



Inside the Middle Market



September 18, 2007

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

Brown Gibbons Lang & Company

Cleveland

1111 Superior Avenue
Suite 900
Cleveland, OH 44114

Chicago

Two Prudential Plaza
180 N. Stetson Avenue
Suite 3600
Chicago, IL 60601

Boston

Two International Place
16th Floor
Boston, MA 02110

www.bglco.com

How Did We Get Here?

Observers have described the turn of events leading to today's credit squeeze as a "vicious cycle." From what began as liberal lending in a prolonged low interest rate environment, fueling the once-burgeoning subprime mortgage market, became a contagion that spread to other credit markets, most notably the leveraged loan market, to investors across the globe. Credit derivatives funding the now subprime bust — CLOs, CDOs — would permeate into the world of leveraged buyouts (LBOs), eventually making their way to the middle market spurring the growth of higher-yield second lien debt. Capital was poured into a new class of buyers in private equity deals — hedge funds — at a breakneck pace.

Cheap debt and flexible credit terms have been described as "rocket fuel" for the unprecedented level of LBO activity over the last two years. Private equity firms were the winning bidders in over 40 percent of mega LBO transactions, many involving household name companies, with transaction sizes increasing well over the \$5.0 billion peak of 2003 and 2004. Growth occurred at all levels — size of acquisition targets, size of transactions — fueled by record fund raising activity.

This complex web began to unravel when the U.S. housing market started to turn. The subprime mortgage market came to a screeching halt following sharp rises in delinquencies and a leveling out of housing prices. The major subprime players, largely unregulated lenders financed by securitized loans from Wall Street, have shuttered operations — first triggered by New Century Financial filing for bankruptcy protection in April, then the nation's second largest subprime lender. The subprime fallout is expected to linger for months to come as losses are realized when loans reprice. The equity markets have reacted in kind, sending the Dow Jones Industrial Average on a bumpy ride, plunging over 1000 points from a high of 14,000 in mid-July.

The credit boom/bust has resulted in a significant market correction over the last eight weeks, as investors now recognize the glut of overvalued and excessively risky debt products in the marketplace. CLOs have been particularly under fire as they account for over 50 percent of the money supply for existing transactions in the institutional and high yield markets. This lack of liquidity has stalled many of the "mega" private equity deals financed by Wall Street investment banks, with upwards of \$250 billion in buyout-related debt clogging the syndication pipeline, possibly forcing a massive sell-off of these large holdings over the next several months. Mega LBOs hitting the newswire like the repricing of Home Depot Supply by private equity consortium Bain Capital, Carlyle Group, and Clayton, Dublier & Rice, have stalled the market with onlookers wondering when the next casualty will surface. September and October will be critical months in setting the stage for future LBO activity as several mega-financings hit the market — First Data Corp., Alliance Data Systems Inc., and Manor Care Inc., among others.



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

Where Do We Go From Here?

What he termed a “period of transition for the financial markets,” President Bush has reassured investors stating that the economy can “weather any turbulence,” indicating that the current stresses on the credit and financial markets are “modest in relation to the size of the economy.” U.S. Treasury Secretary Henry Paulson also responded, saying in an interview with the Wall Street Journal, “The economy and the markets are strong enough to absorb the losses.”

Credit “Dislocation”

The subprime crisis should be viewed as a micro and not a macro problem, according to Diane Swonk, Chief Economist and Senior Managing Director at Mesirow Financial. In an interview with Bloomberg news, she pointed to continued soundness in the banking system, an improving lending market for prime borrowers, and rising FHA mortgage originations, a market that was virtually nonexistent during the subprime heyday, as positive indicators. In the same discussion, the subprime mortgage market was sized down to a small percentage (approximately 15 percent) of the overall residential mortgage market in the U.S. Even if you assume a worst case scenario unfolding in the subprime shakeout, it is not going to bring down the U.S. economy. In August 2007, President Bush announced plans to work with the Federal Housing Administration to aid borrowers hurt most by the subprime crisis; the market reacted favorably.

