

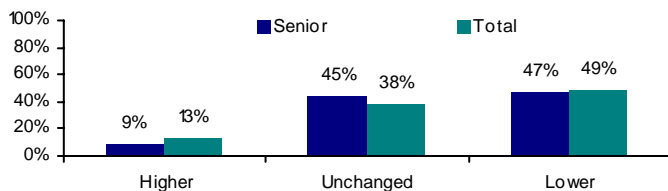
# Lender Sentiment Survey: What the market thinks...

While there is a myriad of data regarding the outlook for the credit markets, the information available relates primarily to the larger leveraged loan market, with the middle market either an afterthought, summarized in a single line, or forgotten altogether. **To address this information shortfall, we recently surveyed 118 middle market lenders, including both senior and mezzanine lenders, on their views for 2009.** We achieved a 40% response rate on six questions addressing four critical areas: leverage, liquidity, pricing and defaults.

## Leverage

While the mid-market was somewhat insulated from broader market conditions in early 2008, the second half of 2008 was a tumultuous period as leverage multiples took a turn for the worse. By the fourth quarter of 2008, leverage multiples were significantly off from historical highs achieved in the second quarter of 2007. In fact, broader market statistics for senior and total debt multiples used in leveraged buyouts shrunk to unprecedented levels of 2.0x and 3.0x, respectively, by December 2008. Will the pain and suffering continue into 2009? The vast majority of respondents believe it will – approximately 90% of all lenders surveyed expect multiples will either stay low or go even lower from today's levels.

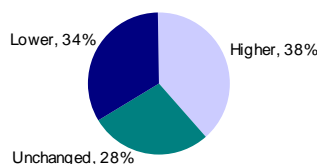
Chart A: 2009 Leverage Expectations



## Liquidity

Middle market liquidity, so rampant in the first half of 2007, has all but disappeared as we kick off 2009. The collapse of the CLO market has severely restricted lenders' ability to underwrite new credits. BDCs, which continue to trade substantially below book values, have limited access to new capital. Commercial finance companies and banks have retreated from the market under the weight of under-capitalized balance sheets, and other alternative sources of capital have elected to take a wait-and-see approach. Under this backdrop, some optimism remains amongst our respondents – 38% believed liquidity will improve this year, compared to only 6% who believed the supply of capital would increase at the beginning of 2008.

Chart B: 2009 Liquidity Expectations

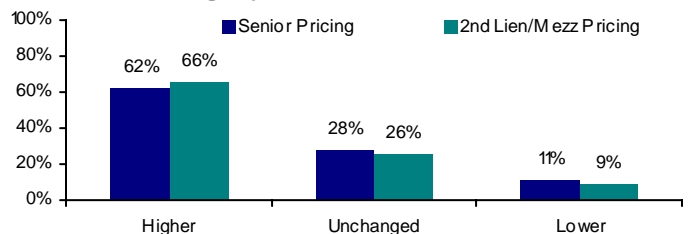


Source for Charts A, B, C, D: Lincoln International LLC

## Pricing

In 2008, the cost of debt skyrocketed, along with closing fees. The combination of reduced liquidity, panic selling of securities, and economic uncertainty drove some yields up to equity-like returns. Was this step up enough? A large majority of respondents indicated no; 62% of those surveyed expect to see higher prices in the senior debt market, while 66% expect junior capital will rise in parallel.

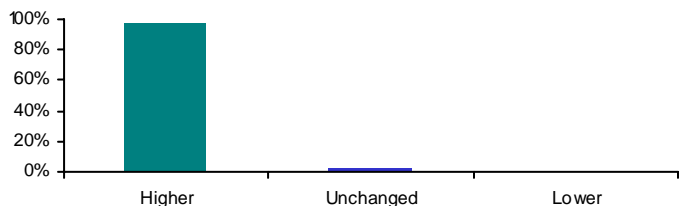
Chart C: 2009 Pricing Expectations



## Defaults

Lenders (like economists) rarely agree unanimously on anything. However, when asked about the expectation of problem deals/defaults, one sole voice felt default rates would remain unchanged. Default rates entering 2009 were not widely off historical averages; however, almost all surveyed believe the worst is yet to come. Looking at the increase in percentage terms, defaults are up some 15x from the rock-bottom levels of 2007. This is by far the steepest climb on record. And it comes as no surprise. Company earnings are declining while covenant requirements are tightening, and for those borrowers able to lock into covenant-lite and PIK-toggle deals of the roaring 2006/2007 days, lenders will have to wait until the underlying credit has deteriorated dramatically before any action can be taken.

