



*RKJ Partners, LLC is an Atlanta, Georgia based investment banking firm designed to specifically assist lower middle-market growth companies in executing transactions between \$2MM to \$75MM.*

**IN THIS ISSUE:**

OVERVIEW	1
DEAL FLOW	2
CAPACITY	2
VALUATION	3
TERM & STRUCTURE	4
OUTLOOK	5
ABOUT RKJ PARTNERS, LLC	7

**CYRIL JONES**  
Managing Partner  
[cyril@rkjpartners.com](mailto:cyril@rkjpartners.com)

**GREGORY FICKLIN**  
Managing Partner  
[greg@rkjpartners.com](mailto:greg@rkjpartners.com)

**RKJ PARTNERS, LLC**  
4514 Chamblee Dunwoody Rd.  
Suite 170  
Atlanta, Georgia 30338  
p. 404.963.8592  
f. 404.920.2159  
[www.rkjpartners.com](http://www.rkjpartners.com)

# U.S. Middle Market Financing Update

AUGUST 2011

## I. OVERVIEW

Since the beginning of 2011, RKJ Partners, LLC (“RKJ”) noted a decline in M&A volume, increased lending capacity in the middle market and uncertainty as it relates to the health of the US economy:

- ❖ **Middle Market M&A Volumes Decline** - Middle market M&A volumes declined 33.5% in Q1 ‘11. We believe the large decline is primarily attributed to the volume of transactions that were “pulled ahead” into 2010 due the uncertainty at the time surrounding future tax rates. Despite the decline in M&A volumes, middle market transaction multiples remained robust in Q1 ‘11 at 7.5x, a slight uptick compared to Q4 ‘10 multiples of 7.4x. We anticipated stronger activity from the private equity universe as LBO lending (according to S&P) in the middle market recorded moderate gains increasing 6% in Q1 ‘11 to \$1.3 billion from Q4 ‘10. There is a significant build-up of future M&A activity from the private equity universe as they race to put “dry powder” to work before they are forced to give it back to limited partners. This dynamic, coupled with strong activity from strategic buyers and private business owners’ desire to take “chips off the table” after the extended downturn, should create an optimal environment for M&A activity for the remainder of 2011.
- ❖ **Middle Market Lending Is Back** - Middle market lending activity posted the strongest quarter since Q3 ‘07. Unfortunately, the devil is in the details, as the increase in loan volume in Q1 ‘11 was fueled by dividend recapitalizations and debt refinancings which accounted for 55% of the total loan volume. Lending activity on LBO transactions as percentage of total volume declined from 37% in Q4 ‘10 to 27% in Q1 ‘11. According to S&P data, senior debt multiples for middle market LBO transactions in Q1 ‘11 increased to 3.8x senior debt/EBITDA compared to 3.4x senior debt/EBITDA in Q4 ‘10. S&P also reported that total LBO equity contribution for deals with EBITDA of \$50 million or less averaged 32.6% of the total capital structure in Q1 ‘11. The decline to 32.6%, which is only slightly higher than 2007 equity contributions, was a surprise. Our data points deviate from the S&P reported figures as we continue to see private equity funding approximately 40% of the capital structure in order to consummate deals.
- ❖ **U.S. Economic Recovery Remains Uncertain** - Real gross domestic product increased at an anemic annual rate of 1.8% during Q1 ‘11, the sharpest decline since Q2 ‘10. This deceleration was due to significant increases in food and energy costs for the consumer, less defense spending by the federal government and declines in construction spending. While the lackluster results are being chalked up by many economists as temporary, the rise in food and gasoline prices is troublesome as the U.S. consumer remains fragile. However, there are positive economic signals that indicate the U.S. economic recovery is still on track. March housing starts increased on a month-over-month basis and U.S. non-farm private employers added more than 200,000 jobs for the third month in a row in April.

