Buyout$

The State of the Market for Financing Mid-Sized Companies

By Danielle Fugazy
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Editor's note: In July SSG Capital Advisors sponsored an industry roundtable discussion that was moderated by Editor Danielle Fugazy. The following is an excerpted transcript of the roundtable discussion.

The participants were:

- Robert Smith, Managing Director, SSG Capital Advisors
- Michael Goodman, Managing Director, Wafra Partners
- **Seth Lehr, Partner, LLR Partners**
- J. Drexel Knight, Principal, Parkway Capital
- Carl Peterson, Senior Vice President, GE Commercial Finance, Special Situations
- Bob Dean, Managing Director, Wachovia National Bank

FUGAZY: How much are hedge funds affecting your business now, and what do you foresee down the line?

KNIGHT: Hedge funds have had a moderate influence in our business, which is at the lower end of the middle market. I expect their presence in this market segment to increase, as they increasingly look at new opportunities to generate yield and returns for their investors. As competitors, they can bring a lot of capital to bear very rapidly and are pretty driven by valuation. Clearly, however, they tend to do less diligence than we do.

FUGAZY: Is there anything that Parkway Capital is doing to combat the entrance of hedge funds into your market?

KNIGHT: We have to exhibit a greater willingness to look at difficult transactions that may require more of our historic expertise, and perhaps perform more due diligence on the front end, so that we can get our hands around the deal. In some cases, we have found that the hedge funds are less inclined to do this.

PETERSON: Hedge funds act quickly, and we find ourselves trying to compete against that speed to get to a proposal and a commitment. That's a balancing act. You may be able to match the hedge funds in regard to speed, but how certain are you that you have your entire bank and organization behind you, so that you can deliver what you've promised? Hedge funds may be less concerned than we are about deliverability.

SMITH: I don't think the speed aspect will go away as long as hedge funds continue to focus on middle market financing. That's a dynamic that exists today on all deals and financings. Hedge funds are particularly streamlined in terms of their decision-making and due diligence, and that's an attractive attribute for many clients.

FUGAZY: Has Wachovia been doing anything to be speedier or more efficient?

DEAN: There's a big difference between our organization and the hedge funds, in that we're heavily regulated. This necessitates certain levels of due diligence that they don't have to concern themselves with. For that reason, we'll never be as fast as the hedge funds. However, we have improved our process dramatically in recent years, partially in response to this increased competition. The biggest challenge for a large organization like ours is that, after you've gathered all the resources, you have to be prepared to deal with those contingencies that can put the breaks on a deal. For example, the company may suddenly decide that it isn't ready, or wants to reconsider the terms of the deal.

FUGAZY: How do the private equity players generally seek financing?

SMITH: Our deals get structured many different ways with the senior "asset-based" component typically providing the base around which the deal is structured. Second tier mezzanine pieces are common. Because relatively few of our deals have historical cash flow, it is difficult to assess structure in the context of multiples.

LEHR: I'm not exactly sure what "traditional mezzanine" even means today. I do remember what mezzanine used to be, which was a pretty high coupon, whether it was current or PIK (payment In Kind)-there was some mix between the two. And then, there was an equity component through warrants. From there, it became interest only and the equity component was driven by the sub-debt fund or the mezzanine fund's willingness to buy an equity strip. Now it's even reduced down to where they'll buy the strip, but the cost of the money has gone down dramatically. It's not just a matter of availability, but it's the terms under which the funding is available that's become really interesting.

There is always a last-out senior piece and a mezzanine or sub-debt piece available. With the businesses we look at, this throws in an element of risk to the capital structure that we're probably uncomfortable with because of the overall scale of the business. You certainly don't want to start chasing your tail on an unraveling capital structure.

KNIGHT: I agree that this concept of mezzanine finance really doesn't seem to exist in the market anymore, and we don't even refer to it. We call ourselves junior capital providers. We look to invest alongside business owners, whether they're equity sponsors or management teams, and invest anywhere along the balance sheet where it makes the most sense from a risk return standpoint. Our participation is driven by where ownership needs the most additional financial leverage. This means we might participate on the senior side, on subordinated debt, preferred equity or whatever the situation calls for.