Chart D: 2009 Default Expectations



**Putting it all together, middle market lenders forecast that the credit markets will remain challenging in 2009 with low leverage levels, tight liquidity, higher pricing and more problem deals working their way into portfolios. And since lenders are the ones making the credit decisions, many of the perceptions expressed here are likely to become reality. Does this mean that deals will not get done? Not at all. Rather, it means marginal credits will not get funded, creative structures will carry the day, you will need to conduct a broad process to access capital and you should expect longer and more time-consuming diligence to complete a transaction.**

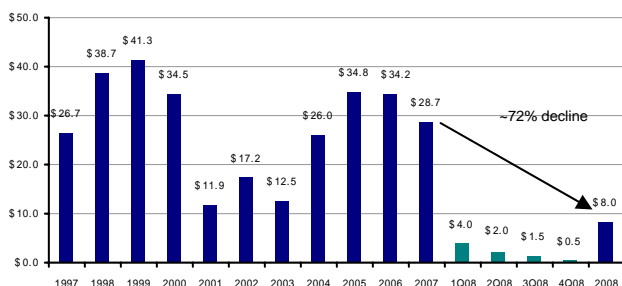
# Looking Back on 2008 . . . and Ahead to 2009

It's been quite a year, and we can't think of anyone in the financial world who isn't thrilled to see 2008 end in hopes that 2009 bestows some benevolence to the credit markets. The large cap market saw its downfall in the summer of 2007, but the middle market continued to survive. All that changed in October 2008 when even the middle market finally encountered its own drastic decline in credit availability.

As a result, the syndication market is extremely fickle and putting together a senior debt facility of anything over \$75.0 million is a real challenge.

Fortunately, the circumstances for the asset based senior debt market are not nearly as dire as those for cash flow based financing. Traditional banks are continuing to participate in this market and pricing, although higher than in the past, is often in the L+300-400 range. Many of these institutions received TARP money to shore up their balance sheets, have new budgets to fill and are clearly open for business in 2009. We are, however, seeing asset based lenders take a more conservative approach on their advance rates, particularly for loans against fixed assets. This is primarily due to uncertainty over appraisal values, which have fluctuated widely in many industries over the past year.

**Chart E: Total Middle Market Loan Volume (\$ in billions) (Issuers with EBITDA of Less Than \$50 million)**

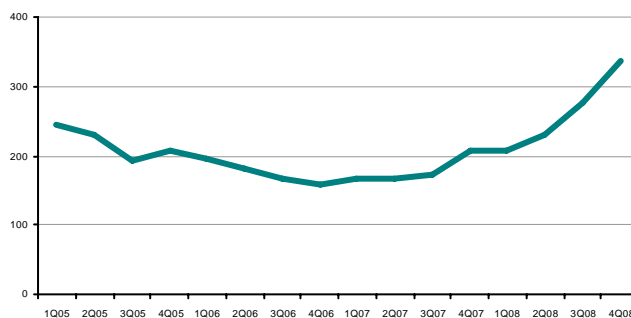


Source: Standard & Poor's Leveraged Commentary and Data

But because it is a New Year, rather than twill on all the bad news we continue to read about in the papers, we thought it better to share some thoughts on what, if any, financings are getting done right now.

Starting with the senior debt market, the cash flow side of the market has seen the greatest deterioration. Many cash flow lenders have simply exited the market, often because their own source of capital has dried up. Some have openly disclosed their decision to abandon the market while others, in hopes of being able to some day return to lending, have masqueraded their inability to lend by declining everything they see as not "fitting their criteria". For those few cash flow lenders that continue to lend, senior debt multiples are a fraction of what they were 12-18 months ago, often peaking at 2.0-2.5x trailing twelve month EBITDA with pricing at L+600-800 and 300-500 basis points up front.

