

# Porter, White & Company

## Private Capital Markets Update

Winter 2011, Number 2

### Executive Summary

- General advances in the US economy are driving significant improvement across the US private capital markets for debt and equity.
- Lenders' and investors' appetite for risk has increased dramatically in the last 6 months.
- Improving valuations are beginning to bridge the pricing gap between buyers and sellers.
- PW&Co has seen these national trends in action in its recent deals in Alabama and the mid-South, and this is reflected in significantly increased availability of risk capital from our network of local and national investors.
- Interest rates are remaining near historical lows, while lending multiples are beginning to return to pre-Great Recession levels. Debt availability for large companies has improved more rapidly than for small companies.
- M&A activity is set to increase in 2011, with a focus on small and middle-market companies.

### I. Overview

In our initial PW&Co Private Capital Markets Update last summer, we reported the beginnings of a "thaw," but did not anticipate a return to the heady days of 2006. While we are still far from 2006 conditions, the Private Capital Markets<sup>1</sup> have improved even more than we would have anticipated, both in Alabama and Mississippi and across the United States generally.

This is reflected in continued historically low interest rates, increased availability of both debt and equity capital, and improved valuation multiples. However, larger companies are attracting significantly more favorable terms than smaller firms.

In our own direct experience, we have closed deals in the last six months that simply would not have been available in the marketplace a year ago. In summer 2010, we stated that "it is a bad time for non-distressed businesses to voluntarily enter a sales process" but that a "strong business, well prepared, should be able to raise debt in

this environment on reasonable terms." Today, we see a more robust supply of buyers for profitable companies at reasonable valuations, and continuing improvement in availability of debt for companies that can articulate their financial and strategic story to lenders.

### II. Improvement in Debt Markets Accelerating

As American banks have returned to health, their desire to lend is increasing, while interest rates are remaining at historically low levels. Because of this, we are beginning to see banks and asset-based lenders become more aggressive as they bid for lending business. This is reflected in the number of lenders who report that they are "loosening standards" under which they evaluate potential loans.

Another significant development in recent months is the meaningful return of mezzanine debt to the marketplace. This category of debt, which effectively sits between traditional secured senior debt and unsecured equity, had been largely unavailable<sup>2</sup> during the "Great Recession."

The table below summarizes PW&Co's observations of debt leverage and rates seen in the market today.

**Table 1: Debt Leverage and Interest Rates**

Debt Tranche	Current	Jun 2010	3 Years Ago
<i>Leverage (EBITDA Multiple) *</i>			
Senior	2-3.25x	2.5x	3.25-3.75x
Mezzanine	3x - 4x	2.5x	4x+
<i>Interest Rate / Target Return *</i>			
Senior	200-400	300-400	150-250
Mezzanine	18-20% (12-14%)	18-20% (12-14%)	18-22% (12-14%)

\* Note that leverage multiples tend towards the high end of the range for larger companies, and the low end of the range for smaller firms. "Senior" tranche displays bps spread over LIBOR. "Mezzanine" tranches displays total return, with expected coupon interest payments in parentheses. Source: PW&Co research

Table 1 above shows several key trends. First, we see leverage multiples increasing over those available in Summer 2010. This is most dramatic in the mezzanine

space. Secondly, we see slow improvement in pricing on a “spread” basis over LIBOR. Since LIBOR remains low by historical standards, this means that debt pricing is very good from a borrower’s perspective.

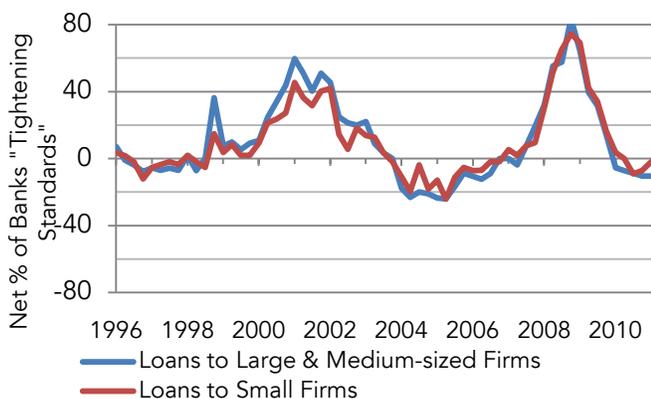
While leverage multiples, especially for senior lenders, are still far from the levels seen prior to the “Great Recession,” it is clear that the debt markets have returned from the darkest days of 2009-10, in part because of the limited supply of quality deals.

