Inside the Middle Market



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State of Middle Market Financing in the U.S.

2010 brought a rebound in the M&A market and with it a clear improvement in the number of quality businesses coming to market. Many middle market businesses returned to profitability, with some reaching or exceeding pre-recession levels. Sponsors saw more favorable lending terms, providing the needed support for increased buyout and dividend activity and with it higher valuations. Market indicators suggest that trend is continuing.

In our April survey of capital providers, lenders revealed that they are feeling the pressure of weak first quarter deal flow. The combination of a slow M&A market and increased liquidity in the debt markets has brought loosening in the form of higher leverage levels and lower spreads. Lenders are maintaining a credit first mindset and are waiting on a much anticipated influx of quality deal flow to bring supply and demand in balance and normalize structures.

Despite a slow first quarter, lenders are maintaining a decidedly optimistic outlook on future deal flow for the year. They point to a growing M&A and dividend pipeline that suggests robust deal activity is on the horizon, and improved capital availability and healthy lending budgets should supply a hungry appetite for financing. The bulging pipeline is expected to produce a flood of deal flow beginning at the mid-year mark, which lenders say could constrain capacity in the marketplace and push asset selectivity higher. So, for prospective sellers, today's window for seeking exits is particularly advantageous given the long list of eager buyers and the processing capacity to get deals closed.

Provided there is continued stability and growth in the economy, the foundation needed to support an active M&A and dividend environment is in place. Stability of earnings will allow more people to start seeking liquidity. Sponsors have ample capital to put to work, and lenders are waiting for more deal activity and are prepared to lend into high-quality transactions.

PARTICIPATING FIRMS

Amalgamated Capital
Ares Capital Corporation
Babson Capital Management LLC
CapitalSource
Churchill Financial LLC
F.N.B. Capital Corporation
Fifth Third Structured Finance Group
GE Antares Capital
Golub Capital
Madison Capital Funding LLC
Maranon Capital, LP
MidCap Financial, LLC
Midwest Mezzanine Funds
Monroe Capital LLC
NewStar Financial
Northstar Capital, LLC
NXT Capital, LLC
PNC Mezzanine Capital
RBS Business Capital
US Bank
Wells Fargo Bank, N.A.

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State of Middle Market Financing in the U.S.

DEAL FLOW

A slower than anticipated M&A market brought in $14.3 billion in new money issuance in Q1 ‘11, according to Thomson Reuters LPC. Although a healthy 64 percent increase from a year ago, loan volume hardly satisfied lenders, particularly coming off a robust fourth quarter in 2010, which brought in nearly $30 billion. Lenders attribute some of the slowdown to the pull forward of deal activity into Q4 ‘10 as sellers looked to complete deals ahead of pending tax legislation. Improving liquidity and lack of new issue supply forced lenders to manufacture deal flow in refinancings and repricings as a means to deploy capital and protect assets. Dividend recaps have made a strong showing as a means to put capital out in good quality loans. Scarcity of quality M&A deal flow has required lenders to turn to more aggressive structures in an effort to win deals. According to a recent Thomson Reuters survey of middle market lenders,[(1)] 95 percent of respondents fell short of their lending goals in Q1 ’11, leaving lenders hungry to put capital to work.

Lenders said some of the void in the M&A market can be attributed to a lack of family-owned businesses coming to market. These companies are playing the waiting game, hoping for a longer trend line of improving performance to garner a higher valuation. Other lenders said there are a number of sponsors that are ‘wannabe’ sellers. They have portfolio companies that made it through the downturn and are rebounding, but they have more improvement necessary before market valuation catches up with expectations. Still others say companies are waiting on first quarter financial results so they can go to market with their best foot forward.

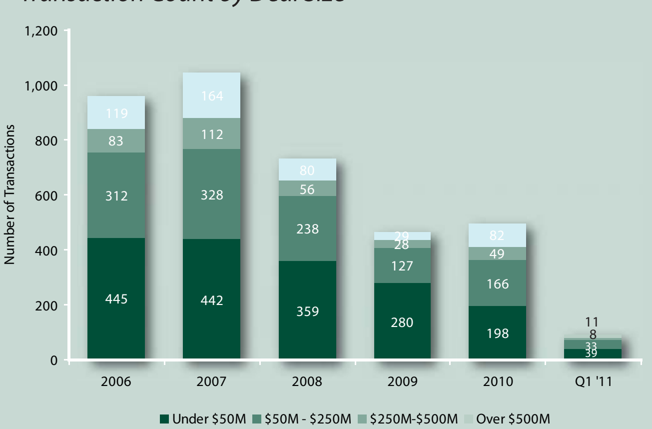
Lenders say the pipeline of M&A and dividend activity is in process, and they are beginning to see it build now. The sentiment is that the market will get very busy again. “I think everyone is waiting for M&A financing, whether you are talking about cash flow or asset based lenders. The money is definitely out there and available to facilitate the transactions,” said Ira Kreft, a senior vice president at RBS Business Capital. Lenders say that if that next wave of deal flow comes through, M&A activity will spike up again as private equity funds become very active.

Lenders say time to close is shortening. Diligence is still rigorous, and sponsors and lenders are not taking shortcuts. However, lenders say more steps are taking place in parallel—quality of earnings, customer calls, management background checks—including financing running parallel with the signing of the purchase agreement with diligence in process. In addition, twelve months into a modest recovery, lenders have more confidence in the stability of earnings and do not see as much downside risk. Surveyed lenders say the “foot dragging” out of fear that the numbers will erode appears to have gone away. “In today’s market, sellers of quality businesses have many choices in terms of potential buyers and a key consideration in their selection process is whether a buyer can move quickly and close on terms agreed to upfront. So, we are seeing processes move, not in a way that is cutting corners, but they are moving expeditiously,” said Tom Gregory, a managing director at Maranon Capital.

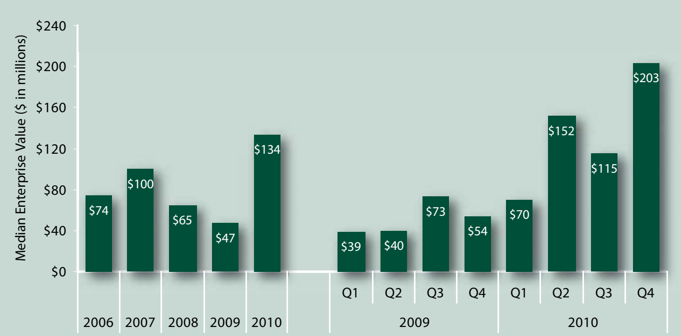
Overall, lenders are expecting 2011 to be a solid year for M&A and dividend financing. It has been a slow start to what is expected to be a frenzy in the second half of the year. Stability of earnings will allow more people to start seeking liquidity.

Private Equity Transactions

Transaction Count by Deal Size



Median Deal Value by Year



Source: PitchBook.

NOTES: (1) Thomson Reuters LPC Q2 ‘11 Quarterly Middle Market Survey.

State of Middle Market Financing in the U.S.

CAPACITY

Turning on the spigot

Lenders say there has been a sea change in the amount of liquidity that has come into the middle market. The increase in capacity is coming from multiple sources. Banks are starting to develop or restart leveraged loan teams and efforts. New BDCs are forming, and existing players have shored their balance sheets to the point where they are actively out in the market and have come back to be a real force in the middle market again. Commercial finance companies are also seeking additional funding sources. "Commercial finance companies are returning to the market due to greater availability of capital. BDCs have returned as a viable source of capital, and that market has been active recently," said Timothy Clifford, executive vice president and head of Amalgamated Capital. "Also, leveraged finance businesses that can use retail deposits as a funding source have a significant competitive advantage in the form of stable, low-cost capital." "Banks and BDCs both have come into a significant amount of liquidity and are starting to focus on really putting it to work," said Howard Widra, chief executive officer at MidCap Financial LLC. "There are new people lending in the markets on a regular basis, and there are more new entrants to come for leveraged transactions," Widra said. "For whoever has demand, there will be supply in the leveraged loan market, as long as the credit is in the ballpark." "There clearly is more money chasing deals at all levels," said Robert Radway chief executive officer at NXT Capital, LLC. "Access to capital is generally more favorable for everyone," commented Jeffrey Kilrea, a managing director at NewStar Financial. "This is a year where lenders have cleaned up their balance sheets, have more favorable liquidity positions, and want to put that money to work. And middle market leveraged lending is still an area where you can make an attractive spread for what is considered modest risk."