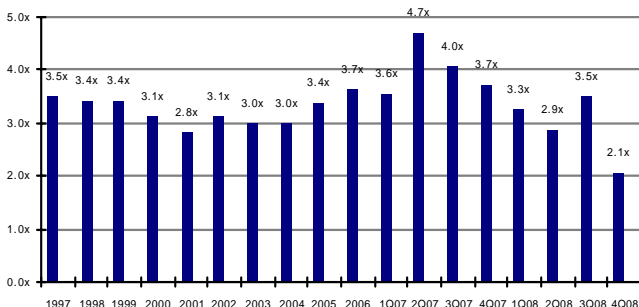
**Chart G: Average Asset Based Spreads Over LIBOR**



Source: Standard & Poor's Leveraged Commentary and Data

Nevertheless, asset based lenders are seeing their market share increase and are proving to be a stable and, in many cases, a more flexible senior debt financing alternative.

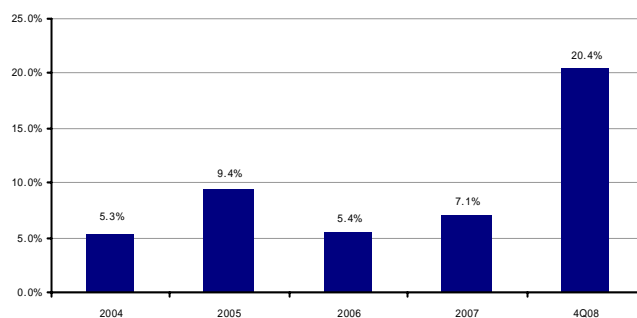
**Chart F: Average Senior Debt Multiples of LBO Middle Market Loans**



Source: Standard & Poor's Leveraged Commentary and Data

But before you get too excited that there is some hope, most of these lenders are only providing capital to their best customers, and then, only if they can agent the deal. Oh, and did we mention that the company must be a strong, stable performing business with good visibility into 2009?

**Chart H: Asset Based Lending as a Percentage of Total Loan Volume**



Source: Standard & Poor's Leveraged Commentary and Data

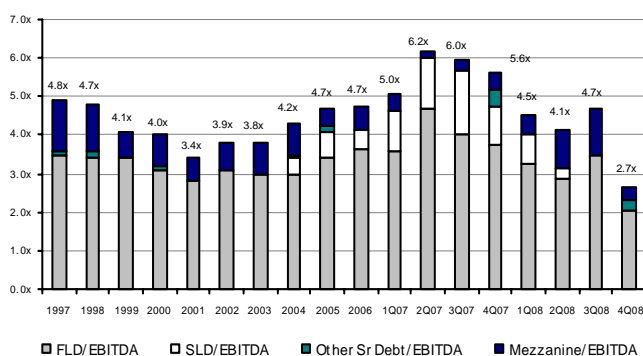
With respect to distressed deals, because asset based lenders currently have their choice of loans to make, they are more often declining those deals with earnings issues, even if the company has a strong collateral base. In the current environment, no lender wants to go into a deal relying on liquidation to be their exit, so unless the company has the demonstrable cash flow to make debt service payments, the

asset based market is usually not available. As a result, companies in distress or with earnings declines may have more difficulty than usual accessing this market, even with a strong asset base. In addition, asset based lending only works for companies with significant assets so industries such as business services or healthcare find this market to be of little help.

But don't despair entirely, because there continues to be a strong market for junior capital. In fact, while the availability of second lien loans has declined significantly, we see no decrease in the availability of mezzanine capital, although terms and pricing have changed considerably in the last 90 days. For the most part, mezzanine providers are the only class of lenders that have the same amount of capital to lend today as they did a year ago. But because of the high demand for their capital, their focus is on credit quality.

It has been many years since we've seen more and more companies have difficulty projecting their earnings. Although the reasons are understandable, lenders shy away from industries and companies that are unpredictable, or have the potential for earnings volatility. And for those that can demonstrate consistency of earnings, unfortunately the total debt multiples available to them have decreased substantially in the last 90 days with most companies unable to get more than 3.5x TTM EBITDA.

Chart I: Average Total Debt Multiples of Middle Market LBOs



Source: Standard & Poor's Leveraged Commentary and Data

And despite the ample liquidity in the sub debt market and decreased leverage multiples, pricing has increased, with most mezzanine tranches priced in the 16-20% range. Warrants are also now normally required, a significant change in the past 90 days, and prepayment penalties have increased, often requiring a two year no call.

### Overview of Current Mezzanine Pricing

- Cash coupons of 12% - 14%
- PIK rates of 2% - 4%
- Closing fees of 2% - 4%
- All-in yields of 16% - 20%

So putting this all together, can anything actually get done?

