

Porter, White & Company

Private Capital Markets Update

Summer 2010, Number 1

Executive Summary

- Slow, sporadic improvement in economic indicators is leading to very slow improvement in the private markets for debt and equity
- Improvements in the lending environment have benefited larger companies more than smaller businesses
- Bank regulators continue to drive banks to resolve existing troubled loans and to avoid new loans to small businesses that are perceived as risky
- Mergers and acquisitions (and other equity investment activity) is increasing in volume, but is still very short of a 2006-2007 peak
- Valuations have shown signs of stabilization and recovery after hitting a bottom during 2009; but there is often still a space between seller expectations and buyer willingness to pay
- PW&Co's network of local and national investors are showing much more willingness to invest and take risk than was visible 6-12 months ago, but buyers still expect a bargain

I. Debt Markets Showing Slow Improvement

The debt environment remains difficult. Over the past three years, virtually every type of lender has become and remains more conservative in the amount of money it is willing to lend, and on the terms at which it is willing to lend it.

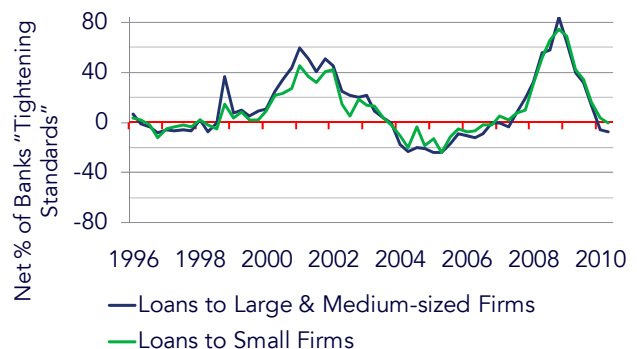
A. Banks Slowly Easing Availability; Small Businesses Still Squeezed

Current survey and data trends on lending standards, loan pricing, demand for loans, and size of credit lines generally point to a lending environment that is "less bad," indicating a thaw in the market. Still, debt remains hard to come by. According to data from the Federal Reserve,¹ U.S. banks stopped tightening standards on many commercial & industrial (C&I) loans in the fourth quarter of 2009, and banks generally kept their lending standards unchanged in the first quarter of 2010. While the result is "less bad" than further tightening, standards remain quite stringent.

Terms and conditions on loans have stopped getting worse. Survey results indicate that terms to firms of all sizes also remained largely unchanged, including loan covenants, collateral requirements, risk premiums, and maximum maturities.²

As LIBOR and Prime remain at historical lows, the use of increased spreads and "LIBOR floors" (in certain cases) means that much of the cost savings have not flowed through to borrowers who enter into new loans or renew maturing debt. While the most recent Fed survey shows that spreads remain generally unchanged (after 2 years of net tightening), the largest borrowers were more likely than smaller borrowers to receive eased pricing terms.

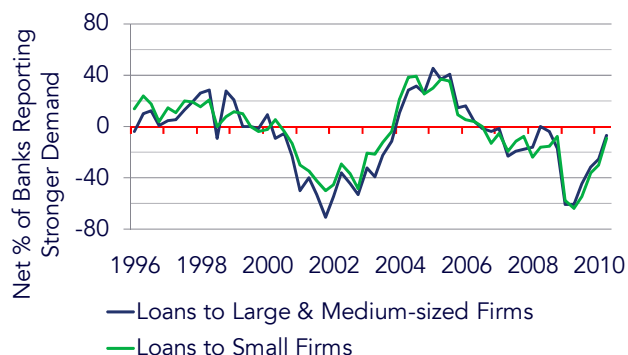
Figure 1: Changes to C&I Lending Standards



Source: *The April 2010 Senior Loan Officer Opinion Survey on Bank Lending Practices*, Board of Governors of the Federal Reserve System. Data is for domestic respondents. "Large and Medium-sized firms" are defined as firms with annual sales of \$50 million or more.

The drop in lending is not one-sided; business owners have also shunned debt, due in part to reduced capital investment and a reduced need to finance working capital (from lower sales and tighter operations).

Figure 2: Changes in C&I Loan Demand



Source: *The April 2010 Senior Loan Officer Opinion Survey on Bank Lending Practices*, Board of Governors of the Federal Reserve System. Data is for domestic respondents. "Large and Medium-sized firms" are defined as firms with annual sales of \$50 million or more.

Not surprisingly, loan demand is highly related to levels of capital investment and working capital (financing of inventory and accounts receivable). According to data from the National Federation of Independent Business, the frequency of reported capital outlays over the past six months was unchanged at 46 percent of all firms, two points above the 35-year record low reached in December 2009.³ A pickup in M&A, increased capital expenditures, and increased sales and working capital can all be expected to boost loan demand across the economy.