> "Everyone has turned on the spigot. Capital is readily available, particularly for good credits."
>
> —Preston Walsh
> PNC Mezzanine Capital

Talking growth

Lenders expect liquidity to continue to improve driven by higher lending goals in 2011. The long-standing cash flow players anticipate "more of the same" in terms of loan growth, many coming off very strong years in 2010, which is expected to bring ample liquidity as they look to meet goals for 2011. Many lenders were successful in meeting aggressive budgets in 2010 and expect that 2011 will be an equally strong year provided there is enough deal flow to accommodate growth targets. "I think there are a lot of pretty big budgets out there," said Chris Williams, a senior managing director at Madison Capital Funding LLC. "It goes back to supply and demand. You have a lot of lenders wanting to do at least the same or better volume in 2011. There is just not a lot of deal flow."

Madison Capital Funding had a banner year in 2010. "We closed 78 transactions in 2010 and put out over $1.7 billion in net funded commitments. We were agent on a very high percentage of those deals. It was a great year for us," Williams said. "We are looking to do similar if not more volume in terms of committed dollars and transactions for 2011."

Golub Capital is expecting growth in 2011. "In 2010, we put out over $1 billion in new commitments and our goal in 2011 is to try to do the same. We think that is a good number in this market," offered Andy Steuerman, a senior managing director at Golub Capital. "We balance velocity with a stringent credit mindset. There is a point to where you want to put money out, but you want to put it out in the best credits. It would be great if we could do more. If the market dynamics say that structures are getting too aggressive or the companies are not as attractive, then we will do less."

NXT Capital, LLC CEO Robert Radway commented on the lender's growth plans in 2011. "2010 was our start up year, so we had a six-month window when we were open for business. Overall, we were pleased with the progress that we made. We hit the targets that we had set for ourselves, and we have been able to expand our capitalization both on the equity and the debt side since our start," Radway said. "Clearly, we have expectations to do more than we did last year and thus far it looks favorable. We are seeing liquidity return to us as much as it is returning to the broader market, and we are seeing a greater flow of that capital come our way than last year. We will continue to look at various ways of increasing the amount of funding that we have for our business. One of the things we are looking at is the execution of a CLO which would probably occur sometime in the third quarter."

MidCap Financial, LLC CEO Howard Widra said the healthcare-focused commercial finance company is looking to grow substantially this year. "We plan on growing our net assets $400 million to $500 million, which would be new business origination of approximately $800 million, roughly doubling last year's loan volume. While that is a firm-wide goal, we hope to at least double the number of transactions we did a year ago in leveraged lending." MidCap focuses exclusively on providing debt solutions to middle market health care companies and offers leveraged loans, asset based loans, real estate loans, and venture debt. The lender received an SBIC license in December 2010, which will allow the firm to provide financing to qualifying small businesses in the healthcare sector.

Taking the lead

"Speaking just to the active players and budgets they are looking to meet for 2011, there is a ton of liquidity," said Chris Williams at Madison Capital Funding. Williams said that when you talk about supply, there needs to be a delineation between your long-standing cash flow lenders that are consistently active in the middle market because that is what they do, regardless of market conditions, and the players that selectively come into the market as participants. "The stable players are the ones that have been there in the slow times, in the bad times, and in the aggressive times," Williams added. "It is always easy to be the darling of the market when you have a new player on the block and everybody is looking for debt. What is more telling is when there is a hiccup in the market, are you still around after that."



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Taking the lead

There are probably five or six credible lead arrangers in the traditional middle market, survey participants said. If you broaden the group to participants, the list grows to about 25. "Lenders that have come in on the fray over the last year are very aggressive right now because they need to put assets on their balance sheet," said Chris Williams at Madison Capital Funding. "It will be interesting to see if everyone is as active as the year progresses. I do think when deal volume picks up, you will see more of a balancing of the supply and demand," Williams added. "I think there is still pretty solid execution in the middle market," commented Andy Steuerman at Golub Capital. "For the average middle market deal, you can get three or four lead lenders. I don't know how many more you need to put a competitive process in place," Steuerman added. "The middle market is pretty well balanced," Steuerman said. "We have a pretty good window into every process that is in our targeted zone. We have not heard of any deals failing to get done, even if we are not participating." Steuerman added, "That tells me that the market is absorbing the flow. For a really good deal, you are not seeing someone clawing around because they cannot find any lenders that are open for business. That just does not exist."

Banks are active

Banks are expected to continue to be active this year. They have slowly gotten their capital ratios back into appropriate levels and are willing to take some risk again. "The banks are back in the market now as they have worked through the majority of their issues and are looking to improve revenues," commented Preston Walsh, a partner at PNC Mezzanine Capital. "The commercial banks seem to be very active right now. They have surplus deposits sitting there and are looking to find a home for that money," Williams said.

"Markets are wide open," offered Jeff Hastings, a senior vice president at US Bank. "Every bank in the country is aggressively pursuing loans. I would say there is a ton of liquidity out there looking for good deals." Many banks still have a fair amount of exposure to real estate and need diversification in their loan book. They are looking to be fueled by commercial & industrial (C&I) loan growth, survey participants said. "Since banks are flush with cash, the best way to deploy it is to push C&I loan growth, either as cash flow loans or asset based loans," commented Timothy Clifford at Amalgamated Capital. "That is why the market has been somewhat frothy for lenders. People are looking for more feet in the street and more business development folks to drive that business." "Banks are actively seeking new customers again," offered Steve Kuhn, a vice president in the Structured Finance Group at Fifth Third Bank. "Over the last few months, I think banks have gone from looking inward to focusing now on deals. Banks were so internally focused on improving their portfolios, that now they have worked through those issues and are out aggressively calling to add assets again."

A majority of survey participants said regional banks have been aggressive in the market and expect them to continue to be active. "Banks are obviously using deposits as their main source of capital, so they can afford to be very aggressive with pricing," offered one lender in our survey. "If they want an asset bad enough, they are going to get it," the lender added. "Part of the problem the regional banks are running up against is they too are getting refinanced on deals. So, they are trying to originate at least at a pace to keep up with the refinancing activity that is taking assets off their balance sheets," commented Tom Gregory at Maranon Capital. "Spreads relative to where interest rates sit today are attractive, so we expect them to be a constant force."

Bring on the BDCs

BDCs are expected to fill some of the void in the senior cash flow market. There are currently six BDCs in the pipeline so far this year including Monroe Capital which filed in March and Churchill Financial which filed in April. Since the beginning of 2010, eight BDCs have gone public and raised $770 million.[1] Surveyed lenders said current market dynamics suggest that new BDCs will be much more senior debt-focused and have lower return expectations. Solar Capital was the first middle market senior loan BDC, investing in first-lien, unitranche, and second-lien debt instruments, according to its IPO filing.

Some lenders in our survey said they see BDCs being much more active in the market above $10 million in EBITDA and almost exclusively in sponsored buyout transactions. Larger BDCs are trying to create assets with a yield of 10 percent or better, which is reflective of their leverage constraints and dividend requirements, lenders said, and dictates participation in unitranche deals, last outs in a first-out last-out structure, and mezzanine. BDC participation in the traditional senior part of the structure is typically somewhere between 3x-3.5x EBITDA, but lenders do not see them competing aggressively for that business given their return requirements. Other lenders said BDCs were becoming more active in the lower market, particularly given the slow M&A transaction environment.

In March 2011, Monroe Capital LLC filed a registration statement with the SEC for a proposed IPO to form a BDC. The BDC will invest $5 million to $25 million in senior, unitranche, and junior secured debt in lower middle market companies. Targeted returns on senior and unitranche secured debt are 9 percent to 15 percent, according to its public filing. Also in March, Monroe announced the closing of a new $250 million fund, Monroe Capital Partners Fund LP, which will focus on senior and junior/mezzanine debt and equity co-investments in middle market businesses with a minimum EBITDA of $3 million. The new fund is primarily a debt fund that will target the lower middle market, said Tom Aronson, head of originations at Monroe Capital.

