDCs whose sole financing vehicle is the public equity markets, there is not a very obvious path going back to market, lenders said, and if conditions do not materially change, some BDCs will begin to run up against capital constraints. BDCs have been more selective with their capital, some lenders said, and asset selectivity will begin to play out in pricing and structure. Return hurdles may make it more challenging for them to put money to work in the current environment. Some lenders observed that the recent volatility in the equity markets has been relatively brief so there hasn't been a long enough period to affect available capacity.

"The larger, well-established BDCs appear to have ample liquidity and continue to be very active in the market, and dependent on market conditions, will continue to have access to additional capital," offered Robert Radway at NXT Capital. "The prospective entrants that have filed for IPOs to raise BDC capital will have to wait a long time. I think that window is closed and will likely remain so. At the margin, that ultimately reduces capital available for middle market transactions."



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### Pockets

EBITDA reaches an inflection point as it relates to liquidity at $10 million, with $5 million a hard and fast minimum for most lenders. Below $10 million in EBITDA, there is less liquidity, and the liquidity is a function of leverage, with the primary source of capital coming from regional banks and one-stop providers. Between $10 million and $25 million of EBITDA, there is no shortage of capacity in the market, surveyed lenders said.

"The interesting point about liquidity at the lower end of the market is the appetite for cash flow leverage. If you have senior leverage less than 3x, you are going to have a fair amount of liquidity," commented Tim Clifford, president and chief executive officer at Abacus Finance. "Banks have capital to lend and they are trying to build their volume, so senior leverage that is 2x-3x fits their risk appetite. It is usually at above 3x where it becomes more challenging."

Regional banks can be aggressive on price and structure if they view an opportunity as a relationship play, lenders said. "Bank lenders, if they are the incumbent, are much more willing to stretch and go outside their box," offered Brent Burgess at Triangle Capital. "If the bank has the relationship, they know the business, and like the management team, they will be pretty aggressive. They will meet the leverage ask much more frequently."

While liquidity is not readily available once you dip below $10 million of EBITDA, there are capital providers that are active in the space. "I haven't seen size really matter here. A good company of any size is getting financed," offered Andy Steuerman at Golub Capital. "We will finance a $5 million EBITDA business, but it has to be a really attractive $5 million EBITDA business. Chris Williams at Madison Capital Funding echoed that sentiment. Roughly 25 percent of the lender's portfolio is loans to companies with EBITDA of $5 million to $10 million. "I think there is a real opportunity for the $7s to $10s—for the right sponsor, the right sector, the right opportunity, the right visibility, and the proper runway to growth," said Jeffrey Kilrea at CIT. "Once you have the conversation with the sponsor and see where they want to take the business and how many opportunities they have identified, you want to get behind it because you have that annuity stream in the future that you covet."

The greater the leverageable assets in a business, the easier it is to secure financing. "The lower market (sub $8 million EBITDA) is principally a market for asset-based and senior secured deals that are fully collateralized or with a stretch component," Ira Kreft at RBS Business Capital told us. "Banks are less willing to take significant air on those deals," commented Jeff Hastings at US Bank. "Company EBITDA levels are shrinking so banks are leaning on their balance sheets and quality of assets." Hastings added, "Some companies feel they had been treated unfairly two to three years ago by their bank, so they like that asset-based deals have less restrictive covenant packages. And by getting into longer-term asset-based structures, they feel more confident in their lenders."

### NEW LENDER PROFILE


**ABACUS FINANCE GROUP, LLC**
**Tim Clifford**
*President and Chief Executive Officer*

As the founder of newly-formed Abacus Finance, Tim Clifford once again has his eye on the small deal market. Launched in June 2011, Abacus will focus exclusively on providing cash flow-based senior debt financing to private equity-backed middle market companies, targeting businesses with between $3 million and $15 million of EBITDA.

An affiliate of New York Private Bank & Trust, Abacus has the advantage of a low-cost, depository funding model, and with an initial $750 million in lending capacity, has the capital to bring liquidity to the lower middle market. Clifford is credited with having launched two leveraged finance groups under such a funding model, including successfully starting Amalgamated Capital. "Abacus serves an important market niche, and we have seen a lot of deal flow from both our loyal sponsor network and from building new partnerships with private equity sponsors. Our funding model offers long-term stability and a platform that is committed to the lower end of the market."

Clifford seeks to deploy roughly $150 million a year over the next five years. Abacus is off to a particularly strong start this year, having already deployed over $100 million in commitments in five transactions just since its June launch and expects to exceed $150 million by year-end.





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### Mezzanine

Lenders say the mezzanine market has gotten more competitive, citing new entrants with the expansion of SBIC-backed funds, as well as one-stop options and the return of second-lien in some structures which compete against the traditional senior mezzanine structure. Mezzanine lenders are aggressively trying to win mandates because there is so much liquidity, so pricing has gotten tighter. "The mezzanine market is a taker, and the senior lenders are setting the parameters," offered one lender. "Because there are so few attractive deals, they are taking what is out there." "Right now there are not a lot of deals and the good ones are going to be priced aggressively," commented Whit Edwards, a principal at BB&T Capital Partners Mezzanine. "It is a supply and demand issue. There has been a decent amount of capital raised dedicated to the mezzanine market with relatively few transactions."

Mezzanine lenders are feeling the impact of a relatively soft M&A market and a crowded playing field—particularly the newer firms. "In a softer market and uncertain economic climate where certainty of close is important, sponsors will defer to the lenders they know," commented Mike Foster, a senior managing director at Midwest Mezzanine Funds. "It is hard for all of us to put money out, and it is going to be even harder for some of the newer firms in this M&A market. If the M&A market picks up, there will be more opportunities for everyone. We are not there right now."

The lower middle market (sub $10 million EBITDA) is more competitive for mezzanine than it is for senior debt, lenders say, and competition is very aggressive. Driving that is the lower leverage appetite of senior lenders for the smaller deals, which is creating more opportunities for mezzanine players. "We have closed on more $7 million to $10 million mezzanine investments than we have in a number of years," commented Mike Klofas, a managing director at Babson Capital Management. "We are still seeing some value in the smaller mezzanine space and are taking advantage of it." "Lower middle market deals can still get done," offered Stephen Gurgovits, chief executive officer at F.N.B. Capital Corporation. "There are more opportunities for mezzanine in this space, given that banks in the sub $10 million EBITDA market aren't being very aggressive on leverage or structure on these smaller deals." "Most lower middle market deals need mezzanine capital," Edwards added. "It depends on the growth profile of the business. There are a lot of growth-oriented businesses that are $5 million to $6 million in EBITDA that really need to have more mezzanine than senior in the capital structure. There are some businesses that grow quite nicely that are on the upper end of the EBITDA range that can garner very strong senior leverage, but there are others that might need more heavy mezzanine-oriented structures," Edwards said. "You still have the issue of a relative imbalance between availability of senior and junior capital, and at some point if the senior becomes less and less available, you can use more junior but only to a point because the cost of it is so much greater that it impacts the economics on the equity," Foster added.

> "We always believe that no matter what the economic environment, you can find transactions that make good sense from a credit or risk point of view."
>
> —Robert Radway
> NXT Capital, LLC



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## DEAL FLOW

While the first half of 2011 was dominated by dividend recaps and refinancings, lenders say M&A deal flow is picking up, reflecting a better mix of new platforms and a healthy level of add-on activity as a lower-cost growth option for sponsors. Quality deal flow is continuing. "There is a lot of capital out there with sponsors right now. They are trying to find ways to be creative to drive their returns," commented Chris Williams at Madison Capital Funding. Opportunistic refinancing and dividend recap activity is less "en vogue" in the current environment. Any dividend recaps that come to market will likely involve only a modest dividend to a sponsor, a function of the reduced risk appetite of lenders.

Q4 '11 is starting out strong, some lenders say, building on positive momentum from a pick up in deal activity after Labor Day. The post-holiday pick up is relative, as most lenders anticipate steady volume but not enough to match the comparable period we saw in 2010. To be sure, the market dislocation in August slowed the M&A pipeline and has some lenders predicting a softer Q4 '11, with volume falling short of what typically is one of the busiest quarters of the year.

### Still waiting on M&A

Lenders are seeing more deal flow but not the wave everyone was expecting. Survey respondentts offered their perspective on the slowing pace of M&A activity. "Either sellers are concerned about the predictability of their own numbers thinking that they may be rendered vulnerable in a sale process or they are thinking that buyers are scared of the environment and will be unwilling to pay," offered Tom Gregory at Maranon Capital. "To the latter point, we do not see any evidence of that. Transaction multiples are continuing to be aggressive. And certainly for the deals that we are active in funding, the businesses are performing well, and we are comfortable with the predictability of the cash flows and do not think the sellers are being disadvantaged at all. Certainly there is a part of the market that got spooked by the economy and the ability of buyers to transact and hold up."

