

Buyouts

www.buyoutsnewsletter.com

YOUR SOURCE FOR LEVERAGED AND MANAGEMENT BUYOUTS

Middle Market Showing Bruises From Credit Crunch

By **Jeremy Harrell**

The liquidity shortage has finally caught up with the middle market, giving renewed power to loan providers and forcing sponsors to scramble to get debt commitments for deals.

The shift back to a lender's market—not seen since 2002—means that LBO shops are going to get less debt for deals, pay more for what they do get, and contend with tighter covenants that place restrictions on capital expenditures and add-on acquisitions. And that's just for firms that can secure debt agreements for portfolio companies. Sponsors considering complex situations or companies in struggling sectors will have a hard time convincing lenders to underwrite

the deals. At the same time, buyout firms that were cavalier with lenders during the bull market will face much more difficulty securing leverage.

"We're sitting in an absolutely perfect spot," said **Christopher Williams**, managing director of mid-market lender **Madison Capital Funding**. "The market can't do anything but bring us more opportunities. We should be able to pick our spots, and get attractive financing."

It appears to be a new development

for the middle market, where deal pros maintained for months that liquidity was still strong despite credit disruptions that have shut down the large and megasized deal markets. Indeed, the disappearance of securitizations for virtually any kind of asset has wiped away roughly half of the buyers of middle-market debt, said **Robert Long**, managing director of business development company **Allied Capital Corp.**

In response, buyout firms are seeking out nontraditional lenders such as hedge funds, many of them led by former bulge-bracket leveraged-lending pros unafraid of holding large slices of debt for the long term. "A third of the [debt pros] who knew what they were doing went to hedge funds," said **Benjamin**

COVER STORY

Hochberg, partner of **Lee Equity Partners**. The only down side, he said, is that hedge fund pricing tends to be more opaque than at traditional lending institutions. Sponsors therefore need to take it upon themselves to conduct their own price checks. “Hedge funds are a better place to go. They’re willing to hold their commitments.”

Firms are also taking unusual steps to assuage seller concerns over certainty of close. Denver-based **KRG Partners**, for instance, recently plunked down all equity to buy a company, bridging the debt, in order to meet the seller’s goal of reaching a deal agreement by year’s end.

Without as much leverage available, mid-market shops also will have to plan to wring greater operational improvements from their portfolio companies to generate the returns they aim for and that limited partners have grown accustomed to. Unfortunately, that job will be made even more difficult by the fact that lenders are putting more restrictive terms into their credit agreements.

Loan Pricing

As deal multiples crept up in late 2007, so did the prices firms were paying for the debt—an alarming development for value-loving buyout shops.

Sponsors are now paying at least 400

basis points above LIBOR for middle-market leveraged loans, up from 300 bps or 325 bps as recently as nine months ago. That kind of pricing, by the way, is for well-performing companies in recession-resistant industries. “You want to push leverage? Your company is in a troubled sector? Then you’re in a world of hurt right now,” Allied Capital’s Long said.

Credit spreads for mid-market leverage loans began rising in the second half of 2007 and in the fourth quarter spiked to their highest levels over LIBOR since 2002, the last time the middle market experienced average spreads of more than 400 points above LIBOR, according to Standard & Poor’s (see chart on page 4).

Pricing also isn’t following typical patterns. It used to be that smaller deals carried wider credit spreads, reflecting their riskier credit profiles. That’s no longer true, Madison Capital Funding’s Williams said. Debt facilities above \$250 million require syndication, and the few collateralized-loan obligations (CLOs) in business won’t touch a piece of paper that offers less than LIBOR plus 400. Meanwhile, sponsors employing clubbed debt deals that don’t need to be syndicated can sometimes secure loans at LIBOR plus 375.