Lenders such as Monroe are starting to obtain liquidity and will be more of a force in the middle market. Aronson said lenders reliant on the CLO market came under pressure during the credit crisis and are looking to diversify their pools of capital so they are not dependent on a single funding source. "We have always been in the lower middle market. Our specialty is partnering with the senior commercial lenders and ABL lenders to offer a one-stop solution to lower middle market businesses nationwide," Aronson said. "The ABL market is robust right now, so we think there is a real opportunity for lenders like us. Under their formula, ABL lenders cannot always satisfy the funding requirements of companies in need of growth capital. There are a number of good businesses that performed reasonably well during this difficult period and are now looking for capital to grow." Today, Monroe has $700 million in assets under management. The firm is looking to raise an additional $150 million through the BDC vehicle.

NOTES: [1] Investment Dealer's Digest.



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Pockets

Lenders in our survey still reference EBITDA minimums, saying that there generally are two pockets of liquidity in the middle market, with $10 million in EBITDA being the line of demarcation. Today, anything above $10 million is enjoying very good market reception, lenders say, with a very long list of potential sources of capital. "For any deal that is between $10 million and $20 million in EBITDA, the long-standing cash flow players will be fighting tooth and nail to win that mandate," said Chris Williams at Madison Capital Funding. Survey respondents told us that as you approach $30 million in EBITDA, they are starting to see some of the bigger banks come down and try to compete in that upper end of the middle market.

The lower middle market

Lenders say the universe of potential capital providers is reduced when you dip below $10 million in EBITDA. "I would characterize that market as one where transactions and lender groups still happen by appointment, because there are people that come in and out of it depending on a variety of factors," commented Ryan Golding, a director at CapitalSource. "Deals are still getting done, but there is not the same depth of interested lenders in any given transaction that might be present upmarket. Where they are getting done is on a regional basis. It is usually a question of finding the right lender at the right time in the right geography." One-stop/unitranche players, regional banks, and SBICs are the primary lenders to the sub $10 million EBITDA market, with SBICs being the most active below $5 million, survey participants said. Select finance companies continue to maintain an active presence in the sub $10 million market. Madison Capital Funding is one of those players, with roughly 20 percent of its portfolio in companies with EBITDA between $5 million and $10 million, Williams said. The lender's minimum EBITDA target is $5 million.

While many senior cash flow lenders draw the bright red line at $10 million, survey participants say that liquidity is returning to the small deal market. "For very high-quality assets, liquidity is starting to improve for companies with less than $10 million in EBITDA," Brian Schneider, a partner at Northstar Capital, LLC, told us. "It has taken awhile, but liquidity is slowly coming back in the lower middle market," commented Steve Kuhn at Fifth Third Bank. "Particularly within the last four to five months, we have seen more banks move into that space. We are competing against more banks on transactions this year," Kuhn said.

It is still situational, but regional banks are maintaining a strong presence in lower middle market deals, some lenders said. Survey respondents said regional banks are very aggressive on deals that have the appropriate leverage profile and are in their footprint. Others say regional banks are active in the lower middle market but only up to a certain degree. As long as senior leverage is 2.5x and below, regional banks will be very competitive. They still want straight-line amortization, but they are very price competitive. When senior leverage gets closer to 3x, they become less competitive.

For some lenders, the bright red line has blurred. "The more liquid the market gets, the lower people are willing to go. As people become more tolerant, you are seeing the line go from $10 million to $8 million to $7 million," offered Howard Widra at MidCap Financial. "You almost have to call the line $7.5 million, because I think a lot of the traditional lenders are more and more willing to step down into that space." Widra indicated that when the deal gets smaller, either the leverage goes down so it is still appealing to the banks or the pricing goes up to move to the BDCs, but the deals still get done. And for the smaller deals, you do not need as many buyers. According to a recent Thomson Reuters LPC survey of middle market lenders[(1)], 55 percent of respondents said they would finance a deal with less than $10 million in EBITDA, which is up from 38 percent in the previous quarter.

Lenders are selectively going down market for the right opportunities. "Last month, we were looking at a financing opportunity for a company that had $7 million in EBITDA. There were three lenders competing for it, and all three lenders would compete for a $25 million EBITDA opportunity too," said Andy Steuerman at Golub Capital. "There is more selectivity at $7 million. You may not get the same leverage and you may get wider pricing, but there is still availability for solid companies." "We generally work with private equity sponsors that are acquisitive in nature, so if we see an opportunity in the sub $10 million market that has visibility to grow via a quantifiable tuck-in acquisition strategy or organic EBITDA enhancement, we will actively pursue it," offered Jeffrey Kilrea at NewStar Financial. "I think there is liquidity, but maybe it is not the structure that people want. For the smaller deals, lenders are going to look at them more as a stretch secured deal or a stretch asset based deal rather than a pure cash flow structure," said Ira Kreft at RBS Business Capital. "Those deals are going to have to get financed with more equity, and they are primarily going to be senior debt and sub debt with a more conservative structure than you might have seen a couple of years ago. But those deals can definitely get done."

Mezzanine

Lenders say there is more than enough mezzanine capital to support the market, pointing to substantial money raised through standalone mezzanine funds, BDCs, and SBICs in recent years—saying there is far more junior capital available than there are deals. Lenders in the lower middle market say competition has increased. The regulatory environment has spurred new entrants to the marketplace as more capital providers apply for SBIC licenses.

Lenders say second lien is gaining traction, but has not overtaken mezzanine yet. Interest in second lien typically starts at EBITDA of $15 million, survey participants said, and is most prevalent once you go above $30 million.

Most mezzanine players want bigger bites, some surveyed lenders said, so it can be difficult to find mezzanine for the smaller deals. The sub $8 million EBITDA market ($5 million to $8 million) was cited as difficult to secure mezzanine financing. Some mezzanine lenders have a cutoff of $7.5 million in EBITDA, said some participants in our survey.

NOTES: [(1)] Thomson Reuters LPC Q2 '11 Quarterly Middle Market Survey.



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COMPANY PERFORMANCE

Middle market companies are maintaining strong discipline on expense controls. Companies have cut the fat and as they start to look to grow again, they are capturing that margin. "What we are seeing is strong management teams that cut expenses and realized that they can run their businesses leaner, so their profitability is much better," commented Jeff Hastings at US Bank. "Any moderate growth in revenues is creating some fairly sizable profits. We are seeing that a lot more than we are seeing industry growth or economic reasons to cause revenues to increase dramatically."

Generally speaking, lenders are not seeing huge revenue improvement and expect flat to moderate growth for most businesses in 2011. The more cyclical companies were up quite dramatically out of 2009's trough. There has been a moderation or leveling off of that growth into 2011, but it is still forecasted to be good, some lenders said. There are sectors where businesses are outperforming because they have a transformative model, surveyed lenders said. But companies with an economic model are not seeing robust growth. "For the 'garden variety' business, we are seeing very modest topline growth and somewhere between 100 and 200 basis points of EBITDA improvement," commented Tom Gregory at Maranon Capital. "Those companies really worked the cost side of the structure when the economy was down and have performed better on an earnings basis because they are operating leaner and more efficiently."

Companies that had deferred spending during the downturn are now starting to invest in growth. Some are looking at expanding sales and marketing or are filling holes in management teams. Others are increasing capital spending or looking at acquisitions again. As companies have gotten their capital structures back into order, they are starting to become more comfortable making those investments and spending the money. "There has not been a material shift in capital spending," commented Robert Radway at NXT Capital. "In most of our deals we are modeling fairly significant capital expenditures. I would say it is not a significant investment in revenue-generating capabilities, but we are seeing people plan for growth in the economy."

> "There is still a premium on quality. Every few weeks there is 'the' company that shows up in the middle market. Everybody wants to buy it, and everybody wants to lend to it. The company is very sought after."
>
> —Andy Steuerman
> Golub Capital

Talking industry

Sectors that were generally out of favor during the recession are becoming more acceptable now. Areas of the economy that have seen a fairly significant contraction and a return to some level of stability are becoming of greater interest to the broader sponsor community, surveyed lenders said. Some of the more cyclical sectors like retail and restaurants, automotive, heavy machinery, and building products are gaining more favor with a view that they already reached bottom and are starting to see the turn given the improvement in the economy. "A year ago, people were still focusing on what they perceived to be defensive sectors. The broad market felt good about healthcare, food and beverage, technology, and consumer products at the non-discretionary value-end—that was the short list. Now, everyone is feeling more comfortable starting to evaluate and look at almost any opportunity again," commented Ryan Golding at CapitalSource. "In the hardest hit sectors, people are expecting to be able to draw a line under a trough in terms of performance. There is more expectation that a broader array of sectors will move to growth mode," Golding said. "If a cyclical business performed reasonably well and came through the downturn as a survivor that would suggest the company is a market leader and is well managed," offered Mike Foster, a senior managing director at Midwest Mezzanine Funds. "There is also the view that there is a higher growth trajectory and earnings upside for the more cyclical plays."

