



MIDDLE MARKET INSIDER

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The Global M&A Middle Market Insider is published by Global M&A, one of the world's leading independent M&A advisory firms. Specialized in the middle market, we provide support and opportunities locally and internationally for clients buying or selling companies as well as financings, corporate restructurings and other corporate finance transactions.
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State of Middle Market Financing in the U.S.

Overall, 2009 was a year of gloomy headlines, red ink, and few closed deals. Middle market M&A declined sharply with the recessionary economy and banking industry crisis which all but shut down the credit markets. Business owners were operating in survival mode, conserving cash and right sizing their operations to navigate the downturn.

While *good* deal flow slowed to a trickle for the better part of 2009, lenders said the market began to open up in the fourth quarter. It may be too soon to mark a turnaround for M&A; however, a meaningful uptick in deal flow and improved quality have market participants more optimistic about future prospects. Signs of life appear to be returning to the deal market.

To be sure, few expect to see a slingshot effect out of the Great Recession. It is expected to be a modest and slow recovery. However, there has been a shift in sentiment among market participants. The pit is no longer bottomless. Panic and fear have largely subsided. The economy is stabilizing, so there is better visibility in earnings and business prospects for middle market companies. Confidence is returning.

There is pent up demand in the market among sponsors and lenders alike; a forced 'diet' has left them hungry for new deals. Credit is returning. Capital providers are heading into the new year with cautious enthusiasm, with mandates to grow middle market lending. These green shoots of optimism might point to steady deal flow in the middle market in 2010.

“The whole spectrum is coming together. You have more liquidity than you had a year ago. Capital providers have more visibility and as a result are gaining more confidence and an increasing willingness to make investments. Additionally, sellers’ expectations have become more reasonable.”

– Timothy Clifford
Amalgamated Capital

Participating Firms

Amalgamated Capital	Maranon Capital, LP
Babson Capital Management LLC	Northstar Capital, LLC
BB&T Capital Partners	PNC Business Credit
Fifth Third Bank Structured Finance Group	TriState Capital Bank
GE Antares Capital	US Bank Business Credit
Golub Capital	Wells Fargo Capital Finance
Madison Capital Funding LLC	

State of Middle Market Financing in the U.S.

The market is reviving but is still not incredibly active, so lenders are picking their spots and are being aggressive on certain deals. While the lender ranks may have thinned, those with capital are looking to put money to work in good middle market deals. Several lenders tell us in interviews that their current deal flow is strong, with many starting the year with a healthy pipeline. This may be a good barometer of future deal activity for an M&A market that can only go up from here.

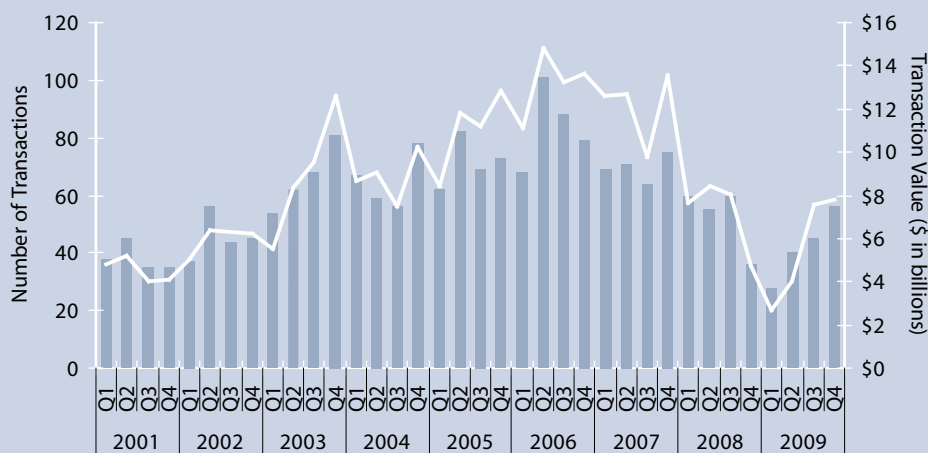
How are middle market businesses faring through the downturn? What are the drivers to getting deals done in the current environment? In this edition, we revisit our discussion of the state of the financing markets by reaching out to capital providers to gain insight into these and other questions from the vantage point of an investor in the middle market – looking ahead to what it means for middle market lending and deal making in 2010.

“For a good company, there was money. There had to be a willing seller and a willing buyer, and that was really more the challenge than there was no financing. The financing was more expensive and it was more conservative, but it existed. But the sellers wanted their price, and the buyers wanted a discount, so you couldn’t get a deal done.”

– Andy Steuerman
Golub Capital

Historical Middle Market LBO Activity

Quarterly LBO Activity



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

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Liquidity Slowly Improving

It is a dynamic environment. Everyone has faced challenges and issues due to the severity of this business cycle. "2009 was not a year of long, slow, rolling trends in the credit markets," said one lender we interviewed. It went from nobody in the market to everybody in the market. Calling it a 'whipsaw effect,' lenders came in and out of the market, in some cases taking heavy hold positions and pricing very aggressively on the very few high quality deals that came to market.

