Inside the Middle Market

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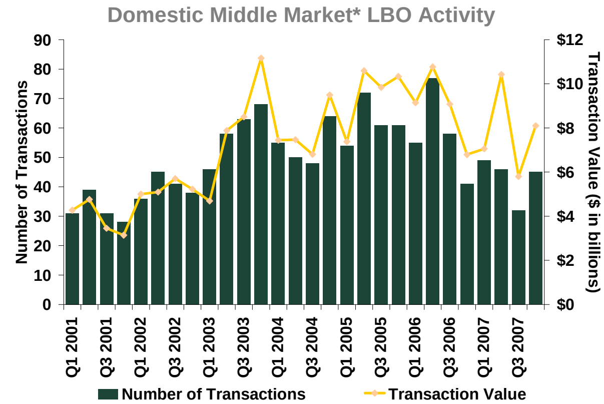
State of Middle Market Financing in the U.S.

Looking back

After the market correction

The middle market had been humming along, seemingly unscathed by the credit woes of the large leveraged buyout market, which experienced a sharp drop off in activity in the third and fourth quarters of 2007. The challenging credit market forced some private equity firms to move further down market, creating more middle market deal flow. Middle market M&A activity remained fairly steady and was bolstered by strategic buyer transactions. Although pricing had inched up and leverage multiples contracted slightly, credit availability and valuation multiples remained strong.

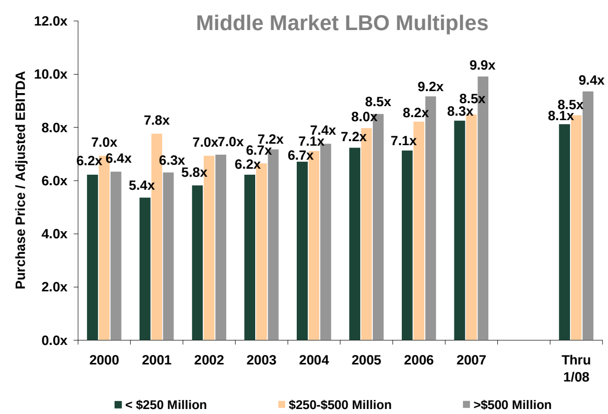


*Deal values between $25 million and $500 million

Source: Thomson Financial

Out of the gate

Middle market LBO activity is off to a promising start and is keeping pace with 2007 levels, with 35 transactions announced through February 2008 (vs. 30 in 2007) for a deal value of $5.0 billion (vs. $5.5 billion in 2007). Valuations continue to remain healthy.



Source: Standard & Poors LCD

What has changed

Fast forward six months. Economic conditions in the U.S. have worsened, and a recession is believed to be here or looming on the horizon. While empirical data does not yet confirm that we have entered a recession, many have already made the leap, asking the tough questions — how long and how deep will the recession be? Consumer confidence is at its lowest level in nearly 15 years. Still reeling from skyrocketing food and gas prices, many consumers have also seen their home values plunge, further reducing consumption. Housing market woes are expected to persist at least through this year. All of these factors have led to a general pullback in consumer spending.

The financial markets have not stabilized. The subprime fallout continues to rear its ugly head. Some of the largest global financial institutions are reporting substantial subprime-related losses, spooking leveraged loan investors and sending them packing, and the bleeding hasn't stopped. At recent count, an estimated 2 million mortgage holders will see their loans reprice this year. The Federal Reserve has taken substantive action hoping to breathe life back into the financial system, cutting rates in January by 1.25 percentage points — the largest one-month rate reduction in 25 years. And it is anticipated that the Fed will cut rates again. The Bush administration approved an economic stimulus package with the hope to boost spending. From Wall Street to Main Street, we all wait, wondering if these actions are enough to avert a recession.

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Has the middle market bubble burst? Looking at deals we have in market, we see a very different dynamic at work in the lending environment. We certainly have observed marked changes from six months ago when we last completed our survey of middle market lenders (BGL Inside the Middle Market, Sep. 2007). Most notably, credit scarcity is no longer limited to the large leveraged buyout market. Changes are taking place more swiftly, and the health of the economy is the pendulum that will cause the credit markets to deteriorate further if conditions worsen. That being said, many speak with reserved optimism that the middle market has proven its resilience and can weather this storm.

Where are they now?