Lenders cited automotive as an industry that is gaining traction. "A lot of automotive companies have rationalized their businesses down to the point where they can breakeven at 10 million units car and light truck," said Ira Kreft at RBS Business Capital. "Upticks in volumes for the companies that are very volume sensitive can drop a lot of money to the bottom line. I think some of those companies can perform very well." Similarly, building products is expected to see greater momentum this year. "The market has bottomed. Companies have taken out expenses, and if they are at least break even to positive cash flow now, with any kind of resurgence, they should perform reasonably well. It would seem a fairly reasonable place to play," Kreft said. Kreft cited sub sectors within building products such as the replacement/remodeling market that have seen a little more stability and still performed relatively well through the downturn.

"If you have a good business model, a good management team, and the company has performed well, I think that trumps the industry, except the "three r's" are still really tough: retail, restaurants, and real estate," said Steve Kuhn at Fifth Third Bank. Lenders are extra skeptical of companies that have exposure to commodity prices in today's rising rate environment.

The business services, healthcare services, healthcare IT, and food sectors continue to be held in high favor. "Healthcare companies did not struggle nearly as much in this last cycle," said Howard Widra at MidCap Financial. "Even with the government issues, there is more tailwind than headwind for healthcare companies." Widra said within the broader healthcare industry, areas of particular interest include healthcare records and preventative medicine. Government reimbursement continues to be an area of concern, with specific reference made to Medicaid, given state budgetary issues occurring throughout the country. "There is more discussion taking place on the topic of reducing healthcare reimbursement at the state level than we have ever seen," commented Jim Barnett, a director at CapitalSource. "We are looking at our portfolio to identify where we might be negatively impacted by potential adverse changes."



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VALUATION

Lenders are predicting it will be a seller's market in 2011. Company performance and business fundamentals are improving, so there is more comfort with run rate earnings and the visibility of the pipeline. Sponsors and lenders are anxious to put money to work. Limited new M&A deal flow is driving a competitive market, and pricing and leverage have improved for sponsors. These dynamics are expected to bolster valuations for the foreseeable future. "We don't see anything that is going to drive purchase multiples down on any size company. There is so much private equity capital out there that needs to be deployed," commented Tom Gregory at Maranon Capital. "People who want to sell, unless there is a problem with their story, can get a pretty full price right now," said Howard Widra at MidCap Financial.

"It is a good market for both buyers and sellers. I think the price of debt will be more attractive than it has been in the last few years, which should allow buyers to pay more. And it is a good time for sellers as well," commented Steve Robinson, a managing director at GE Antares Capital. "It is definitely a seller's market," said Chris Williams at Madison Capital Funding. "You have funds with a lot of capital to deploy, and there are not a lot of places to put it right now. For the high-quality deals that do come to market, the auctions are very frothy. Purchase price multiples are very high right now." "We would characterize the current environment as a seller's market. Generally speaking, sellers with pristine businesses are able to command above top-dollar," commented Ryan Golding at CapitalSource. "The question will be if supply changes or overall quality changes, how will that impact multiples."

Survey participants shared their views on current valuation trends:

Steve Kuhn at Fifth Third Bank offered, "There is more competition on the stronger deals, and multiples are creeping up. We are seeing EBITDA multiples range between 5x-7x, which compares to multiples in the 4x-6x range this same time last year. In meetings over the past few weeks, we are hearing multiples of 6x-7x, even 6.5x-7.5x." Kuhn's group provides senior cash flow financing for companies with EBITDA between $2 million and $12 million.

"Quality businesses with all the attributes—barriers to entry, strong market share, defensible positions, strong cash flow—are tending to get high single- to low double-digit multiples," said Jeffrey Kilrea at Newstar Financial. Kilrea has seen multiples of 7x-10x on various businesses this year. Kilrea's group provides senior cash flow financing for companies with EBITDA between $5 million and $30 million.

"For attractive, growing businesses with at least $10 million in EBITDA, it is very common to see multiples in excess of 8x," said Chris Williams at Madison Capital Funding. "And you are seeing healthy purchase multiples even for the smaller businesses, if they are good quality and showing growth." Williams' group provides senior cash flow financing for companies with EBITDA between $5 million and $50 million.

"It is not uncommon for us to see most processes in the 8x-10x EBITDA range," offered Andy Steuerman at Golub Capital. "We have seen a tremendous number of deals in the 8x-10x range, and we have seen more than a handful go over 10x." Growth-oriented platform companies can trade over 10x. "It is very rare that people can value shop for good companies," Steuerman added. "If you want to be a value buyer you are going to have to take some level of fatal flaw—a company with a cyclical past, a customer concentration issue, a business that doesn't come with a management team. There has to be some kind of issue that makes other people withdraw." Smaller companies or companies with issues tend to be valued in the 6x-7x EBITDA range, Steuerman said. Golub provides senior cash flow financing for companies with EBITDA between $5 million and $50 million.

> "It is definitely a seller's market. For the high-quality deals that do come to market, the auctions are very frothy."
>
> —Chris Williams
>
> Madison Capital Funding LLC



State of Middle Market Financing in the U.S.

VALUATION

Quality

Weak deal flow is driving a fiercely competitive market for the highest quality transactions. Structures are continuing to become more aggressive, and asset selectivity is being pushed higher. Given these market dynamics, lenders say there will be more of a focus on quality this year. “There is still a premium on quality,” commented Andy Steuerman at Golub Capital. “Every few weeks there is ‘the’ company that shows up in the middle market. Everybody wants to buy it, and everybody wants to lend to it. The company is very sought after,” Steuerman said. “Then you find the lesser quality company, whether it is in a cyclical or lesser desired industry, that still could be attractive, but people are little bit more cautious and should be,” Steuerman added.

Some lenders speak to a clear bifurcation in the market as it relates to quality of new deal opportunities. “Quality is either good or it is bad. It is not a range,” offered Brian Schneider at Northstar Capital. “If it is a good deal, it trades at a high multiple. Then, there are the deals with a lot of hair on them that trade at low multiples. There are not a lot in the middle.” Preston Walsh at PNC Mezzanine Capital echoed this sentiment. “Three years ago, there might have been a company with potential issues, but those issues were not readily apparent because of robust economic growth. Now, after the Great Recession, if a company had an issue, it was most likely exposed. That has created a barbell in quality in the market,” Walsh said. Companies recognized as high quality performed well throughout the recession, had management teams that demonstrated their strengths, and exhibited some secular growth. On the other hand, there are companies that did not perform as well, exposed some weakness in their management teams or had some hair. There are few in between,” Walsh added. “At this point, it is very clear what the market regards as quality companies, and by quality for a lender you are talking about the stability of cash flow, and those companies are getting aggressively pursued by the private equity and the lending community.”

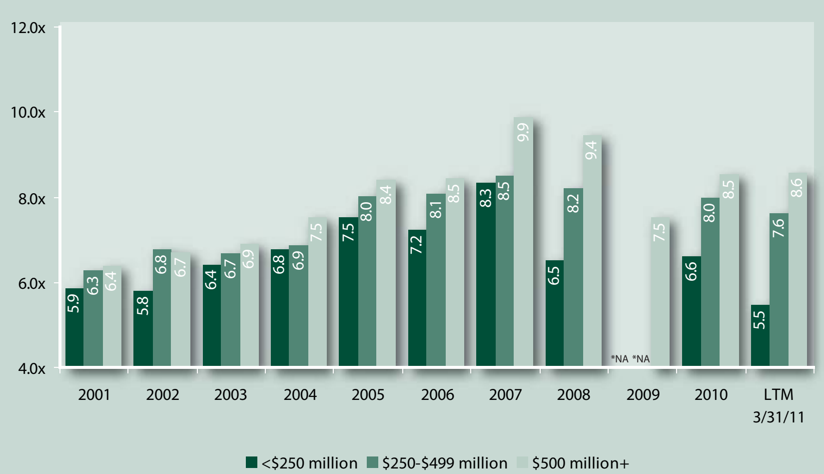
“There is a real difference between the average company and the really good company,” offered Ira Kreft at RBS Business Capital. “The average company is probably going to price at 10 percent to 20 percent below where a really good company prices.” The really good companies came through relatively unscathed through the downturn. They generate strong cash flow and are very efficient from a working capital standpoint, so they drop a lot of cash flow to pay down debt. Those are the companies that are commanding high prices—multiples at 9x or 10x. That contrasts sharply with the ‘run-of-the-mill’ general industrial companies which are still pricing down in the 4.5x–5.5x range, Kreft said.