We polled participants, asking them, 'How large is the universe of active middle market senior lenders?' Steve Robinson, a managing director at GE Antares Capital, told us, "To truly lead deals, I might say 25. That number will include a lot of banks. On an individual deal, it may be closer to 10. You eliminate a lot of banks if there is not an angle for them." Andy Steuerman, a senior managing director at Golub Capital, offered, "The universe is not that frothy. I would look at it as an 'on appointment' basis. You have to look at every situation uniquely. If you get to what I would call lead arranger senior lenders, there are probably 5."

There are fewer active senior cash flow lenders that dot the landscape and fewer new entrants to the market than there were a year ago. It is more about flight to quality and who has been around. However, while the number may be fewer, it is growing. Credit appears to be slowly returning. Mike Klofas, a managing director at Babson Capital Management LLC, commented, "In the early part of 2009, you had less than a handful of senior lenders who expressed any interest in middle market lending – maybe two or three. Clearly now there have been more coming back into that market. There are probably at least a dozen or so active participants lending money." Steuerman added, "For a really good company, we never left the market, and in every quarter, we did a new deal. 2009 was a good year for us – we finished the year as the number one lead arranger." With the goal to deploy \$1 billion in middle market debt financing this year, Golub Capital will be active. Steuerman added, "We are still going to be a top three player permanently in the market, and I expect us to have more activity than we did last year."

"From a lending perspective, having an economy that has at least bottomed out gives you some basic ability to underwrite cash flows being presented, making it much easier to deploy capital."

– Tom Gregory
Maranon Capital, LP

"Credit is becoming more abundant for quality companies. I think people are willing to come back into the market for companies with a better risk profile."

– Mark Kiskorna
PNC Business Credit

Commercial banks on the sidelines are coming back. "We are seeing commercial banks coming back more and more," Robinson said. "The question is going to be, as multiples creep up higher, will that pull the banks back. When senior leverage is 2.5x, it is a lot more attractive business for the banks," Robinson added. Established relationships and footprint are essential for the banks. Banks are no longer going out of footprint and are really tightening their lending parameters. The consensus, however, is that banks will step up and be more active this year. "Liquidity is coming back, mostly from the regional institutions and the national banks that probably have aggressive budgets going into 2010. They are flush with cash, which is driving the recent trends in higher leverage and lower pricing," said Timothy Clifford, head of Amalgamated Capital.

Regional banks are stepping up and filling some of the shortfall. TriState Capital Bank (TriState), a regional player in Northern Central Ohio, had a very active year in 2009, ranking as one of the top lenders in private equity according to PitchBook. "Last year, we grew by approximately 50 percent over 2008 levels, said Andy Randall, President of the Ohio region at TriState Capital Bank. Randall added, "We intend to be active in 2010. If we grow similar to 2009 levels, we will be very happy." TriState reported loans of \$1.3 billion in 2009 – sizable growth from \$180 million in 2007. Leveraged lending accounts for a growing percentage of TriState's loan portfolio.

Asset-based lenders continue to fill some of the void left by the senior cash flow market. Looking back to 2009, one respondent told us, "We have done more deals with asset based lenders than any prior year out of necessity more than anything else because they were the only game in town." Asset based lender PNC Business Credit has been active. Mark Kiskorna, a senior vice president, told us, "Our deal flow is very strong, and we anticipate it will continue to be strong. As M&A has pulled back slightly, it is being filled with refinancings and restructurings. Kiskorna added, "Some sponsors would never have considered an asset based

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lender because they have always had cash flow lenders lining up. They are talking to us not only for new deals but also to help provide portfolio solutions – for example, allowing a portfolio company to have a committed facility to operate the business and implement a restructuring plan.”

The Lower Middle Market

New entrants hold the promise of bringing more liquidity into the lower middle market. Amalgamated Capital, the newly formed sponsor finance division of Amalgamated Bank, made its entry to the market in September of last year. “Given the general dislocation in the market, we saw an opportunity to launch a business at an extremely opportune time. In the lower middle market, you have less supply, lower leverage, and higher returns,” said Timothy Clifford at Amalgamated Capital. Clifford is targeting companies with EBITDA of \$3 million to \$20 million across a broad range of industries.

Clifford timed his entry when lenders had either retreated or exited the lower middle market all together. It is very hard to find financing on small deals; there are not a lot of lenders starting to come back into the market. Some lenders commented that six months ago, there were no cash flow lenders looking at companies with \$5 million to \$10 million in EBITDA, versus two years ago, when the lender universe that would do a minimum of \$5 million was much larger. The market is shallow and more a play for regional banks, some lenders said. Clifford said, “Below \$5 million, there really is no one other than us and maybe regional banks.”