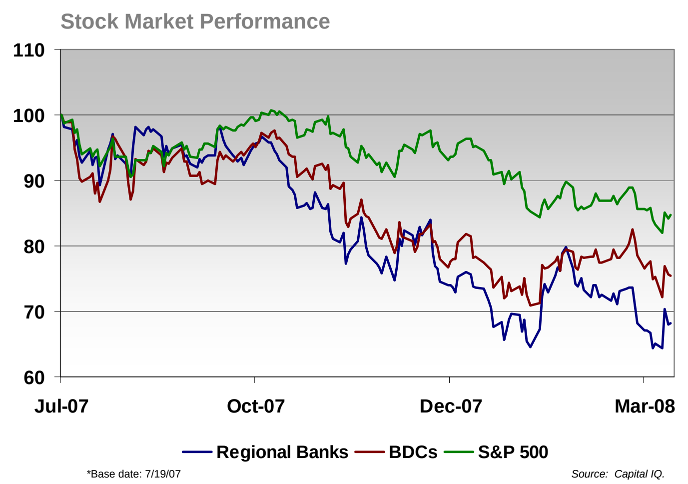
The biggest story of the lingering credit dislocation is liquidity. As we compare the field of capital providers today versus a year or even six months ago, we see a very different playing field in the senior lending community. Liquidity is much tighter than it was, and the demand for senior debt financing far exceeds supply. There are fewer "active" senior lenders, as some have retrenched or have been sidelined due to capital constraints. What is driving the supply/demand imbalance?

CLO vehicles, which were a major source of LBO funding in the last three to four years, have dried up. Warehouse lines have been pulled, and investors are not willing to put in new money, limiting the ability to take on new investments. In turn, some of the specialty finance companies whose primary funding was CLO or hedge fund capital have been sidelined. Leveraged finance groups of the major investment banks have temporarily shut down, and it is unclear when they will re-open for business. Market disruption from recent consolidation is also impacting liquidity. GE's acquisition of Merrill Lynch Capital took out a big mid market lender. There is also market uncertainty surrounding the future direction of regional commercial banks such as LaSalle under the helm of new owner Bank of America. BDCs, historically active players in the middle market space, have also come under some pressure due to recent market volatility, constraining their ability to access the public markets to raise additional capital.

The general sentiment is that commercial banks have pulled back. While this group has the financial capacity and the balance sheets to back them, banks have not been insulated from the subprime and housing crises and the health of loan portfolios will have a trickle down affect on corporate lending. And then there is the consideration that commercial banks are traditionally more conservative than cash flow lenders — even during the best of times.

*"I wouldn't quite call it a credit crunch. **Money is available**, and it's really quite cheap because of the lowering of rates that has taken place. What has taken place is a re-pricing of risk…leading to an unavailability of…"dumb money," of which there was plenty around a year ago."*

— Warren Buffett, February 2008



The public equity markets have spared no mercy on the financial services sector. Our peer composite index of regional banks is down 32% since the market correction last July. Similarly, BDCs are down 25% over the same period. With the equity markets in flux and stock prices down, capital is under stress.

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The good news

The active senior lenders are still telling us that the lending appetite is strong for quality middle market companies. "For active players, the market will not slow down. From a lending perspective, it could be a very strong year," says Mike Miller, Managing Director at Allied Capital Corporation ("Allied Capital"). Mr. Miller adds, "Lenders whose portfolios are in good standing and don't rely on the securitization market for funding will bring liquidity to the market." "Good deals will find capital," Trevor Clark, Managing Director at Madison Capital Funding, told us. "We are bullish about new business. It is a good market from an investment perspective. We are seeing much more favorable terms. Deals and structures are tighter and make sense," says Randy Schwimmer, Senior Managing Director and Head of Capital Markets at Churchill Financial. And the large commercial banks are telling us they are actively trying to grow loans.