How does today’s turmoil compare to the credit crunch in 1998? According to Larry Meyer, former member of the Board of Governors and Vice Chairman, Macroeconomic Advisors for Goldman Sachs, what differentiates the severity of a credit crisis is by how aggressively equity prices fall. Looking back to 1998, the equity markets responded with a 19 percent drop in the Dow Jones Industrial Average (“DJIA”) versus a four percent drop this cycle. Many observers view the current credit tightening as more of a technical correction and believe the financial markets can absorb the recent shocks, avoiding a true “credit crunch” when the credit markets are frozen. One key indicator cited— default rates on corporate debt — are at a historical low.

Fed Intervention

The Federal Reserve has said it will act to avoid a recession. Its first move in August was to lower the discount rate, injecting over \$60 billion dollars in temporary funds to the banking system over a two-day period. The market will be tuned in on September 18 when the Fed meets next, many anticipating a cut in the federal funds rate to stimulate the economy. Diane Swonk, in the September 2007 “*Themes on the Economy*” newsletter, stated, “Historically, economists have overestimated the costs associated with financial crises and underestimated the rebound in growth. The stimulus created by a crisis-induced easing of monetary policy, in particular, is significant. Economic growth in both 1988 (the year after they stock market crash of 1987) and 1999 (the year after the Russian debt debacle and the failure of LTCM) exceeded 4 percent.” In summary, the economy should again prove its resilience.

Looking Ahead

Although the U.S. equity markets remain relatively volatile, they have shown indications of recovery. The DJIA is up just over seven percent year to date, coming back nearly 600 points from the mid-July market correction. What about the future of private equity? The private equity industry is not over, one observer noted; there will just be noticeable changes going forward. Leveraged buyouts will look and feel different. Deals sizes will be smaller. Prices and leverage will be lower. There will be more scrutiny; private equity buyers will be taking a closer look at underlying companies. Industry observers cite strong performance in private equity portfolio companies. This confidence, coupled with an abundant amount of capital to be deployed, should provide the buoys to move deals forward.





Inside the Middle Market

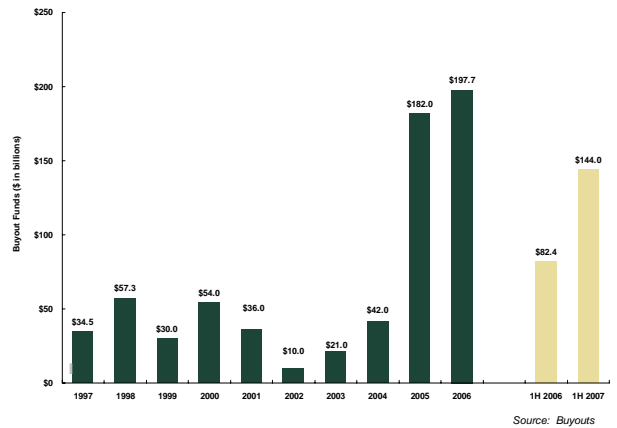
State of the Middle Market Financing Markets in the U.S.

M&A in the Middle Market

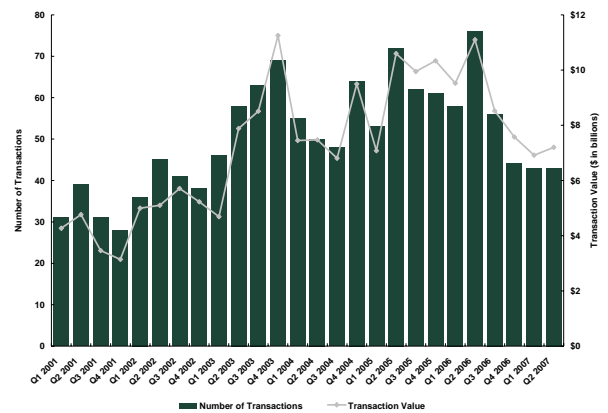
Before the correction

The typical questions we encounter from entrepreneurs and owners of middle market businesses about mergers and acquisitions, such as “What is my business worth?” and “When is a good time to sell” perhaps take on even more meaning in light of recent market events. Available transaction data on the middle market before the correction point to a robust M&A market, supported by record levels of capital raised from the private equity community, healthy valuation multiples, and significant depth in financing sources.