When you look at all of the untapped capital and the number of private equity-backed companies currently held in portfolios, there should be more deals in the market. Lenders observe that some sponsors have done their dividend recap and may want to sell, but their valuation expectations are keeping them on the sidelines. "My sense is there is a backlog of companies that were looking to sell. The choppiness in the market has sidelined certain sellers, and because the financing markets have backed up, there is a view that valuations may start to become impacted," commented Karen DeCastro, a principal at Ares Capital Corporation.

"2011 has been choppy and volatile, and even when the middle market seems to be insulated, uncertainty tends to put people on their heels," remarked Randy Schwimmer at Churchill Financial. "I think it will shape up to be a good year overall. My view is that the clouds will clear, and we will have a much more attractive environment going forward than people expect."

### Time to close is lengthening

Due diligence is more rigorous and deals are taking longer to close. Economic uncertainty has led to a choppier deal market, and it is making it more difficult to get deals over the finish line. Lenders shared their observations on deal processes today:

- Buyers are stretching out processes because they are concerned about closing into a softening situation. The forward look is cloudy, so there is more scrutiny of backlog and order levels to gain insight into future performance.
- Bank lenders are much more cautious. "Anyone who has to go through a central credit committee is automatically more cautious now. It is making everything take longer," commented Preston Walsh at PNC Mezzanine.
- Third party diligence materials and business plans are getting scrubbed and scrutinized. Lenders say that the amount of money being spent on diligence in bidding processes is staggering. "In some situations, sponsors are paying enormous amounts of money on diligence even before they win a deal," offered Brent Burgess at Triangle Capital. "Because they are spending so much money, there is a lot of risk for them if they don't win or if they do win and the deal falls apart."
- Sponsors are being pushed to deliver committed financing packages because bankers are trying to minimize the risk of a company getting repriced or retraded.
- Respondents speak to an increasing frequency of rebound deals where lenders have big out provisions.

Deals are taking longer in the diligence process, in part, because sponsors are adjusting to the new pricing environment. "We are seeing sponsors lengthen the process to both see if the market improves as well as confirm that earnings are remaining stable. This is leading sponsors to reevaluate their purchase price," said Steve Robinson at GE Antares Capital. Lenders say most sponsors are being disciplined about walking away from deals if issues surface in diligence that do not support their price. "While some sponsors previously may have overlooked issues because they believed they could mitigate or fix them, most recognize that blowing past a red light, regardless of the need to put money out, is a bad strategy," offered one lender. "It is sort of binary—it is go or don't go," remarked one lender we surveyed. "If a business is slightly soft, it is going to be reflected in the price, and it is not going to be pretty. And if a business is even halfway attractive, there is so much capital chasing it, it is going to attract a lot of interest and garner a healthy multiple."

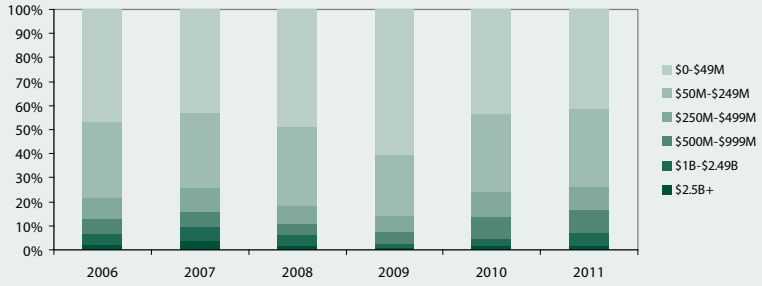




# State of Middle Market Financing in the U.S.

## Private Equity Transactions

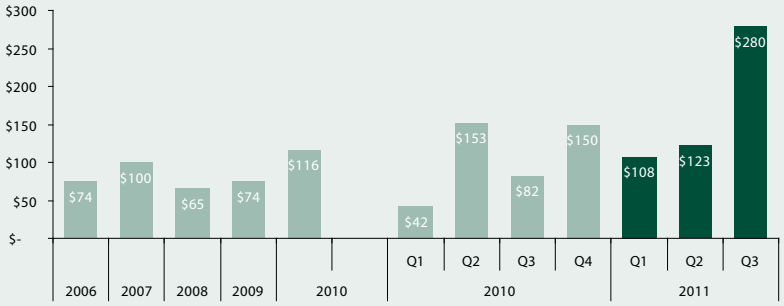
### *Transaction Count by Deal Size*




Private equity buyout activity is on par with 2010 levels, with 1,080 transactions reported through Q3 '11, which compares to 1,049 transactions for the comparable period a year ago. The lower middle market continues to dominate deal activity, based on number of transactions*, with deals under $250 million accounting for 75 percent of private equity deal flow so far in 2011. Add-on activity, as a percentage of total buyout activity, climbed to 50 percent, increasing from 41 percent in 2006.

**Percentages calculated for transactions with disclosed values*

### *Median Deal Value by Year*




The median buyout size reached a record level of $123 million through the year-to-date period.

The sponsor M&A market is expected to drive deal flow in the coming years, supported by an overhang of unspent capital and growing backlog of portfolio companies waiting on exits.

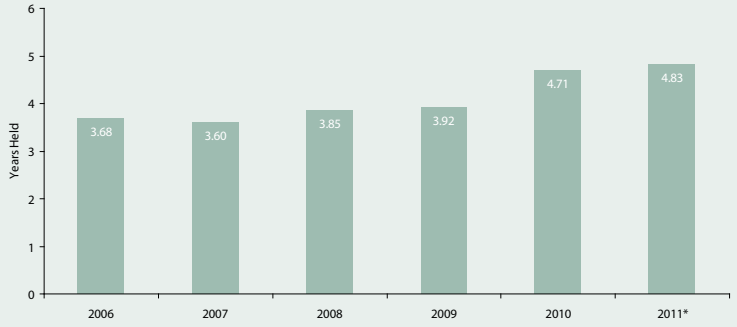
### *The Overhang*

Private equity groups have seen their hold periods extended, with the average time to exit extending to 4.8 years through Q3 '11.

The cumulative overhang of unspent private equity capital exceeded $435 billion in Q3 '11, down from just under $475 billion in 2010, highlighting that sponsors are beginning to tap the capital surplus. Private equity will be buying as funds look to extend their investment periods to put money to work.

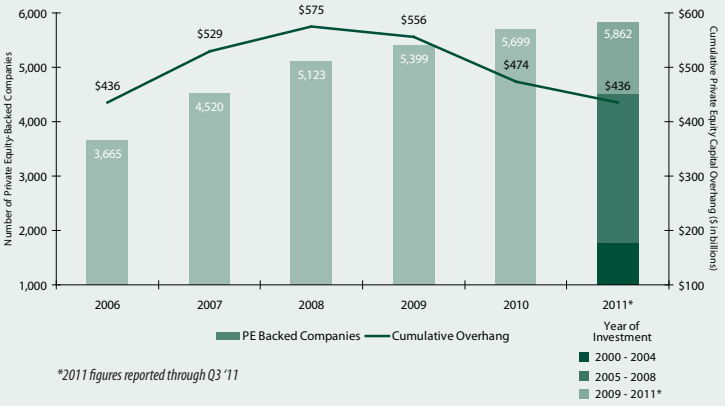
The aging of private-equity backed portfolio investments shows a growing backlog, with a current inventory of 5,862 companies through Q3 '11—a 60 percent increase from 2006—of which 73 percent represents investments made during the period 2005 to 2008 and 16 percent during 2000 to 2004.

*Average Time to Exit*




*Source: PitchBook.*

*Portfolio Company Inventory and Dry Powder*




**2011 figures reported through Q3 '11*

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## THE ECONOMY

### The elusive bottom

The jury is still out on the double-dip. Some survey respondents see a second recession coming; some would argue that we might already be in one. Macro concerns have increased the probability, with some economists pegging the likelihood of a double-dip at more than 30 percent. Lenders anticipate continued economic uncertainty and the concern that there is going to be slow growth for the foreseeable future is much higher than it was even three to six months ago, which is entering into valuations and expectations on leverage.

Lenders tell us the double-dip is factoring significantly into credit analysis, and in the current market environment, the focus is on quality businesses with high free cash flow that have demonstrated strong relative performance during the last economic downturn. There is more caution around cyclical companies. And for companies that performed well since the downturn, lenders are examining whether they can retrench to pre-2008 levels in a short time frame. Lenders are performing serious stress testing to gain comfort that transactions can weather a difficult 2012 and 2013, which impacts their views of leverage.

