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# Buyouts

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## The State Of The Financing Market For Middle Market Cos.

By Danielle Fugazy  
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Editor's note: Last month SSG Capital Advisors sponsored an industry roundtable discussion that was moderated by Buyouts Editor Danielle Fugazy. The following is an excerpted transcript of the roundtable discussion. This is the first part one of a two-part series.

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: What's the financing environment like right now?

DEAN: The market is quite robust and aggressive, with exceptionally strong cash flow markets and increased competition. This competition is not only from banks, but from institutional lenders, hedge funds, B-lenders and even the high yield market.

April's Senior Loan Officer Opinion Survey showed that large, middle and small-end banks have eased their lending standards. Thanks to the size of the new business budgets of these banks, the cleanliness of their portfolios, and their willingness to take on added risk, the market continues to be quite aggressive. It will probably stay this way through at least December, short of a major blip in the economy, or a major default of a high profile credit.

GOODMAN: The mergers and acquisitions market is robust, even frothy in some sectors, and certainly from a private equity perspective, it has picked up. Many quality assets are being brought to the market, driven by the enormous amount of capital that's available at all of the debt to mezzanine to equity.

**LEHR: It's a great time to be an asset-seller. If there's anything in your portfolio that can be monetized, now is the time to do it, even if it's premature relative to the maturation of the company. The valuation in today's market will make up for that. However, with many transactions that are getting done-typically those with staple financing-everything has to work just right to generate an equity return, let alone to fund all of the debt raised. From a buyer's standpoint, there's a lot of opportunity to acquire assets. The question is whether they can be structured in a way that allows for moneymaking over some period of time?**

SMITH: The markets are frothy at the moment. It's only a matter of time before many of the deals that are being done today become restructuring candidates.

PETERSON: Our workout shop is considerably less busy this year than it was two years ago. Who knows when things will pick up again on the restructuring side? Twelve months, 36 months? One indicator is that some commercial banks have started putting out calls to get some personnel back into their workout shops.

That's not because there's currently a portfolio quality issue, but these banks anticipate that it may occur next year.

I read recently that Single-B issuers or below represented close to 40% - 50% of the high yield market in 2005, versus 20% - 30% in 2002. At some point, those lower quality high yield bonds will drive the restructuring business.

KNIGHT: With too much money chasing too few quality deals, the spreads on Single-B issues have dropped below 400 basis points, and are very tight. It's awfully difficult to get paid for equity, as well, in this market, which has forced us to be more creative in how we look at deals.

FUGAZY: What does it take to win deals in this environment?

**LEHR: We've never been particularly interested in auctions. Of our 24 investments, only two have been driven through an auction process.**

**We are regionally-oriented and spend a lot of time "working the territory" to develop relationships with companies. It's a very competitive climate, and there 's always somebody looking at your deal. We try to develop long-term relationships with companies. As long as you're fair and in this environment that means you can't be under the market then you probably will get your shot.**

**We've never been comfortable with a competitive process that doesn't permit sufficient time to learn who your partners are. We don't have a complement of executives sitting around, waiting to be inserted into a situation, so we rely on our partnerships with management, where there is a clear alignment of interest. The more the process is driven on a competitive basis, the less you have the ability to do that.**

GOODMAN: Not that long ago, you could find an undiscovered company within 50 miles of a direct airplane flight. Now you have to take two planes, drive 150 miles and then maybe you'll discover an opportunity that someone hasn't unearthed. It has become very difficult to find quality, non-auction deals, and often if they're not in an auction, the level of sophistication or advisory guidance that the business owner has these days limits your upside.

Consequently, you have to create value, post-closing.

Whether you want to or not, you find yourself participating in some of these auctions today. Even if it's a limited auction where you can do homework ahead of time, it is still difficult.

At the end of the day, the most important thing is to maintain your discipline and not push too hard to do deals. On the buy side, you have to be careful in this market. If you win in a full-blown auction now, do you lose later?