Amalgamated has the advantage of a flexible and stable capital base. “It is not coming from the CLO market. It is not coming from a warehouse facility. It is coming from an old-fashioned depository base,” Clifford said. Since September, Clifford’s team has closed three deals and has two more pending this year, with plans to deploy \$100 million in capital in 2010.

“You have a greatly reduced number of players looking to offer capital, and with deal flow down, when the attractive businesses do come to market, there is a lot of competition among the active players to try to win those mandates.”

– Chris Williams

Madison Capital Funding LLC

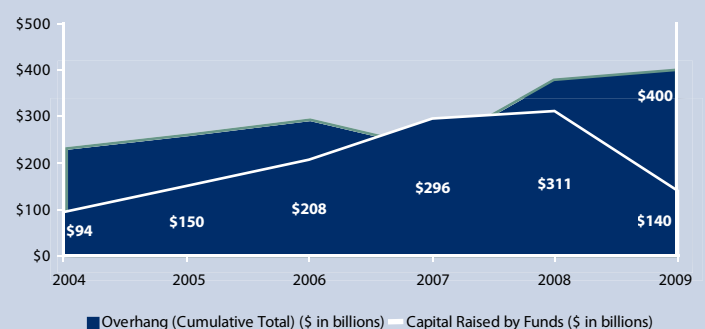
The current dislocation is also benefiting active players that target the small deal market. “We are extremely active in the lower middle market space,” Chris Williams, a senior managing director at Madison Capital Funding LLC said, estimating that roughly one-quarter to one-third of the lender’s portfolio is financings for companies with targeted EBITDA of \$5 million to \$10 million. The middle market lender also has the advantage of stable, patient capital with parent company New York Life Insurance Company, “...one of the few Triple-A rated financial institutions, which has been a godsend for us,” Williams added. Andy Steuerman at Golub Capital commented, “We tend to be very active in the lower end of our range, or companies with \$5 million to \$15 million in EBITDA, because of our capital base.”

The Capital Conundrum

The middle market needs new players of some scale to bring much needed capacity to fund deals. The conundrum, said Tom Gregory, a managing director at Maranon Capital, LP is, “In the middle market, so call that private equity funds with \$1 billion or less in capital under management, there is over \$100 billion in capital available to fund new deals and the weighted average investment period is now less than three years. We believe that capital is going to be deployed, and it is going to be deployed in new deals over the next three years. And fundamentally there are no glaring new sources of debt capital available to fund them.”

Lenders said that ultimately some new pockets of senior money will have to come into the market for it to continue growing. It will take awhile for that alternative money to come back, but lenders are confident that it will, whether it is the institutional CLO model or something different.

Capital Trends: Private Equity Fund Raising Activity



Source: PitchBook.

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The Businesses

Stable and Predictable

A key element lenders are looking for today in new deals is a demonstrated ability to navigate the 2009 turmoil. "If a company was able to make it through the year relatively unscathed, it is a pretty powerful commentary on the quality of the company," commented Mike Klofas at Babson Capital Management LLC. Lenders are quick to add that there are not many companies that meet that criterion – those that weathered the storm are prized assets.

If a company performed reasonably well given the economy, that track record gives comfort to lenders and prospective buyers. And with stability in a base business, lenders are able to feel more secure where the company sits, whereas before, there was no visibility. "No one was sure how far this was going to go," commented one respondent.

To be sure, the recession has taken its toll. Lenders comment that they are seeing companies with little to no top-line growth, but through aggressive cost cutting measures, some have managed to sustain earnings within a material percentage of what they had done historically. Quality of earnings is really a cost-driven improvement or sustaining of earnings. "If you have a quality company that has been able to sustain the earnings for the last 12 to 18 months, and you have a real reason to exist as a business, I think credit is coming back to those businesses, and it is competitive for those businesses," commented Mark Kiskorna at PNC Business Credit. "The companies that have had greater access to capital have been ones that have not had the volatility of revenues and earnings over the last year and have some level of predictability or visibility into the next 12 to 18 months. Those are companies that are attractive to sponsors as well as to lenders," commented Whit Edwards, a Vice President at BB&T Capital Partners.

With all eyes on the speed of the economic recovery, lenders are looking ahead to growth prospects. Brian Schneider, a partner at Northstar Capital, LLC, offered, "Most businesses have cut to the bone. Now it is time to focus on revenue generation. The survivors with strong selling teams and good products will likely stick around." Schneider added, "We are looking for companies that performed through the cycle, and when they come out, they are going to perform at four percent to five percent growth."

Some lenders have the view that quality has diluted, although not materially, speaking to a recent upswing in lower quality companies that are now coming to market. What passed as a quality company two to three years ago might not be the same today. Six months ago, if a poor quality company came to market, the transaction did not get done. There was too much fear. Lenders are still not receptive to those less than pristine deals, but the difference may now be that a transaction gets done but at a lower multiple of purchase price and funded debt.