### Self-fulfilling prophecy

Lenders are cognizant of the self-fulfilling prophecy created by overweighting conservatism in the current environment. "Pessimistic reporting makes for great news, and it ultimately impacts the mind of the consumer. Consumers spend less so there is reduced demand. Companies then reevaluate their growth prospects and push out hiring plans. Without job creation, growth is stifled," commented Ira Kreft at RBS Business Capital. Lenders say middle market businesses have slowed hiring, and capital spending is earmarked for cost takeouts as opposed to capacity expansion for growth. "When you look at 2008, it felt like a financial market crisis. Now it feels more like a traditional recession," Andy Steuerman at Golub Capital told us. "People are spending less. They are worried about their jobs. I think you are looking at changes in behavior, and in some cases, those changes become permanent. Many people have modified how they live. Companies have to adjust to that. Companies that are financed have to adjust to that."

Companies have reduced expenses, delevered, and built up liquidity. While they feel they can selectively make acquisitions, they want to feel comfortable that the economy has bottomed and conditions will not get significantly worse. However, they also see an opportunistic window and want to time the market before some "acquisition fever" takes over and multiples escalate. "Unless there is a systemic change to an industry or a business model that is driving growth or consolidation, if it is just business as usual, you are not as bullish. People are just being more cautious," Steuerman added. "The question of a double-dip comes up in every credit discussion," remarked one lender in our survey. "It is often dismissed based on the industry, but you have to ask it. You also cannot treat everything as if it was 2008 or you wouldn't do any new business."

### Double-Dip?

***Lenders shared their observations on how the potential for a double-dip recession is factoring into credit discussions and analysis:***

*Steve Robinson, GE Antares Capital*
I think there is concern about it, particularly as you are considering cyclical companies whose performance is more tied to the economy or ones that experienced a significant decline during the downturn. It is not the one risk factor that would make lenders turn down a deal.

*Andy Steuerman, Golub Capital*
We have feared a double-dip recession the entire year, and that mindset has played into our selection bias. For the deals that we have gone after with vigor, you would see that there is a bias toward, 'What if things go badly,' as opposed to optimism. In many ways we were being contrarians earlier in the year, perhaps more so than most other lenders.

*Chris Williams, Madison Capital Funding*
We have that discussion in every deal, but it is one piece of the puzzle. A positive takeaway is that you have a very recent factset with which you can analyze company performance during one of the most treacherous downturns on record, giving you a measure of the cyclicality of businesses.

*Robert Radway, NXT Capital*
I think everybody is looking at it. That is the challenge in this sort of environment. You think there might be a downturn. In fact, you are assigning a greater than 50 percent probability to it. But the question is how deep will it be and what impact will it have on the company that we are financing and the sponsor is acquiring. We have a look back to 2009 to see how a company performed in the dip at that time. Can it weather another downturn and what will be the impact on EBITDA? That is the most difficult assessment to make, both as an equity investor and as a lender.

*Tim Clifford, Abacus Finance*
The Great Recession is now our acid test. We look at company performance in 2008 and 2009. Did they lose 15 percent of EBITDA—or did they lose 50 percent? We also look at cost structures. Businesses with heavy fixed costs worry us. We prefer those companies with higher variable costs; those that can absorb some volatility through changes in their cost structure along with likely pricing pressures.





# State of Middle Market Financing in the U.S.

## SECTOR

Economic uncertainty has tipped the scale in favor of defensive sectors, but the key takeaway from lenders is that no industry is "hands off." Generally speaking, any business that can demonstrate some level of recurring revenue from a large base of customers appeals to lenders, and they are more willing to stretch on leverage for those types of businesses. "We try to stick to our knitting and focus on the sectors we know," commented Jeffrey Kilrea at CIT. "But I can't say there is anything that we give an immediate "desk-kill" to."

Recession-resilient industries are faring better. Companies that have been consistent performers are tied to "in favor" industries such as business services, food, and healthcare—sectors that were less impacted by the downturn. Other sectors cited for better performance include security and government defense.

Lenders do say there is heightened caution and scrutiny on healthcare services given regulatory uncertainty and potential cuts in reimbursement. "Demand for healthcare is resilient, and while the sector does not move with the economy, it has its own industry cycles. We are seeing that right now with the reimbursement cuts," said Howard Widra, chief executive officer at healthcare lender MidCap Financial. "There are varying opinions on the degree to which areas are impacted. Sectors that have wide margins focused on Medicare will get squeezed and always have. The time that it takes the government to squeeze out that excess profit has accelerated. The most significant changes that you have seen in certain industries, like home health, are a result of that."

Respondents say certain lenders are committing significant capital to sectors they like, sponsors they like, and companies they have banked before. "When they find an opportunity in one of their specialty areas, lenders jump all over it," Kilrea said. "They are looking to deploy more meaningful assets against better credit opportunities." One lender spoke of the strategy to overweight certain verticals, leveraging their specialized knowledge to be aggressive so "we made sure we won those deals."

### Cyclicals

Sectors such as retail, traditional media, building products, and OEM-related auto have seen slower deal flow. Some lenders say building products is still getting a lot of scrutiny, but it is not the pariah that it used to be. Certain manufacturing and consumer-oriented businesses can get financing but lenders are proceeding with caution.

Lenders say the first half of 2011 was a re-introduction to the market of cyclical sectors. They tell us it is not "hands off" again like it was in 2009 and 2010, but there is more caution towards sectors that are tied to the economy, citing heavy industrials and certain consumer products sectors as industries under more intense scrutiny. "The challenge is underwriting a conservative enough case, taking into account the possibility of a double-dip in 2012, and structuring a deal appropriately," said Scott Reeds at RBS Citizens. "The good thing is you probably have at least four to eight quarters of positive momentum coming out of the recession, so lenders feel a lot better about those businesses. They are just being more conservative on those types of credits, and rightfully so." "The recession forced manufacturers to realign their cost structures and improve efficiency, and along the way, some gained market share as weaker competitors went away," said Mike Foster at Midwest Mezzanine Funds. "You can look at some of those niche businesses and value and leverage them properly, so they can look pretty attractive."

Lenders have maintained their skepticism on businesses that are dependent on consumer discretionary spending. "Selling to retail mass merchants is a tough business right now," Foster said. "We are inside the deals, and trying to get your arms around order levels and consumer spending patterns is very difficult. When you are on the outside and only getting 60 percent of the information and trying to figure that out is even more challenging. I don't think people are racing to buy or finance those companies until you see how the fourth quarter plays out."

Some lenders say they didn't "turn off" automotive, and if you are a healthy automotive company, there are still interested lenders. "We have seen more interest and activity in the automotive industry, due to a combination of more stability, with volumes at levels that can generate positive cash flow in light of cost reductions instituted over the last few years, and more reasonable valuations," said Ira Kreft at RBS Business Capital. "With the bankruptcies and restructurings that have occurred over the last few years, investors, particularly unnatural owners such bondholders who converted their debt to equity, are seeking liquidity and bringing these Tier I automotive suppliers to market."



# State of Middle Market Financing in the U.S.

## COMPANY PERFORMANCE

Portfolio credit quality remains strong, and companies are performing despite the economy. "We complete portfolio reviews every quarter, and consistently over the last several quarters we have seen an uptick in the overall rating of the portfolio," said Chris Williams at Madison Capital Funding. "There are over 250 companies in the portfolio, so it is a very broad brush of the middle market economy. "Usually the lower middle market businesses that we finance are an earlier indicator of economic conditions," offered Stephen Gurgovits at F.N.B. Capital Corporation. "Our portfolio is healthy. No one is in covenant violation. No one is in default. In fact, some of our businesses are having a record quarter." Performance blends, as respondents speak to portfolio companies that are tracking to plan, a handful that are having banner years, and very few that are down measurably year-over-year. In aggregate, portfolios are growing slightly better than the economy.

Cyclical businesses saw substantial improvement in 2010. The companies that experienced significant declines in 2008 and 2009 are fighting back but performance has not returned to pre-recession levels. "In many instances, companies are not improving because the economy is improving. They are improving because they figured out what was wrong and fixed it. Many companies have cut costs to the bone," commented Brent Burgess at Triangle Capital. "As a lender, you have to ask, why did this company survive?" added Andy Steuerman at Golub Capital. "Many companies did some heroic things to survive the last downturn. The question becomes, can they go back and do that same trick twice? There are only so many times you can cut 30 percent of your workforce. There may be no more to cut." There are no easy cost saves anymore. 2008 and 2009 forced companies to get lean.

### Growth remains elusive

For the "garden variety" middle market company that is steady state, lenders are not assuming significant top line growth. Most companies are growing only moderately. They are beating prior year results but are behind budget, and growth is on a slow but upward trajectory. EBITDA growth has largely been achieved through expense control as opposed to revenue growth. "Because of the market hiccup, some companies are not meeting projected EBITDA for 2011," commented Steve Kuhn, a vice president in the Structured Finance Group at Fifth Third Bank. "Performance is up from 2010 but is not tracking to the 2011 plan. We are seeing that across a number of industries." "Some companies are not growing as rapidly as they had projected," added Preston Walsh at PNC Mezzanine. "The economy is not helping them. As a result, we have seen them go back and revise their long-term forecasts."