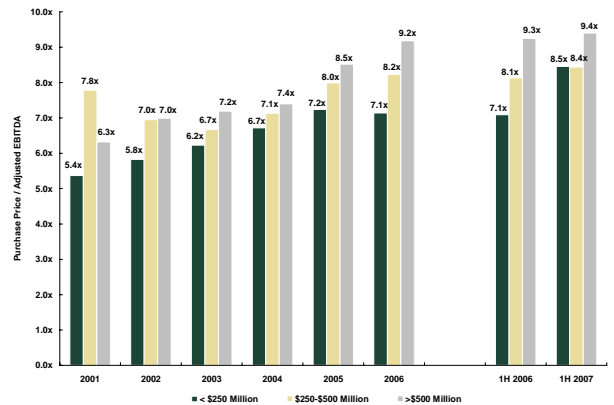
Capital Trends: Buyout Funds Raised



Middle Market* LBO Activity in U.S.



Middle Market LBO Multiples





Surveying Capital Providers

How has the credit squeeze trickled down to the middle market and how is it impacting deals? To shed light on these questions, we surveyed various capital providers representing a cross-section of the capital structure — from senior cash flow and asset based lenders to subordinated debt and mezzanine investors — to gain insights on how current market conditions are impacting middle market M&A.

To better define the middle market for purposes of our survey, we framed our questions using a hypothetical \$10 - \$15 million EBITDA company (“Company X”) possessing all the attributes of a desirable acquisition target: favorable growth profile and margin performance; diverse customer base and end markets; strong and deep management team; attractive industry profile; no outstanding issues. In this example, we specified the company’s asset base would dictate a cash flow deal. We asked participants for a barometer on current pricing, structure, and appetite to finance an acquisition of Company X in today’s deal environment. We identified several resounding themes from our discussions.

Participating Firms

- BBH Capital Partners
- Black Diamond Commercial Finance, L.L.C.
- Dymas Capital Management, LLC
- FirstLight Financial Corporation
- Freeport Financial LLC
- GE Antares Capital
- GE Commercial Finance
- Gladstone Management
- GMAC Commercial Finance
- Goldman Sachs Specialty Lending Group, L.P.
- Hercules Technology Growth Capital
- Madison Capital Funding LLC
- MFC Capital Funding
- Midwest Mezzanine Funds
- Northstar Capital, LLC
- PNC Business Credit

Flight to Quality

Good news. Quality middle market deals are still getting done. Referring back to Company X, Trevor Clark, Senior Managing Director at Madison Capital Funding LLC adds, “Quality deals (of this size) can and will clear the market.”

The standard questions when evaluating middle market businesses have not changed. The review process has just become much more selective. What will differentiate one company from the next will be the value proposition:

- How viable is the business?
- What is the strength of the franchise?
- How defensible is the market position?
- How compelling is the story behind the cash flow generation?

Sector focus

No noticeable sector shift is taking place; none of the interviewed firms indicated they have exited specific industries. All firms we spoke to are taking an ‘eyes wide open’ approach on housing and related sectors, consumer-oriented discretionary, and automotive — which has gotten even tougher. General manufacturing and distribution are still pretty solid, with healthcare even in more favor now.