Generally, lenders feel the outlook looks more predictable, but it is company and sector specific in terms of growth rates and potential volatility. Businesses with contracts and recurring revenue, sizable relative market share, value-add, and high barriers to entry give lenders more comfort. Conversely, those with project-oriented revenues and customer concentration, for example, make lenders wary. It is all about stability and predictability.

"Companies are appropriately performing or outperforming market expectations on occasion, so quality tends to be better. I think people know that there is not going to be a lot of tolerance for fatal flaws, be it customer concentration, material volatility, or heavy cyclicity."

– Andy Steuerman
Golub Capital

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The Businesses

The Right Industry

Lenders and sponsors have more of an appetite for certain sectors, and our findings were consistent across the firms interviewed. Sectors in favor include business services (looking for contracted, predictable revenue and high barriers to entry); education; healthcare services (focus on cost containment); and healthcare IT. All have a common theme in that they have high cash flow, high return on assets, and low cap-ex. Food and beverage is still very much in favor, with private label segments of particular interest. With disposable income under pressure, consumer products have fallen out of favor; however, lenders said that staples are a good buy and still of interest. Manufacturing and distribution-oriented businesses are struggling to get any interest, lenders said.

Education companies have seen a recent run-up in multiples. However, some lenders believe that the sector is overheated given the sheer number of deals coming to market. The argument is that the sector is somewhat countercyclical, which proved out with the economy. Generally speaking, the performance of education companies over the past 12 to 18 months has been outstanding, lenders said.

Out of favor sectors are generally still out of favor. There are opportunistic situations that sponsors will consider, but they will be at depressed valuations and very low leverage. Sectors

that are low on the radar include automotive, heavy cap-ex industrial, housing/building products, consumer discretionary, and retail. Companies tied to commodities are generally non-starters. Forecasting margins and determining what is sustainable have been the hardest aspects in analyzing those companies, lenders said.

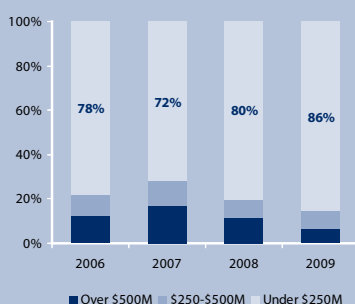
The Right Size

EBITDA minimums have always been there, but the lines have blurred as lenders began moving down market due to sparse deal flow. Some lenders are adhering to EBITDA minimums starting at \$10 million, but it is a bank-by-bank, lender-by-lender bias.

On a selective basis, some lenders will relax some of those rules. "We are relationship driven. If we have a relationship with a sponsor in other ways and they have a smaller transaction, we are going to take a long, hard look at that," said Scott Nielsen, a Vice President in the Structured Finance Group at Fifth Third Bank. For other lenders like Madison Capital Funding LLC, an active player in the lower middle market, companies with \$5 million to \$10 million in EBITDA are a focus. "It is a great market for us to play, given the overall lack of competition in the space," Chris Williams said. Some lenders generally say they have to get comfortable that EBITDA will go above \$10 million fairly quickly, and the business would have to be really attractive, to relax the rules. Nine times out of ten a smaller deal is not going to meet those hurdles.

Private Equity Transactions

Percent of Private Equity Transactions Count by Deal Size



Median Deal Value by Year



Source: PitchBook.

The median private equity transaction size of \$34 million in 2009, on par with 2002 levels, is reflective of the down-sizing of transactions during the credit crisis. Deal size trended up in the third and fourth quarters, perhaps indicative of market optimism as the economy is stabilizing and credit terms are loosening.

Deals under \$250 million in transaction value continue to account for a growing percentage of private equity dollars. The need to deploy capital will continue to drive deal flow in the lower middle market as sponsors look for add-on opportunities as tuck-ins to existing platforms. According to PitchBook, add-ons represented 29% of all buyouts so far in 2010 – an increase from 23% in Q4 2009. "As it relates to a market correction, the lower end is likely to rebound sooner. Unlike the larger buyout deals, lower middle market transactions are structured with less leverage and require fewer participants," said Timothy Clifford, head of Amalgamated Capital.

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Valuation Expectations Aligning

Valuation multiples are down a half to a full turn lower, but the gap might be significantly wider if you start talking about the high end, lenders said. Other lenders said multiples are seemingly what they used to be. Lenders caution against putting too much weight on valuation multiples as the sample size of truly representative transactions is small due to scattered deal flow. Raw numbers can be misleading as each situation is company and deal specific. Some overriding themes uncovered in the valuation discussion include:

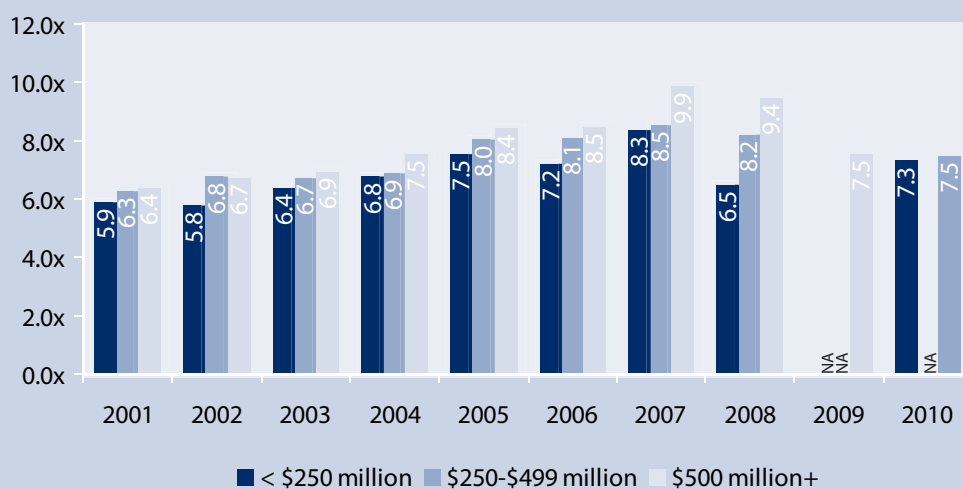
The recession effect. Lenders tell us that the valuation gap is narrowing as buyer and seller price expectations have become more aligned. Two years into a recession, a seller is realizing that the business is now affected. There has likely been some top-line pressure and earnings have probably declined. "It really comes down to this, no longer in today's environment does a buyer have to pay a premium to the seller for the implied earnings improvement, or value creation, that the buyer is planning to achieve and implement post closing, as they did in years past," offered Mark Kiskorna at PNC Business Credit. Some lenders said seller expectations have come down slightly, but the buyers are paying.

Stability and predictability. Visibility in earnings weighs heavily in valuation. A bottoming economy enables lenders to look at projections with a little more clarity. "For some of the more stable companies that have exhibited solid performance and have limited volatility in earnings, there is strong interest, and those companies are getting premium valuations – not at the pre-credit crisis levels, but they are going to command a premium relative to other acquisition opportunities," said Whit Edwards at BB&T Capital Partners.

Flight to quality. With deal flow down, quality assets are in high demand. "We were somewhat surprised at how high valuations remained for good businesses even during the bad market given the lack of capital support," said Chris Williams at Madison Capital Funding LLC. "It was almost a feeding frenzy when a good company would come to market," Williams added. Andy Steuerman at Golub Capital, said, "There are not any bargains out there. If there is a bargain, there is a reason."

Purchase Price Multiples in Middle Market LBO Transactions

EBITDA Valuation Multiples by Transaction Size



Source: Standard & Poors LCD.

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Valuation Expectations Aligning

Size has always mattered. The bigger the company, typically you see a little more multiple expansion. Larger deals are going for higher valuations; however, those are the outliers. “For deals with less than \$10 million in EBITDA, the multiples are staying within the 6x range. Above \$10 million in EBITDA, multiples are in the 7x-8x range, if they are growing,” commented Brian Schneider at Northstar Capital, LLC. “That 6x-7x range is a pretty comfortable range for sponsors, but they are still spending a ton of time on diligence.” At the lower end of the middle market, multiples may look more like 5x-6x.

The overhang. There is still an abundance of equity capital that remains uninvested so sponsors are continuing to put it to work. Lenders recalled several situations last year where sponsors were outbid in processes. One lender cited seeing

the multiple bid up from 6 to 9 times for a business. “If you want to try to peel back why we think purchase multiples are so extraordinarily high for good, basic businesses, it is because that money needs to go somewhere,” Ian Larkin, a Managing Director at Maranon Capital, LP told us. “In the context of sectors in favor, which tend to be grouped into food and beverage, healthcare services, business services, and postsecondary education, we continue to see valuations go off at 8 to 12 times,” added Tom Gregory at Maranon Capital, LP. Even as leverage has relaxed and multiples are inching up, gaps in the capital structure remain, so equity contribution remains at record high levels. Sponsors may be overequitizing to win deals. Whit Edwards at BB&T Capital Partners commented, “We are seeing a willingness by sponsors to capitalize acquisitions with 50 percent to 70 percent equity.”

Equity Contribution in Middle Market LBO Transactions



*Middle market transaction values less than \$500 million.

Source: Standard & Poors LCD.