Broadly, lenders tell us company performance remains healthy and there is little evidence of softening. Commenting on in-market deals, Robert Radway at NXT Capital offered, "Trailing-twelve-month EBITDA is quite strong and at a peak compared to the last three to five years," "It is the go forward analysis—what is the downside now—that is where we spend a lot of our time." "The companies that are performing fairly well tend to be in more defensive sectors or are gaining market share. Companies selling business-to-business are faring much better than business-to-consumer companies," offered Ira Kreft at RBS Business Capital. Certain sectors are seeing continued strength, lenders say, with healthcare and technology frequently cited in discussions on growth.

"Middle market companies have taken out costs, inventories remain lean, and productivity remains high. If there is growth, they have excess capacity within their existing operations so that incremental revenue drops straight to the P&L," said Brian Schneider at Northstar Capital. "The question lenders have asked is: Over the last couple of years, has a company grown due to market share wins where weaker competitors were consolidated or have you seen a true organic growth of the business," commented Whit Edwards at BB&T Capital Partners Mezzanine. "That is the part that everyone has to figure out. Sustained unemployment has been a drag and the longer unemployment lingers at the current levels, it makes it more difficult for businesses to generate growth."





# State of Middle Market Financing in the U.S.

## VALUATION

### Bifurcated market

Lenders say there has been a strong flight to quality since the start of the downturn and the recent market dislocation has instilled a heightened sense of caution. Marginal deals are not even being considered in the current environment, some respondents said. "It has been months since anyone has looked at the "marginal" deal," remarked one lender in our survey. Survey participants say it is a tougher market, and lenders are becoming more selective from a credit perspective.

M&A deal flow is not robust, so the quality deals that come to market are oversubscribed, and multiples for the highest quality businesses are being pushed up by virtue of scarcity and surplus capital. Corporate buyers need to show growth and are paying up for the right assets. Sponsors are being aggressive in auctions and are bidding up purchase multiples, which a function of fewer deals in the marketplace and continued pressure on funds to put dollars to work. "The highest quality companies are commanding premium multiples, and that has been very consistent through this whole economic environment," commented Ira Kreft at RBS Business Capital. "Companies that performed well and demonstrated growth through the downturn are garnering high multiples. And for the companies that have not performed, it really is a case of the haves and have nots out in the market."

Size matters even more. Lenders say the $10 million inflection point in EBITDA is playing more into valuations in today's market. The adage that bigger is better is surfacing in valuations, and with more size and scale comes a premium affixed to the multiple. And lenders say the "large company premium" is getting larger. For businesses with less than $10 million in EBITDA, the haircut on the purchase price multiple can be 1x to 1.5x EBITDA or more.

This dichotomy is putting a band on multiples in the market:

- Larger ($10 to $12 million EBITDA or more) A to A+ companies are attracting significant interest at high valuations
- Mid-sized to larger B to A- companies and carve-outs are getting done at good valuations from a historical perspective
- Valuations for smaller (<$7 million EBITDA) B- and below companies are more varied

"It has been and probably will be even more of a bifurcated market, to where the really good assets are going to be oversubscribed and have a lot of interest around the table. And the ones that have lagged or have a nuance like a customer concentration will not be as well-received from the credit markets," offered Whit Edwards at BB&T Capital Partners Mezzanine. "We have seen it this year. The transactions that have traded at premium valuations involved companies that grew through the recession, looked fairly stable, and had a long-term positive outlook for their business. We see a flight to quality, and it will be more so if credit tightens."

### Capital excess

A supply and demand imbalance has lenders fighting over a handful of deals. "You can be flat and still be exciting to a buyer right now," offered one surveyed lender. "There are only so many healthy deals that are trading. At most, it is two to three deals a week across the whole middle market." "In some cases, sponsors are paying what typically would be considered growth multiples and applying them to companies that just survived. Some may have performed well but on an economy that is going to be flat going forward. Again, it is that flight to quality," commented Brian Schneider at Northstar Capital. "Some businesses have outperformed because the market has consolidated so they have taken market share, and they have grown faster than their competition," added Edwards. "If companies have higher growth, you can pay a premium number. But that is the part that investors are having difficulty figuring out, whether there is going to be growth for the next three to five years."

Corporate buyers have stockpiled cash and are looking to acquisitions in the slow organic growth environment. "There is still a big disparity between some of the public and private company valuations, to where you see some public companies trading for 6x EBITDA and they are buying private businesses for 9x-10x," Edwards said. "There is just not a lot of growth available to large corporations so they are willing to pay up for companies that appear to provide growth." One lender recalled a deal where the strategic bid was 10x and the next closest bid was 7.5x. Another recalled, "I can hardly remember the last deal we saw at 7x." "There are not a lot of companies moving through a process at less than 7x," commented Mike Klofas at Babson Capital Management.

> "It is a good time to be a seller. If you have a business whose numbers are sustaining in this economic environment, then you have a unique property. If you are taking that property to market, people will pay up for it."
>
> —Tom Gregory
> Maranon Capital



# State of Middle Market Financing in the U.S.

## VALUATION

### Scorecard

Lenders shared their observations on valuations in today's market:

*Tom Gregory, Maranon Capital:* We are seeing a range of 7x-10x for most of the deals that we see in the middle market, and it is probably skewing on the high end of that range for many of them. Most of our view on multiples is tempered by service businesses, which would include business and software services and healthcare services. Companies in the food space are also trading well. Gregory excluded manufacturers, distributors, and consumer products companies from the range. Manufacturing businesses are the most prone to being cyclical in a recessionary environment so there is a lot more caution around those companies.

*Tim Clifford, Abacus Finance:* Purchase price multiples have jumped. A growing and profitable company that had been a 7x EBITDA multiple may now be at an 8x or 9x multiple. Companies with strong growth, double-digit EBITDA margins, and those in attractive industries such as healthcare IT or software, are going to command high single-digit to low double-digit multiples. In the lower end of the market, there are some outliers below 5x; a typical deal will fall within the 6x-7x range.

*Chris Williams, Madison Capital Funding:* A broad range is 6x-8x with probably more in the 7x-8x range. For really attractive businesses, it is easy to see multiples exceed 8x. Deal volume is not tremendous, so when a new high quality platform does come to market, there is a sort of frenzy going on around those types of businesses.

*Andy Steuerman, Golub Capital:* It is not uncommon to see valuations in the 8x-10x range as being fairly normal for companies demonstrating healthy growth. If there is more modest growth, multiples fall into the 7x-8x range. A 6x multiple implies that there is usually something wrong; it is usually a cyclical business or has a nuance like a customer concentration or other material issue. Six times is like the new floor. A 5x multiple means it is just broken.

*Scott Reeds, RBS Citizens:* High quality businesses are going for high valuations, and the auction processes are extremely competitive. The middle-of-the-road companies or tougher stories are going for more reasonable valuations, and the processes are taking longer. Cyclical businesses have bounced back after the recession but the uncertain economic climate has put pressure on multiples. Those businesses are going for lower valuations, 5x-6.5x EBITDA. Right now, you need the right kind of buyer who understands those sectors and is willing to capitalize those businesses correctly.

Purchase Price Multiples in Middle Market LBO Transactions

*EBITDA Valuation Multiples by Transaction Size*


| | 2001 | 2002 | 2003 | 2004 | 2005 | 2006 | 2007 | 2008 | 2009 | 2010 | Oct-11 |
|---|---|---|---|---|---|---|---|---|---|---|---|
| <$250 million | 5.9x | 5.8x | 6.4x | 6.8x | 7.5x | 7.2x | 8.3x | 6.5x | NA* | 6.6x | 6.3x |
| $250-$499 million | 6.3x | 6.8x | 6.7x | 6.9x | 8.0x | 8.1x | 8.5x | 8.2x | NA* | 8.0x | 7.9x |
| $500 million+ | 6.4x | 6.7x | 6.9x | 7.5x | 8.4x | 8.5x | 9.9x | 9.4x | 7.5x | 8.5x | 9.1x |

*NOTE: Data not reported due to limited number of observations for period.

Source: Standard & Poors LCD.





