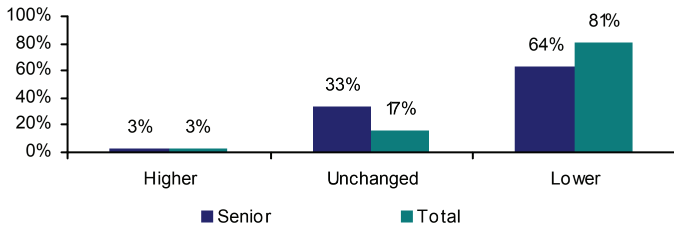
Lender Sentiment Survey: What the market thinks...

While there is a myriad of data regarding the outlook for the credit markets, the information available relates primarily to the large cap, publicly-traded corporate lending environment with the middle market either an afterthought, summarized in a single line, or forgotten altogether. ***To address this information shortfall, we recently surveyed 117 middle market lenders, including both senior and mezzanine lenders, on their views for 2008*** *and achieved a 35% response rate. The six-question survey addressed four critical areas: leverage, liquidity, pricing and defaults.*

Leverage

Leverage, though off of highs achieved in the second quarter of 2007, still remains at levels that exceed 10 year highs. In the fourth quarter of 2007, total leverage of middle-market LBO loans hovered at 5.6x, after two quarters of successive decline. The majority of respondents believe that levels will retrench, particularly as it relates to total leverage with 81% of respondents believing that 2008 will witness lower total leverage multiples.

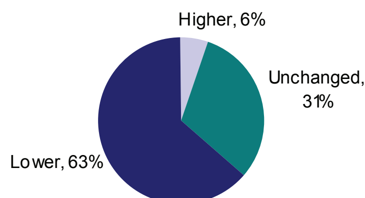
Chart A: 2008 Leverage Expectations



Liquidity

Liquidity, so prevalent in the first half of 2007, was far scarcer in the second half. The collapse of the CLO market severely limited funding sources for some middle-market lenders, while others elected to take a wait-and-see approach. Opportunistic hedge funds and alternative providers of capital filled some of the gap, and while these participants increased their share of the total lending market, the sustainability of these additional sources of funding is somewhat uncertain. Only 6% of respondents believed that liquidity would be higher in 2008, while 31% thought it would be unchanged. The remaining 63% believed the amount of liquidity in the market will continue to decline.

Chart B: 2008 Liquidity Expectations

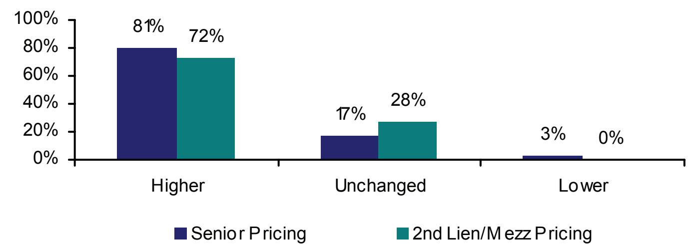


Source for Charts A, B, C, D: Lincoln International LLC

Pricing

In the second half of 2007, a new market clearing price was established. The combination of reduced liquidity and market uncertainty drove price increases of 100 - 150 basis points through the end of 2007. But was this 100 - 150 basis points step up enough? The vast majority of respondents indicated no; 81% of those surveyed expect to see higher prices in the senior debt market, while 72% expect the same in the subordinated lender market. Whether this increased pricing reflects additional risk in the market or the market simply demanding more yield for assuming the same level of risk is not clear. However, the result is the same – borrowing costs are likely to rise. Coincidentally, we have recently observed an additional 50 basis point increase in pricing.

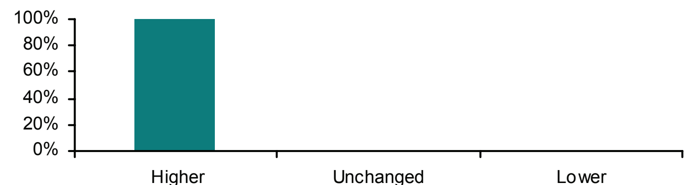
Chart C: Pricing Expectations



Defaults

Lenders (like economists) rarely agree unanimously on anything. However, when asked about the expectation of problem deals/ defaults, **all** respondents indicated they expect this number to increase in 2008 relative to 2007. Given that default rates are well below historic averages, this should be of little surprise, especially in the context of the lending environment that prevailed until recently. Additionally, concern over a slowing economy is raising fears of problems with portfolio companies.

Chart D: Default Expectations



Putting it all together, ***middle market lenders are expecting the credit markets to be tighter in 2008 with less leverage, lower liquidity, higher pricing and problem deals working their way back into portfolios.*** *And since lenders are the ones making the credit and lending decisions, many of the perceptions expressed 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, and funding will generally be more expensive and at leverage levels that are still high by historic standards but off the peaks of 2007.* ▪

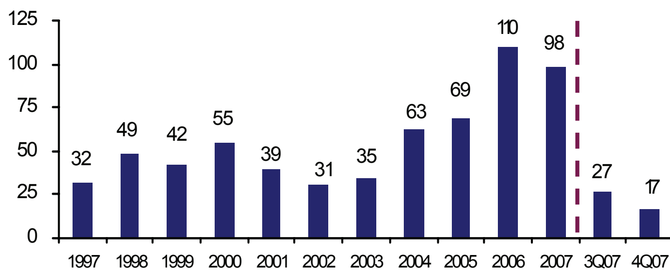
After 2007 Shift; More Reasonable Structures Emerge

From a business owner's perspective, 2007 started off just great. Leverage multiples were at historic highs, lenders decided covenants were irrelevant, interest payments could be turned off by using a toggle, and principal amortization was minimal. And then came August.