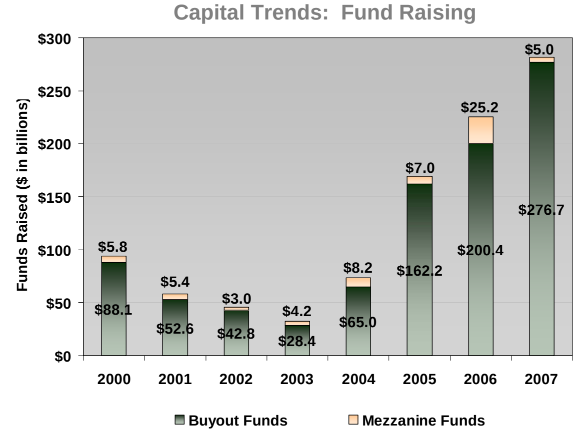
Mezzanine's return

While the second lien boom of the last two to three years has come to a "screeching halt," in the words of one lender with whom we spoke, the funding gap has created a resurgence in demand and opportunity for mezzanine. And as spreads between second lien and mezzanine have narrowed, mezzanine has become more attractive because it is viewed as more stable, patient capital. Mezzanine is seeing more deal flow and is taking a larger piece of the debt structure (ranging from 1.0-1.5x of total leverage). "Capital is out there for good companies," says Michael Foster, Senior Managing Director at Midwest Mezzanine Funds. "The availability of quality [mezzanine] deals is the highest it has been in three to five years [since the last cycle]," Mr. Foster adds. "It is a very compelling time to be doing business. We are in a better risk-adjusted place," says Christina Novicki, Senior Vice President and Director of Business Development at BBH Capital Partners.

Fund raising

The supply of mezzanine capital is healthy. New and old players are joining the mix — CIT Group, GSO Capital Partners, New York Life Capital Partners, and The Carlyle Group, among others — and are flush with capital from recent fund raises. GE Commercial Finance ("GE") and Allied Capital announced in December 2007 the formation of a $3.6 billion senior secured unitranche loan fund, with GE taking the senior and Allied Capital taking the junior capital portions of debt commitments.

We are also following on the heels of a record year in buyout fund raising — topping $276 billion in 2007 — which leaves substantial equity capital that will need to be put to work. Recent estimates from *Buyouts* put the figure at roughly $500 billion.



Source: *Buyouts*

Profiling capital providers

A class of buyers that brings some liquidity to the middle market include equity-backed special opportunity funds and finance companies. We spoke to a few, including Maranon Capital L.P., Bridge Finance Group LLC, and Laurus Capital Management LLC. These firms are institutionally-funded and offer one-stop financing solutions — from senior, subordinated, and mezzanine debt financing — and bring with them access to reliable, patient capital and a healthy appetite for financing middle market buyouts.

Maranon Capital L.P. ("Maranon") employs an integrated investment strategy, predicated on a one-stop financing capability, primarily in the lower middle market (companies with $5 to $30 million of EBITDA and enterprise valuations of $30 million to $150 million). With mezzanine financing as its core product, Maranon also provides senior cash flow loans and has the ability to make significant equity co-investments. Investment targets include non-sponsored transactions in partnership with management teams and private equity sponsored leveraged buyouts. Maranon's founding partners — Ian Larkin and Tom Gregory — are former private equity veterans from American Capital Strategies. At the time of this writing, Maranon is in the market raising its first $250 million mezzanine fund.

Bridge Finance Group, LLC ("Bridge") also targets the lower middle market. We spoke with Randy Abrahams, President and CEO, about what Bridge can offer in today's lending environment. "We have the balance sheet, enabling us to bring reliable capital for the right opportunities. We provide access to senior financing through our revolver and term loan products for a unique niche in the small- to mid-size end of the market and will underwrite senior facilities for companies as small as $4 million of EBITDA. We are efficient and can offer reliability in funding in very narrow time windows and bring certainty to close." Bridge continues to add to its growing list of success stories and shared with us this example:

Bridge partnered with private equity sponsor Pacific Onset in January 2006 to finance the acquisition of collection services platform, H&R Accounts Inc., providing $10 million in senior revolving/term loans. A year later, Pacific Onset approached Bridge again, looking to finance its first add-on acquisition, PMD, Inc., which would effectively double the platform. Bridge moved quickly, completing due diligence alongside the sponsor, and supplied an additional $10 million in senior financing to fund the acquisition. Today, the platform is performing well above expectations.

State of Middle Market Financing in the U.S.

Surveying Capital Providers

The credit markets are changing around us. We reached out to lenders to get a fresh look on the middle market — broadening our universe from the target group approached in our September survey (*BGL Inside the Middle Market*, Sep. 2007). We kept the framework for our questions constant, using "Company X", a desirable $10 - $15 million EBITDA company, as the acquisition target — to get a pulse on the credit appetite for middle market acquisition financing and to ask lenders where they see the market heading.