**LEHR: At some point, all of us at this table have probably experienced a moment in recent months where we said, "Wow, look at where the market is!" For me, it was when a mediocre company with a low single-digit growth rate was being offered by an investment bank on behalf of a large private equity fund and providing with stapled financing at 6x. That should be the starting point of pricing for a company with solid growth, but for a company with modest growth, it's a little surprising.**

PETERSON: I've noticed that leverage has not started to level off. Even after the first five months of 2005, it's continued to rise, whether it's for acquisitions, stapled or not.

DEAN: One of our portfolio companies was recently sold for 8x trailing 12-month EBITDA. From our market perspective, it's difficult to finance that because the cash multiples are just so high. It's also difficult to figure out where the investor will recognize its profit in that deal.

SMITH: LLR Partners had looked at deal recently that had a stapled financing at 6x. Do you follow these deals that go to market with the financings, or track the results of the deal? Does that financing get done as contemplated, or does the efficiency in the equity market roll it back? How are they ultimately functioning, and how do they play out when a deal closes?

**LEHR: I can't tell you how that specific deal ended, because we dropped out very early. We originally looked at it with a strategic partner. But I just received a notice of another deal in the market research area that had been provided staple financing and it closed under the anticipated term.**

GOODMAN: We don't see a lot of deals with stapled financing, but when it's there it does seem to be credible because the investment banker's reputation is on the line. Many private equity funds may not even spend a tremendous amount of time looking for other lenders, because they presume that the financing will be there-and this allows them to focus their energies on completing their business due diligence.

FUGAZY: Let's discuss private equity firms, and the astronomical amount of money they're spending on deals.

KNIGHT: The ease of execution, the certainty to close, and the firm's reputation are the most important factors in funding a deal. We attempt to build relationships with private equity sponsors, with the assurance that we are in it for the long-term and will deliver on our promises. Furthermore, my partner and I have full discretion over the funds and are the sole decision makers. But quite frankly, we don't kid ourselves. In this market, price overwhelmingly determines who wins transactions.

Senior lenders, hedge funds and equity institutions are driving this. The senior lenders are more aggressive and are lending higher multiples of cash flow. The second lien lenders are a new phenomenon in the market, and are providing additional liquidity. Some hedge funds look to do essentially that entire right hand side of the balance sheet. We've also worked with equity sponsors who want to deploy capital by putting in that piece themselves, because they've got fundraising constraints and want to get the capital out the door. In effect, we're getting squeezed by everybody.

PETERSON: For a senior lender, the most important thing is to quickly get comfortable talking about issues aside from price. Price is generally your first competitive aspect, but after that the priorities are speed and the need to convince people that you're going to be there for the transaction. Often, it boils down to how flexible you can be when structuring the transaction, which is a function of how well you understand the company, as well as its unique industry currents and challenges.

GOODMAN: I've heard a number of the lenders say that pricing is the driver. Perhaps this is true at the higher levels of the market, where cash is a great deal more fungible and people are chasing it. Consequently, pricing becomes an almost commodity-like driver.

At the lower end of the market, in the \$4 million to \$8 million EBITDA range, there are fewer players. Although, naturally, I want to get the best price to drive my returns, I may be willing to give up a little upside if I have the confidence that I will be able to close with somebody. That

confidence to close the deal may significantly influence my decision, because at this segment of the market there may not be 12 other groups out there also looking to lend.

Clearly, the lower you go, the higher the risk. These companies are often not as sophisticated or mature. They're generally more dependent on just a few key individuals and the risk/reward balance isn't always right for lenders. However, for those willing to take the risk for the returns, there is a lot less competition.

The lower end of the market also provides opportunities for a lot of the mezzanine funds that are looking to put capital to work. These funds may also focus on the senior portion of deals. In the past they have always blended mezzanine and equity, but some groups are going the other way.