Does that mean the concerns about small business financing are over-blown? Unfortunately, no. As the data indicates, banks have yet to unwind the considerable tightening made as a result of the financial crisis and small & medium-sized firms are still struggling to obtain loans from banks.

PW&Co has observed the impact of tightening regulation of banks, especially somewhat troubled banks, in terms of how they handle existing loans as well as new loans. We see certain banks being very aggressive in acting against troubled loans, and being very hesitant to loan to small and medium businesses that formerly would have been valued customers. While most (even mildly) distressed firms have no choice other than to ride out the situation with their existing bank, businesses seeking new loans should seek multiple proposals and think carefully about the health of their lending institution.

Accordingly, as certain banks continue to maintain tight credit (albeit at a lesser level than recent history), borrowers may face cash shortages as they receive less borrowing base per unit of collateral, even for purely asset-based lenders (ABLs). Consequently, commercial and industrial borrowers are well served to closely watch inventories and accounts receivable.

B. Mezzanine Debt Still Tight

While much of mezzanine capital is used in conjunction with mergers and acquisitions, it is also available as a source of growth capital or to refinance existing debt. Data indicate that the market for mezzanine capital, like the senior lending market, is still tight. Mezzanine lenders are reporting that appetite for risk and lending multiples of cash flow decreased during 2009.⁴

Current typical thresholds for qualifying for mezzanine capital include:⁵

- 1.25x - Fixed charge coverage (min)
- 1.50x - Debt service coverage ratio (min)
- 2.00x - Senior debt to EBITDA (max)
- 3.50x - Total debt to EBITDA (max)
- 0.60x - Debt to net worth (max)
- 0.60x - Debt to tangible net worth (max)

Businesses that are not used to dealing with mezzanine lenders should expect and prepare for a much more difficult diligence and more stringent covenants than they have seen from traditional bank lenders. Where senior lenders tend to focus on historical and current financials, mezzanine lenders focus much more diligence attention on assessing the management team and downside future scenarios related to financial risk and business risk.

C. Leverage Ratios Tight; Rates Low

The table below summarizes PW&Co's observations of debt leverage and rates seen in the market today, and presents perhaps the most important change in the debt markets over the last three years: a reduction in lending multiples.

Table 1: Debt Leverage and Interest Rates

Debt Tranche	Current	Oct 2009	3 Years Ago
Leverage (EBITDA Multiple)			
Senior	2.5x	To 2.0x	3.25-3.75x
Subordinated	N/A	N/A	3.5-4.25x
Mezzanine	2.5x	To 2.5x	4.0x+
Interest Rate / Target Return *			
Senior	300-400	350-450	150-250
Subordinated	N/A	N/A	250-350
Mezzanine	18-20% (12-14%)	18-22% (12-14%)	18-22% (12-14%)

* "Senior" and "Subordinated" tranches display bps spread over LIBOR. "Mezzanine" tranches displays total return, with expected coupon interest payments in parentheses.

As each debt tranche takes less risk, and as the subordinated debt market has dried up, the total cost of capital for new or renewal debt has increased dramatically in spite of low rates. Businesses that have seen significant reductions in revenues and earnings have the "double whammy" of weaker earnings and lower lending multiples.

II. Private Equity Markets Improving

The availability of private equity investment for small and medium sized businesses has improved over the last 6-12 months. PW&Co's network of local and national investors are showing more willingness to invest and take risk than was apparent 6-12 months ago, but buyers still expect a bargain. This is reflective of the broad national trends discussed below.

A. Mergers & Acquisitions Activity Recovering

M&A activity has shown some recovery in 2010 after being down significantly across nearly all sectors and markets in 2009. While the worldwide value of deals in 2009 (\$2.1 trillion) was down 28.2% from 2008, M&A with U.S. involvement in the first quarter of 2010 (\$275.1B) increased 59.8% compared to 1Q 2009.⁶

Table 2: 1Q 2010 M&A Activity (U.S. Targets)

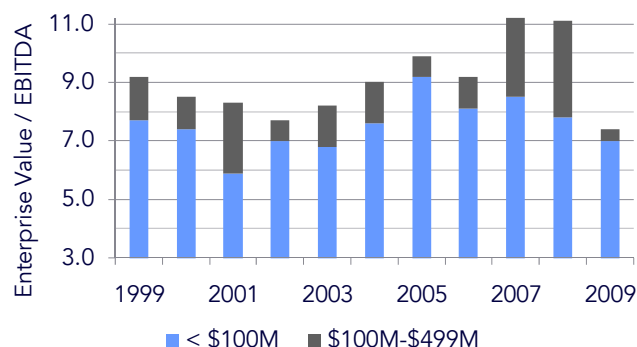
	U.S. Target	U.S. Small-Cap (Value up to \$50M)
M&A Volume	\$199B	\$5B
vs. 1Q 2009	27.7%	-1.9%
# Deals	1,826	1,668
vs. 1Q 2009	0.3%	-2.3%

Source: Thomson Reuters "Mergers & Acquisitions Review," First Quarter 2010. Not all announced deals have a disclosed value.