While a lot has changed, some things remain the same. Here is what they said:

Participating Firms

Allied Capital Corporation
American Capital Strategies, Ltd.
BBH Capital Partners
Black Diamond Commercial Finance, L.L.C.
Bridge Finance Group, LLC
Churchill Financial LLC
Dymas Capital Management, LLC
Fifth Third Bank Structured Finance Group
GE Antares Capital
Gladstone Management
GMAC Commercial Finance
Goldman Sachs Specialty Lending Group, L.P.
Golub Capital
Laurus Capital Management, LLC
Madison Capital Funding LLC
Maranon Capital L.P.
Midwest Mezzanine Funds
Northstar Capital, LLC
US Bank Middle Market Commercial Banking

Change in mindset

The days of liberal lending are over. "Before, every company could get financed and sold," commented one lender we interviewed. While most would not say lenders had been cavalier, there is definitely more scrutiny of deals in today's environment. Senior lenders are choosier about deals they want, and negotiating leverage has shifted even more in favor of lenders over borrowers.

Flight to quality. Marginal deals have gone away, and lenders are backing off if a company has a "story." As soon as you introduce "hair" into a deal (customer concentration, cyclicality, industry issue (s), capex), you see a ding in the capital structure. There are no more free passes. Lenders are more discerning about industries — looking at where a company is in the credit and business cycle and whether the business is demonstrably recession resistant. As we are heading into a downturn, there is more scrutiny of growth assumptions before buying into upside potential. Sponsors are "beating up" lenders on due diligence, requiring them to do more diligence on the front-end before going to term sheets. Tom Gregory, Managing Director at Maranon Capital adds, "Sponsors are scrutinizing company performance even more closely, looking hard at month-to-month trends, and to ensure company performance is holding up, are extending time to close."

Change in lending. Before the credit crisis, the debt markets were driven largely by velocity of investing rather than thoughtful investing, some lenders would argue. "Now we are seeing more normalized leverage opportunities. Lenders are discussing the appropriate leverage for the business — looking at debt in terms of what is best for the company, versus in the past, what the market would bear," commented Christina Novicki, Senior Vice President and Director of Business Development at BBH Capital Partners. Private equity will return to its roots, acquiring good companies and pushing the envelope on operational efficiency — as one cash flow lender we interviewed summed up, "Capital structure isn't what makes returns."



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Reducing risk

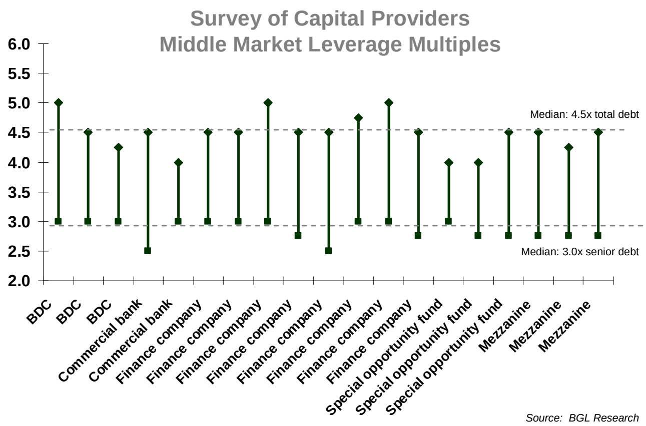
Less leverage. On average, leverage multiples have contracted a half to a full turn from six months ago:

- Nine of the 19 respondents in our March survey reported senior debt multiples under 3x (versus only two in the September survey).
- Nine of the 19 respondents are repeat participants from our September survey. Eight of the nine firms reported lower leverage multiples from September — reductions ranging from .25x up to .75x on senior debt.