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Terms and Structure

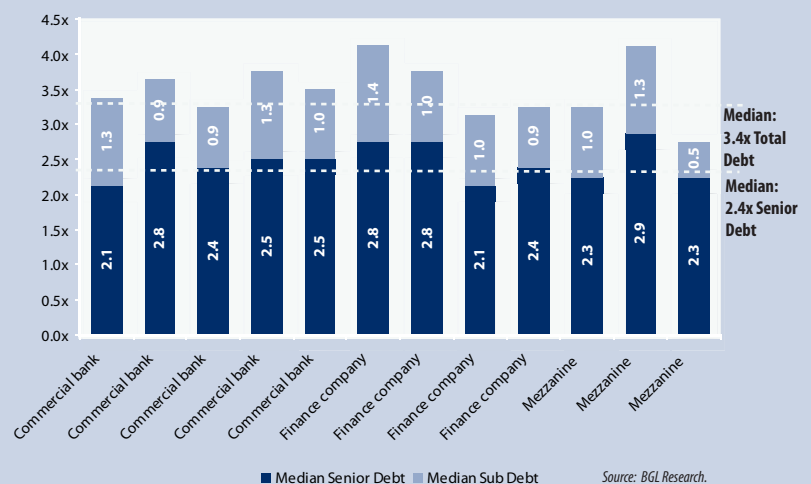
Leverage and Pricing

The debt markets are becoming more liquid, with leverage and pricing reflective of a more competitive market. Leverage at closing is higher now than it was six to nine months ago, lenders said, looking back on a 2x senior debt market that was priced at L+700 in the beginning of 2009. "The market changed in a distinct way in the second half of the year," Tom Gregory at Maranon Capital, LP told us. "The market grew in the same period." Gregory told us that in the third quarter, 150 to 200 basis points of yield were taken out of the senior debt market and leverage was brought back to 3x. "In a short period of time, we saw leverage go up to 3.5x on the senior tranche in certain deals. We saw banks taking underwriting risk. We saw loose dividend baskets. We saw dividend recaps getting done. It was pretty shocking just how quickly the market went from zero back to almost 100," said one respondent.

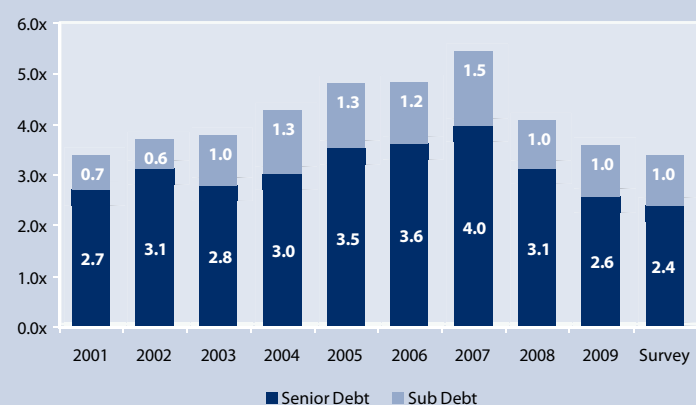
Leverage is trending up. A really strong credit can garner 2.5x-3x senior leverage, lenders said, but for one with 'hair,' senior leverage might be more like 2x-2.25x. This compares to the previous cap on senior leverage of 2x – or less – 1.75x-2x. Second lien is still gone, our survey participants said. It is really a senior/equity or a senior/mezzanine/equity market. The band for total leverage ranges from 3x to 4x, consisting of one to 1½ turns of mezzanine. For certain opportunities, lenders are seeing some movement on the upper end of that range, particularly as the market continues to improve. "Could you go north of 4.5x for the right deal, yes," said Steve Robinson at GE Antares Capital.

The aggressive nature of the market has led to some competitive pricing dynamics. The senior market has moved down under L+600 now, and most pricing falls in the L+500-575 range. This compares to L+700 at the height of the bad market. "We did see some opportunities where companies had 'righted the ship,' so to speak. Pricing became very aggressive on the senior lending side in those situations, going from L+400-600 to L+300 or less," said Andy Randall at TriState Capital Bank. "These were just good looking middle market companies in the \$30 million to \$80 million range where pricing was under L+300."

Survey of Capital Providers
Leverage Multiples (Debt to EBITDA)



Leverage Multiples (Debt to EBITDA)



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Terms and Structure

There were some relatively large banks stepping up and trying to put together, in some instances, a two or three bank club deal," Randall added. Floors have come down; most are in the 2 percent range. Sub debt is clearing at 16 percent to 18 percent with a combination of current pay (12 percent), PIK (2 percent to 4 percent), and warrants. Lenders said that warrants are much more a part of the capital structure in mezzanine transactions now, whereas a year ago, sponsors resisted.

Drilling down in the lower middle market (sub \$10 million in EBITDA), structure is more conservative, which translates into lower leverage and higher pricing. Timothy Clifford at Amalgamated Capital said leverage has moved up anywhere from a quarter turn to a half turn to a 2x–2.5x senior debt market and a 3.5x total debt market. Senior pricing is in the mid-six hundreds. There is going to be some movement, the smaller the deal, Clifford said. Under \$5 million in EBITDA, senior leverage may be closer to 2x. On \$5 million to \$10 million in EBITDA, senior leverage may be closer to 2.5x, plus or minus.

Below \$10 million in EBITDA, there are two types of opportunities, Clifford said. There is a senior mezzanine execution where you might be able to get 2.5x senior/3.5x total. The alternative is to do a one-stop at maybe 2.75x to 3x – not as much leverage as you would get on the senior mezzanine execution, but in order to get the additional half turn of senior leverage, you are paying for it. A one stop might be priced closer to 10 percent plus.