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

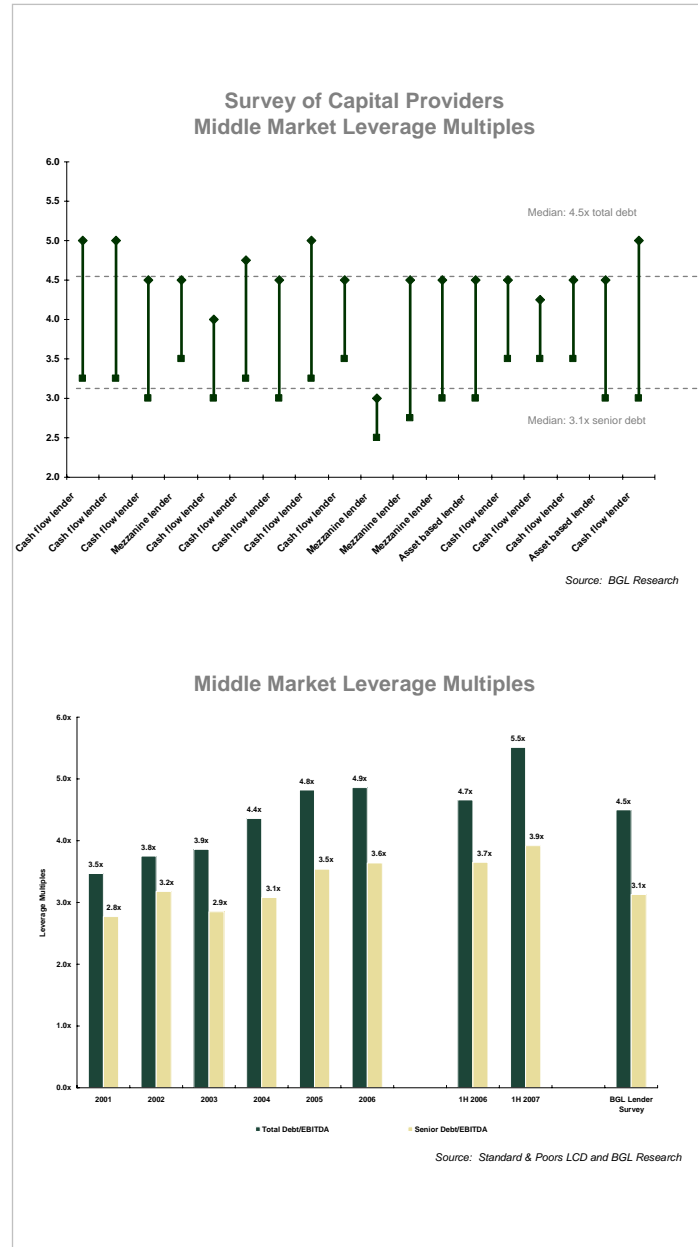
Less Leverage

One message is clear; the trend now is lower leverage. Today's buyer will be more rational and balance sheets will look more conservative. Hugo Gravenhorst, Managing Director of Black Diamond Commercial Finance, LLC, stated "We are going to see a disciplined lending environment for the next twelve months. Sellers waiting for the lending market to get frothier may be on the sidelines." Leverage multiples have come down a half to a full turn from the 4x senior/6x total debt levels seen three months ago. In the chart provided is a tally of results on the current leverage appetite for Company X. On waiting for expansion in leverage multiples, John Tilson, Managing Director & Principal at Brown Gibbons Lang & Company said, "Time may not be your friend. Capital gains and carry tax rates will be under intense review before and after the 2008 election."

Lenders are taking a more cautious approach to pure cash flow loans. Businesses with a low base of leverageable assets are harder to finance. "For pure service companies with no assets, we could not get there," stated one cash flow lender we interviewed.

Negotiating leverage has shifted from the borrower to the lender. On the recent de-levering of the credit markets, Mr. Gravenhorst commented, "It should become a more favorable market for lenders. Lenders should start seeing better terms. Discipline will force a return to "old school" credit packages with meaningful amortization and tighter covenants." Covenant cushions are returning to 15 to 20 percent, a decrease from 30 percent levels prior to the correction.

"Covenant-lite," a term not as widely seen in lower middle market transactions, will come back in the next few years, one respondent noted, appearing more like "old-fashioned" asset-based lending - no covenants only if there is a hard-core borrowing base.





Inside the Middle Market

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

Availability of Capital

We are not in credit clamp down,” suggests Michael Foster, a Senior Managing Director at Midwest Mezzanine Funds. The playing field has just changed. Club transactions are more the norm and for larger mid market deals likely the only way to get deals done. “No one is taking post closing syndication risk,” one respondent told us. According to one cash flow lender we interviewed, the club market can be an easier way to effectively raise a bank group, and in deals like our Company X example, with two to three lenders providing financing. Club transactions may be sponsor-specific as some private equity firms may have a few really good relationships with lenders. Sponsors will be deliberate about who the lenders in the bank group are as completion of deals is more important. Lenders, in turn, may choose to provide financing on a club basis as a way to spread risk and still participate in quality deals — accepting lower spreads to do so.