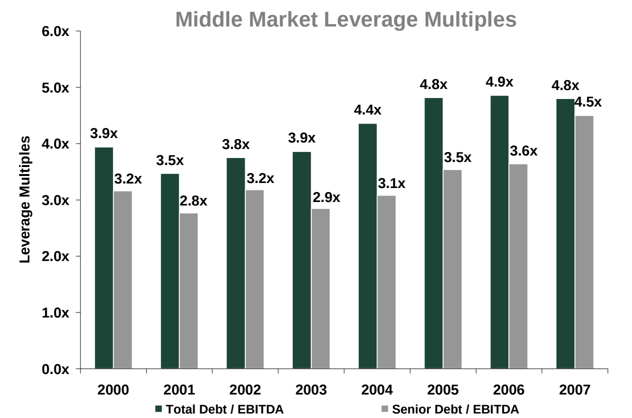
Because each opportunity is business and situation specific, there is variability in the leverage that businesses will fetch. What you will see is an adjustment in leverage for relative risk, plus or minus a quarter to a half turn depending on size, some lenders say. Because this market segment is less efficient, one lender offered, it is possible to get higher leverage for deals of this size (Company X). If you are a stand-out credit (emphasis on stand-out) of Company X's size, you might be able to stretch to 5x on total leverage, but that is the absolute upper end of what today's market will bear. We are seeing a return to conservative structures with meaningful amortization and reasonable and tight covenants. The days of covenant-lite and equity cures are over.

Size matters even more. Reduced depth in the market, as well as lenders reducing their hold sizes, has made financings above a certain size much more difficult to arrange. The issue becomes finding the lenders for the bank group. A $100 million financing is challenging in today's market and is in the minority, some lenders say. It may require cobbling together seven to eight lenders on a $100 million facility versus three to four on $60 million (Company X), making smaller deals easier to finance and more attractive to lenders now. For sponsors, which lenders are in the bank group has taken on added significance. An increased number of participants in a bank group adds complexity. Lenders speak to fundamental changes to the credit agreement and covenants. And often the last lender in is dictating terms on price and leverage.

Equity checks are getting bigger. On average, equity contribution has increased to 35-40% (in some instances topping 60%), with more equity equating to better structures and terms. One lender spoke to seeing equity levels at 40 – 55% routinely in deals. From the lenders' perspective, current levels reflect where equity should be.



Source: BGL Research



Source: Standard & Poors LCD

Club to close. Club deals are the norm if not the only way to get deals financed and closed. Some lenders are still committing to fully underwrite deals, but the consensus among lenders is that far fewer underwritings are getting done. GE Antares Capital will take on underwriting risk for the right middle market opportunities. Steve Robinson, Managing Director, told us, "It is a great time to be in business. We are still underwriting and have increased our hold sizes to offset liquidity issues in the market." Mike Miller, Managing Director at Allied Capital, adds, "We're bullish on the market opportunity. Few firms like Allied, via our unitranche fund, are able to underwrite and hold an entire facility. But, in most cases we are which should add value to sponsors in the M&A process." Sponsors are weighing the cost/benefit for the higher price tag. Underwriting fees have increased — 2.5% is the new 2% — but lenders contend there is enough liquidity in this segment of the market to forgo underwriting, unless time to close is an issue.



State of Middle Market Financing in the U.S.

Surveying Capital Providers

Repricing risk

Pricing is up on all debt tranches. The senior rule today — higher leverage means higher pricing, and sponsors are paying for it. "Standard pricing" at L+450 is setting the floor, but spreads have been seen ticking up to L+500 - 700 depending on the deal specifics. The 100+ basis point increase from six months ago may give some sponsors pause. However, when you consider how much Libor has dropped, the all-in rate today at L+450 (7.5%) versus six months or even a year ago at L+300 (8.5%) is very similar.

Interest rate floors are working their way into term sheets — some say not dramatically, others say emphatically that they are back. And lenders are saying floors are getting priced slightly in-the-money. If Libor continues to slide (many anticipate the Fed will cut rates again) dipping below 3%, interest rate floors will become a household term.

Pricing on second lien is up (L+750/900). Mezzanine pricing has not changed materially, despite the up tick in other debt financing. All-in rates of 14-17% were indicated in our survey, comprised of cash coupon (12%+) and payment-in-kind (2-3%+), anchoring more at 15%. Probably the biggest change is that mezzanine investors are asking for and getting equity co-invests. Warrants are coming back, and to quote one lender we contacted, "are no longer limited to smaller, "hairier" deals." We can expect to see more use of warrants if markets worsen.

At the end of the day, some lenders say there is a lot less pressure on pricing. Sponsors are more focused on "closability," and are willing to pay for certainty to close.