## II. DEAL FLOW

A slower than anticipated M&A market brought in \$14.3 billion in new money issuance in Q1 '11, according to Thomson Reuters LPC. Although a healthy 64 percent increase from a year ago, loan volume hardly satisfied lenders, particularly coming off a robust fourth quarter in 2010, which brought in nearly \$30 billion. Lenders attribute some of the slowdown to the pull forward of deal activity into Q4 '10 as sellers looked to complete deals ahead of pending tax legislation. Improving liquidity and lack of new issue supply forced lenders to manufacture deal flow in refinancings and repricings as a means to deploy capital and protect assets. Dividend recaps have made a strong showing as a means to put capital out in good quality loans. Scarcity of quality M&A deal flow has required lenders to turn to more aggressive structures in an effort to win deals. According to a recent Thomson Reuters survey of middle market lenders, 95 percent of respondents fell short of their lending goals in first half of 2011, leaving lenders hungry to put capital to work. The void in the M&A market can be attributed to a lack of family-owned businesses coming to market. These companies are playing the waiting game, hoping for a longer trend line of improving performance to garner a higher valuation. Also contributing to the shortage of sellers is a number of private equity groups ("PEGs") that are uncommitted sellers. They have portfolio companies that made it through the downturn and are rebounding, but they have more improvement necessary before market valuation catches up with expectations. Still others say companies are waiting on second quarter financial results so they can go to market with their best foot forward. The pipeline of M&A and dividend activity is in process, and they are beginning to see it build now. The sentiment is that the market will get very busy again. If that next wave of deal flow comes through, M&A activity will spike up again as private equity funds become very active. The time granted to close transactions is becoming shorter. Diligence is still rigorous, and PEGs and lenders are not taking shortcuts. However, lenders say more steps are taking place in parallel - quality of earnings, customer calls, management background checks - including financing running parallel with the signing of the purchase agreement with diligence in process. In addition, twelve months into a modest recovery, lenders have more confidence in the stability of earnings and do not see as much downside risk. Overall, lenders are expecting 2011 to be a solid year for M&A and dividend financing. It has been a slow start to what is expected to be a frenzy in the second half of 2011. Stability of earnings will allow more people to start seeking liquidity.

## III. CAPACITY

### LIQUIDITY IN THE MARKET

There has been a material change in the amount of liquidity that has come into the middle market. The increase in capacity is result of many initiatives. Banks are starting to develop or restart leveraged loan teams and efforts. New Business Development Companies ("BDCs") are forming, and existing players have shored their balance sheets to the point where they are actively out in the market and have come back to be a real force in the middle market again. Commercial finance companies are also seeking additional funding sources. Also, leveraged finance businesses that can use retail deposits as a funding source have a significant competitive advantage in the form of stable, low-cost capital. Lenders have cleaned up their balance sheets, have more favorable liquidity positions, and want to put that money to work. Middle market leveraged lending is still an area where you can make an attractive spread for what is considered modest risk.

### GROWTH

Lenders expect liquidity to continue to improve driven by higher lending goals in 2011. The long-standing cash flow lenders anticipate "more of the same" in terms of loan growth, many coming off very strong years in 2010, which is expected to bring ample liquidity as they look to meet goals for 2011. Many lenders were successful in meeting aggressive budgets in 2010 and expect that 2011 will be an equally strong year provided there is enough deal flow to accommodate growth targets.

### BANKS ARE ACTIVE

Banks are expected to continue to be active in 2011. They have improved their capital ratios back into appropriate levels and are willing to take some risk again. Many banks still have a fair amount of exposure to real estate and need diversification in their loan book. They are looking to be fueled by commercial & industrial (C&I) loan growth. The market has been somewhat frothy for lenders. Banks are currently hiring more business development professionals to drive new business. Banks are actively seeking new customers again. Over the last few months, banks switched from looking inward to focusing now on deals. Banks were so internally focused on improving their portfolios that now they have worked through those issues and are out aggressively calling to add assets again.