At the end of the day, people like ourselves who are caught in the middle have to be able to morph their structures to serve their master, which is the majority owner. This could be an equity sponsor, or management, or another party. As we look at our business model, we have to ensure that we can sustain our business to do that over the long term. The market has really changed mezzanine financing as we knew it five or eight years ago. I don't think it really exists in the market anymore.

PETERSON: There aren't many senior lenders for companies with less than $10 million in cash flow. It's tough for our institution to go down that low. We've spent a certain amount of time looking at how well companies with under $100 million in revenue or under $10 million in cash flow performed relative to larger companies, and we are very careful before going into that space.

KNIGHT: That's our group's primary market, and the competition we're seeing is from commercial banks, including Citizens and PNC, but also smaller, regional banks. They're all out there pushing on the markets. It's astonishing when you look at some of the deals that are getting done, a

number of which are six or nine months out of bankruptcy. Often, the group that brought a company through bankruptcy is now looking to cash out. We looked at a deal like that-a company that had EBITDA of about $8 million-and 10 banks bid on it.

LEHR: One thing we're seeing a lot of, and embracing, is a recapitalization structure. It works particularly well for an owner-operated company as compared to a professional, investor-driven company. This allows owners to take a substantial amount of capital off the table, and helps them become more comfortable with the idea of driving the business forward more aggressively, since they are not the only one providing risk capital. But the owner would still have a significant amount invested.

This presents the entrepreneur with the alternative to do a modest control transaction using some leverage off of a smaller business. The owner will have growth capital availability and alignment of interest with his investors regarding growth. He can grow the business aggressively, and as it gets bigger, other sources of capital will become available and multiples will expand. This is something that appeals to a lot of owners, who think it's too early to sell but want to take something off the table while the market remains frothy.

FUGAZY: What are you seeing today that you weren't seeing 12 months ago-or were seeing 12 months ago but has disappeared.

DEAN: From the perspective of financing terms, we've seen the loosening of the structures, a drop in pricing probably anywhere from 50 to 100 basis points on average, and far greater hurdles in regard to achieving a good return in today's market. That being said, we have to remain aggressive to maintain market share, which is everyone's goal. The good news is that pricing has come down somewhat and structures haven't gotten as bad as what we've seen in past markets. I think a lot of banks have learned from the mistakes. They don't hold as large a piece of a deal as they used to and are better equipped to protect themselves on the downside.

SMITH: In the past 18 months we've seen a bigger and bigger proliferation of niche financing. You see more firms that lend only to finance companies today, or to healthcare companies. We still have the traditional cash flow lenders, small ticket lenders, large ticket lenders, etc., but each of those boxes has gotten more defined in the last 12 months.

PETERSON: Across GE, we're starting to organize our different financing businesses around specific industries where it makes sense. In Commercial & Industrial Finance, we focus on seven industries that account for more than two-thirds of our portfolio. Although we play in many other markets, we're looking to these seven for growth-Automotive, Steel & Metals, Transportation & Construction, Aerospace, Paper & Forest, Food & Agriculture, and Chemicals & Plastics.

LEHR: If you've been around long enough, there isn't anything that's happening now that you haven't seen before. The thing that I'm captivated by is the explosion in the second lien market over the last two years. And you tell me, is that what used to be called the term B loan? It seems to me that there are so many different pools of capital available today, so that it is very easy to bulk up the overall leverage of the transaction.

What's startling to me is somebody comes up with a new take on an existing idea, and within six months, there's billions of dollars aggregated around that servicing and driving the market.

KNIGHT: It begs the question, what happens 12 months from now? Do these funds continue to proliferate?

DEAN: And what happens when the market turns and some of these deals start getting into trouble? How will these secondary lien lenders react in a bankruptcy, and how will the documents hold up in bankruptcy?

LEHR: That's such a critical, yet subtle, indication of the frothiness of the market-the senior lenders' willingness to share that collateral position, in order to be able to win the deal.

KNIGHT: Many senior lenders think second lien lenders are really subordinated debt, and there are a lot of second lien lenders who think they have collateral. That's another interesting aspect that has to be sorted out.

PETERSON: I'm not sure that one particular bankruptcy will be precedent setting, because so many of the documents between so many of the different parties differ about conditions. Nevertheless, someone will have to cut a path through what is essentially uncharted territory.