Terms

Even with leverage inching up, lenders said the structuring side of the credit underwriting is still disciplined and has not eased. Looking at today's term sheets, some common elements include:

- Libor floors present in majority of transactions
- Full set of covenants and cushions between 15 percent and 20 percent
- More up front amortization – lenders are trying to amortize between 40 percent to 50 percent of the term debt over the first five years of the deal. Some regional banks are looking at tenors of three or four years. In the lower middle market, lenders want straight line amortization, but there can be some flexibility on larger transactions. It also varies by institution. The small regional bank will ask for straight line, lenders said, and the further you go away from the bank situation, the more aggressive in the amortization.
- Two-year make-wholes with prepayment penalties
- Seller guarantees more prevalent
- Senior closing fees of 2 percent to 3 percent – the 3 percent end of the range being typical
- Add-ons can be difficult to execute in certain cases, and if of a significant size, they are breaking up credit agreements executed under more favorable terms.
- Negotiating for more time on the indication of interest is much more prevalent now than it has been in the past.
- Sponsor due diligence is more intense than ever before, lenders said. Lenders are asking tougher questions and have more direct contact with management.

Structure

Equity contribution is a critical piece in the capital structure and will be one of the last things to change, if it does at all, lenders said. Lenders want to see that skin in the game. Lenders said they are seeing anywhere from 40 percent to 60 percent equity going into transactions, with several respondents commonly seeing minimums of 45 percent in today's market. The low end of that range is more often a situation where a sponsor is buying an asset-rich business at a very low multiple, one lender said. Fresh new equity might start at 30 percent to 35 percent.

Creative financing is still a critical element, whether it is in the form of an earn out, seller note, or rollover equity. A 50/50 debt/equity structure is the most prevalent. For high-growth companies, the structure may be 40/60 or 30/70 debt and equity, respectively.

Timothy Clifford provided some perspective on the lower middle market, "In some of our transactions, we are seeing earn outs." Clifford added, "Equity contribution typically falls in the range of 60 percent plus. If it is a senior only equity execution, you are seeing equity closer to 60 percent. If you have a strip of institutional mezzanine, equity may be 45 percent, the mezzanine 20 percent, and the senior is the balance. In general, the loan to value on the senior is going to be somewhere between 30 percent to 40 percent."

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Terms and Structure

Reduced Holds

Hold sizes have come down on a deal and institution-specific basis, with lenders commonly seeing caps of \$15 million to \$25 million. "Previously, large banks were holding \$30 million and now may be more comfortable at the \$20 million level. Other lenders holding \$25 million might be more comfortable at \$15 million. There are a few out there who will hold above \$20 million, but that is the exception," said Timothy Clifford at Amalgamated Capital. "There are a few of us who will hold \$20 million to \$40 million. There is probably a bigger universe of \$10's to \$15's," commented Andy Steuerman at Golub Capital. "Our typical hold size is \$20 million to \$25 million in any single deal, but we can go up to \$40 million. We do not do that often, but it is something that we can offer up if we need to," offered Chris Williams at Madison Capital Funding LLC. Scott Nielsen at Fifth Third Bank told us, "Our hold sizes have started to rebound. We are at if not somewhat above the hold levels we had in mid-2008. That has been very positive for us." "We are seeing club deals with participants taking heavy hold levels to get a deal done," offered Steve Robinson at GE Antares Capital.

Providing additional insight on hold levels, Brian Schneider at Northstar Capital, LLC, commented, "For larger deals, senior lenders only want to hold \$20 million to \$25 million in any one deal. When you get two or more senior lenders into a transaction, the combined senior package morphs at these common denominator levels – whether it be higher pricing, lower leverage, or more stringent covenants/structure. A sponsor might look at doing a unitranche for the whole piece of paper to get a deal done."

Clubbing

Clubs are the norm in the current market. Sponsors are often going back to their relationship banks to fill out a bank group. "Sponsors want to know there are certainties, so they go to lenders they trust. There is a high premium to going to known lenders. People keep putting the same clubs together," Steuerman commented. Sponsors need to make sure lenders are real and are going to be able to close, said one respondent. With a

more shallow senior cash flow market, some sponsors have been forced to expand their core lender group. "This has been a tremendous opportunity for those who are in the marketplace to develop new relationships," Nielsen said. "It certainly has for us. We have been talking to certain sponsors for the first time. They are calling us, and we are calling on them. Our new teams are showing that we are trying to meet demand," added Nielsen.

Once you get above \$125 million to \$150 million of senior facility size, it becomes more difficult to get deals clubbed together. "It is easier to form a club with three to four lenders. That is the maximum number that you are going to want to club together. Once you get above that, it becomes a matter of finding someone who is going to take some underwriting risk," Williams said. "We and other people are underwriting," Robinson said, "which I do not think was necessarily the case nine months ago. This is obviously a positive for the industry as groups are willing to step up with their balance sheets. I would put that at a pretty small number of lenders that are underwriting," added Robinson.