Valuation

Is 8.5 the new 10? As the credit markets repriced last year, valuation multiples were expected to adjust in lock step, though most lenders attest that is not the case. Michael Foster of Midwest Mezzanine Funds told us, "There has not been enough bad earnings news yet. When we start hearing actual bad news as opposed to expected bad news, valuations will start to fall." "For strong companies, multiples have not contracted. For "story" companies, multiples are most definitely down," another lender told us. "Purchase price multiples have come down, but not as much as would be expected — a half to a full turn at most," Randy Schwimmer, Senior Managing Director and Head of Capital Markets at Churchill Financial, commented.

Some lenders see beginning talk of price reductions, some believe in-process deals already reflect reduced valuations, while still others believe lower purchase multiples are still six months away. "We had been in a bull market for so long, sellers haven't caught up to the reality of where the market is," commented one lender, pointing to the disconnect between seller expectations and what buyers are able to get in financing, and thus willing to pay. To garner an 8x multiple with 5x leverage was a challenge even three months ago.

Lenders don't anticipate leverage multiple expansion in the foreseeable future, so we will reach an inflection point where seller and buyer interests will diverge. Sponsors will either be writing bigger equity checks and lowering target returns or purchase multiples will come down. Creative financing, one lender offered, may be the way to bridge the valuation gap. Dare we say seller notes or earn outs? These terms were virtually nonexistent in the M&A heyday of the recent past. The overwhelming response we received is that neither is to a lenders' liking. Lenders would rather see owner/operators rollover equity than use seller financing, because the former better aligns interests. Our experience has been that sellers would rather roll equity than take earnouts.

Sector outlook

'Stable and predictable' is in vogue, and the state of the economy is influencing where lenders pick their spots:

- Housing and related sectors are generally out of favor. Lenders are looking with a jaundiced eye at homebuilders as well as building products, particularly if selling into residential construction. Commercial construction is also getting a harder look.
- The softening economy and general pullback in consumer spending is causing lenders to shy away from retail and consumer-oriented discretionary businesses. Retail channels catering to lower income consumers are of particular concern as spending dollars are more at risk.
- Automotive is still very tough. Banks who have historically lent to auto in the past find themselves with extra hoops to jump through to get credit approvals.
- Consumer products may see more scrutiny. Lenders are concerned about consumer spending and are asking the tough questions — how defensible is the product niche, the degree of differentiation, stickiness of customers.
- The inflationary environment, coupled with slower growth, is making some food companies less attractive.
- Interest in cyclical businesses, on the whole, is down.



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Looking ahead

In our discussions with lenders, we identified two different camps when asking where this year will shake out.

We're still "peeling the onion." We have not seen all the fallout from the subprime crisis, and the jury is still out on the economy. Growth is slowing, and performance is likely to be flat, with certain sectors (healthcare and other growth sectors) faring better. If economic conditions worsen and credit markets deteriorate further sending default rates rising, we can expect to see more contraction. Lenders in this camp are searching for the bottom, estimating leverage will contract another quarter to half turn in the second half of the year. Pricing will not go down, but we have likely hit a ceiling.

Hoping for a softer landing. Corporate America is still healthy. Balance sheets are strong, and performance is not slowing as in previous recessions. Default rates are still near historic lows. Lenders in this camp are saying that pricing volatility is settling and that we have reached a stabilization period in leverage. Liquidity may improve slightly. "Several factors may lead to some loosening in the second half," says Tom Gregory, Managing Director at Maranon Capital, "Uncertainty in default rates is already priced into spreads. We will have more visibility on interest rates and the depth of a recession, and the debt overhang from the syndication bubble should be priced through and cleared." Capital needs to be deployed, and private equity can't stay on the sidelines. "For private equity, it is a great time to be carefully buying to take advantage of the credit markets," says Mr. Gregory. Drawing on parallels to the M&A markets of 2001 and 2002, he adds, "Had private equity been aggressively buying then, portfolio returns would have been phenomenal."

Although we may be heading into a recessionary economy, the general consensus is that the impact on M&A activity will not be as pronounced [as in 2001]. With less debt chasing deals, activity is likely to slow this year. Large cap buyouts will be sidelined, certainly through the first half and likely for the balance of the year. What does this mean for the middle market? It is an election year, and there is an expectation that capital gains treatment will change under the new administration, which may buoy M&A activity. With some private equity firms benched, strategic buyers may step up and seize this buying opportunity. The cheap dollar has made U.S. properties more attractive, and globalization trends will continue to drive cross-border activity. Deal flow should be steady, with the caveat that price expectations are fair, offered one lender.

The middle market may prove its resilience once again.



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