It is important to note that the debt market has recovered most vigorously for medium to large companies, with EBITDA over \$10 million. For smaller companies, recovery is still ongoing. As applied to Table 1, the general rule is to assume that the high end of the leverage multiple range is most applicable to large companies, and the low end is more relevant to small companies.

### A. Senior Bank Debt Remains Inexpensive; Availability Improving

While U.S. banks have not dramatically changed their lending standards over the past three months, large banks in particular have begun to ease standards on commercial and industrial (C&I) loans. 18% of large banks reported easing lending standards for large and middle-market firms over the past three months, and 10% reported also easing lending standards for small firms.<sup>3</sup>

**Figure 1: Changes to C&I Lending Standards**

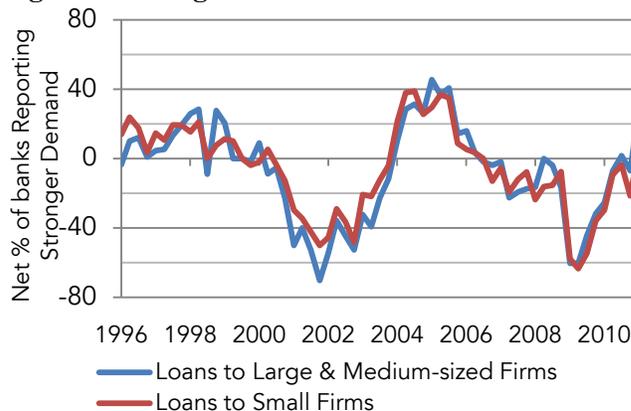


Source: *The January 2011 Senior Loan Officer Opinion Survey on Bank Lending Practices*, Board of Governors of the Federal Reserve System. Data is for domestic respondents. “Large and Medium-sized firms” are defined as firms with annual sales of \$50 million or more.

Large banks notably eased standards for middle-market and large firms, including maximum credit lines (22%),

maximum maturity (41%), cost of credit lines (38%), spread of loan rates over the bank’s cost of funds (63%), risk premiums (22%), and loan covenants (25%).<sup>4</sup> Banks are still hesitant to ease standards for small firms, but large banks have eased the cost of credit lines (28%) and spread of loan rates over the banks cost of funds (45%).<sup>5</sup>

**Figure 2: Changes in C&I Loan Demand**



Source: *The January 2011 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.

In the most recent Fed Senior Loan Officer Survey, 50% of large banks reported greater demand for C&I loans from large and middle-market firms (annual sales of \$50 million or more) with a lesser increase in demand from small companies.<sup>6</sup>

Increased C&I loan demand was driven by a pickup in M&A activity, reduced borrowing from other bank or nonbank sources, increased working capital financing (financing of accounts receivable and inventory), and increased capital expenditures.<sup>7</sup>

These initial movements towards looser lending standards and increased demand for loans are reflective of general perceptions that the US economy is moving forward with a broad recovery. In lockstep with this perception is a willingness to take additional risk (such as adding debt or using cash for acquisitions) in pursuit of higher returns.

### B. Asset Based Lending Remains Strong

Asset-based lending continues to be a viable option for companies looking to leverage working capital assets. At \$600 billion in 2008, asset-based lending was 14% of total

non-investment grade loans, and since then, it has grown to over 20%.<sup>8</sup>

Commercial banks have seen spreads return to normal levels, and capital finance companies are starting to see reduced rates as their own lines of credit become more stable. Smaller deals tend to be priced on the high end of the spectrum, as shown in Table 2.

**Table 2: Asset Based Lending Rates**

Asset Based Rates by Lender	
Commercial Bank	Libor +2% to Libor +4%
Capital Finance	8% to 12%

Asset based lenders are currently lending as much as 65% of the borrower's current inventory market value and up to 85% of receivables.<sup>9</sup>

### C. Mezzanine Debt Returns to the Marketplace

Mezzanine lenders are returning to meaningful activity. This is reflected in willingness to extend greater amounts of leverage than was available six or 12 months ago.