# State of Middle Market Financing in the U.S.

## VALUATION

### Still a sellers market?

If it is a quality business, the seller is still in the driver's seat, lenders say. There is still more than enough competition for the market, and there is always someone waiting in the wings. "At the end of the day, these are still pretty frothy auctions," offered Tom Gregory at Maranon Capital. "We have a sense that for most quality companies, there are three to five buyers right around the edges all hoping to win. It is not like anybody can play the seller for an advantage." Chris Williams at Madison Capital Funding added, "Given some of the recent uncertainty, it may not be quite as strong, but it is still a seller's market. When you are sitting on a nice business and you are going to bring it to market, you know you are going to get a good price for it."

The advantage may be shifting to buyers if market uncertainty and volatility persists, some lenders say. Buyers are being patient.They realize that the tables might be turning in their favor and will probably be more aggressive when it comes to purchase price negotiations. "Clearly some sponsors have taken a step back and are looking at transactions with a more conservative perspective as it relates to near-term company performance. In some situations, that has led to terms being renegotiated or deals falling apart. From our vantage point, that has been more the exception than the rule," offered Robert Radway at NXT Capital.

### Downtick ahead?

Purchase price multiples were ticking up until the market correction, but if lenders tighten up leverage, the ability to pay a higher multiple is reduced. "For the high quality names, I think valuations are still elevated," commented Karen DeCastro at Ares Capital Corporation. "It is a little too early to tell, but I would expect companies that are coming to market today may see lower valuation multiples given where leverage levels are coming in. Directionally, I would assume valuations for the lower quality credits will come down." "The hotly-competed assets may hang on to the high multiple," commented Preston Walsh at PNC Mezzanine. "However, given the recent economic uncertainty, multiples seem to be coming down by a quarter to a full turn depending on quality. The challenge is that sellers may put their deals on hold because they don't think they will get the multiple they expect."

"Has there been some erosion in multiples, maybe, but we have not seen much of a shift. You don't hear about situations where a company that would have commanded an 8x multiple last year is now 6x," Radway said. "For attractive properties that have steady cash flow and a business model that people are confident will stand up to a more difficult economic environment, I think people are still paying up."

"Sponsors don't want to take a lot of risk, but they also have capital to deploy. They would rather pay a little more for a good business than get a bargain on a bad one," said Brent Burgess at Triangle Capital. "Multiples for good businesses are stretching, and I don't see that changing a lot. Through lower-cost tuck-in acquisitions, sponsors will look to buy down the multiple over time. Even if lending pulls back, I don't think it is going to impact multiples that much. Sponsors will just put in more equity."



# State of Middle Market Financing in the U.S.

## TERMS AND STRUCTURE

### Leverage

Leverage levels are coming in, some survey participants said, as lenders become more conservative in their expectations of near-term EBITDA. Some lenders said that banks are beginning to pull back on structure to 3x/4x on senior and total leverage, respectively. Senior lenders were going above 3x during the first half of the year; they are back at 3x or below now. Others said some banks will go above 3x senior leverage but it starts to top out at 3.25x.

Mezzanine lenders said there is a hard cap on what senior lenders are willing to allow from a sub debt leverage perspective. Senior lenders are looking to trim leverage by as much as a half turn, with total leverage coming back into the 4x-4.5x EBITDA range and with more caution. The leverage range for mezzanine is 1x–1.25x EBITDA.

"Pre-August, there were some deals in the market that were 'edge of the envelope' in terms of leverage and pricing but that has eased now with some of the cautionary notes in the market. Amidst that, it is harder to get storied deals done," reported Randy Schwimmer at Churchill Financial. "Plain vanilla, well-structured deals are going to be a lot easier to get done in the current environment." Some lenders say that competitive pressures have kept leverage levels relatively intact. "There are not enough healthy deals to feed the lenders that are there, so it is not difficult to get the leverage," a surveyed lender told us. "It is a weird dynamic. Competition is not impacting price. Lenders are winning deals on leverage." "A good deal is still going to get the leverage," commented Ira Kreft at RBS Business Capital. "The difference is if it is a tougher deal, you are not going to get it at all. A lender is just going to say, 'I am not willing to do the deal.'"

"Sponsors are more focused on closability," said Brian Schneider at Northstar Capital. "It is the sponsors telling the senior lenders, 'We know that you can provide this much leverage, but tell us how much you can provide comfortably, and we will fill the gap with mezzanine.' I think the senior lenders will give sponsors more leverage than they want. The mature sponsors are being disciplined and are not taking as much leverage as they are offered."

### EBITDA scale

Broadly, multiples dial back a half to a full turn in leverage when you dip below $10 million in EBITDA, lenders said. "The leverage differential on smaller companies is more acute than it has ever been," said Mike Klofas at Babson Capital Management. "It goes back to flight to quality, and the perception that large is more stable." The consensus was that senior lenders are not getting aggressive on leverage for the smaller companies.

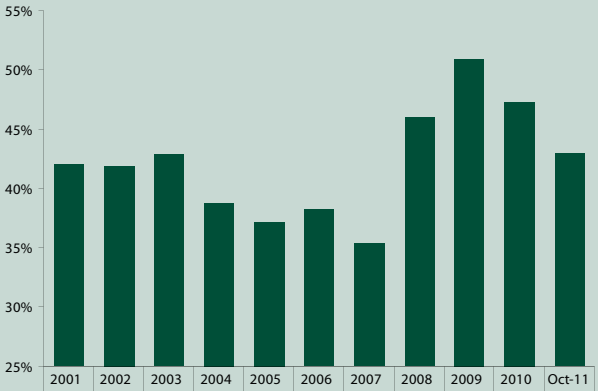
Leverage varies widely depending on the credit profile of the business. If it is a solid business with lower capital expenditure requirements, the leverage numbers will adjust slightly up. If it is a cyclical business, they will adjust down. The most cyclical businesses look like 2x-2.5x senior and 3x-3.5x total, lenders said. "If we are looking at a business that has $8 million of EBITDA that is in an attractive industry and has demonstrated stable performance, consistent cash flow, and has good customer diversification, it might attract the same leverage multiple as a larger company with all of the same characteristics," offered Chris Williams at Madison Capital Funding. "There is a lender for every deal out there. It is just a matter of finding the right risk appetite," said Mark Tauber at CapitalSource.

## Acquisition Financing Trends

*Leverage*


| | 2001 | 2002 | 2003 | 2004 | 2005 | 2006 | 2007 | 2008 | 2009 | 2010 | Oct-11 |
|---|---|---|---|---|---|---|---|---|---|---|---|
| Senior Debt/EBITDA | 2.7x | 3.1x | 2.8x | 3.0x | 3.5x | 3.6x | 4.0x | 3.1x | 2.6x | 3.2x | 3.5x |
| Total Debt/EBITDA | 3.4x | 3.7x | 3.8x | 4.3x | 4.8x | 4.8x | 5.4x | 4.1x | 3.6x | 4.1x | 4.1x |

*Equity Contribution*




| | 2001 | 2002 | 2003 | 2004 | 2005 | 2006 | 2007 | 2008 | 2009 | 2010 | Oct-11 |
|---|---|---|---|---|---|---|---|---|---|---|---|
| Equity Contribution | 42% | 42% | 43% | 39% | 37% | 38% | 35% | 46% | 51% | 47% | 43% |

*Middle market enterprise values between $25 million and $500 million.*
*Source: Standard & Poors LCD.*





# State of Middle Market Financing in the U.S.

## TERMS AND STRUCTURE

### Leverage (continued from page 12)

#### Ebitda between $7 million and $10 million

Broadly, for companies with EBITDA between $7 million and $10 million, senior leverage will be in the range of 2.5x-3x. If it is a bank execution, the senior will be at 2.5x leverage or less. Total leverage will be in the range of 3.5x-4x with the additional leverage coming from mezzanine. The smaller the credit facility, the greater the probability there will be a seller note that takes the place of an institutional slice of mezzanine. A one-stop can look like 3x-3.5x total leverage.

Leverage on an asset-based or senior stretch facility for EBITDA of $7 million or less looks like senior of 1.5x-2.25x and total of 3x-4x. Leverage for companies with EBITDA of $7 million to $15 million will expand to a 2x-3x range on senior and 3.5x-4.5x total for asset-based structures and cash flow loans from commercial banks.

#### Ebitda between $10 million and $25 million

Leverage on a "middle of the strike zone company" can look like 2.75x/3.25x senior and 4.25x-4.75x total. Lenders say that for really nice credits, it is not unheard of to see 3.5x/5x. Leverage for a one-stop facility looks like 4.5x for a comparable senior mezzanine structure. Some lenders say as leverage dials back, the high end is more like 4x-4.25x.

### Pricing

Middle market senior spreads widened in Q3 '11 by 50 to 75 basis points in response to broader market volatility, which compares to the large market which widened anywhere between 100 to 200 basis points.

#### Ebitda between $7 million and $10 million

Senior institutional pricing will range from L+500-600 with a Libor floor of 150bps. Bank pricing will range from L+400-450 typically with no Libor floor.

