



VIEWPOINT

ISSUE 30

A Publication of
Mirus Capital Advisors, Inc.

FINDING THE RIGHT FIT IN A TIGHT CREDIT MARKET: AN OVERVIEW OF THE LENDING ENVIRONMENT FOR MIDDLE MARKET COMPANIES

By Bas Van Der Brugge

Most middle-market entrepreneurs are more concerned with the equity markets than the debt markets. They want to understand how the equity of their Company is being valued by the market and what they can do to maximize that value – important questions to ask throughout the evolution of any business. However, the credit markets are also essential in creating and realizing value. Debt capital, whether it is a modest line of credit or a sizable term loan, is critical to the growth of most businesses. And with financial buyers playing an increasingly important role in middle market M&A, credit market conditions affect the number of potential buyers for a business and the price those buyers are willing to pay.

In the wake of the sub-prime mortgage crisis and other macro-economic developments, the debt markets have changed significantly. In this issue of Viewpoint, we take a look at the current climate in the credit markets, its impact on middle market borrowers and how companies can obtain the financing they require even in this volatile financing environment.

WHY THIS MATTERS:

- *Changes in the credit market are effecting debt terms and the time required to raise debt*
- *The difference between securing financing and securing attractive financing in this market has become more significant – business owners need to know how to get the best result*
- *If you're looking to sell your company, the changes in debt market will likely impact the value that a financial buyer could offer for your business*

MIDDLE-MARKET CREDIT ENVIRONMENT HAS STABILIZED

It was June 2007 when Standard & Poors gave its first indication that downgrades were coming for major financial institutions as a result of their investments in sub-prime mortgages. Since then, credit markets have been volatile for all manner of borrowers, and several large financial players have had major disruptions. Liquidity dried up in the second half of 2007, and the secondary market for leveraged loans came to a standstill, as buyers tried to shore up their balance sheets. Yet what seemed, at first, to be a technical correction limited to the upper end of the debt market, had spread by late summer into the broader market.

YOU HEARD IT HERE FIRST

Last June, Mirus posed the question, relative to the leveraged buy-out climate: "Efficient Market or Market Bubble?" (see Viewpoint Issue 22). We ended the piece with the following thought: "no savvy market player should assume that current, nearly ideal conditions will continue indefinitely."

By the end of 2007, concerns about a broad economic slowdown had emerged. "When we got into later in the fourth quarter of last year, what started as a technical correction looked like it might be more serious as people started to get worried about the economy," says [Brad Stewart](#), Vice President of Financing at Audax Group

Through most of the first quarter of this year, the credit market remained in flux. It was not until the Federal Reserve's broad-based intervention in the market, avoiding a Bear Stearns collapse in March; providing investment banks with emergency financing from the discount window for the first time ever; and making cash loans available to commercial banks – that the environment seemed to stabilize. By mid-May, Federal Reserve Chairman, Ben Bernanke, noted "some improvement in financing markets," adding that "There are welcome signs, of course, but at this stage conditions in financial markets are still far from normal."¹

While financial markets have found firmer ground, borrowers generally face more challenging conditions than in years past. The Duke University/CFO magazine survey of large company CFOs found that, in the first quarter of 2008, credit conditions directly hurt 35% of companies through decreased availability of credit and higher interest rates.² Mirus has observed that credit remains available to middle market

companies for most situations, although it may take longer to obtain and require more intensive due diligence than before. The key aspects of the current credit markets relevant to business owners are higher spreads for cash-flow based loans, a fairly stable asset based lending environment, and tighter leverage and equity contribution requirements.

CASH-FLOW LENDING SPREADS ARE UP, WHILE LIBOR HAS COME DOWN

Cash flow lending, which in 2006 and 2007 was the primary source of capital for leveraged buy-outs, has become harder to find as the cost of capital or commercial finance companies has been rising in a volatile market. The LIBOR spread for a typical middle market cash flow loan is now in the range of 450 to 550 basis points (May 2008), up from approximately 250 to 300 basis points at the credit market's peak a year ago.

Yet while spreads have widened, the all-in cost of debt for many companies hasn't increased. "As a result of the Fed's actions, LIBOR has dropped from this time a year ago," says Brad Stewart, Vice President of Financing at Audax Group. "So debt financing is actually cheaper today than it was a year ago on an all-in basis, because LIBOR has corrected by 300 [basis points] and spreads on average are up maybe 200 points on cash flow lending".

This point is further illustrated by Standard & Poor's Leveraged Commentary group reporting that all-in rates for B+/B rated new issues peaked in the third quarter of 2007 at 9.27% and have since fallen back to 8.44% in the first quarter of 2008.