Size

Some lenders say there is still a clear differentiation in multiples as you move above $10 million in EBITDA, quantifying the differential at 1x to 1.5x. “Valuations are definitely trending up for the $10 million-plus EBITDA companies,” said Mike Klofas, a managing director at Babson Capital Management LLC. “7x is the new norm for an average company in an average industry. For good companies with all of the characteristics, 8x is not out of the realm of reasonableness. We have even seen some stellar companies that are in the 9x-10x range.” Klofas said that it is unusual to see purchase price multiples much above 6x for companies with less than $10 million in EBITDA. And companies with issues, no matter the size, can be purchased for 6x or less.

Purchase Price Multiples in Middle Market LBO Transactions

EBITDA Valuation Multiples by Transaction Size



**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.

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"Multiples are driven more by the growth dynamic of a company and not necessarily size," said Karen DeCastro, a principal at Ares Capital Corporation. The market is becoming more and more competitive, so you are seeing sponsors stretch even on smaller companies to the extent there is an attractive growth profile for the business."

Timothy Clifford at Amalgamated Capital, shared his perspective on the lower middle market. Clifford's group provides senior cash flow financing for companies with EBITDA between $3 million and $15 million. "We have seen multiples increase in the market, depending on the quality of the company and the situation. If you have a good company with double-digit EBITDA margins and an attractive growth profile, you are going to pay a much higher multiple for it." Clifford puts the valuation range between 5.5x-7x for companies of this size, saying that companies closer to $10 million in EBITDA typically will fall in the higher end of that range—at 6x-7x. "It is really a function of EBITDA size, margins, and growth."

Recovering

Most industries have seen a fairly significant recovery, and lenders say there is more confidence in the earnings profiles of middle market businesses. Companies saw an uptick in performance beginning in late 2009, which carried through into 2010 with consistency across industries, with the improvement driven by margin enhancement against a lower topline. Lenders say that they are now seeing an improving topline against an already established but higher operating margin.

Stability in earnings is accommodating additional leverage in structures today, which enables sponsors to pay more for businesses. "We have seen EBITDA multiples go from, on average, 7x-7.5x to close to 9x," said Robert Radway at NXT Capital. "Sponsors believe they are acquiring companies at a cyclically low EBITDA level. So, while they are paying 8x or 9x trailing EBITDA, on a forward basis, with continued growth in the economy and strategic improvements they expect to make in the target company, they should see EBITDA increase fairly significantly over the next several years. When they look back on these deals a few years from now, they are still going to make a whole lot of sense."

Focus

Specialization goes a long way in today's competitive market. Andy Steuerman at Golub Capital commented, "It is a little bit easier for the groups with the industry specializations to pay the highest price because they spend a considerable amount of time in an industry and realize when they are buying something very attractive. It is more difficult for someone who has not spent that time to get conviction as quickly when a process begins to escalate." Lenders are required to have that same level of conviction and many are making investments in certain sectors to be smarter on the companies they pursue and be more value-added to their client base.

Valuation gap

Lenders in our survey said the gap between buyer and seller value expectations has narrowed, and many said there is no gap at all. The seller's gap during the past couple of years was not related to the purchase multiple, said some lenders, it was related to the underlying earnings of the business. Tom Gregory at Maranon Capital told us, "If you had a business that was making $20 million in EBITDA in 2007 that you thought could sell for 8x, and in 2009, the business was making $15 million, you could probably still sell it for 8x. But you were leaving a lot of money on the table. Those businesses are coming back. Purchase multiples are holding steady to firming, and earnings are rebounding, so there isn't much of a gap anymore."

> "Financing multiples are coming back and private equity dollars need to be deployed. Valuations are likely only to go up."
>
> —Tom Gregory
> Maranon Capital, LP



State of Middle Market Financing in the U.S.

TERMS AND STRUCTURE

Leverage is up and spreads are down across all debt tranches, a function of increased liquidity and the overall lack of new M&A deal flow in the marketplace. "Every quality deal in the country is oversubscribed. Everybody wants it, so pricing gets shaved and structures are more aggressive. It is very competitive right now, " said Jeff Hastings at US Bank. That healthy appetite extends to M&A and dividend recap opportunities, survey participants said.

Leverage

Ebitda scale

Broadly, multiples drop off a quarter to a half turn in leverage when you dip below $10 million in EBITDA, lenders said.

EBITDA below $5 million:

For companies with less than $5 million in EBITDA, senior leverage will be under 2x. There might be a slice of mezzanine but the mezzanine will be on the upper end, closer to $5 million. In many instances, it will be a senior only execution.

EBITDA between $5 million and $10 million:

For companies with EBITDA between $5 million and $10 million, senior leverage will be in the range of 2.5x-2.75x. This compares to 2x-2.5x in our November survey, an increase in leverage of a half turn or slightly more. Total leverage will be in the range of 3.5x-3.75x and the additional turn is mezzanine.

These structures will apply to asset light businesses. The larger the asset base, you are inviting more competition from banks. Historically, asset based lenders did not have an appetite for large airballs in the smaller end of the middle market. Today, a regional bank might structure an asset-based transaction that is 50 percent secured, some lenders said. The minimum asset coverage six months ago would have been at least 70 percent. Previously, airballs needed to disappear within 18 months. That time is extending to 36 months and even 48 months in certain situations.

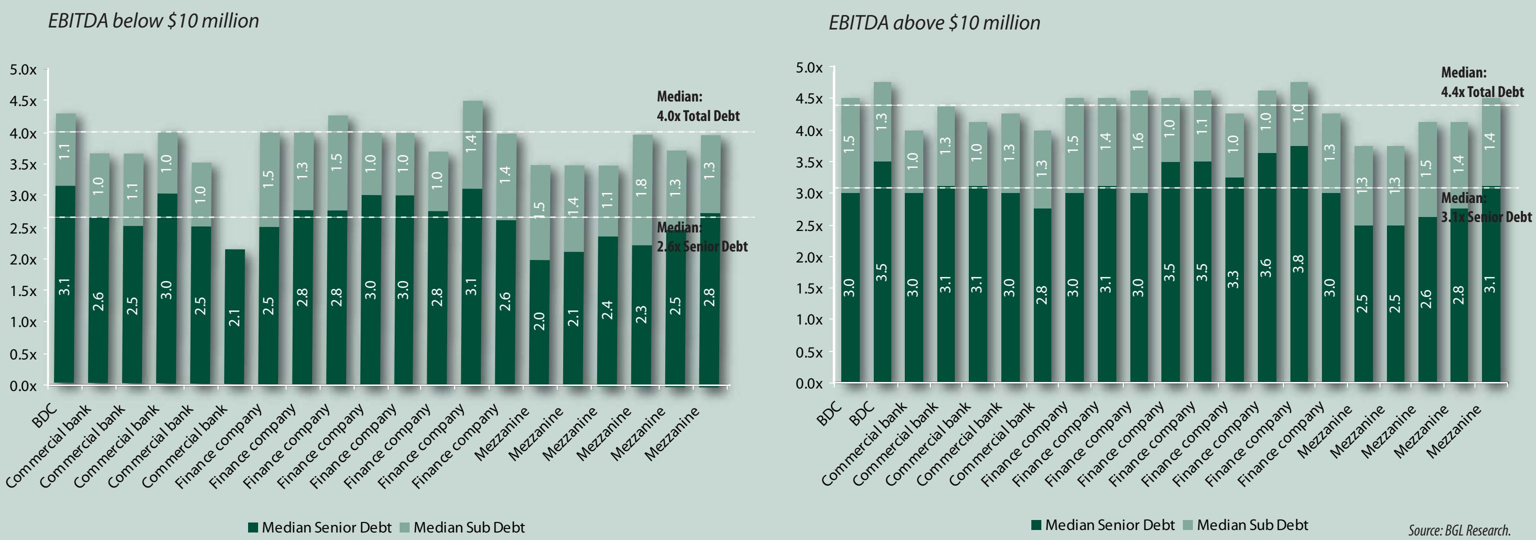
Speaking to the trend toward increasing leverage, Timothy Clifford at Amalgamated Capital said, "We have all had to go up in total leverage. Last year, we only bid on a few deals with 4x total leverage. This year, we have had to bid more aggressively, which is reflective of the competition in the marketplace." In our April survey, more than 70 percent of respondents quoted 4x in the range of total leverage for less than $10 million in EBITDA, compared to 32 percent in our November survey.