### BUSINESS DEVELOPMENT COMPANIES ("BDC'S") ARE ACTIVE AGAIN

BDCs are expected to fill some of the void in the senior cash flow market. There are currently six BDCs in the pipeline so far this year including Monroe Capital which filed in March and Churchill Financial which filed in April. Since the beginning of 2010, eight BDCs have gone public and raised approximately \$770 million. Current market dynamics

suggest that new BDCs will be much more senior debt-focused and have lower return expectations. Solar Capital was the first middle market senior loan BDC, investing in first-lien, unitranche, and second-lien debt instruments, according to its IPO filing. BDCs are expected to be much more active in the market above \$10 million in EBITDA and almost exclusively in sponsored buyout transactions. Larger BDCs are trying to create assets with a yield of 10 percent or better, which is reflective of their leverage constraints and dividend requirements and dictates participation in unitranche deals, last outs in a first-out last-out structure, and mezzanine. BDC participation in the traditional senior part of the structure is typically somewhere between 3x-3.5x EBITDA, but lenders do not see them competing aggressively for that business given their return requirements. BDCs are becoming more active in the lower market, particularly given the slow M&A transaction environment. In March 2011, Monroe Capital LLC filed a registration statement with the SEC for a proposed IPO to form a BDC. The BDC will invest \$5 million to \$25 million in senior, unitranche, and junior secured debt in lower middle market companies. Targeted returns on senior and unitranche secured debt are 9 percent to 15 percent, according to its public filing.

#### EBITDA BENCHMARKS

There are two pockets of liquidity in the middle market - with \$10 million in EBITDA being the line of demarcation. In today's market, anything above \$10 million is enjoying very good market reception with a very long list of potential sources of capital. However, the universe of potential capital providers is reduced when companies produce EBITDA below \$10 million. One-stop/unitranche players, regional banks, and SBICs are the primary lenders to the sub \$10 million EBITDA market, with SBICs being the most active below \$5 million. Select finance companies continue to maintain an active presence in the sub \$10 million market. It is still situational, but regional banks are maintaining a strong presence in lower middle market deals. Regional banks are very aggressive on deals that have the appropriate leverage profile and are in their footprint. Regional banks are active in the lower middle market but only up to a certain degree. As long as senior leverage is 2.5x and below, regional banks will be very competitive. They still want straight-line amortization, but they are very price competitive. When senior leverage gets closer to 3x, they become less competitive. For some lenders, the bright red line has blurred. When the deal gets smaller, either the leverage goes down so it is still appealing to the banks or the pricing goes up to move to the BDCs, but the deals still get done. And for the smaller deals, you do not need as many buyers. Lenders are selectively going down market for the right opportunities. For the smaller deals, lenders are going to look at them more as a stretch secured deal or a stretch asset based deal rather than a pure cash flow structure. Those deals are going to have to get financed with more equity, and they are primarily going to be senior debt and sub debt with a more conservative structure than you might have seen a couple of years ago. But those deals can definitely get done.

#### MEZZANINE MARKET

Currently, there is more than enough mezzanine capital to support the market, pointing to substantial money raised through standalone mezzanine funds, BDCs, and SBICs in recent years. Competition has increased in the lower middle market. The regulatory environment has spurred new entrants to the marketplace as more capital providers apply for SBIC licenses. Second lien lending is gaining traction, but has not overtaken mezzanine yet. Interest in second lien lending typically starts at EBITDA of \$15 million, and is most prevalent once you go above \$30 million. Most mezzanine players want bigger bites, so it can be difficult to find mezzanine for the smaller deals. The sub \$8 million EBITDA market (\$5 million to \$8 million) could prove to be difficult when attempting to secure mezzanine financing. Some mezzanine lenders have a cutoff of \$7.5 million in EBITDA.

### **IV. VALUATION**

RKJ is predicting it will be a seller's market in 2011. Company performance and business fundamentals are improving, so there is more comfort with run rate earnings and the visibility of the pipeline. PEGs and lenders are anxious to put money to work. Limited new M&A deal flow is driving a competitive market, and pricing and leverage have improved for sponsors. These dynamics are expected to bolster valuations for the foreseeable future.