"Sellers are much more focused on closability. If they can get certainty on close for half a turn less they are going to do it. People that they sign up with have to have capital committed. The fewer parties that are a part of that capital commitment, whether it is one sponsor and one lender or one sponsor and two lenders, sellers are more apt to go that route."

– Brian Schneider
Northstar Capital, LLC

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Looking Ahead

Stability and predictability will drive M&A in 2010. The economy is stabilizing. We have reached a bottom. It might stay here, but it is not going to get worse. The credit environment is stabilizing. Lenders are returning to the market. Leverage is growing and pricing is tightening – trends that lenders expect will continue. “It is a good time for the financing markets. The market has gotten more competitive, and credit is easing. I think it is going to be a better financing market in 2010,” said Andy Steuerman at Golub Capital. “We should see more activity this year as companies get healthier and believe they can access the credit markets,” said Andy Randall at TriState Capital Bank.

The consensus among participants interviewed is that there will not be any marked improvement in the M&A or general economic environment until the second half of 2010. Lenders are anticipating slow to moderate deal flow during the first half of the year: As confidence returns, more participants will start to come back into the market, and deal activity should pick up during the second half of the year. Volume will improve from 2009 levels but will not reach the levels seen in 2006/2007.

Obstacles

We are in the early stages of a very slow and difficult recovery which will continue to foster cautious behavior. While terms may be loosening, the flow of credit is not easing. Capacity to fund deals, particularly given the refinancing levels, remains in question. The Fed is still very much present across the banking industry, and it is going to mean different things to different banks. There are certain banks that are not lending, or they are very tight, respondents said. Lenders also fear that we may still be in the early stages of seeing the commercial real estate market unwind, which could keep bank balance sheets under pressure, impeding their ability to grow. “Among the banks that are able to participate right now, you have seen terms easing,” said Scott Nielsen at Fifth Third Bank. “Investment bankers and sponsors are pushing on leverage, but the credit divisions within banks are still very leery. No one is in a race to get back to where we were. That didn’t pay off,” Nielsen added.

What will drive deal flow?

2009 was a year on the sidelines, building a backlog of deal flow and pent up demand to put capital to work in quality deals. Lenders offered their insights into key drivers of M&A activity this year:

Willing sellers. Business owners are adjusting their valuation expectations. They are fatigued from a prolonged recession and may be looking ahead to slower growth prospects. They put sale processes on hold when the crisis hit and do not believe 2007 is coming back any time soon. “I think there have been a number of companies that have been held back from going to the market until there was some level of stability in the financing markets,” said Whit Edwards at BB&T Capital Partners. “So now you are starting to see the companies that have demonstrated stable performance through the downturn. Obviously, those are more attractive assets in this marketplace,” Edwards added.

Private equity’s return. Exit activity is poised for a surge in 2010. If sponsors are raising money, they are going to have to show cash returns. There will be private equity groups selling for that reason. There are sponsors with portfolio companies whose holding period has been extended – longer than they are used to – that they are going to want to sell. “We think there is going to be a convergence of private equity dollars searching for deals while private equity funds are pushing deals into the marketplace. That will create a lot of churn or trades among private equity investors that should propel a decent amount of middle market private equity M&A deals over the next two to three years,” Tom Gregory at Maranon Capital, LP told us. “We are seeing a little bit of the logjam breaking right now,” said Mike Klofas at Babson Capital Management LLC.

“The markets are returning to normalcy or a new normal – not the old normal but something we can rely on going forward.”

– Ian Larkin
Maranon Capital, LP

“We saw a real pick up in exit activity in the fourth quarter. Strategic buyers came out with preemptive bids for several of our portfolio companies. They have cash to put to work,” Klofas added.

Strategic buys. Strategic buyers are flush with cash and will need to acquire because the organic growth is not there.

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Refinancings. Lenders have been trying to proactively address their maturities and stay off the refinancing cliff that lies ahead. Maturities will precipitate sales processes or refinancings that give the companies more time. Refinancings may take the form of a whole new financing group and package, lenders said. “We expect the level of refinancing activity will be tremendous this year,” said Chris Williams at Madison Capital Funding LLC, adding that the firm closed two refinancings last month. “There are a lot of portfolio companies coming to the end of their tenors on financings. Sponsors do not want to exit those investments on a down period in earnings, so are extending their

facilities two or three years with the intent to benefit from a positive upswing in earnings as the economy recovers,” Williams added.

Tax considerations. Participants are convinced that the tax environment is changing – and not for the better – which will push more sales into this year.

The floodgates could open during 2010, lenders said, which should mean steady deal flow in the middle market – assuming that the financing markets and the economy remain stable. Coming off a year as tumultuous as 2009, those might be big assumptions; however, the M&A market can only go up from here.

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