EBITDA above $10 million:

Leverage on a "middle of the strike zone company" can look like 2.75x-3.25x senior and 4.25x-4.75x total, which compares to 2.5x-3x senior and 4x-4.5x total in our November survey. It can be a half turn range on both the senior and the mezzanine for the vast majority of deals, lenders said. On balance, lenders speak to a quarter turn increase in leverage from six months ago.

Survey of Capital Providers

Leverage Multiples (Debt to EBITDA)



Source: BGL Research.

State of Middle Market Financing in the U.S.

TERMS AND STRUCTURE

Lenders in our survey said they have seen very few deals done in the $10 million to $25 million EBITDA segment with senior leverage that exceeds 3.5x. A recent Thomson Reuters LPC survey[1] suggests that middle market lenders may be stretching their comfort level. Survey findings reported 30 percent of respondents cited their senior leverage tolerance level has gone up above 3.5x for sponsored deals—up from 10 percent in the prior quarter. Lenders say there are 3.5x/5x deals being proposed right now. "We put out a proposal the other day at 5.25x total leverage," offered one lender in our survey. The EBITDA size of the company was $35 million.

Leverage is much more company specific than it is purely a function of size. "Some deals may fall in that $10 million to $15 million EBITDA range but have actuarial-like characteristics in terms of the cash flow, and as a result they command a higher leverage multiple," said Robert Radway at NXT Capital. "We certainly look at the size of the company, and it factors into our decision," said Chris Williams at Madison Capital Funding. "However, if there was a really nice company with $8 million in EBITDA and it had a "twin" company with $14 million in EBITDA, I don't know that there would be a difference from our perspective in terms of what leverage multiple we would put on it." Lenders said cyclical businesses or ones with "hair" might look more like 3x/4.5x.

Pricing

Broadly, spreads have come down in recognition of the marketplace. Lenders said pricing pressure is more pronounced in the $10 million to $15 million EBITDA segment as lenders are chasing deals pretty aggressively, while pricing remains unchanged in the $5 million to $10 million EBITDA segment. Others say the lower market can be more competitive because the source of capital is largely banks and asset based lenders. Lenders expect continued compression in that market, saying spreads could narrow by 25bps-50bps. Libor floors are still very prevalent and can range from 125bps-175bps.

Pricing comes down to the source of capital; it is institutional pricing or it is bank pricing. As the commercial banks are coming back and getting comfortable with doing deals, given their low cost of capital, they often are not putting in Libor floors, and they are pricing them at what for them is a very healthy spread. However, on an all-in basis relative to an institutional buyer, the pricing looks less expensive. "They are making a relationship play," commented Tom Gregory at Maranon Capital. "In a world where a L+275 or L+300 credit is a pretty wide spread for them, I think they view it as a relationship faux pas to charge a floor."

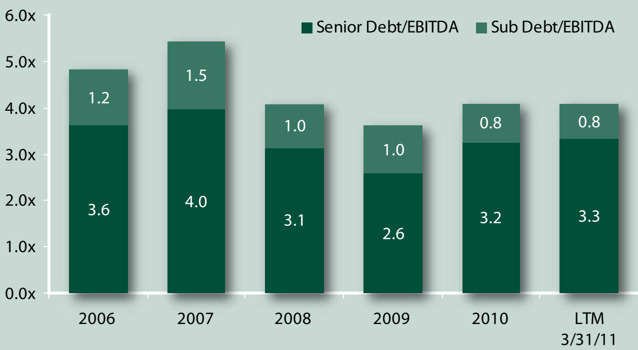
EBITDA below $10 million:
Pricing has come down roughly 100bps-150bps from a year ago, Timothy Clifford at Amalgamated Capital told us. A deal done in Q4 '10 at L+600-650 looks like L+500 or less today.

For EBITDA below $5 million, senior pricing for finance companies will be in the L+500-550 range with a 150bps floor. For EBITDA between $5 million and $10 million, senior pricing for finance companies will be in the L+475-525 range with a 150bps floor.

EBITDA above $10 million
Pricing on a "middle of the strike zone company" for finance companies typically ranges from L+450-500 with a floor of 150bps. This compares to L+500-550 with floors of 175bps-200bps in our November survey. The band on pricing stays within this range for most transactions, lenders say.

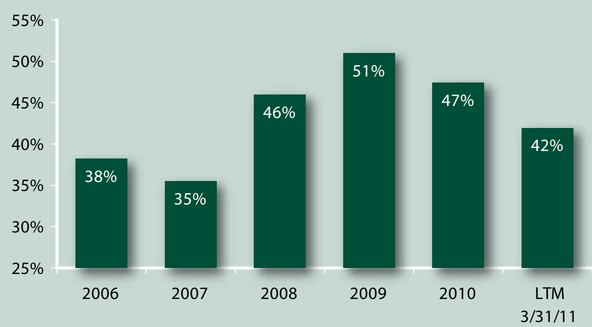
Acquisition Financing Trends

Leverage



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

Equity Contribution



NOTES: [1] Thomson Reuters LPC Q2 '11 Quarterly Middle Market Survey.

State of Middle Market Financing in the U.S.

TERMS AND STRUCTURE

Bank pricing varies widely, but lenders say the 'discount' to a nonbank lender can typically range from 50bps to 100bps. Broadly, for pure cash flow loans, surveyed lenders speak to senior spreads in the high 300's to low 400's over Libor with no floor. For structures with some asset coverage and EBITDA below $8 million, a one-bank deal might look like L+225 with no floor. If there is a bigger bank group, pricing might look like L+225 with a floor of 100bps-150bps. For EBITDA between $8 million and $15 million with some asset coverage, pricing can look like L+175-275 with a 100bps floor. When you go above $25 million in EBITDA, pricing can look like L+375 with a 100bps floor. Bank participants indicated they often are getting better pricing in the larger transactions, saying that because of the credit crisis the larger corporate entities are more concerned about flexibility and stability in their bank groups.

"We have seen more competition from regional banks than from commercial finance companies, especially within the last three to six months," commented Timothy Clifford at Amalgamated Capital. "For example, if you have a deal at 2.25x senior leverage, you can expect that a regional bank would charge L+400 with no Libor floor whereas a commercial finance company would charge L+500 with a 150bps Libor floor. On these lower leveraged deals, sponsors are attracted to the terms from the regional banks, and so it can be difficult to compete. As a result, commercial finance companies are focusing much more on higher leveraged deals such as refinancings and dividend recaps." Clifford did indicate, however, that once senior leverage gets to 3x, you lose a lot of banks. The credit box for most banks is going to be up to 3x senior and 4x total leverage.

One-stop financings

One-stop financings are facilitating deal flow in the lower middle market, although lenders said they are seeing them in greater frequency in the $8 million to $15 million segment of the market. One-stop players have been increasingly drawn to the lower market, in part, due to the current lack of deal flow and because structures enable them to put out a critical amount of capital. "For a business with $7 million in EBITDA, one-stop players can offer leverage in the range of 3x-3.5x," said Mike Foster at Midwest Mezzanine Funds. "If a one-stop player can lend $15 million to $25 million in an opportunity, that will be very attractive to them." Foster said that one-stop players are actively competing on businesses in the lower end of the market and in certain situations, have been more competitive from a pricing standpoint. Lenders say scarcity of deal flow and the influx of capital into BDCs have changed the pricing metrics around one-stop financings. In the example provided, pricing is going to be a blended rate of roughly 9 percent. Leverage in a one-stop is typically a quarter turn to a half turn less than a traditional two-party structure.