Quality businesses with all the attributes—barriers to entry, strong market share, defensible positions, strong cash flow—are being offered high single- to low double-digit multiples. For attractive, growing businesses with at least \$10 million in EBITDA, it is very common to see multiples in excess of 8x. Growth-oriented platform companies can trade over 10x. If PEG's and lenders desire to be value buyers, they must be willing to accept some level of fatal flaw—a company with a cyclical past, a customer concentration issue, a business that doesn't come with a management team. Smaller companies or companies with issues tend to be valued in the 6x-7x EBITDA range,

#### QUALITY

Weak deal flow is driving a fiercely competitive market for the highest quality transactions. Structures are continuing to become more aggressive, and asset selectivity is being pushed higher. Given these market dynamics, there will be more of a focus on quality in 2011. Companies recognized as high quality performed well throughout the recession,

had management teams that demonstrated their strengths, and exhibited some secular growth. On the other hand, there are companies that did not perform as well, exposed some weakness in their management teams or had some issues/challenges. The really good companies came through the downturn relatively unscathed. They generate strong cash flow and are very efficient from a working capital standpoint, so they drop a lot of cash flow to pay down debt. Those are the companies that are commanding high prices—multiples at 9x or 10x. That contrasts sharply with the run-of-the-mill general industrial companies which are still pricing down in the 4.5x–5.5x range.

#### SIZE

There appears to be a clear differentiation in multiples as you move above \$10 million in EBITDA, quantifying the differential at 1x to 1.5x. Multiples are driven more by the growth dynamic of a company and not necessarily size. The market is becoming more and more competitive. PEGs are stretching even on smaller companies to the extent there is an attractive growth profile for the business.

#### RECOVERING

Most industries have seen a fairly significant recovery, therefore, lenders have more confidence in the earnings profiles of middle market businesses. Companies saw an uptick in performance beginning in late 2009, which carried through into 2010 with consistency across industries, with the improvement driven by margin enhancement against a lower top-line. Lenders are now seeing an improving top-line against an already established but higher operating margin. Stability in earnings is accommodating additional leverage in structures today, which enables PEGs to pay more for businesses.

#### INDUSTRY SPECIALIZATION

Specialization goes a long way in today's competitive market. It is easier for the groups with the industry specializations to pay the highest price because they spend a considerable amount of time in an industry and realize when they are buying something very attractive. It is more difficult for someone who has not spent that time to get conviction as quickly when a process begins to escalate. Lenders are required to have that same level of conviction and many are making investments in certain sectors to be smarter on the companies they pursue and be more value-added to their client base.

#### VALUATION GAP

The valuation gap between buyer and seller value expectations has narrowed. The seller's gap during the past couple of years was not related to the purchase multiple, it was related to the underlying earnings of the business. Purchase multiples are holding steady to firming, and earnings are rebounding, so there isn't much of a gap anymore.

## **V. TERMS AND STRUCTURE**

Leverage is up and spreads are down across all debt tranches, a function of increased liquidity and the overall lack of new M&A deal flow in the marketplace.

#### LEVERAGE - EBITDA SCALE

Broadly, multiples drop off a quarter to a half turn in leverage when you dip below \$10 million in EBITDA.

- ❖ EBITDA below \$5 million: For companies with less than \$5 million in EBITDA, senior leverage will generally be under 2.0x. There might be a turn of mezzanine, but the mezzanine will generally be on the upper end, closer to \$5 million.
- ❖ EBITDA between \$5 million and \$10 million: For companies with EBITDA between \$5 million and \$10 million, senior leverage will be in the range of 2.5x-2.75x. Total leverage will be in the range of 3.5x-3.75x and the additional turn is mezzanine.

