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Please Don't Freeze in August

It's only August. We should all be out enjoying the hot summer weather. Yet winter may be coming early this year as we see signs of a freeze upon us.

Of course, I'm not talking about the weather, but financings for middle market companies—particularly those thousands of companies that make up the back bone of the economy with sales below \$1.0 billion and EBITDA below \$50.0 million. Much of the read on this market has always been anecdotal since obtaining data on this end of the financing market has consistently been challenging. But a few statistics, together with conversations with lenders and a little amateur psychology, yield substantial conclusions.

First, shares of business development companies (BDCs) have plummeted and now trade at approximately 80% of their net asset value. While this is devastating for their shareholders, the real concern may be the BDCs' sudden inability to raise additional capital. BDCs have been flourishing for the last two years and their continued ability to raise new capital has made them a force in providing financings to middle market companies. With the spigot potentially closed, these finance companies will be unable to deploy capital at the same rate they have been and, with limited resources, they will undoubtedly be more selective and lend to only the best of credits.

Second, the S&P LCD leveraged loan index, which is a composite of large, liquid below investment grade loans, has gone from par to 89. As we saw in 2008, when you can buy a liquid loan on the secondary market yielding 7.5%, why would you deploy capital in new deals that only yield 5-6%? Hedge funds in particular, also a major provider of capital to middle market companies during the last two years, are well-known for being able to rapidly shift investment strategies in the wake of opportunities. So it should come as no surprise if we see these institutions backing away from the new issue market in favor of more lucrative opportunities in the secondary market. Many of these funds made huge sums of money investing in secondaries during the last crisis and it would be naive to believe they won't try it again.

Commercial banks have always been leery of the middle market and usually decide to play in this space only after returns in the large cap market become too thin. With yields

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on below investment grade debt increasing, and the recent large outflow of capital in high yield funds, it would seem logical that many banks and financing companies now have the ability to revert back to providing capital to larger credits rather than the middle market.

Asset based loans will continue, but these lenders may get concerned that a slow down in the economy will, once again, lead to a decline in appraised values which, in turn, is likely to cause these lenders to lower their advance rates. And it's hard to imagine anyone making a cash flow loan without requiring new models that factor in potential economic stagnation or decline. Companies survived by drastically cutting costs the last time around. With companies already lean, it may be difficult to offset a decrease in sales with any further cuts so the effect on earnings could be significant.

Institutions have the same amount of capital today as they had two weeks ago. So, interestingly, compared to 2008, this is not a liquidity crisis but a crisis in confidence. We have lost confidence in our leaders to do the right thing so most lenders believe that the prudent path today is simply to wait it out and see what happens. Keep in mind that, as a lender, if you fail to make a loan, even if it turns out to be a good loan, you still have a job and capital deploy. But if you deploy capital today, and the loan turns bad, you are not only out of funds, but often a job.

So we believe that lenders, rather than simply close shop the way they did in 2008, may just stall for time to see how the current crisis plays out. They still have funds to deploy and a need to make returns for their investors. We saw a huge increase in leverage, and a decrease in pricing, for most of this year, with some deals attracting leverage of over 5.0x and equity as a percent of total capitalization falling to 35%. As a result, any correction may just bring the market back to a more rational level. And even in the difficult days of 2008 and 2009, a good credit with a compelling structure was still able to get financing.

But trying to read the tea leaves today is challenging. This waiting game could be only days, if confidence improves and stability to the overall markets return. But it could stretch out if the markets are simply uncertain as to what direction the economy will take. Hopefully winter won't be starting early this year.

Ronald A. Kahn helps buyout firms secure debt for acquisitions and related transactions. Reach him at rkahn@lincolninternational.com