Surveyed lenders said in certain situations, having the ability to offer a one-stop can help secure the deal from a financing standpoint. If pricing is within an acceptable materiality threshold and there is a reasonable terms package, in many cases sponsors will opt for the ease of execution if the economic savings are not significant.

Mezzanine

Mezzanine has also had some pricing pressure. Lenders speak to a 100bps-200bps reduction primarily on sponsored transactions. For EBITDA less than $15 million, pricing is 12 percent current pay and 2 percent to 3 percent on PIK plus equity buy-in, when you are able to buy equity. For EBITDA above $15 million, pricing is 12 percent current pay and 1 percent to 2 percent on PIK where lenders are doing an all-rate deal. Many lenders say they are not seeing second lien below $15 million in EBITDA.

Mezzanine lenders say they are seeing signs of loosening. Warrants are generally available only in smaller deals or for the more storied credits, and while equity co-invests can still be obtained in most cases, they remain a negotiating point in most deals. Mezzanine lenders say it has been more difficult to get warrants in deals that are of a reasonable size. Six months ago, on deals below $15 million in EBITDA, warrants in most cases were still available. Today, lenders say that number is closer to $10 million because of the supply and demand inequity in the market. Some mezzanine lenders even put the number closer to $5 million. "For your down-the-middle, industrial business with decent cash flow, a good sponsor, a good management team, and market leverage, it is going to be difficult to get warrants," offered one lender in our survey. "Sponsors are not giving away free equity in warrants," said another lender. "If you want a ride in the equity, you need to put in money side by side with the sponsor." Most mezzanine lenders do not want to lend into deals with no equity upside. All rate deals are getting executed in the middle and upper end of the market, so there is concern that pressure may filter down.

Equity contribution

Sponsor equity contribution as a percent of the capital structure has moderated and is back in line with a historical average of 40 percent, declining from 2009 levels of 50 percent required to get deals done. Transaction structures are accommodating higher leverage, which is reducing the equity requirement in deals.

Lenders referenced equity contributions as low as 35 percent in the middle market in the peak of the cycle, indicating that we are not back to that level yet. There is still resistance at 40 percent, surveyed lenders said. In certain situations, survey respondents saw contributions dip below that 40 percent threshold in the first quarter, holding the belief that sponsor equity will trend closer to the 35 percent range as the year progresses. Sponsor equity has always been an important aspect of the credit, so most mainstream lenders are looking for a minimum of 35 percent.



State of Middle Market Financing in the U.S.

TERMS AND STRUCTURE

Underwriting

Lenders say there a much larger appetite for underwriting today, which is a function of so much liquidity in the market chasing deals. That is a significant shift from our November survey, when very few lenders, if any, were taking underwriting risk. Survey participants say there is a greater frequency of underwritten deals even in the lower end of the middle market, and when you go above $10 million in EBITDA, lenders are looking to underwrite large amounts. “Given the liquidity that is out there, it gives all the arrangers confidence that they know there are people out there salivating for paper that need to put dollars to work,” commented Chris Williams at Madison Capital Funding. “The market is so aggressive right now that you definitely see the arrangers taking on underwriting risk.” Williams said that most of the proposals are dollar certain, and while flex is still quite prevalent, the range of the flex has narrowed.

While lenders have exhibited a greater willingness to underwrite facilities, some lenders in our survey question whether sponsors are willing to pay for the underwrite today. “If the debt requirement is $100 million, many sponsors feel they can cobble together four like-minded lenders and pay one of them a quarter or a half point to run the documentation,” offered a lender in our survey. “That way, they reward all their friends and do not have to limit it to just one.”

Not many lenders have been given the opportunity to or have been forced to actually go long a large credit, said some lenders, so it remains to be seen whether they have the appetite for underwriting or not. “Lenders are looking to more aggressively win and control deals,” said Howard Widra at MidCap Financial. “Certainly people are out there representing that they are willing and able to go long transactions and want to do that. I believe they should because it is easier than it has been any time in the past couple of years to be able to find partners.”

Clubs are still the way most deals are getting done, lenders say. “Any sponsor who is relationship-based is trying to form a club and bring their relationship players into the group. For a smaller deal of $60 million and below, that is pretty easy to do,” Williams said. “When the credit markets were tight, it was difficult to find four lenders for a $50 million to $70 million facility. It is not so difficult right now,” Widra said. “The desire for assets has gone up so quickly that it is much easier to get everything done.” Steve Robinson at GE Antares Capital added, “The market is more receptive to new loans versus six months ago due to the excess supply of money chasing fewer deals.” Deals with EBITDA of $8 million to $15 million tend to be club deals that require two to five lenders. Those can get done relatively easily today, lenders say.

Hold levels

Lenders are selectively stepping up with larger hold levels and using their balance sheets, partly because there is a lack of deal flow, and they want to put assets to work into good companies, said several participants in our survey.

Bank hold levels are going up. Bank participants in our survey say that hold levels of the smaller regional banks are double the levels of what their norms used to be. “The only way to go and gain a greater share of outstandings is to go up in your hold level,” said one bank participant in our survey. As some institutions have gotten larger, given the size of the institution and their overall loan book, they feel more comfortable holding more because it is not as big in relation to their portfolio as it might have been a couple of years ago.

“We are seeing banks and institutions not wanting to hold more than $25 million or $35 million of senior debt in a leveraged deal,” offered a mezzanine lender in our survey. Most lenders want to hold $20 million to $25 million on their balance sheet, and selectively, if they find the asset that they really like, they will commit more. “Because there is more liquidity in the market, it allows you to speak for more, so you will see people speak for $25 million or $30 million, but everyone is holding $15 million or $20 million,” Widra added.

The active, long-standing players will have larger hold levels. “The higher end of our hold level is $45 million. Our OFS fund has allowed us to take up our hold sizes, and in certain situations, we can go above $45 million,” Williams said. “A typical hold size for us is $25 million to $30 million. If we are the agent on the deal, we will likely hold $30 million, if not more. If we are a participant, we are probably going to be closer to $20 million to $25 million.” Williams said a typical hold for most other participants is $15 million to $20 million.



State of Middle Market Financing in the U.S.

TERMS AND STRUCTURE

Terms

Loosening took place very quickly and has been most prevalent in the broadly syndicated market, where lenders are witnessing a come back in covenant lite and second lien structures. Lenders are seeing looser terms trickle down into the middle market, particularly at the upper end, marking the cutoff at $30 million in EBITDA. Some lower the cutoff to $15 million in EBITDA. Lower middle market lenders are also feeling pressure. Some say the market is maintaining discipline in the documentation and lenders are holding on to terms, while others say there has been creep.

Lenders say they are getting by asked sponsors that crossover between the large market and the middle market to have a starting point that is on the large market deals and structures. One lender in our survey offered the following perspective, "I reviewed a sponsor term sheet ask recently which was the most aggressive, 2007-large cap style position on all the small points. I do not think it will settle there, but the insertion of that pressure in the process inevitably leads to some softening across the board with respect to terms and structures." The lender added, "We continue to go through an education process as to why we don't think that is appropriate for middle market transactions. We have been able to successfully achieve that." "It is a delicate balance," added Andy Steuerman at Golub Capital. "There is always a point to where people want to draw the line on discipline. It really just depends on your perspective of holding a line." The difference, Steuerman indicated, is that typically in the larger market, the lead arranger is placing small amounts of loans with a large number of buyers, and in the middle market, there is a smaller number of buyers buying larger pieces, so they tend to be more focused. "There is more focus on the terms and conditions for someone who is writing their own $25 million to $40 million ticket than someone who is writing a $5 million to $10 million ticket," Steuerman said.

> "In the lower end of the market, there is a lot less room for error, so lenders are being conservative on the capital structure and on deal terms. If there has to be a tradeoff, lenders will be more willing to compromise on price than on structure."
>
> —Mike Foster
>
> Midwest Mezzanine Funds

Lenders say some of the terms that dictated a loose structure 12 months ago are making their way down to the middle market. Lenders gave the following as examples of larger market terms that are creeping into middle market deals ($15 million to $30 million EBITDA):

- Equity cures
- Accordions
- Delayed draw term loans
- Term B-like amortization in deals (citing 1% amortization for the term of the deal in certain situations)
- Step downs in pricing
- Elimination of Libor floors

If credit dynamics seen during most of the first quarter continue to stay strong, lenders say we may see begin to see that impact the smaller end of the middle market. Lenders do say there is more push back on smaller companies because of the market perception of credit risk. However, if the supply/demand imbalance persists, loosening could push down even further. "Pricing and structure changes are certainly present in the larger market. You are seeing fewer covenants and looser documents overall, and those changes surfaced a few months ago," commented Chris Williams at Madison Capital Funding. "We are already starting to see some of these terms make their way down to the traditional middle market." "You could see some willingness to loosen for relationship purposes on the part of commercial banks," said Ira Kreft at RBS Business Capital. "In many instances, that is where banks are competing, and they will play a little bit more of that relationship card."