ASSET-BASED LENDING ENVIRONMENT HAS REMAINED RELATIVELY STABLE

Not surprisingly, in this more conservative environment, more and more borrowers have begun to consider asset-based loans as an alternative to cash flow loans. "Certainly over the last six months as the industry has shifted, there has been a concern with liquidity and balance sheet strength," says [David Paikin](#), Senior Vice President of Danversbank. "I think this has driven more business back to asset-based lending. We are definitely seeing structure and pricing becoming a bit more conservative or at least trending back to historical norms. [However,] for stronger credits, there is still as much of an appetite as ever for asset-based loans."

Paikin adds that asset-based loans offer borrowers more flexibility in a slower growth environment, since they do not rely as heavily on cash flows, which may fluctuate with the

¹ "Bernanke Says Turmoil in Markets Is Easing," the New York Times, May 13, 2008.

² "Darkness Visible: CFOs See Recession through 2009," by David M. Katz, CFO.com, March 12, 2008.

broad economy. However, in the asset-backed market, prices have gone up and terms have turned more restrictive. Paikin says that spreads are up 50 to 100 basis points since their lows in 2007, and that lenders have gone "back to basics" in terms and deal structures.

Paikin also noted that, despite concerns about a weakening economy, few companies outside troubled industries like automotive and housing seem to be having trouble with their asset-based loans. "Companies that are well-managed, well-capitalized and with strong planning are performing well," he said. "We're not seeing, in asset-based lending, difficulty with default rates at this time. We are actively looking to grow our portfolio."

LESS AGGRESSIVE SENIOR DEBT HAS REDUCED TOTAL LEVERAGE, IMPACTING BUYOUT RETURNS

At the same time that spreads have widened, cash flow lenders have reigned in the amount of leverage they are willing to provide. "For deals under \$100 million, we have seen total leverage come down from [multiples of] 4x EBITDA on senior and 6x EBITDA for total debt in the middle of 2007 to about 3x senior and 4x to 4.5x EBITDA total debt in the current environment," notes [Paul Holian](#), Director at commercial finance company, NewStar Financial. "Of course, these metrics vary depending on industry and the specific performance of the Company." In the broader middle-market, which includes deals up to \$50 million in EBITDA, this same trend can be seen. Average debt multiples of middle market leveraged buyout loans peaked in the second quarter of 2007 at 6.2x, and have since fallen to 4.5x, as illustrated in Exhibit A. Notably, the contraction of senior debt multiples from 4.5x to 3x is driving

the overall reduction in leverage. Further, second lien debt has all but disappeared from the market as the market for senior debt has become less competitive and as a result, senior lenders are no longer forced to accept a second lien in the overall debt structure.

In this new, more conservative environment, the cost of capital is rising. With less senior and second lien debt available, buyers are relying on more expensive mezzanine debt, and lower debt-to-equity ratios. These trends have resulted in a requirement for financial sponsors to contribute more equity to buy-outs or become less competitive on valuation. Exhibit B shows the average equity contributions in middle market LBO transactions increasing from 34% in 2007 to 44% in the first quarter of 2008.

Moreover, many banks are demanding higher levels of debt amortization – or paying down principal – in contrast to the interest-only / bullet payment structures that were common in 2006 and 2007. Contractual amortization increases the monthly fixed charges for a business, and puts a natural limit on the amount of leverage a company can take on, since it will have to devote a higher proportion of its cash flows to servicing debt.

These changes most directly impact buy-out transactions and "add-on" investments for private equity-backed operating companies, where investors traditionally leverage the acquired companies with debt to magnify their return on equity. Mirus has started to see leverage and equity contribution requirements impact the valuations that financial buyers are able to pay for companies. Strategic buyers, more often using their own balance sheet strengthened by several years of strong economic growth, are able to pay cash or use more traditional asset-based financing. As these buyers do not face the same challenges as financial sponsors, many are stepping up their M&A activity in 2008.