#### Ebitda between $10 million and $25 million

Senior institutional pricing will range from L+550-600 with a Libor floor of 150 basis points. This compares to L+450-500 in our April survey. Bank pricing will range from L+350-400 typically with no Libor floor.

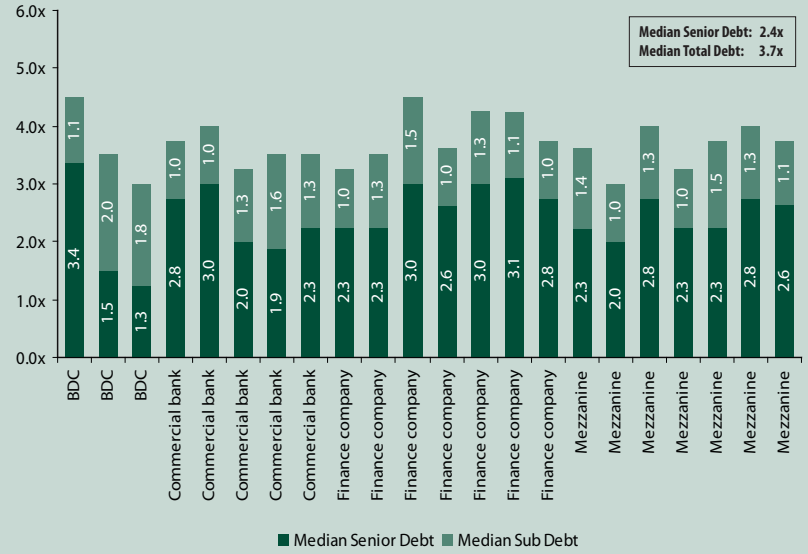
Unitranche structures are pricing at all-in rates of 11-13 percent depending on size and credit profile. Senior stretch facilities are pricing in the 9-10 percent range.

Asset-based deals are pricing in the L+175-300 range depending on risk rating and liquidity.

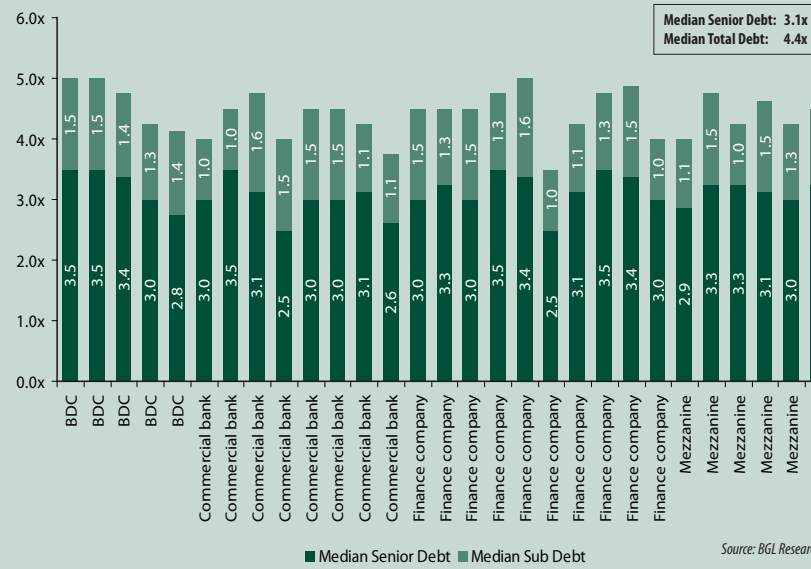
Survey of Capital Providers

*Leverage Multiples (Debt to EBITDA)*

*EBITDA between $7 million and $10 million*




*EBITDA between $10 million and $25 million*




*Source: BGL Research.*

# State of Middle Market Financing in the U.S.

## TERMS AND STRUCTURE

### Mezzanine

Lenders say mezzanine has not seen pricing adjust with the market dislocation and because of competitive pressures there has been some compression. "Mezzanine doesn't fit every deal, and the attractive deal list has not quite cleared the demand yet," said Preston Walsh at PNC Mezzanine. "Playing into that, you have funds that didn't put money out for two years, so with the flight to quality, you have lenders competing aggressively on those deals viewed as solid credits."

Broadly, competitive pressures have tightened pricing on mezzanine, with lenders citing a coupon of 11-12 percent cash pay and 1-3 points of PIK. Surveyed lenders provided market metrics on mezzanine pricing today:

**Ebitda below $10 million:** 11-12 percent cash pay; 1-3 points in PIK. 12-14 percent all-in with 150-200bps in closing fees. Warrants in sub $5 million EBITDA businesses are fairly normal but unique for those with $5 million to $15 million of EBITDA.

**Ebitda between $10 and $25 million:** 12 percent cash pay; 2-3 points in PIK; 200bps in closing fees. No warrants.

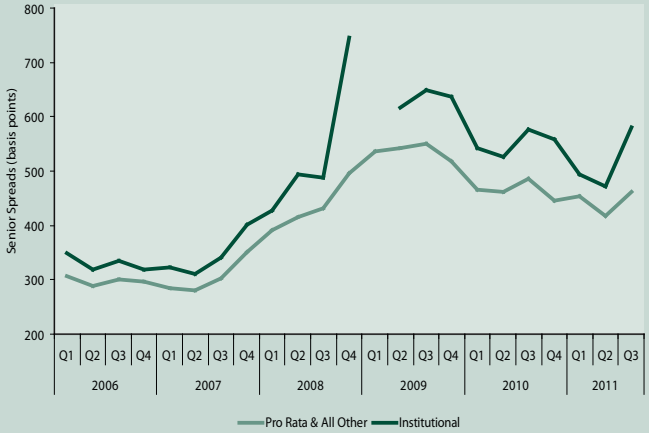
**Ebitda above $25 million:** Lenders said this market is seeing Libor floating pricing at 11 percent current pay, which could be L+900 with a 200bps floor; 1-2 points in PIK; and 100-150bps in closing fees.

### Second lien

Senior lenders are still trying to push back on second lien, and given where pricing is today, you can expect to see more mezzanine getting done, survey respondents said. Second lien pricing has gapped out in recent weeks. "If first lien spreads are bumping up to L+600, second lien spreads also have to increase. The delta between first lien and second lien in the first half of this year was roughly 400bps but is now more like 500-600bps. If your yield on the first lien is now 8 percent, you are looking at 12 percent-plus yield on the second lien, which might as well be mezzanine pricing," said Randy Schwimmer at Churchill Financial. "Where is second lien pricing going to go if it is bumping up to mezzanine? That is one of the questions that the market is grappling with today."

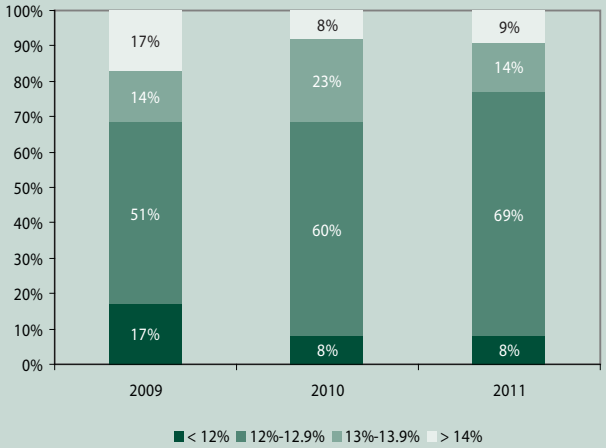
Historical Pricing Trends

*Senior Spread on Middle Market Sponsored Loans*




*Source: Thomson Reuters LPC.*

*Mezzanine*




*Source: The State of the Mezzanine Market, Churchill Financial.*





# State of Middle Market Financing in the U.S.

## TERMS AND STRUCTURE

### Equity contribution

Sponsor equity contribution exhibited a declining trend continuing through Q3 '11, falling to 38 percent in July, according to data reported by S&P LCD, the lowest level since the downturn—a function of increasing leverage being offered in transactions. October data reflected a reversal of that trend, with equity contribution ticking back up to 43 percent, in tandem with a downtick in leverage multiples. While lenders cite an average range of 35 percent to 40 percent required for most transactions, if market uncertainty and volatility persists, minimum equity will moderate at the 40 percent minimum level. When purchase price multiples begin to move up north of 8x, equity requirements increase. It is not uncommon for equity to exceed 50 percent or more in those situtations.

In the lower market, minimum sponsor new equity typically starts at 30-35 percent, assuming there is additional rollover equity, and it depends on the type of transaction as well. "We emphasize new equity versus rollover equity," commented Tim Clifford at Abacus Finance. "New equity is crucial because it validates the growth story of a business." Clifford cited the range of 40 percent to 50 percent as the desired contribution of total equity in the capital structure.