Some lenders say the only material changes in the lower middle market have been in pricing and leverage. "In the lower end of the market, there is a lot less room for error, so lenders are being conservative on the capital structure and on deal terms," commented Mike Foster at Midwest Mezzanine Funds. "If there has to be a tradeoff, lenders will be more willing to compromise on price than on structure." Others say the market is trending toward looser covenant structures with fewer covenants and bigger cushions, although there are no indications that the lower middle market is reverting to covenant lite deals yet. As EBITDA gets larger, lenders are offering longer or stepped-up amortization on term loans, including structures with six or seven years on the amortization; slower amortizations with an excess cash flow sweep; and more single-digit amortization (citing sub 5 percent amortization). There also has been loosening on fixed charge coverage. One lender cited ratios of 1.1x–1.15x today, down from 1.30x a year ago.



State of Middle Market Financing in the U.S.

OUTLOOK

All the elements needed to support a healthy transaction environment are in place, creating a good dynamic for sellers of quality businesses:

- Middle market companies are performing well. Many have stabilized revenues and are showing positive growth, and with disciplined cost saving measures, saw profitability return to or even best pre-crisis levels. There should be motivated sellers.
- Corporations are sitting on surplus idle cash, and acquisitions represent the best use for those funds in the slow growth economy. And corporate acquirers are actively pursuing growth-oriented buys—a shift from the recovery mindset prevalent during the recession.
- Sponsors and lenders have ample capital and an ample willingness to put it to work.
- Structures continue to accommodate higher leverage levels—and market indicators suggest that trend is continuing—which will drive deal volume and valuations will rise.

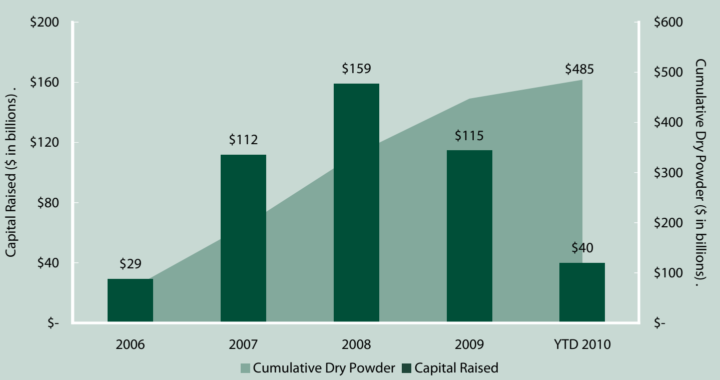
"It is a very good market to get deals done," said Preston Walsh at PNC Mezzanine Capital. "Buyers have a large amount of capital and can get leverage. There are sellers who have waited for earnings and markets to improve before selling. There are many drivers in favor of increasing deal volumes right now." "The economy has stabilized and is growing again, and there is less fear and anxiety, creating a good environment for deploying capital," offered Tom Gregory at Maranon Capital. "Overall, we think 2011 is going to be every bit as strong as last year." The consensus among lenders in our survey is that deal flow is coming.

Drivers of deal flow in 2011

Private equity will be a significant driver of deal activity in 2011. Billions in private equity capital remains unspent and needs to be put to work, and a growing number of sponsors are faced with aging portfolio investments that they need to monetize in order to return capital to their limited partners as they look to raise new funds this year. "Private equity's desire to deploy capital and drive liquidity and realizations in their portfolio is likely to produce a torrent of deal flow," commented Tom Gregory at Maranon Capital. "Private equity is selling. And private equity is buying. That is what is driving deal flow." Gregory pointed to the 1,200 private equity funds that will be in the market this year raising capital. They will all need to show realizations off of several years where there have been substantially none.

Private Equity Overhang

Buyout Funds Raised and Dry Powder



Year-to-date period as of October 31, 2010.
Source: PitchBook.

Average Time to Exit



State of Middle Market Financing in the U.S.

OUTLOOK

"The mix of companies coming to market this year will largely be private equity sellers and will tend to be broadly characterized as the cyclical businesses—the manufacturers and distributors that could not be brought to market in 2009 or 2010 because they were still recovering," commented Tom Gregory at Maranon Capital. "Therefore, I think we will see more cyclical plays in the market to be sold, and maybe they trade at a lower acquisition multiple compared to the business services and healthcare services companies."

More companies may seek minority sales this year, driven by the desire to monetize holdings but also remain partially invested for the future growth. "Management teams and business owners realize that there can be more growth in the future. Rather than give that up by cashing out entirely, many see the value in partially investing alongside a private equity sponsor to stay vested in the future performance of the business," offered Timothy Clifford at Amalgamated Capital.

Given the push for loan growth, dividend recaps are seeing continued support from lenders, so sponsors are taking advantage of the increased liquidity in the market to seek partial realizations in some of their portfolio holdings.

Caution

Structure

Lenders are being more cautious as the market transitions to higher leverage and tighter pricing. How aggressive structures get will depend on how hungry that initial surge of deal flow is and whether or not there are enough transactions to satisfy people—where supply and demand balances out. "We believe some patience in the roll out of 2011 will be helpful from a pricing and leverage perspective," Gregory said. "We don't think it is going to continue to erode. We think it will stabilize and perhaps improve." "We continue to believe that there is far more demand for capital than there is supply. We think spreads will continue to hold up and do not see leverage getting more aggressive," said Andy Steuerman at Golub Capital. "Could spreads stabilize in the L+450-500 range? Sure, particularly in the context of a L+300 spread historical average. I do not see spreads falling away from where they are and they probably do not widen a lot more either." "The issue will be where people go from a leverage standpoint," said Preston Walsh at PNC Mezzanine Capital. "Right now, I think people are still aware that lending at 5x or 6x did not make sense. The question will be if someone starts to go above the cap, call it 4.5x-5x."

Over the longer-term, lenders see a more positive supply and demand equation, pointing to the large number of refinancings that will occur over the next few years, as well as the expiration of reinvestment periods for most of the older vintage CLOs, that should soak up liquidity within the market and get supply and demand more on par. That is going to demand capital and will bring money off the sidelines whether through existing players or new players. Some lenders expect there to be less CLO liquidity among the existing providers which will begin to put some discipline on the larger segment of the market.

Economy

Concerns remain that a shock to an already fragile economy could stifle progress and inhibit momentum toward a more robust recovery. Adverse changes in the macroeconomic environment, with lenders citing inflation, geopolitical risks, and rising commodity prices as key areas of concern, have the potential to impact the availability of capital and impede deal activity. Lenders are cautiously optimistic that when the Fed pulls away its supports that the economy will be strong enough to withstand a substantial shock; however, economic growth is expected to be measured at best. "There is healthy skepticism, because while we are still aggressively putting out money, we don't feel like there is a huge bull market rushing behind us," Steuerman said. "We are trying to still keep our credit first view. We are looking at new opportunities and saying, if we double dip, would we be happy being in this company, and that is how we are still looking at everything."

Regulatory uncertainty

The passing of healthcare reform and Dodd-Frank last year present an uncertain regulatory and legislative environment. "I think there is still a lot of indigestion in the marketplace in terms of understanding the implications of these new laws for capital providers as well as portfolio companies," said Stephen Gurgovits, chief executive officer at F.N.B. Capital Corporation. "Uncertainty is not good for growth. It is harder to make strategic decisions, and it is harder to allocate capital."

Bulging pipeline

Lenders expect a glut of new issue supply could hit the market mid-year, which many see as a major challenge in terms of physical resources to process the surge in deal flow. Processing time will be elongated given constraints to handle the flow of transactions in the market, which will likely create opportunistic financing and buying situations as a more stringent selection process allows only the highest quality deals to close. Those that are playing the waiting game may lose some of their advantage if the window to today's seller's market closes.

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