**Table 3: Qualifying Thresholds for Mezzanine Capital**

	May-10	Dec-10
Current ratio (min)	1.0x	1.3x
Fixed-charge coverage ratio (min)	1.2x	1.2x
Senior debt service ratio (min)	1.8x	1.3x
Total debt service ratio (min)	1.3x	1.2x

Source: Pepperdine Private Capital Markets Project Survey, *Survey Report - Winter 2011*

This is demonstrated by generally looser loan qualifying thresholds, as shown in Table 3, and in increased leverage multiples, as demonstrated in Table 1 above.

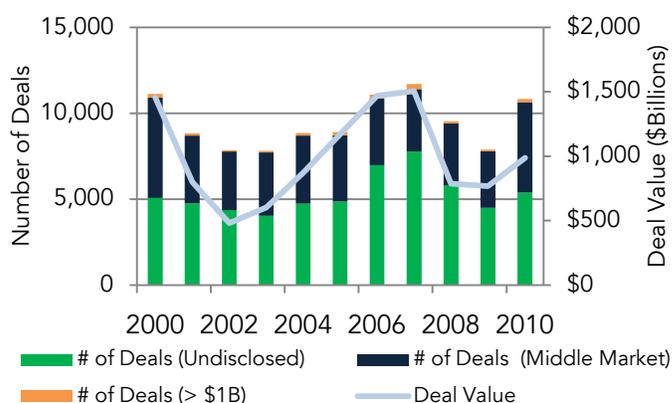
## III. Private Equity Markets Show Broad Improvement

The availability of private equity investment for small and medium sized businesses has improved over the last 6-12 months, and looks to remain strong throughout 2011. This reflects our general theme of an increased appetite for risk in pursuit of return. This is driving not only increased availability of capital, but higher valuations as well.

## A. Mergers & Acquisitions Activity Recovering

M&A activity surged in the second half of 2010, with a continued focus on middle-market M&A transactions. Corporate acquisitions increased almost 40% over 2009, with 60% of the deals being made by a private acquirer, mostly middle-market size.<sup>10</sup> The total number of M&A deals looks to increase even more rapidly this year as US companies begin to spend excess cash on strategic acquisitions and private equity firms look to unload capital overhang.

**Figure 3: US M&A Activity**



Source: Dealogic and Robert W. Baird & Co. Incorporated M&A Market Analysis.

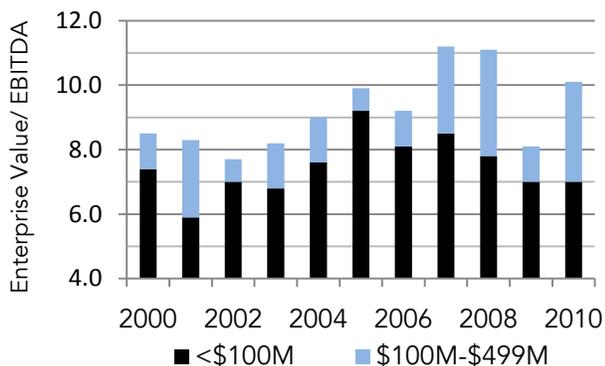
The number of worldwide M&A deals increased 16% last year, while the US middle-market M&A activity jumped 59%. US Middle-market deal value also jumped 72% to \$344 billion, up from 2009's \$200 billion low.<sup>11</sup> Bankruptcy related M&A activity dropped 38% in 2010, indicating positive economic trends.<sup>12</sup>

Corporate acquisitions look to increase in 2011, as companies begin to deploy the ~\$2 trillion cash sitting on US balance sheets. 26% of US CFOs report that their company is expecting to take part in a merger or acquisition, and 91% said that their company would be making the acquisition.<sup>13</sup>

## B. Valuations Improving

Valuation multiples saw a resurgence in 2010, up sharply from the bottom in 2009. On a last twelve month (LTM) basis, the median EBITDA multiple for deals up to \$1 billion increased from 7.6x in 2009 to 8.6 in 2010.<sup>14</sup>