Lenders commented on the increasing trend for sponsors involved in secondary transactions to rollover a minority position into the new deal. "When you have valuation gaps in sponsor-to-sponsor transactions, we are seeing the seller roll over some equity, which was unheard of before," offered one lender. Lenders say they are seeing private sellers roll over more equity in transactions today. "A couple of years ago, the average rollover seemed to be 20 percent," said one lender. "Now the average is more like 25 percent to 35 percent."

### Outlook on leverage and pricing

#### Leverage

The majority of lenders surveyed expect leverage multiples to remain relatively stable and do not expect a dramatic contraction. "If it's a nice deal, there has not been any meaningful contraction," said Chris Williams at Madison Capital Funding. "It is more binary, either lend or not lend," said Ira Kreft at RBS Business Capital. "The focus will be on better quality companies." "We haven't really seen the capital structure push back yet, driven in part because we haven't seen the buyer seller multiple compression yet," added Andy Steuerman at Golub Capital. "The fear of the double-dip is there, but it hasn't been reflected in some of the processes we have seen." Steuerman said that cyclicals have had a faster contraction, and the capital structures have adjusted better. In higher-growth companies, the purchase prices and the requests for leverage are still pretty frothy.

If a true double-dip happens, all bets are off, lenders said. If leverage dials back, most do not expect to see as rapid a pullback as we saw two years ago. "The first thing that would come would be reduced leverage," commented Whit Edwards at BB&T Capital Partners Mezzanine. "If we saw deterioration in the business climate, we would prefer a reduction in leverage than a tweak to pricing." "Overall, I would expect leverage levels to decline but they will likely remain higher for the best credits in the market," offered Karen DeCastro at Ares Capital Corporation. "It really depends on the credit. Leverage levels are coming in, probably more so for lower quality names and less so for higher quality names."

#### Pricing

In recent weeks, senior spreads have moved up roughly 50 basis points with senior pricing approaching 600 basis points over Libor. Lenders expect spreads are likely to stay in the 500-600 range, pushing up to the higher end. "Recent activity from bellwether lenders has signaled pricing at L+550 with a 150 basis point Libor floor and 200 basis points to close, which is seemingly telling the market where pricing needs to be," commented Tom Gregory at Maranon Capital.

"Pricing is anticipated to go up because most banking institutions are going to be forced to get more yield," commented Jeff Hastings at US Bank. "In addition, for banks to play in the cash flow arena, they are going to require enhanced pricing given the elevated risk profile."

Competitive factors may put downward pressure on pricing but not in the near-term. There still remains a huge disconnect in pricing between the banks, middle market finance companies, and the institutional term loan lenders, which is the factor driving prices up in the current market. "We are going to have to see some kind of reconciliation in pricing between the larger market and the middle market," Gregory added.



# State of Middle Market Financing in the U.S.

## TERMS AND STRUCTURE

### Underwriting

Lenders are evaluating underwriting opportunities more stringently, with most survey respondents speaking to a reduced appetite given current market conditions. If deals are being underwritten, there is a significant amount of pricing and structural flex negotiated in the deals. Arrangers are looking for sufficient price flex to underwrite any deal, citing a range of 250-300 basis points, and 'bells and whistles' in terms of structural enhancements in the flex language, including call protection. "Lenders have largely met their loan and fee budgets, so there is not a lot of upside for taking on a ton of downside risk in the face of this pretty volatile market right now," was a view of one lender surveyed. Uncertainty in the syndications market has led sponsors to favor buy and hold investors because of the certainty in pricing and closing.

Selective is a frequently used term in the discussion of underwriting. "We are definitely taking a close look at our flex language, but we are certainly underwriting," offered Steve Robinson at GE Antares Capital. "We are underwriting but are very selective even in good markets," commented Andy Steuerman at Golub Capital. Another lender provided this perspective on underwriting, "We are still talking about boxing flex and going long on deals that do not require institutional investors. For deals that do, it would be deal by deal, and I would guess many lenders are going with flex. I cannot imagine too many people taking on that risk."

Lenders are concerned about execution, and when a deal gets to a size that requires tapping the institutional market, selling down the facility can be a challenge today. Survey participants peg the senior facility size at roughly $150 million, approaching $200 million, which is a manageable, straightforward transaction. "A senior debt facility of $150 million, while not a hard and fast number, is relatively easy to get done," Robinson said. "You still have appetite from banks, finance companies, and the active CLOs that are comfortable with the middle market. "Above $150 million, to try and get institutional interest in deals becomes more difficult and price sensitive."

Offering a perspective on underwriting appetite for large market deals, Mark Tauber at CapitalSource said, "It is a credit by credit, deal by deal analysis. Today, there is depth for certain larger deals, and they are getting done. The tough deals, i.e., dividend recaps, deals that push the envelope on leverage, are under a lot of scrutiny. Every underwritten deal is going to have pricing and structure flex because of where the market is now."

Some survey participants see continued appetite to underwrite going forward, saying certain lenders will be willing to use their balance sheet for the risk and return profile. "In the sub $150 million deal size, it is open for business," said Scott Reeds at RBS Citizens. "Lead arrangers are willing to use their balance sheets to support M&A activity. Given the recent volatility in the markets, we are often happy to have partners, mitigate our distribution risk, and still support our clients."

Most lenders say the middle market is more of a relationship model and still a club market. "It depends on the sponsor and the depth of their lending relationships. Some have their go-to lenders and can pull together a club fairly easily," said Chris Williams at Madison Capital Funding. "A senior debt facility of $100 million to $125 million or less that requires a club of three to five lenders is a fairly easy deal to get done. Above $125 million, you start to require more participants so it becomes more difficult to fill out the transaction and the last dollar in drives the pricing." Today, club participants are required to show up with a term sheet and a commitment letter to get invited into certain deals that are being aggressively pursued.

### Hold levels

Hold levels remain stable, with lenders holding less on cyclical credits from a risk mitigation perspective. Hold limits range from $15 million to $25 million in most deals, with leads typically holding between $20 million to $30 million and participants $10 million to $15 million.

Larger middle market lenders are being more aggressive on hold levels, some respondents say, using their balance sheets as a means to convey their value proposition in the current environment. Lenders cite $50 million as a high hold level, with $25 million to $35 million held for their own book. "Assuming the right credit criteria, certain lenders will put a big hold out there if it gives them a competitive advantage to win a deal. They are also telling the market that the deal should be done," a surveyed lender told us. "Some of the unitranche providers, particularly the BDCs, have been quite aggressive in taking on very substantial commitments and holding those commitments for their own books. That remains a variable in the market," commented Robert Radway at NXT Capital. "Senior lenders remain disciplined, and are either are clubbing up on deals or underwriting them with either captive sidecars or very consistent participation partners coming into their deals. Generally, I think people are sticking to their hold size discipline, from $15 million to $25 million and no more."

Lenders are more mindful of where they are putting their capital to work. Those with specializations or industry verticals are leveraging where they have had success from a credit outcome perspective and allocating their capital there. "Are we going to look at a sector where we have had success historically with a management team that we have backed before and a sponsor that has expertise in the sector as well? Yes, we are going to look at that a lot harder," offered Jeffrey Kilrea at CIT.





# State of Middle Market Financing in the U.S.

## TERMS AND STRUCTURE

### Terms

Lenders say the market has reverted back to more disciplined credit terms. Survey respondents speak to higher fees, higher pricing, call protection, and within banks that are underwriting and syndicating, there has been a substantial increase in pricing and structural flex. Across the board, covenants have become tighter and are more reflective of what was seen throughout 2010. Cov-lite that was trying to creep back into the market no longer has an audience, and equity cures are getting push back.

Recent tightening is not necessarily signaling a pullback, lenders said. "Terms will always come back, even when markets are healthy," said one lender we surveyed. "It is all whittling away at the edges a bit," said another lender. Most notably, amortization is going up (back to 5-10 percent annual amortization) and excess cash flow sweeps are increasing (50 percent is now more like 75 percent). In addition, you are starting to see other 'bells and whistles' on deals like call protection selectively coming back into the market.

"Now the lenders have a little bit more leverage over the sponsors. It is just easier to say no," remarked one survey participant. "It is situation-specific," commented Andy Steuerman at Golub Capital. "If you are bidding on a middle market deal and four banks like it and all four will finance it, my sense is a client is going to find a way to keep terms loose. For a tougher deal that you are willing to work on, terms will be more lender-friendly." "The loan investors have the power of the pendulum right now. They get more terms," said Steve Robinson at GE Antares Capital.