Valuation multiples plummeted in 2009 due to the impact of the global recession and credit crisis on the deal appetite for buyers and sellers. And, as sellers hold out for a return to 2007 earnings and multiples and buyers hold out for bargain pricing, valuation has become very difficult to establish in many cases.

There are some signs of a potential stabilization or recovery of valuations. On a last twelve month (LTM) basis, the median EBITDA multiple for deals up to \$1 billion increased from 7.2x after 3Q 2009 to 7.5x in December.⁷ Separate data show that median valuations have continued to recover into 2010.⁸ In addition to increased availability for debt financing for M&A, a year-long rally in the equity markets has supported valuations of prospective targets, as public-company comparables are a critical M&A valuation benchmark. Depressed EBITDA levels may have also played a role in the late-year uptick in multiples, as buyers may be giving more credit for future growth off a trough EBITDA number.

Figure 3: Median EBITDA Multiple by Deal Price



Source: Capital IQ and Robert W. Baird & Co. Incorporated M&A Market Analysis. Median multiples are calculated using deals for which meaningful data is available. Figures exclude transactions involving minority stakes, stock repurchases, and spin-offs.

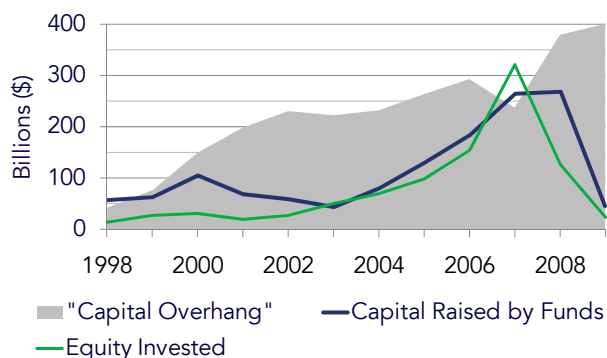
As evidenced in Figure 3, smaller companies consistently sell for lower multiples than larger companies on average because of the generally higher risk attached to the performance of smaller companies and, therefore, a higher cost of equity capital.

B. Private Equity Becoming More Active

Following a couple of very slow years, private equity firms are contributing more to M&A activity in 2010. While declining 43.5% in 2009 (to \$133.8B), resulting in the slowest full-year period since 2002, worldwide PE-backed M&A ended 2009 with the largest three-month volume since 3Q 2008.⁹ PE-backed M&A (\$32.4B) in the first quarter increased 89% over 1Q 2009.¹⁰

Private equity firms are facing pressures to execute deals, as sellers looking to exit long-term holdings and as buyers seeking to deploy large amounts of committed capital. The table below illustrates the record levels of “capital overhang,” or funds raised but not deployed, by US-focused funds raised by US investors.

Figure 4: Capital Overhang for US-Focused Funds Raised by US Investors



2009 data is through April 2009.

Source: Pitchbook. *Private Equity Investment Trends – 2Q 2010*.

Private equity firms still face important headwinds, including ongoing focus on struggling portfolio companies, uncertainty related to the economy and valuations, and lesser debt availability to get deals completed.

Business owners should be aware that the majority of PE firms expect to have operating control of the companies they invest in. PW&Co is seeing this trend become more pronounced, especially in distressed situations.

Business owners exploring a sale to private equity firms should expect a rigorous due diligence and sale process; PE firms estimate they only close one deal for every 100 business plans received.¹¹ Today’s environment also makes it important to have a strong company to sell and to look for buyers with a natural connection.

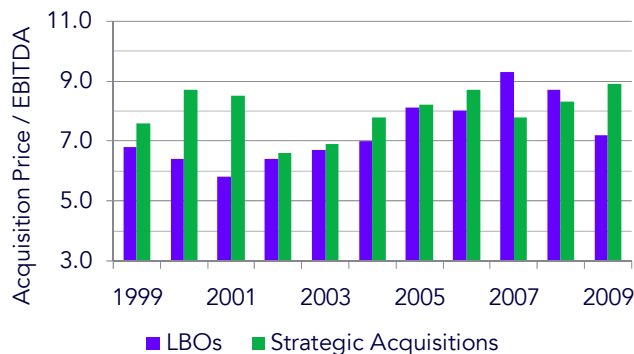
C. Synergistic Buyers Re-entering Market

Strategic acquirers have recently taken increasing shares of total M&A volume from private equity (up to 77% of M&A volume in 2009 from 69% in 2007).¹² Many view the current environment as a good time to buy as a result of large cash hoards, access to capital, lower valuation multiples, and less competition from private equity firms than they faced during 2004 to 2007.