Fortunately the answer is yes, although the bar is set high and the financing needs to fit precisely into the box or it won't happen. We have seen the most success with capital structures that combine an asset based senior debt facility with a mezzanine tranche.

Besides the quantitative aspects of these successful financings, there are several qualitative aspects that we find are imperative to getting transactions done:

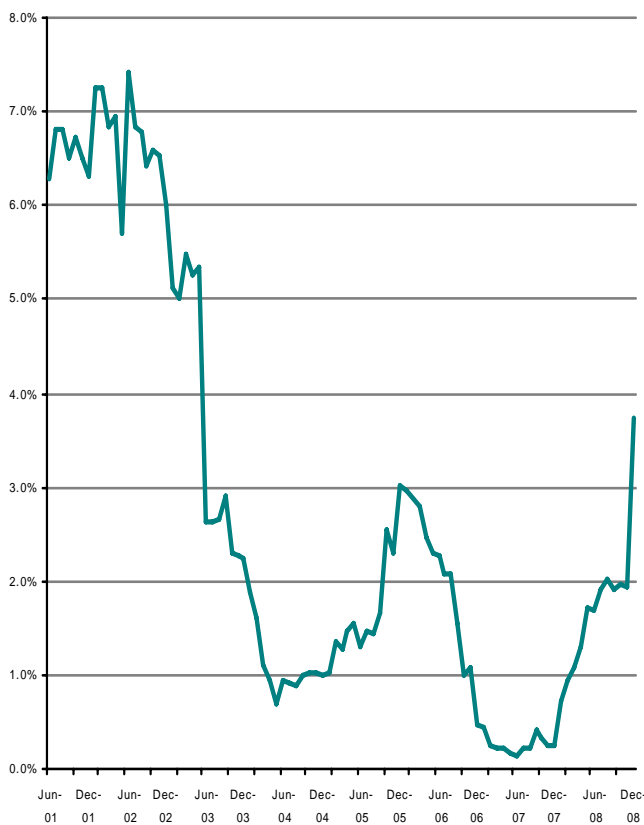
- **Go to market with a compelling capital structure**  
Compared to previous periods when you could approach lenders with an aggressive structure and expect that they would respond with the required levels, lenders that are still active in the market today are seeing a large amount of deal flow. As a result, those financings that are not properly structured are usually dismissed out of hand by the lender.
- **Go broad**  
Because a lender's appetite for a given credit is harder to determine in this volatile market place, we have found that the best results occur when the financing is shown to a wider range of lenders than in the past. While relationships still matter, an institution's own credit restraints may make it impossible for them to be accommodating, so showing the potential financing to a larger group and broader type of lender makes it more likely that your deal will get done. In addition, this approach provides the best opportunity to achieve the most favorable pricing and terms.
- **Make every effort to reach a decision maker in the lending organization**  
This advice is not designed to discredit a lender's marketing officers, but we have found some to be overzealous and a little ahead of their institution in committing to a financing. Having contact with someone who knows what's going on in the organization will result in a more efficient process and prevent unpleasant surprises down the road.
- **Creativity is often key to bridging the gap**  
For example, seller paper, earn outs and minority investments are all tools that haven't been used that much in the past, but are certainly being explored and implemented today. However, these alternatives are often complex in their own right, so using them in conjunction with what the market requires, is very important.

Lincoln's Debt Advisory Group has years of experience in arranging financings in every type of market. At the end of December, Lincoln's Debt Advisory Group successfully completed a dividend recap for a manufacturing company. We are also currently completing documentation on the refinancing of a business services company, repaying the debt held by a syndicate of senior lenders no longer active in the market. Finally, we have several other financings that are in the preparation phase and should be coming to market within the next few weeks. Thus if you're thinking about accessing the credit markets, give us a call. We'd be happy to put our knowledge to work for you.

# Restructuring on the Rise: Trends and Best Practices for Borrowers

In 2009, many companies and business owners will have to face the unpleasant task of restructuring their balance sheets. The numbers bear this out (no pun intended). As of December 2008, the lagging 12 month default rate was 4.35% by number of loans and 3.75% by principal amount outstanding. This represents a 15x increase versus December 2007's historically low level of 0.26% by number of loans and 0.24% by principal amount. While the current level is not far off from the historical average of approximately 3.0%, storm clouds are circling for 2009 and further increases are likely.