These structures will apply to asset light businesses. The larger the asset base, lenders are inviting more competition from banks. Historically, asset based lenders did not have an appetite for large air balls in the smaller end of the middle market. Today, a regional bank might structure an asset-based transaction that is 50 percent secured, some lenders said. The minimum asset coverage six months ago would have been at least 70 percent. Previously, air balls needed to disappear within 18 months. That time is extending to 36 months and even 48 months in certain situations.

- ❖ EBITDA above \$10 million: Leverage on a company generating more than \$10 million in EBITDA can look like 2.75x-3.25x senior and 4.25x-4.75x total. It can be a half turn range on both the senior and the mezzanine for the vast majority of deals.

Pricing comes down to the source of capital; it is institutional pricing or it is bank pricing. As the commercial banks are coming back and getting comfortable with doing deals, given their low cost of capital, they often are not putting in Libor floors, and they are pricing them at what for them is a very healthy spread. However, on an all-in basis relative to an institutional buyer, the pricing looks less expensive.

- ❖ EBITDA below \$10 million: Pricing has come down roughly 100bps-150bps from a year ago. For EBITDA below \$5 million, senior pricing for finance companies will generally be in the L+500-550 range with a 150bps floor. For EBITDA between \$5 million and \$10 million, senior pricing for finance companies will be in the L+475-525 range with a 150bps floor.
- ❖ EBITDA above \$10 million Pricing on a company generating more than \$10 million in EBITDA for finance companies typically ranges from L+450-500 with a floor of 150bps. The band on pricing stays within this range for most transactions.

#### ONE-STOP FINANCINGS

One-stop financings are facilitating deal flow in the lower middle market, although lenders are seeing them in greater frequency in the \$8 million to \$15 million segment of the market. One-stop players have been increasingly drawn to the lower market, in part, due to the current lack of deal flow and because structures enable them to put out a critical amount of capital. One-stop players are actively competing on businesses in the lower end of the market and in certain situations, have been more competitive from a pricing standpoint. Lenders say scarcity of deal flow and the influx of capital into BDCs have changed the pricing metrics around one-stop financings.

#### MEZZANINE

Mezzanine has also had some pricing pressure. Currently there is a 100bps-200bps reduction primarily on sponsored transactions. For EBITDA less than \$15 million, pricing is 12 percent current pay and 2 percent to 3 percent on PIK plus equity buy-in, when you are able to buy equity. For EBITDA above \$15 million, pricing is 12 percent current pay and 1 percent to 2 percent on PIK where lenders are doing an all-rate deal. Mezzanine lenders are seeing signs of loosening. Warrants are generally available only in smaller deals or for the more storied credits, and while equity co-invests can still be obtained in most instances they remain a negotiating point in most deals. Most mezzanine lenders do not want to lend into deals with no equity upside. All rate deals are getting executed in the middle and upper end of the market, so there is concern that pressure may filter down.

#### EQUITY CONTRIBUTION

PEGs contribution as a percent of the capital structure has moderated and is back in line with a historical average of 40 percent, declining from 2009 levels of 50 percent required to get deals done. Transaction structures are accommodating higher leverage, which is reducing the equity requirement in deals. Lenders referenced equity contributions as low as 35 percent in the middle market in the peak of the cycle, indicating that we are not back to that level yet. There is still resistance at 40 percent, surveyed lenders said. In certain situations, survey respondents saw contributions dip below that 40 percent threshold in the first quarter, holding the belief that sponsor equity will trend closer to the 35 percent range as the year progresses. Sponsor equity has always been an important aspect of the credit, so most mainstream lenders are looking for a minimum of 35 percent.

## **VI. OUTLOOK**

All the elements needed to support a healthy transaction environment are in place, creating a good dynamic for sellers of quality businesses:

- ❖ Middle market companies are performing well. Many have stabilized revenues and are showing positive growth, and those with disciplined cost saving measures, saw profitability return to or even best pre-crisis levels. There should be motivated sellers.
- ❖ Corporations are sitting on surplus idle cash, and acquisitions represent the best use for those funds in the slow growth economy. Corporate acquirers are actively pursuing growth-oriented buys—a shift from the recovery mindset prevalent during the recession.
- ❖ PEGs and lenders have ample capital and an ample willingness to put it to work.
- ❖ Structures continue to accommodate higher leverage levels—and market indicators suggest that trend is continuing—which will drive deal volume and valuations will rise.