At American companies, cash on the balance sheet is close to 11% of assets, a 60-year high.¹³ The free cash flow of non-financial companies has held up surprisingly well during the recession as capital expenditures declined along with operating profits. In addition to dividend increases and share buybacks, high cash levels are helping to generate capital investments and M&A activity.

The table below shows that, in 2009, strategic acquirers returned to a long-run trend of paying higher multiples than financial sponsors.

Figure 5: Average Acquisition EBITDA Multiples



Source: S&P M&A Stats and Robert W. Baird & Co. Incorporated.

D. High Net Worth Individuals & Families Slowly Regaining Appetite for Risk

In addition to institutional debt and equity, PW&Co also has deep relationships in the world of high net worth individuals. While these investors are still willing to pursue good deals, they often have less cash on hand than they did in 2006 and have become much more risk averse. They expect very high returns for investments that are seen as at all risky.

III. Summary: Still Difficult Time to Sell; Outlook for 2010/2011 Looking Better

PW&Co's broad view is that this is a bad time for non-distressed businesses to voluntarily enter a sale process. Lower valuation multiples create situations where a business owner who thought her business was worth \$100 million (\$12 million in EBITDA times an ~8x multiple) in 2005 might be told her business is worth less than \$50 million today (\$8 million in EBITDA times a ~6x multiple). If this company is carrying \$40 million in debt, the owner's equity has gone from \$60 million to less than \$10 million.

That being said, business owners seeking liquidity would be well served to begin preparing now if they want to begin an auction in late 2010 or 2011, as at current trends, the equity markets should be functioning and clearing at good valuation levels.

While many debt measures indicate that we are seeing a "thaw," this thaw has not meant a return to the heady days of 2006, nor do we expect it to in the foreseeable future; but a strong business, well prepared, should be able to successfully raise debt in this environment on reasonable terms.

Notes and Disclaimers:

This document presents Porter, White & Company's current view of the private markets (i.e. non-SEC registered transactions) for debt and equity. This document is useful to middle-market companies that are considering debt or equity raises, to lenders and investors who want to better understand market rates for their investments, and for professional service providers who serve companies, lenders and investors.

This document relies on a number of relevant sources, along with PW&Co's recent experiences, and is intended for the general information of our friends and clients. It should not be relied upon for decision-making without consulting with PW&Co. Every transaction is unique, and many of the statements in this document are generalizations; there will be exceptions to these generalizations.

¹ Source: *The April 2010 Senior Loan Officer Opinion Survey on Bank Lending Practices*, Board of Governors of the Federal Reserve System. Data is for domestic respondents.

² Survey question includes terms for applications for C&I loans or credit lines, other than those to be used to finance mergers and acquisitions,

³ *NFIB Small Business Economic Trends*. National Federation of Independent Business. June 2010.
<http://www.nfib.com/tabid/350/Default.aspx>.

⁴ Source: *Survey Report Volume II - Winter/Spring 2010*, Pepperdine Private Capital Markets Project Survey, (Survey deployed October/November 2009).

⁵ Source: *Survey Report Volume II - Winter/Spring 2010*, Pepperdine Private Capital Markets Project Survey, (Survey deployed October/November 2009).

⁶ Source: Thomson Reuters "Mergers & Acquisitions Review," Fourth Quarter 2009 and First Quarter 2010. Note that not all announced deals have a disclosed value. 1Q 2010 data referenced includes 1Q 2010 announced M&A with U.S. involvement.

⁷ Source: Capital IQ and Robert W. Baird & Co. Incorporated M&A Market Analysis. Median multiples are calculated using deals for which meaningful data is available. Figures exclude transactions involving minority stakes, stock repurchases, and spin-offs.

⁸ Source: Capital IQ. *June 2010 Monthly Market Observations*.

⁹ Source: Thomson Reuters "Mergers & Acquisitions Review," Fourth Quarter 2009. Note that not all announced deals have a disclosed value.

¹⁰ Source: Thomson Reuters "Mergers & Acquisitions Review," First Quarter 2010. Note that not all announced deals have a disclosed value.

¹¹ Source: *Survey Report Volume II*, Pepperdine Private Capital Markets Project Survey, (Survey deployed October/November 2009). 13.0% and 15.0% are the results at the first and third quartiles of responses. 14.0% is the median response.

¹² Dealogic and Robert W. Baird & Co. Incorporated M&A Market Analysis. Figures exclude transactions involving minority stakes, stock repurchases, and spin-offs.

¹³ Source: Doll, Bob. "The Bullish Case for U.S. Equities." *The Wall Street Journal*. June 8, 2010.