Part of the problem is that the supply of debt is tight. Mid-market loan

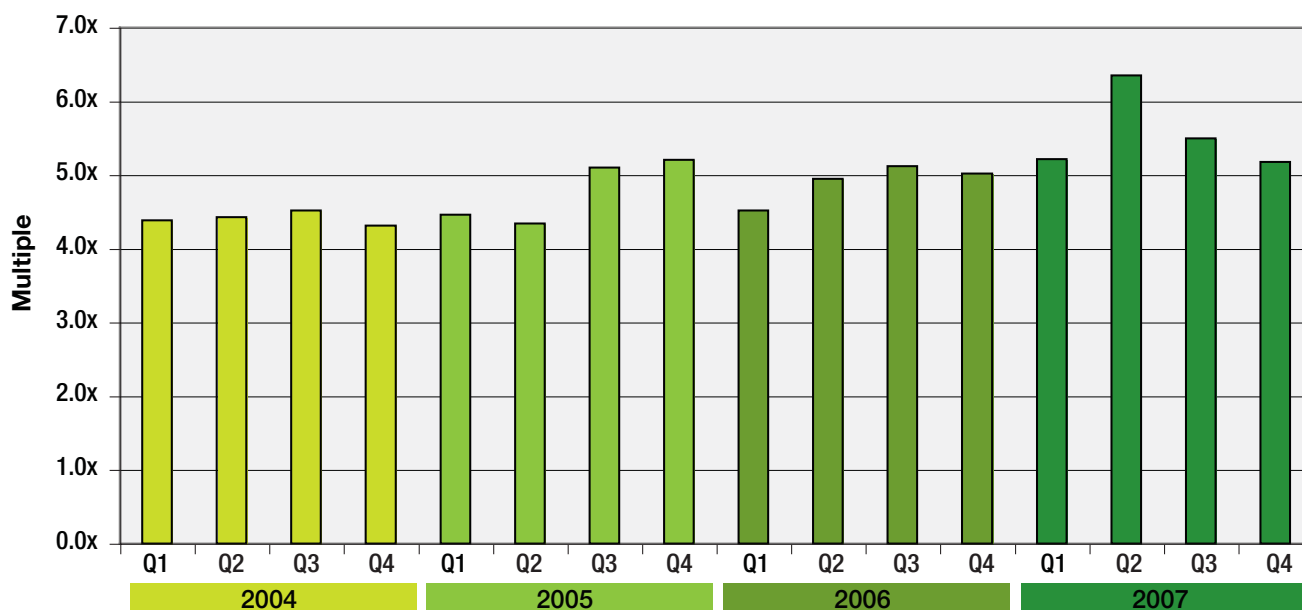
issuance fell in 2007, the first drop since 2001, according to S&P. Remarkably, loan issuance was on pace to reach a new seven-year high before a dramatic contraction took hold in the fourth quarter when less than \$1 billion was issued.

Lenders that either functioned as “thinly veiled” CLOs, as one debt pro put it, or relied on generating fee income by arranging syndicates, have hit the showers because the securitization market has evaporated, and because they’re not generating sufficient fees to maintain costly overhead. As a result, the population of reliable mid-market lenders has shrunk substantially in the last half-year. The ones that remain “are being more selective,” said **Chrisanne Corbett**, managing director of KPMG Corporate Finance.

Making matters worse, from the perspective of sponsors, is the impending takeover of Merrill Lynch’s mid-market lending division by General Electric Co. The deal is set to close at the end of January, erasing Merrill Lynch Capital as a lender that could serve as a lead agent or a major participant in a club credit facility. “There are very few players that can step into that role,” said **Jeff Kilrea**, co-president of corporate finance for mid-market lender **Capital Source**.

Merrill Lynch has told clients that if

Debt-To-EBITDA Leverage Ratios For U.S. Deals Less Than \$1B



Source: Standard & Poor’s

their deals don't close by the end of January, credit decisions will be handed over to GE's commercial finance division and its Antares lending unit. In one case, according to a source, GE has already told one sponsor that it won't honor Merrill Lynch's commitment to take a position in a clubbed facility backing an add-on acquisition, sending a panicked sponsor on a search for a new credit provider.

"If a sponsor has got a club [debt deal], the likelihood that one member of the club drops out increases every week a deal waits," our source said, especially in cases where Merrill Lynch is a member. "Then they've got a hole in their club group, and their deal falls apart."

In addition to paying more for debt, mid-market sponsors are going to get less of it. The average debt-to-Ebitda leverage ratio for deals less than \$1 billion fell to 5.2x in the fourth quarter of 2007 after achieving a three-year high of 6.4x in the second quarter, according to S&P. It's likely the multiple has fallen further in the opening weeks of 2008, since most providers mentioned a typical ratio of 4.5x for new issuances. That leverage level was last the norm in 2004, according to S&P.

Less Capacity

Needless to say, developments in mid-market lending have LBO firms pinning for 2005, 2006 and the first half of

Total Middle-Market LBO Senior Debt Volume By Year

Defined as Issuers with EBITDA of \$50 Million or Less
1997 - 2007



Source: Standard & Poor's

return. Not anymore.