#### DRIVERS OF DEAL FLOW IN 2011

PEGs will be a significant driver of deal activity in 2011. Billions in private equity capital remains unspent and needs to be put to work, and a growing number of sponsors are faced with aging portfolio investments that they need to monetize in order to return capital to their limited partners as they look to raise new funds this year.

#### CAUTION - STRUCTURE

Lenders are being more cautious as the market transitions to higher leverage and tighter pricing. How aggressive structures get will depend on how hungry that initial surge of deal flow is and whether or not there are enough transactions to satisfy people—where supply and demand balances out. Over the longer-term, lenders see a more positive supply and demand equation, pointing to the large number of refinancings that will occur over the next few years, as well as the expiration of reinvestment periods for most of the older vintage CLOs, that should soak up liquidity within the market and get supply and demand more on par. That is going to demand capital and will bring money off the sidelines whether through existing players or new players. Some lenders expect there to be less CLO liquidity among the existing providers which will begin to put some discipline on the larger segment of the market.

#### ECONOMY

Concerns remain that a shock to an already fragile economy could stifle progress and inhibit momentum toward a more robust recovery. Adverse changes in the macroeconomic environment, with lenders citing inflation, geopolitical risks, and rising commodity prices as key areas of concern, have the potential to impact the availability of capital and impede deal activity. Lenders are cautiously optimistic that when the Fed pulls away its supports that the economy will be strong enough to withstand a substantial shock; however, economic growth is expected to be measured at best.

#### BULGING PIPELINE

Lenders expect a glut of new issue supply could hit the market mid-year, which many see as a major challenge in terms of physical resources to process the surge in deal flow. Processing time will be elongated given constraints to handle the flow of transactions in the market, which will likely create opportunistic financing and buying situations as a more stringent selection process allows only the highest quality deals to close. Those that are playing the waiting game may lose some of their advantage if the window to today's seller's market closes.

## ABOUT RKJ PARTNERS, LLC

RKJ is an established advisor to leading lower middle-market growth companies. We provide our clients with experienced-based solutions and unbiased advice. Our comprehensive array of strategic advisory and execution capabilities allows us to meet the needs of our clients and provide an outstanding level of service in connection with a variety of transaction processes, including:

- ❖ **CAPITAL ADVISORY:** RKJ possesses substantial expertise in assisting lower middle-market clients raise capital to fund growth strategies. Whether the capital source is senior debt, mezzanine/subordinated debt, private equity, or venture capital, RKJ has both extensive and relevant relationships within the capital community to enable the deployment of optimal solutions for our clients.
  
- ❖ **MERGERS & ACQUISITIONS:** RKJ serves as a trusted advisor in executing merger and acquisition transactions for lower middle-market clients. In addition to our significant investment banking transactional experience, RKJ's bankers have owned businesses and have served in interim CFO roles for clients. As a result of our experiences as business owners and senior level managers, RKJ's bankers are able to bring a unique perspective to the mergers and acquisitions process. RKJ's mergers and acquisitions services include:
  - ❖ Buy-side and Sell-side Advisory
  - ❖ Divestitures
  - ❖ Leveraged & Management Buyouts
  
- ❖ **STRATEGIC ADVISORY:** RKJ provides financial advisory services to owners, management, shareholders and their boards to assist in the evaluation strategic alternatives and options for extending and/or maximizing shareholder value. RKJ's advisory services include:
  - ❖ Business Valuations
  - ❖ Capital Structuring & Planning
  - ❖ Negotiating Joint Ventures
  - ❖ Strategic Business Development