“The market hasn’t changed materially in this space,” commented Joe Bute, Managing Director of Gladstone Management. “Typical players in this segment of the middle market are not capital constrained right now.” These players — banks, finance companies and other like capital providers — have been less affected by the contagion that is permeating the large senior loan markets. Referring to Company X, some of the firms we spoke with expressed a willingness to fully underwrite deals like this today, indicating their interest in such transactions has not faltered pre- or post-correction. “We will take the underwriting risk for very good companies,” one respondent noted.

“Capital will still be available to some firms, but because of the increasing scarcity of this capital, suppliers will demand better pricing and terms, and will likely get it,” one cash flow lender told us. Pricing on senior has increased 50 to 75 basis points from three months ago, with a blended rate now edging up to L + 400/450.

Doug Zwiener, Senior Vice President at PNC Business Credit commented on asset based lending (“ABL”) during this transition, “The (transition) has been good for us. The current situation allows ABL to become an alternative for equity sponsors getting 3 – 3.5x leverage now versus 4 – 4.5x before using more traditional cash-flow lending sources. With a tightening in senior secured financing liquidity available to equity sponsors, sub debt or equity will need to increase or purchase multiples may decline.”

Second lien appears to be getting hit the hardest. The ramp up in second lien over the last two years has seen a dramatic drop off as primary funding sources (CLO’s, hedge funds) have dried up, as one firm interviewed noted that CLO capital is non-existent at the moment. Some of the firms we spoke to still see a market for second lien but a much less active one based on cost relative to risk position and relative value to alternate investments. Second lien pricing has increased 100 - 150 bps from three months ago, with firms we interviewed quoting a range of L+ 600 - 800 without interest rate protection. One firm noted that the market is heading in a direction where second lien disappears entirely or diminishes in importance and use.

Mezzanine making a comeback

The trend toward more traditional capital structures in deals will mean more play for mezzanine providers, who have been somewhat crowded out during the M&A frenzy of late. Jason Van Dussen, Managing Director in the Capital Markets Group at FirstLight Financial Corporation told us, “Senior lenders are more comfortable with mezzanine. Depending upon how deep mezz will go, an additional quarter to half turn on total leverage is possible.”

The mezzanine market is getting ready. With more stable funding sources (insurance companies, pension funds), funds are flush with cash with the capacity to invest. Michael Foster of Midwest Mezzanine Funds sees a substantial market opportunity for the mezzanine market. “Mezzanine is more practical when credit markets are in flux and during challenged economic times. Timing is better now for mezzanine than it has been in four years.”

We are starting to see an uptick in mezzanine financing as spreads between second lien and mezzanine narrow. One respondent in our survey added that for those deals that initially went to term loan B and second lien lenders, it is now more practical to go the mezzanine route given today’s pricing environment. Mezzanine is more patient capital, typically with a longer hold period. Current mezzanine returns are driven from cash coupon (12%+) and payment-in-kind (“PIK”) (2%+). Pricing has been ticking up in the last few months; all-in returns of 14-18% were indicated in our survey. Mezz providers we spoke to do not see cash coupons changing; rather, pricing structures will include more PIK. Firms we interviewed do not see a return to warrants as too much capital is still available. Mezz players are also seeing more opportunities to co-invest alongside equity sponsors.





Inside the Middle Market

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

Size matters

The “bigger is better” adage as it applies to EBITDA levels, equating to greater scale and market position, typically attracts a larger lending pool. With the recent tightening, we have hit a more level playing field. There is a very real stratification right now in terms of appetite and availability of capital for deals.