As anyone even remotely associated with the financing markets can attest, August 2007 was a tumultuous period with the consequences still reverberating today. Yet, for the middle market, deals continue to get done, and although some of the rules have changed, debt capital is still available to fund acquisitions, growth, refinancings and recapitalizations.

Probably the biggest impact on financings continues to be the reduced number of active providers. Lenders who were funded through warehouse lines and a CLO structures often found they could not go back to the market for more capital.

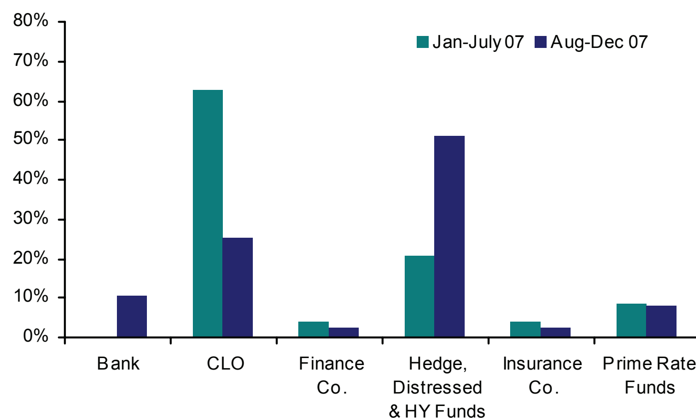
Chart E: Fund Managers that Issued Arbitrage CLOs



Source: Standard & Poor's Structured Finance Group, JP Morgan CDO Research, Merrill Lynch Structured Finance Research. Standard & Poor's LCD.

Money center banks straddled with commitments they couldn't offload also quickly shut off the spigot. As a result, the makeup of the lender group shifted to more relative value participants and the few remaining lenders decided it was too risky to underwrite financings and syndicate them post-closing, creating the need for "club" deals (see related article on page 3). Ascertaining if and when these sources of capital return to the market is critical to determining the health of the financing markets and we anxiously await their return.

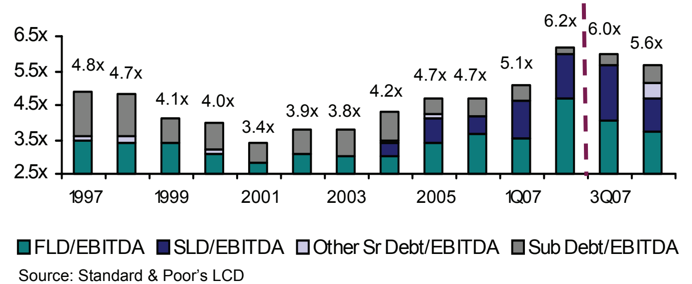
Chart F: 2007 Primary Market for Institutional Loans by Investor Type



Source: Standard & Poor's LCD

Structures, pricing and terms also changed. Leverage multiples decreased by 0.5 – 1.0 turns and often the split between senior debt and junior capital became more skewed towards junior capital. Interestingly, however, if you eliminate the period between the fourth quarter of 2006 and August 2007, current leverage multiples today are at or near historic highs. Whether this continues is contingent upon numerous variables including the health of the economy and default rates, but many of our clients continue to see this as a good time to complete their financings.

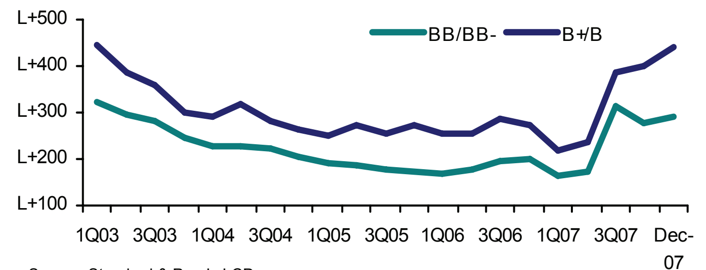
Chart G: Average Total Debt Multiples of Middle Market LBO Loans



Source: Standard & Poor's LCD

Pricing on senior debt has increased by 100 - 200 basis points, pricing grids are less common, standard covenant packages are once again the norm and PIK toggles are extinct. But again, many believe that this earlier period in 2007 was an aberration and the current environment represents more of a return to normalcy. Additionally, recent reductions in the base rates are helping to control all-in borrowing costs.