FUGAZY: Could we talk a bit about loans in general, and what happens if a company breaks loan covenants?

DEAN: We can structure certain deals without covenants as long as there's sufficient liquidity in the transaction. That's governed by the borrowing base and collateral advance rates we put into our deals. Where there are covenants, we try to get the client back to the table if the company begins to exhibit financial distress.

Once we get to that point, it's really just a matter of working closely with the company. We also may work with a consulting firm or investment bank to determine the extent of the problems, depending upon our confidence in the management.

SMITH: We mentioned how hedge funds behave when creditor agreements play themselves out. We have been involved in several assignments over the last year that involved a number of these funds and their senior lenders. The ones that we've dealt with are established and were early into the market, and did not necessarily spring up over the last year. I have found these funds, with second lien positions, to be invariably tough, but smart and rational. I suspect they're rational precisely because they need to work with a senior lender or the company to realize on the loan or the investment that they've made. They're not in a great position of leverage.

In time, it remains to be seen if the newer hedge fund entrants to this market will be as well-prepared for situations when companies break their covenants.

PETERSON: I suspect it will vary by fund. Some are more control-oriented, and negotiate their inter-creditor agreements that way. However, there also are funds that are more participatory and less controlling in nature. There's a wide variety out there.

DEAN: The proliferation of this secondary market is interesting. There are a growing number of funds that are willing to buy deals when the paper starts to deteriorate. These buyers may have goals and objectives that are not always aligned with our goals, as the senior lender. At times, this creates difficulties in dealing with companies that are in turnaround or going through bankruptcy. One party seeks to increase yield and give themselves a better return, while we're trying to get the company to work through the bankruptcy and preserve cash.

PETERSON: Let's be frank, and just acknowledge that some of these funds loan to own. I think the second lien marketplace has many different players-some control-oriented, some chasing yield, and some willing to play along. They have different rights, different remedies and different agreements. During the next downturn, it'll be fascinating to see all that play out.

FUGAZY: What should we expect in the next 12 months?

KNIGHT: We will probably see slower growth in the economy. Inflation will be more of an issue than it has been, including a lot of soft costs, labor costs and healthcare costs. We're already seeing that across the board in virtually all of our companies. For U.S. manufacturers that require raw material, the China factor will continue to be an issue, but a lot of our investments not in manufacturing are feeling the effect of cost pressures. I also think we're in for higher interest rates, which means that leveraged transactions could begin to have some difficulty.

The good news will be that we should continue to see opportunities to invest selectively in value companies that are in growth markets-healthcare, value added distributions, etc. We just have to be careful not to stub our toe while we're doing it.

PETERSON: We've all seen leverage multiples continue to rise, deals getting riskier and markets getting frothier. I honestly think the lower credit quality in the high yield market is going to be the bellwether. Once you start to see problems and restructurings in that space, whether it's six months or two years from now, the economy will pause. That may have significant implications for senior multiples.

Over the next 12 months, however, the flattened yield curve may dominate transactions. Long-term collateralized lenders like GE stand to lose a certain number of transactions to people who want to lock in long-term money because long-term rates have declined. It's not the change in the short-term interest rates that's impacting us; it's the drop in the long-term rates combined with the frothiness of the high yield market that make bank term loans not as competitive as they used to be.

GOODMAN: From a private equity perspective, it continues to be a good time to be selling. On the buy side, given all the capital, people will be continuing to do deals but they will have to structure them very carefully. Those of us who have been around for a while know that everything goes in cycles. The players may change and the capital structure instruments may have different names but at the end of the day, you're still buying and selling companies and doing some of it with debt. If you put too much debt in the company, there is a good chance that you will run into trouble when you hit the down cycle. So looking ahead, the watchword is to be especially careful.

LEHR: From our standpoint, however, interest rate movements probably will not matter that much, although we expect them to trend up relative to the size of the companies that we're involved in, a modest bounce in rates doesn't have a sizable impact.

Most of our portfolio companies have to-date, experienced a pretty strong 2005, and are optimistic about 2006. However, we're keeping substantial reserves on hand, not only to support these companies, but also to employ for potential acquisitions that can be added to our existing platform. In short, this is an interesting time.