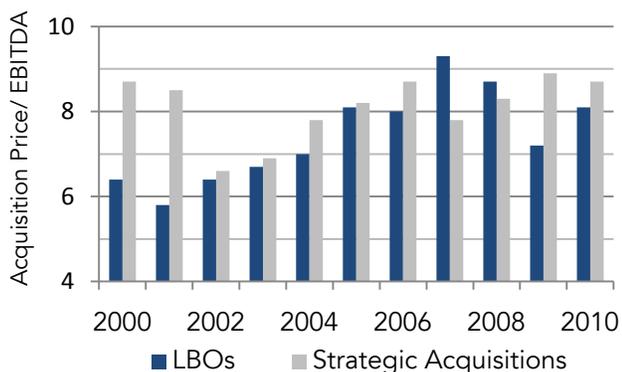
**Figure 4: Median EBITDA Multiple by Deal Price**



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.

31% of US CFOs think that valuation multiples for M&A deals will continue to rise in 2011, showing an increased appetite for growth.<sup>15</sup> Companies with excess cash may be willing to spend more on a strategic acquisition to quickly expand into new markets or develop new products as customer spending returns. The table below shows that in 2010, strategic acquirers continued to pay higher multiples than financial sponsors.

**Figure 5: Average Acquisition EBITDA Multiples**



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

### C. Institutional Private Equity: Active Buyers and Sellers in 2011

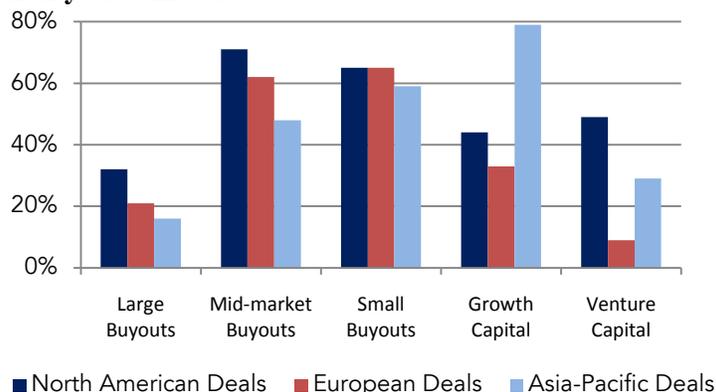
Nearly 70% of respondents to the Pepperdine Private Capital Markets survey reported that demand for business investment is up from six months ago, as are investment standards, appetite for risk, and the quality of companies seeking investment.<sup>16</sup> US Private Equity investment increased 119% over 2009 levels, driven by the reemer-

gence of larger deals.<sup>17</sup> During 2010, 70% of total PE capital invested came from deals over \$500 million, up from 55% in 2009.<sup>18</sup> The continued growth of larger deals can be attributed to increased availability of leverage.

While the number of private equity deals increased, buyouts continued to outpace exits leaving the private equity industry with the largest portfolio company overhang to date.<sup>19</sup> If corporate acquisitions pick up as expected in 2011 and investors continue to push for returns and/or access to capital, private equity will likely divest portfolio companies at record rates.

Following a strong year of recovery, expectations remain high for a continued recovery in 2011. Private capital investors expect middle-market buyouts to be the best area for investment in North America through 2012, followed closely by small buyouts. This is a promising sign for business owners looking to sell their companies or raise growth capital in 2011.<sup>20</sup>

**Figure 6: Best areas for GP Investment over the next 2 years- LP Views**



Source: Collier Capital, *Winter 2011 Global Private Equity Barometer*. Large Buyouts (\$1B or more), Mid-market Buyouts (\$200M-\$999M), and Small Buyouts (less than \$200M)

## IV. The Mid-South Market for Private Capital

PW&Co sees the national trends of increased availability of capital and appetite for risk at work in our core Alabama and Mississippi markets. From July 2010 to today, we have seen consistent improvement in the availability of capital from the private capital markets.

Several of the transactions we have recently been involved in, as sell-side advisors, arrangers of private placements, and in buy-side support of our corporate

clients, would not have been possible (or would have had severely less favorable terms) in the period between the collapse of Lehman Brothers and June 2010.