Companies with less than \$20 million in EBITDA are easier to finance and more attractive to lenders now. Deals involving companies of this size still attract capital providers who can take the whole commitment on a fully underwritten basis, or alternatively, financings can be readily completed on a club basis. Once EBITDA exceeds this threshold, some lenders today may begin to steer away. Reduced depth in the market has made financings above this size more difficult to get done. Best-efforts are more prevalent on underwritten deals with significant structure and pricing (50-75 bps) flex language built in. Underwriting fees have also increased, edging up to 2 percent.

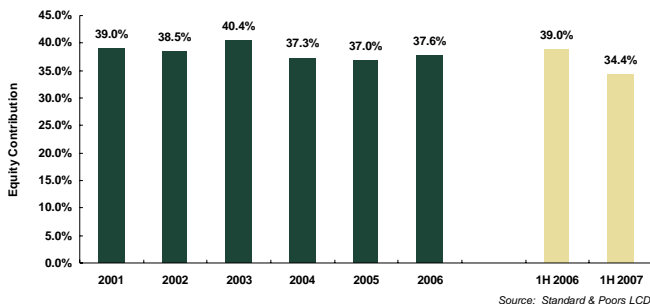
Contraction

With leverage multiples coming down and deals becoming more expensive, it is realistic to expect to see some contraction in valuations or bigger equity slugs forcing buyers to accept lower returns. “Purchase prices are down but not down a lot,” said Timothy Lyne, Senior Managing Director at GE Antares Capital. He added, “As you would expect, purchase price multiples have come down in line with leverage multiples. For very good companies, the debt multiple may come down a half turn, and for story companies that multiple reduction may reach a full turn.” (“Story” companies being those with issues, e.g., customer concentrations, noise in financials.) “You can loosely peg purchase price multiples to contract a multiple of up to 1x. This is company-specific, moving that multiple a half turn up or down depending on the profile of the business,” says Jason Van Dussen, Managing Director in the Capital Markets Group at FirstLight Financial Corporation. Most of the respondents in our survey indicated there is anecdotal evidence of this already taking place, but the proof will be in the numbers as more deals close in coming months.

Bigger Equity Checks

All respondents cited increasing levels of equity needed to get deals financed and expect this trend to continue. Don’t expect to see less than 30 percent equity in deals going forward, and for more capex-intensive businesses, that percentage could exceed 40 percent. One respondent cited two deals in the pipeline that were structured with as much as 50 percent equity.

Average Equity Contribution for LBOs



Source: Standard & Poors LCD

Buyers looking to pay less cash upfront in the purchase price will look for other ways to bridge gaps in valuation. Mark Denomme, Managing Director at Hercules Technology Growth Capital, commented “Rollover equity is an important factor not only to private equity firms, but also to lenders and will come more into play now in funding transactions.” If management and/or selling shareholders roll over 15 - 20 percent equity in the new company, it sends a strong message to lenders that management believes in the company’s growth story. It also represents a sizable equity stake leaving management with “skin in the game” and a vested commitment to growing the business.

Structured earnouts and seller financing, although not as commonly used in the recent M&A boom, are other vehicles used to bridge value shortfalls and may begin to see more traction.





Looking Ahead

How long will the tightening persist and have we reached a bottom? One respondent to our survey commented, “The markets reflect a technical correction. We have not entered into a true credit cycle where things will get even tighter.” One analogy likened the degree of severity of the correction to a cold (short-lived, lasting three to six months) versus a flu (longer in duration and more severe, with the affects prolonged into next year). The reality is that this credit cycle will take some time to work through and has created a different dynamic in the lending environment. The consensus view from our survey is that we won’t see leverage multiples expand in the next three to six months and pricing will remain at current levels for the foreseeable future. Conditions will worsen if there is wider concern of a recession.

Pre-correction, the middle market has seen its highest level of activity since 1999. “From a historical perspective, the window of opportunity for sellers is still open — values remain high and both financial and strategic buyers continue to be aggressive on both value and terms,” says Andrew Petryk, a Managing Director & Principal at Brown Gibbons Lang & Company. And middle market deals are still getting done. Private equity capital is still plentiful and needs to be put to work, and there is a lending pool available that wants to finance acquisitions of high-quality middle market companies. Likewise, corporate/strategic buyers who don’t require the same financing for acquisitions and who may have been crowded out by private equity before will be coming to the market.