Chart J: Lagging 12-month Default Rate by Principal Amount Outstanding



Source: Standard & Poor's Leveraged Commentary and Data

Moreover, Standard & Poor's estimates the current "shadow default rate" at over 8.0%, based primarily on counting companies who have already hired bankruptcy advisors but do not appear in the actual default rate statistics. Many experts and loan market participants are predicting defaults will reach 10%, or even 15% during 2009, eclipsing the previous record high. At Lincoln, we anticipate the default rate will continue to rise due to the following factors:

- **Declining TTM EBITDA** – Previously limited to certain industries such as automotive and building products, but expanded to additional sectors in Q4 2008.

- **Leverage Covenant Step-Downs** – Typically, credit agreements require a 0.25x – 0.75x reduction in leverage each year. With declining EBITDA, companies will have difficulty meeting lower leverage tests.
- **Delayed Reaction Caused by the "Credit Bubble"** – Companies that should have defaulted earlier received additional / rescue financing, staving off default. Also, mechanisms such as equity cures and PIK toggle provisions, negotiated into deals at the peak of the market, have delayed defaults which should have already occurred.
- **Continued Difficult Economic Conditions** – Increased layoffs and unemployment, with major industries and consumer spending remaining weak.
- **Reduced Market Liquidity** – Resulting in more challenging rescue financing / refinancing alternatives.

So, how are companies tackling these situations and what can business owners and managers do to limit the time, cost and potential loss in value associated with a default or restructuring? Since each restructuring is unique, there are no easy or straightforward solutions; however, several themes are emerging in the market.

## First and foremost, borrowers need to be proactive

More than ever, borrowers need to keep lenders informed of a deteriorating situation. This requires a significant amount of additional time and analysis to: (a) understand what is impacting the business, (b) communicate the situation and actions being taken and (c) develop highly effective and impactful presentations and other written materials to be used with the lenders. This communication will likely include bank meetings, particularly if multiple lenders are involved. While this can be extremely time consuming, a proactive approach is well worth the effort in order to maintain credibility with your capital providers throughout the process.

## Complex structures require a more formal approach

Many borrowers are not dealing solely with relationship lenders anymore. Also, many relationship lenders don't have the same flexibility they once had in dealing with borrowers. With the increased complexity of the capital structures completed over the past several years and the increase in the number of overall lenders in the various tranches of debt, consensus risk is higher than ever. In addition, outside market forces are causing lenders to take actions or positions which may be difficult for borrowers to understand or predict. Intercreditor arrangements between senior lenders and second lien lenders are also causing senior lenders to take more drastic actions because they may be unable to pursue traditional strategies such as blocking subordinated debt interest payments or imposing a "standstill" period to come to a solution. Professional management of the process and market knowledge have proven to be key factors in guiding all stakeholders to an acceptable outcome.

**With unprecedented market conditions, time is of the essence and pursuing multiple paths is crucial**

While speed has always been critical in a restructuring situation, rapid and unprecedented deterioration in multiple industry sectors combined with high levels of uncertainty in the financing markets are heightening the timing element for businesses seeking to preserve value. Therefore, companies need to be in a position to quickly, yet thoughtfully, evaluate their alternatives. Then, borrowers often need to pursue multiple paths simultaneously in order to maximize certainty of closing, retain some negotiating leverage and achieve the most optimal outcome. Potential options may include one or more of the following: (a) seeking outside equity and/or debt capital, (b) executing a buyback of debt at a discount (a new trend), (c) pursuing a sale (entire company or division) to a financial or strategic buyer and (d) negotiating a restructuring or debt for equity swap with existing capital providers.

**Uncertain financing markets increase the importance of accessing strategic players**

In recent years, many lenders have been able to solve their problems by being refinanced out of troubled credits. While this is still possible for some deals, primarily by raising some combination of junior capital and asset based senior debt, a sale may be the best alternative. In this situation, outcomes are enhanced when strategics are involved. While there are private equity funds who will buy troubled companies, strategic buyers, with their strong cash positions, synergies and industry knowledge are in a position to pay the highest value. Gaining their attention and getting them to move quickly requires an advisor with strong relationships and a successful history of dealing with strategic players. In addition to the traditional approach of buying distressed companies, certain strategics are also considering creative ways to participate in restructurings such as buying senior bank debt.

