

## Financing Outlook for Mid-Market Companies: More Options, Opportunities and Risks

BY TIMOTHY HALL

**M**id-market companies well-positioned for growth will not lack for opportunities in 2005 to make aggressive moves. With more lenders sparring for deals, including new entrants such as hedge funds, credit has loosened considerably. Today, valuations and debt multiples are at their highest levels since the late 1990s. As long as the economy holds steady and nothing cataclysmic occurs, companies during the next 12-18 months are likely to have plentiful, attractive financing options for leverage buyouts, acquisitions and recapitalizations.



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This promising outlook, however, must be tempered by certain realities. The “frothiness” of the current lending environment should give pause for concern, as should the fact that six-month LIBOR rates rose from 1.1595% in March 2004 to 3.1495% by February 2005. Moreover, leverage is a double-edged sword, since highly leveraged balanced sheets increase companies’ vulnerability to adverse developments such as further upticks in interest rates or sudden pull backs in consumer or commercial spending.

What is the upshot of these mixed messages emanating from the marketplace? Middle-market financing opportunities will continue to exist for select, under-capitalized companies with solid fundamentals, a seasoned management team and a viable business strategy. At the same time, borrowers should guard against becoming over-leveraged and take into account all the risk factors when considering their financing options.

### HIGHER VALUATIONS, MORE FINANCING ALTERNATIVES.

While opinions may differ as to the implications of conflicting marketplace data, one thing is certain: at least for the short term, companies will benefit from higher valuations and more financing options offering greater leverage than at any time since 1997. According to Standard & Poors Leveraged Commentary & Data (LCD), purchase price/EBITDA multiples for deals under \$250 million rose to 6.86 in the first half of 2004 — a

sharp increase from the 4 to 5 times multiples range in 2002.

Average debt multiples of highly leveraged loans likewise have steadily climbed. Today, senior debt in the middle market is available at 3 to 3.25 times EBITDA — up almost a full point from 2002 levels. Mezzanine lenders are willing to lend up to between 4.25 and 5.0 times EBITDA, depending on the size of the business. Borrowers also have taken advantage of a strong market for junior secured loans, which are often used to fill the gap between senior and mezzanine debt.

Clearly, the impetus for these rising multiples has been a private equity community flush with cash and eager to put money to work. And, as lenders became equally aggressive, the spigot for leveraged buyouts (LBOs) was turned wide open. In 2004, total LBO transaction volume approached \$94 billion, which was more than four times the LBO volumes in 2001 and 2002 and far above the recent high of \$57 billion in 1998. M & A deal flow is likely to remain strong throughout 2005, particularly in hot sectors such as retail, for profit education and consumer products.

### FINANCING TRENDS, CONSIDERATIONS

If the supply of capital, whether from private equity firms or debt markets, continues to outpace demand, business owners will have considerable leverage in structuring and negotiating favorable deals. It is important however, that they maintain a clear-eyed perspective on risk/reward ratios, especially since recent developments have ratcheted up their likelihood of becoming over-leveraged.

Whenever capital chases a limited number of quality deals, credit standards invariably loosen. For example, hedge funds have aggressively pursued mezzanine and junior secured loan financing, even on transactions as small as \$10 million to \$20 million. To win this business, they often offer more leverage while at the same time relaxing standard covenant metrics regarding EBITDA-to-debt ratios and fixed charge coverage. This laxity in underwriting adds fuel to a debt market that is dangerously close to becoming overheated.

Another recent development sparked by the hyperactive debt market is rapid refinancing by private equity sponsors. For example, a private equity firm might put up \$10 million to buy a company and refinance that amount within 18 months, effectively retaining ownership of the company while having no equity exposure. The potential downside of this “equity dividend” strategy — especially for former owners who still have a piece of the business — is that a major

adverse event (e.g., losing a big customer) could cause the company’s entire equity value to collapse due to the additional debt burden.

Such factors need to be incorporated into the evaluation process when formulating a growth strategy and selecting a financing instrument and partner. Questions to consider include:

Is this the right time to cash out or expand? Are you willing to give up control? If so, how much of the business will you sell?

How much debt can your cashflow support without jeopardizing the long-term viability of your business?

Will your private equity and/or lending partner be there if times get tough?

### FINAL WORD

The financial community has re-entered the middle market with renewed vigor. Still, certain worrisome factors warrant close attention. Though the economy continues to grow, its engine — consumer spending — could become stalled by excess debt. Since 2000, private household debt has soared by \$2.52 trillion, or 36%, and now is 86% of GDP — far above its 34-year average of 58%. Interest rates no doubt will steadily climb. Plus, jarring changes in geopolitical developments, oil prices or other variables could easily unnerve financial markets and increase the likelihood of a sudden retrenchment in credit.

The current debt market does not yet reflect the precariousness of the economic climate, and lenders no doubt will continue to pursue middle-market “trophy” businesses (i.e., those market leaders with defensible niches, high EBITDA margins and superb management). Although these businesses now have more pricing leverage and more opportunities for growth, uncertainties in the marketplace exacerbate their risks. Given these conditions, smart borrowers would be well-advised to work with lenders who are committed to their market sector, have the resources to withstand any sudden downturns and can help them mitigate risks while taking full advantage of their businesses value and opportunities.

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