Mid-market lenders contacted for this article said that they don't plan to punish sponsors for their aggressive tactics during the last cycle. "Negotiating for sport is not in the spirit of getting a deal done," CapitalSource's Kilrea said. "I'm not going to try to get back what I lost in the last two years. I just want to

Lenders are also pushing for tougher covenants, in part to limit activities that could chip away at cash flow, said **Wray Thorn**, managing director of private equity for **Marathon Asset Management**, a multi-strategy firm in New York that's preparing to raise its first dedicated buyout fund. Debt providers, for instance, might forbid sponsors from

"Negotiating for sport is not in the spirit of getting a deal done. I'm not going to try to get back what I lost in the last two years. I just want to get a good deal."

—Jeff Kilrea,
co-president, Capital Source

2007. Back then debt providers were everywhere, and newly formed lending outfits—some of which are now on the sidelines—offered discounts on rates and fees to build books of business. Some sponsors took advantage and shopped debt providers to squeeze out an extra 25 basis points in reduced interest, even though such a reduction would barely affect a deal's overall

get a good deal."

However, lenders can't help remembering which sponsors played the bully and which cultivated relationships by agreeing to pay lenders a little bit more. "We are not going to turn our attention away from top sponsors because somebody we don't have a relationship is suddenly in a bind," Madison Capital's Williams said.

making add-on acquisitions above a certain price threshold, or place a cap on capital expenditures.

"Typically lenders would like to have as much control as they can and borrowers as much flexibility," Thorn said. "However, I don't view our relationships with our lenders as a zero-sum game. We're working to create value in our investments so that both our lenders and

COVER STORY

our equity investors do well.”

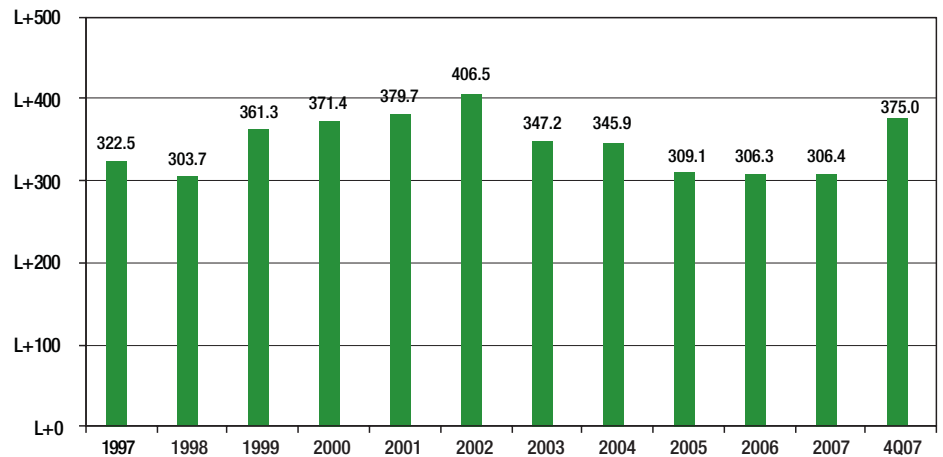
The credit crunch doesn't have to mean lower returns in the middle market. For one thing, buyout firms can bargain harder on deal multiples. So far, however, companies continue to fetch high prices. For deals valued at between \$250 million and \$500 million, price-to-leverage multiples fell as 2007 dragged on, but the fourth quarter average of 8.7x still beat the norm in 2006, according to Standard & Poor's. For deals of less than \$250 million, price-to-leverage multiples rose throughout 2007, topping off in 4Q at 8.9x, the highest quarterly average ratio S&P has recorded for deals of this size since at least 1994.

Sponsors could also try to pick up some bargains among down-and-out companies whose prices have fallen sharply. But that means doing all-equity deals in an environment like this. Lenders are in a great position to call the shots and invest where and when they want. They can take longer to conduct due diligence, and they can say no to shaky companies.

“If they're down-the-fairway deals,

Average Spread of Middle-Market LBO Senior Debt 1997 – 2007

Defined as Issuers with EBITDA of \$50 Million or Less



Source: Standard & Poor's

they're getting financed, and there's competition between private equity firms and strategic buyers," KMPG

Corporate Finance's Corbett said. "But lenders are looking at quality first, then pricing." ❖