## OUTLOOK

### Challenges

#### Macro uncertainty

Lenders are waiting on stability—hope that the economy continues to recover and conditions do not worsen. "If there is stability, people can assess the new environment and get back to business," said Jamie Lewis at RBS Citizens. To that end, key for lenders will be portfolio performance. "The primary concerns continue to be fundamental credit issues—understanding where businesses are in their sector, the impact of changes in the regulatory environment, barriers to entry, and how well they are dealing with competition and retaining customers," commented Randy Schwimmer at Churchill Financial. "How do you underwrite the potential for a downturn? Where do you peg performance on the part of your prospective borrower in light of uncertain economic conditions?" Robert Radway at NXT Capital added. "That drives your comfort level with the asked for leverage." "As people start to get some more confidence in the economy like we had in the first half of this year, there is enough capital with banks and finance companies to make the market more competitive and more appetizing for issuers," offered Scott Reeds at RBS Citizens.

Lenders are concerned about the impact that continued uncertainty in the international markets will have on the cost of capital, portfolio credit quality, and levels of nonearning or nonperforming assets, which will affect credit appetite. "There is a big workout going on in the world," said Brent Burgess at Triangle Capital. "You have a number of countries and large banks that are trying to manage excessive leverage, which is going to lead to slow growth and uncertainty. I think it is pushing a lot of prospective sellers to sell."

#### Political

The political backdrop is in focus, with some lenders holding the view there will be no change in the market, positive or negative, until the election. "Management teams are not worried about the economy," Schwimmer said. "It is the lack of certainty and the lack of confidence in the political environment and how it is going to affect business." "Policies relative to deficit reduction and tax changes—those are big drivers," Burgess added. "If government policy is pro-entrepreneur, I think you could see a lot of capital start to get unleashed. But I am not sure that we are going to get there."

### Liquidity

"The keys to 2012 will be capacity and appetite from the BDCs and institutional term loan lenders, which have been impacted in the recent market downturn, and the ability to access the high yield market for larger middle market issuers," Ira Kreft at RBS Business Capital told us. Lenders foresee tighter CLO liquidity, which will constrain available capacity. "Dollars will have to come from someplace that has not been a natural player in the market driven by really attractive terms and conditions in order to deliver money into the middle market," said Tom Gregory at Maranon Capital. "The only thing that is really helping liquidity is that the alternative for yield is fairly poor," Steuerman added. "If people are looking for yield, there is still a bank loan market." "There is a continual secular increase in liquidity that needs to find a home. The continual compression of interest rates is going to make that need even greater. That will keep this market competitive," commented Howard Widra at MidCap Financial.



# State of Middle Market Financing in the U.S.

## OUTLOOK

### Liquidity (continued from page 19)

"With rates so low and gaining revenue a challenge for the banks, absent some significant correction, the banks will still try to be aggressive within their credit criteria. They continue to see opportunity for good credits at reasonable lending multiples," said Preston Walsh at PNC Mezzanine. "Right now, you have an interesting dynamic, because if there is a good deal on the streets, every bank wants to lend money, so competitive pressures have lowered spreads, and yet, for a lot of banks, their cost of funding is going up," said Jeff Hastings at US Bank. "We think there is probably going to be another mini-correction again next year, which may require some banks to slow down their lending, which we view as a positive for us."

### Loan growth

Lenders are hopeful that the New Year brings more technical drive to put money to work. There will be fresh budgets balanced by some real caution on the economy. "I think interest rates are going to remain low which is positive for lenders and sponsors. Lenders will be looking for growth, but it will be under more scrutiny depending on how volatile the economy is," said Mark Tauber at CapitalSource. While the outlook is still for growth, lenders say that if the market continues as it is today, there will be more asset selectivity. "Budgets will be more moderated for 2012 for many banks because of the recognition of lower demand out there," commented Ira Kreft at RBS Business Capital. "And there will be a continued bias toward better quality deals given the choppiness in the economy."

There is also the continued concern of a supply and demand imbalance with new assets coming into the market. "From an origination standpoint, unless there are more privately held businesses coming to market, we expect 2012 to be similar to 2011," said Brian Schneider at Northstar Capital. Howard Widra at MidCap Financial added, "People are going to put money out. The concern is the pace at which that capital enters the market will exceed the supply of opportunities, and the need for yield will create irrational lending activity."

Many lenders said the "beta" for growth in budgets is debatable, but there always is some increase. "Full stops rarely continue as long as they did in 2008," remarked a survey participant. "It is a good time to be a bank or a finance company because you are open for business and you have capital and are getting better terms," said Scott Reeds at RBS Citizens. "And it is a good time to be deploying assets, especially as sponsors and corporate buyers need to make acquisitions."

### Deal flow

Lenders anticipate deal flow may be off to a slower start in the New Year. "I think that the market will be slow through Q1 '12 as the M&A market needs to either digest the current pricing or the loan market needs to improve," said Steve Robinson at GE Antares Capital. Continued volatility in the institutional term loan and high yield market might impair M&A activity at the large end of the market, lenders agreed.

If we see some improvement in the economic picture, a number of drivers would suggest stronger deal flow in 2012. There is the growing backlog of companies, both entrepreneur-owned and private equity-backed whose hold periods have been extended, waiting to be sold. "Over the past three years, we saw the number of refinancings increase when rates were low, we have just gone through a series of dividend recaps, and now the next thing that needs to drive deal flow is M&A. That is what people are waiting for," said Mark Tauber at CapitalSource. "I would expect there to be a steady flow of deal activity into 2012, including a moderate increase in the number of M&A transactions, as well as a reasonable number of dividend recaps," offered Randy Schwimmer at Churchill Financial. "With public exits less certain given recent volatility in the equity markets, dividend recaps as an alternative strategy to monetize private equity investments will make sense, and we will continue to see those." There is also the potential increase in capital gains rates on the horizon, which lenders say is more real now than it was two years ago.

The small deal market will continue to see steady deal flow, said Tim Clifford at Abacus Finance. "I wouldn't say the lower middle market is completely insulated, but if there is a slowdown in M&A activity in the broader market, the smaller end will be less impacted," Clifford said. "The lower middle market accounts for a higher proportional share of overall M&A volume based on the number of transactions. And because these smaller deals require fewer lenders and less debt to finance, they are easier to get done. Businesses will be bought and sold and that flow will continue."

The oft-cited overhang of unspent private equity capital and aging portfolio investments will drive deal flow. "Private equity groups are still sitting on a lot of cash. They would rather use it than lose it," commented Chris Williams at Madison Capital Funding. "Sponsors are asking for extensions on their investment periods. They are going to put that money out the door." Williams said for private equity sponsors, it is all about economics. "If they know they can get a single or a double, they are going to go for it, even if it means accepting slightly lower returns for a solid business."

Deal flow has to come. "Sponsors seem to be waiting to sell until there is more EBITDA stability and visibility in some of their portfolio companies. Sponsors likely believed that 2011 would have provided that stability and visibility, allowing buyers to underwrite more aggressive valuations. However, because of the continued global macroeconomic uncertainty, their portfolio companies aren't necessarily at that point yet," commented Scott Reeds at RBS Citizens. "We continue to think the next two years are going to be driven by the sponsor M&A market. Activity has started to pick up, but it hasn't become a wave yet."





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## Representative Transactions

Edgetech — a wholly-owned subsidiary of Lauren International, Inc. — has been acquired by Quanex building products
BUILDING PRODUCTS

Goodman Services, Inc. — has been acquired by Metalico
METALS AND METALS PROCESSING

Rennillo Deposition & Discovery — has been acquired by Veritext — a portfolio company of Investcorp
BUSINESS SERVICES

Tempus — has been acquired by Grupo Financiero Monex
BUSINESS SERVICES

AP Specialty Metals — has been acquired by Samuel, Son & Co., Limited
METALS & METALS PROCESSING

Magnum Magnetics — has obtained financing provided by Charter One and PNC Mezzanine Capital
CONSUMER PRODUCTS

The CSC Group — Capture • Integrate • Automate™ — has been acquired by Hyland Software — a portfolio company of Thoma Bravo
TECHNOLOGY

Metrics Marketing Group — has been acquired by Northwest Mailing Services — a portfolio company of KCP
MARKETING & MEDIA

Novapak — PVC Container Corporation — a portfolio company of KCP — has merged with Pretium Packaging — which has been acquired by Castle Harlan, Inc.
PLASTICS & PACKAGING

The melting operations of Commercial Alloys have been acquired by Imperial Zinc
METALS & METALS PROCESSING

The recycling operations of Commercial Alloys have been acquired by RMG Reserve Management Group
METALS & METALS PROCESSING

Skipjack Financial Services — has been acquired by Fifth Third Bank
BUSINESS SERVICES

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.
BUSINESS SERVICES

TAD Metals, Inc. — has been acquired by O'Neal
METALS & METALS PROCESSING

Eaton Vickers Electronic Systems — has been acquired by Siemens
AUTOMATION & CONTROLS

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