Chart H: Average All-in Spread Institutional



Source: Standard & Poor's LCD

Although perhaps a little less prevalent, we continue to see term loan B structures with 1% amortization, particularly for companies with EBITDA in excess of $10.0 million. This is almost always accompanied by a 75% excess cash flow recapture, but the absence of required amortization can provide borrowers with significant flexibility, especially in difficult times. And while there are fewer second lien loans getting done (and often less desire for them, particularly by cash flow senior lenders), mezzanine debt continues to be plentiful and has shown little, if any, increase in pricing.

So what will 2008 be like? Despite the credit crunch, there will be opportunities to complete middle-market financings. There may be fewer providers resulting in higher credit standards, and pricing and terms may not match the peak of the cycle, but quality middle market senior debt deals are in demand and will be favorably received by both equity sponsors and the debt markets. ▪

Join the Club: Senior Debt Financings

In the second half of 2007, a dramatic shift occurred in the debt capital markets, and liquidity withered, particularly for middle-market, cash flow-based senior debt. As a result, we entered 2008 with significantly fewer lenders willing and able to fully underwrite senior credit facilities, and post closing syndications have become a thing of the past. Gone are the days where a borrower or private equity group could make one single call to a relationship lender and trust him/her to complete the transaction as proposed. As many private equity groups can attest, even for those lenders willing to underwrite a transaction, uncertainty surrounding the terms and conditions of their financing has increased, with most senior debt underwriters incorporating the flexibility to change pricing and structure in their proposals.

The shrinking liquidity in the senior debt market is making it harder for deals to get done, but in the middle market, deal activity continues. In spite of the turbulent market and tightening credit conditions, lenders are still "in business" and money can still be raised. In fact, junior capital/mezzanine debt markets remain quite healthy, with many lenders/ mezzanine funds ready and willing to increase their funding to compensate for any shortfalls in senior debt. In addition, private equity funds also are flush with cash that they must put to work on behalf of their investors.

Nevertheless, obtaining an attractive senior debt package is critical to completing a transaction and in the current environment is often the most challenging piece of the capital structure. The practice of "clubbing" the senior debt is becoming more prevalent today as more borrowers/equity sponsors and their investment bankers are themselves assembling a group of banks who agree to provide the necessary financing rather than rely on an agent bank to perform this process. In a club deal, each selected bank agrees to underwrite and hold a portion of the total financing, eliminating the need for any syndication post-closing.

However, the process of clubbing a financing can be quite complex and time consuming. Many industry participants liken the process to "herding cats" as a borrower or private equity principal must deal with and respond to various lender issues, credit "hot buttons", questions and due diligence requests and getting a group of lenders to agree on a common set of terms.

Despite these challenges, the advantages of a clubbed senior debt deal are numerous. First, contacting multiple lenders and creating the club upfront provides the borrower with better control of the financing package. Middle-market lenders continue to offer syndicated financings, but often these syndications provide the lead agent with the ability to change the terms of the proposal, which may result in higher pricing, reduced leverage multiples and more equity – all aspects of a financing where the lead agent's interests may not be well aligned with the borrower. By creating the club, controlling the process and bringing in the right participants, a borrower will achieve a more favorable capital structure. Moreover, by running a more competitive process, a borrower can ensure greater success in meeting desired terms and objectives because in today's market it is difficult to predict each lender's desired risk appetite. Finally, a club enables the borrower to select the final lending group they prefer rather than relying on an agent to get it done.

However, as stated earlier, running a competitive financing process is a time consuming and resource intensive exercise. It also requires an extensive knowledge base of the market players. As a result, there is a growing trend by borrowers/private equity groups to outsource financings to an advisor with the expertise and capability to canvass a wide universe of lenders well-suited for a given transaction. Additionally, this advisor serves as an independent advocate for the sponsor, delivering to its client the best financing package and group of lenders available in today's marketplace, with the benefits far outweighing the cost for these services.

If you have a transaction that requires senior debt financing, Lincoln International's Capital Raising Group would be pleased to assist you. We are currently active in the market with multiple senior debt club deals and can help you evaluate if a club, rather than a syndication, is the right approach for you. ▪

Thank you for taking the time to read the inaugural edition of the Lincoln International Capital Raising DealReader.

Lincoln International's dedicated team of professionals specializes in raising debt and equity capital for corporate and private equity clients. We have extensive experience raising capital to finance leveraged buyouts, acquisitions, recapitalizations, refinancings, management buyouts and shareholder dividends.

Our team has spent years developing insight into how the best financing options can be achieved in the financing community. We give our clients honest, straightforward advice - and results they can rely on.

We hope that you have enjoyed this first newsletter and we would be pleased to help you assess your financial options.

Recent Financing Transactions

has refinanced its portfolio company

$41,000,000
Senior Credit Facilities

has acquired

cpac, INC.

$28,950,000
Domestic Senior Facilities
€2,372,500
Foreign Senior Facilities
$11,000,000
Junior Capital

A portfolio company of

RELIANT EQUITY INVESTORS

has acquired

$37,500,000
Senior Credit Facility

About Lincoln International

Lincoln International specializes in merger and acquisition services, private capital raising and providing fairness opinions and valuations for leading organizations involved in mid-market transactions. With offices in Chicago, Frankfurt, London, Los Angeles, New York, Paris and Vienna, and strategic partnerships with China Everbright and other partner firms in Asia, 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
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