**There is no substitute for experience**

Current market conditions are resulting in an increasing trend toward "liquidating 11's" (a Chapter 11 bankruptcy process which results in an orderly wind-down of the business, rather than a reorganization). Clearly, this result does not maximize value for any of the stakeholders. In order to avoid this

outcome, action needs to be taken swiftly. An experienced advisor provides the benefits of:

- diffusing emotions between the company and lenders which allows negotiations to move forward constructively,
- creating compelling written materials for lenders to use in their internal discussions,
- providing external validation and credibility to strategic alternatives,
- capability to pursue multiple options (simultaneously, if necessary) which enhance negotiating leverage,
- the wisdom not to pursue alternatives which are not viable and will waste time and destroy value.

Lincoln International has significant experience in all aspects of balance sheet restructuring and distressed M&A. With a dedicated Debt Advisory Group and substantial M&A expertise across a variety of industry sectors, Lincoln is the middle market firm best positioned to effectuate a restructuring or distressed sale. We are able to pursue multiple paths in search of the best outcome and have the unique ability to quickly shift to another alternative in order to maximize certainty of closing. Finally, Lincoln has unparalleled access to strategic buyers across the globe by virtue of our international footprint, our legacy of completing corporate divestitures and our history of closing approximately 50% of our deals with strategic buyers.

As you are confronted with distressed companies and thinking about potential alternatives, Lincoln would be pleased to assist you. For each specific situation, we will quickly assemble a global M&A and Debt Advisory team including appropriate industry bankers to assess the situation and quickly, yet thoughtfully, provide you with our independent and unbiased viewpoint on potential strategic alternatives. Our feedback may confirm your initial thoughts and give you further confidence that you are pursuing the right course of action. Alternatively, we may provide a differing view which could lead to a potentially better outcome.

### Strategic Options

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graph TD
    LI[Lincoln INTERNATIONAL] --> R[Restructuring]
    LI --> DA[Debt Advisory]
    LI --> SP[Sale Process]
    R --> DAG[Debt Advisory Group]
    DA --> DAG
    SP --> MGA[M&A Group]
    
```

**Restructuring**  
Restructure the balance sheet with existing lenders and/or investors

**Debt Advisory**  
Seek additional senior debt, subordinated debt and/or equity financing

**Sale Process**  
Partial or complete sale of the Company

### Proven Results

**Pending Transaction**

Senior debt restructuring and refinancing;  
concurrent bank amendment

**\$75,000,000**

Redeemable Preferred Stock

SUN CAPITAL PARTNERS, INC.

**A|C|T**

ACT Electronics, Inc., a portfolio company of Sun Capital Partners, Inc. has sold its Mississippi division to CDR Manufacturing, Inc. (dba Ayrshire Electronics) (Distressed Sale)


**cpi**

Reunion Industries has sold CP Industries to Everest Kanto Cylinder Ltd. (363 Sale)

**EKC** EVEREST KANTO

**Approximately 25% of our 2008 transactions were lender driven / distressed sales**

## Recent Financing Transactions

 <p>has acquired</p>  <p><b>\$6,500,000</b> Senior Credit Facility <b>\$7,500,000</b> Senior Subordinated Notes <b>\$2,250,000</b> Preferred Stock</p>	<p>Dividend Recapitalization</p>   <p><b>\$19,500,000</b> Senior Credit Facility <b>\$7,000,000</b> Senior Subordinated Debt <b>\$4,000,000</b> Preferred Stock</p>	 <p>has recapitalized</p>  <p><b>Undisclosed</b> Senior Credit Facility</p>	 <p>A portfolio company of</p>  <p>has acquired</p>  <p><b>\$37,500,000</b> Senior Credit Facility <b>\$11,500,000</b> Senior Subordinated Notes</p>
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### About Lincoln International

Lincoln International specializes in merger and acquisition services, debt advisory services, UK pension advisory services and providing fairness opinions and valuations for leading organizations involved in middle market transactions. With offices in Chicago, Frankfurt, London, Los Angeles, Madrid, New York, Paris, Tokyo and Vienna, and strategic partnerships with China Everbright in China and ICICI Securities, Inc. in India, Lincoln International has strong local knowledge and contacts in the key global economies. The organization provides clients with senior-level attention, in-depth industry expertise and integrated resources. By being focused and independent, Lincoln International serves its clients without conflicts of interest. More information about Lincoln International can be obtained at [www.lincolninternational.com](http://www.lincolninternational.com)

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Results you can rely on

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