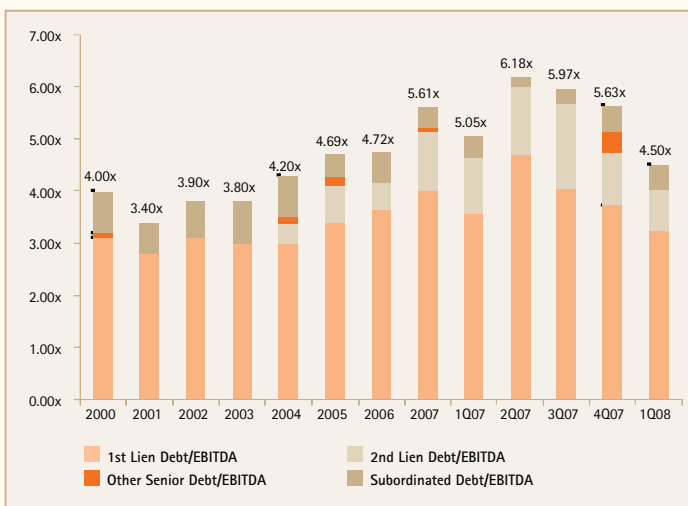


EXHIBIT A

Source: S&P LCD, courtesy of NewStar Financial

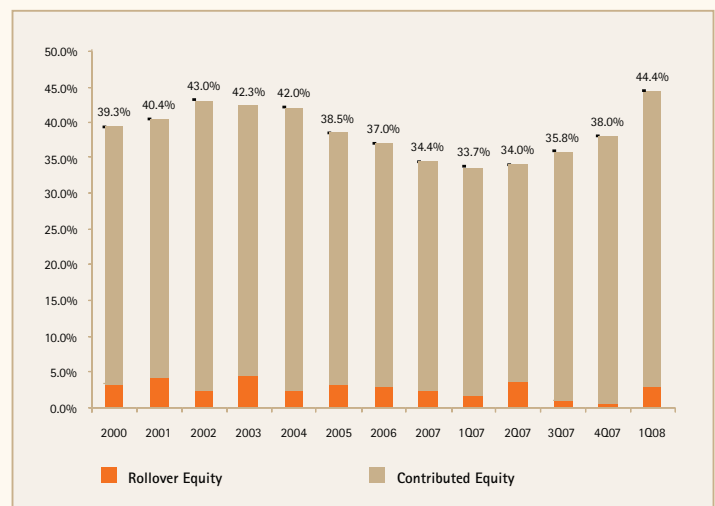


EXHIBIT B

Source: S&P LCD, courtesy of NewStar Financial

WHAT DOES THIS MEAN FOR BUSINESS OWNERS?

That depends on whether and to what extent a business needs credit. While refinancing is more expensive in the current market, it's still readily available for companies looking to borrow against their assets. Furthermore, Mirus believes that many middle market companies can still improve upon key aspects of their lending terms.

Here are some thoughts for business owners in the current credit environment:

1: RE-EVALUATE YOUR BORROWING PROGRAM. Mirus finds that many entrepreneurs still rely on a credit facility put in place a decade or more ago when their companies were still small and unproven. The terms may include a personal guarantee, or they may provide only a fraction of the credit capacity that the company's current assets and earnings would justify. Even in the current, difficult credit environment, these companies can often considerably improve their credit availability or other terms by renegotiating with the lender, or going to another bank.

2: GET PROFESSIONAL ADVICE. Many borrowers feel constrained by geography to borrow from a local lender. However, there are dozens of national and regional banks and finance companies serving every market. Likewise, as the debt market becomes more volatile and less transparent, several lenders will enter or exit a given market in any given year. As a consequence, middle market borrowers may be able to significantly benefit from expert guidance on raising debt. A professional specialist will be able to help you reach beyond the small number of lenders the management team may know and do business with, and shop around for the best deal.

Most experts expect the credit markets to be volatile and constrained for the next year at least, with no real chance of a return to 2007's easy financing environment.

3: BE CAREFUL OF TRIPPING ANY COVENANTS.

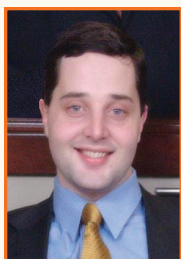
Banks are increasingly vigilant about even minor technical violations of loan covenants, especially in companies that are operating in troubled

industries like housing or automotive. Some lenders are eager to adjust favorable terms that were offered in previous years to current market conditions. Some use slippage in even the most unimportant ratios to trigger a renegotiation of terms, resulting in higher rates, fees, and more restrictive covenants.

4: PLAN AHEAD. Financings now take longer and require talking to more lenders to get the best deal. You only get one chance to make a first impression, so be prepared with a professional financial package, and don't wait until the last minute to begin looking for debt capital.

5: ADJUST YOUR EXPECTATIONS. If you're looking to sell your company, keep in mind that the pricing for financial buyers is under pressure and it takes them longer to put together their debt financing. With fewer financial buyers in the market – and the remaining ones compelled to put significantly more equity into deals – prices for companies are coming down. Be realistic about the changing landscape and don't count on financial buyers as your best acquirer – strategic buyers are highly competitive in the current environment.

Most experts expect the credit markets to be volatile and constrained for the next year at least, with no real chance of a return to 2007's easy financing environment. Spreads will remain wider, and if underlying rates go up, interest costs may well rise further. However, sound, well-managed middle market companies can still obtain financing, even in this challenging market. It just requires more time, more expertise and more flexibility. Keep your finger on the pulse of the debt markets, and be proactive about your financing needs, or call on the professionals at Mirus Capital Advisors.



Bas van der Brugge is a principal at Mirus Capital Advisors, Inc. Founded in 1987, Mirus Capital Advisors is a middle-market investment bank that specializes in merger advisory, capital-raising services, fairness opinions and valuations to entrepreneurs, corporations and professional investors. By combining a proven process, industry and transactional expertise, and personalized service, Mirus has completed hundreds of transactions for both public and private companies. Our affiliate Mirus Securities, Inc. is a registered broker-dealer and FINRA/SIPC member. Additional information about the firm is available on our website www.merger.com.

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