Specific, publicly known examples of PW&Co deals reflecting these trends include the sale of Alabama Outdoors in July 2010, Southern Research Institute's placement of \$20 million in debt at historically low rates in September 2010, and the oversubscribed WEPA capital raise in December 2010.

Confidential PW&Co deals reflecting these trends include the sale of a minority investment in a financial services firm, several synergistic acquisitions and investments by local corporations, and continuing uptick in our deal pipeline. Banks that have been hesitant to extend new credit are now beginning to compete to issue loans to borrowers with reasonable collateral and recent financial results.

## V. Summary: Dramatically Improved Selling Environment and Availability of Debt

PW&Co believes that the environment for business owners seeking liquidity is dramatically improved over recent conditions. Valuations are rising and M&A activity is increasing. Banks are more eager to lend and borrowers are ready to invest in growth.

While we certainly have not yet returned to the halcyon days of the middle of the last decade, capital is available for businesses that have reasonable risk-return profiles. We encourage our clients who are considering the sale of their business, raising debt or equity capital for growth, or contemplating how to put their capital to work most effectively to contact us to discuss how to prepare in advance to achieve the best possible outcome.

**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.

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<sup>1</sup> Often, our clients ask us what we mean by "Private Capital Markets." In this report, we are referring to the broad pool of non-publicly-traded debt and equity that traditionally supports small and medium sized US businesses. Sources of "private capital" include traditional commercial banks, asset based lenders, and mezzanine lenders on the debt side, and private equity firms, family offices, high-net-worth investors, and corporate acquirers on the equity side.

<sup>2</sup> While mezzanine firms remained active during the Great Recession, the amount of leverage they were willing to provide was in most cases not meaningfully larger than the leverage available from senior banks and asset-based lenders. Thus, as a practical matter, mezzanine debt was not a practical option for a period of time.

<sup>3</sup> Source: *The January 2011 Senior Loan Officer Opinion Survey on Bank Lending Practices*, Board of Governors of the Federal Reserve System.

<sup>4</sup> Source: *The January 2011 Senior Loan Officer Opinion Survey on Bank Lending Practices*, Board of Governors of the Federal Reserve System.

<sup>5</sup> Source: *The January 2011 Senior Loan Officer Opinion Survey on Bank Lending Practices*, Board of Governors of the Federal Reserve System.

<sup>6</sup> Source: *The January 2011 Senior Loan Officer Opinion Survey on Bank Lending Practices*, Board of Governors of the Federal Reserve System.

<sup>7</sup> Source: *The January 2011 Senior Loan Officer Opinion Survey on Bank Lending Practices*, Board of Governors of the Federal Reserve System.

<sup>8</sup> Source: Bank of America, "Asset-Based Lending Rides a Perfect Storm" *Capital Eyes*, January/February 2011.

<sup>9</sup> Source: Bank of America, "Asset-Based Lending Rides a Perfect Storm" *Capital Eyes*, January/February 2011.

<sup>10</sup> Source: Robert W. Baird Co., *2011 Middle-Market M&A*, January 2011.

<sup>11</sup> Source: Robert W. Baird Co., *2011 Middle-Market M&A*, January 2011.

<sup>12</sup> Source: Robert W. Baird Co., *2011 Middle-Market M&A*, January 2011.

<sup>13</sup> Source: Bank of America, "2011 CFO Outlook: A Survey of What Finance Chiefs Expect" *Capital Eyes*, January/February 2011.

<sup>14</sup> Source: Robert W. Baird Co. *2011 Middle-Market M&A*, January 2011.

<sup>15</sup> Source: Bank of America, "2011 CFO Outlook: A Survey of What Finance Chiefs Expect" *Capital Eyes*, January/February 2011.

<sup>16</sup> Source: Pepperdine Private Capital Markets Project Survey, *Survey Report - Winter 2011*, December 2010.

<sup>17</sup> Source: Pitchbook, *Annual Private Equity Breakdown 2011*, January 2011.

<sup>18</sup> Source: Pitchbook, *Annual Private Equity Breakdown 2011*, January 2011.

<sup>19</sup> Source: Pitchbook, *Annual Private Equity Breakdown 2011*, January 2011.

<sup>20</sup> Source: Collier Capital, *Winter 2011 Global Private Equity Barometer*, January 2011.