A more pessimistic view of the market — one respondent commented that if you consider potential market volatility, the pending election, threat of war, and other exogenous factors, it is a good time to sell now. Interest rates are still low, and capital gains rates are still very low. Do you play the multiples game and bank on EBITDA growth for a higher valuation in twelve or eighteen months? The unknowns may not tip the scale in favor of that move. The consensus view from our survey of lenders — if the sale decision has been made, there may be more value at risk with a wait-and-see approach. Steve Montross, Senior Managing Director at FirstLight Financial Corporation, adds, “Assess how company performance will be impacted if the economy worsens. Will there be fundamental growth in the business? If a seller expects to be able to receive a fair price, he/she should endeavor to sell now. By waiting, you run the risk that negative developments such as a worsening economy or market credit concerns could emerge and close the sale window.”





Global Leaders

Brown Gibbons Lang & Company is a leading independent investment bank serving middle market companies in the U.S. and internationally. Founded in 1989, BGL has remained true to its mission of delivering corporate finance solutions to companies with enterprise values between \$50 million and \$500 million.

What We Do

- Mergers & Acquisitions
- Debt & Equity Placements
- Financial Restructurings

Industry Expertise

- Automotive
- Business Services
- Chemicals
- Construction Materials & Building Products
- Consumer Products
- Food & Beverage
- Healthcare
- Industrial Products & Manufacturing
- Metals & Metals Processing
- Plastics & Packaging
- Transportation & Logistics
- Wholesale Distribution

Global Access

As the exclusive U.S. partner of Global M&A, BGL has access to global buyers, sellers, and financing sources throughout North America, South America, Europe, Asia, and Australia that is unparalleled in the middle market.



www.globalma.com

parent of

has been acquired by

Select Members of Management and Certain Shareholders

has been acquired by

Tiger Global Management, LLC

has been acquired by

has been acquired by

has been acquired by

TINICUM CAPITAL PARTNERS II, L.P.

An Undisclosed Provider of

Inland Marine Transportation and Logistics

has been recapitalized by

A Private Equity Investor

a portfolio company of

has been acquired by

Cookson C

has divested substantially all of the business and assets of

to

BGL Contacts

Michael E. Gibbons
Senior Managing Director
& Principal
mgibbons@bglco.com
216-241-2800 x212

John R. Tilson
Managing Director
& Principal
jtilson@bglco.com
312-658-1600 x224

Rebecca A. Dickenscheidt
Director of Research
rdickenscheidt@bglco.com
312-513-7476

BROWN GIBBONS
LANG & COMPANY
INVESTMENT BANKERS

www.bglco.com

The information contained in this publication was derived from proprietary research conducted by a division or owned or affiliated entity of Brown Gibbons Lang & Company LLC. Any projections, estimates or other forward-looking statements contained in this publication involve numerous and significant subjective assumptions and are subject to risks, contingencies, and uncertainties that are outside of our control, which could and likely will cause actual results to differ materially. We do not expect to, and assume no obligation to update or otherwise revise this publication or any information contained herein. Neither Brown Gibbons Lang & Company LLC, nor any of its officers, directors, employees, affiliates, agents or representatives makes any representation or warranty, expressed or implied, as to the accuracy, completeness or fitness of any information contained in this publication, and no legal liability is assumed or is to be implied against any of the aforementioned with respect thereto. This publication does not constitute the giving of investment advice, nor a part of any advice on investment decisions and nothing in this publication is intended to be a recommendation of a specific security or company, nor is any of the information contained herein intended to constitute an analysis of any company or security reasonably sufficient to form the basis for any investment decision. Brown Gibbons Lang & Company LLC, its affiliates and their officers, directors, employees or affiliates, or members of their families, may have a beneficial interest in the securities of a specific company mentioned in this publication and may purchase or sell such securities in the open market or otherwise. Nothing contained in this publication constitutes an offer to buy or sell or the solicitation of an offer to buy or sell any security.