

Coping With Economic Realities

The Markets Will Remain Unforgiving in 2009, But Opportunity Exists for Some

By Bryan Jaffe

As the new year dawned, there was a growing sentiment among some market analysts that the U.S. economy might turn around in the second half of 2009. This view hinged upon the belief that unprecedented economic stimulus would arrive from the new administration and that the nearly \$3 trillion in alphabet-soup-acronym bailout programs would produce positive change for both borrowers and lenders alike. By January 2nd, the Dow Jones Industrial Average had rallied 16.4% from its November 21st low, fueling optimism. Frankly, this was not a view we shared.

By the second week of January, the reasoning behind our stance began to come into focus. Unemployment reached 7.2%, the worst since 1993, meaning 2.6 million jobs have been lost during this economic contraction (the most since 1945). Of greater significance was the fact that one million jobs were lost in November and December of 2008 and over half a million people sought unemployment insurance claims for the week ended January 10th, 2009, indicating that the contraction was, in fact, accelerating. What followed was a slew of negative revenue and earnings announcements from market bellwethers and additional requests for bailouts, which has pushed the Dow down over 9.0% year-to-date. Cumulatively, this has had a sobering effect on the analyst and investor communities.

Not Much Near-Term Optimism

While we are not economists by trade, we see economic fluctuations through the performance of our clients and potential clients and through

our access to smart people on the subject. Based on the data available to us, we see very little reason for near-term optimism. The fundamental pillar of our economy, the manufacturing base, has been eroded over the past decade. Economic growth has been fueled by service sector expansion and consumer asset bubbles. With trillions of dollars of wealth having been eviscerated in the fourth quarter of 2008, it will take time for consumers to rebuild their personal balance sheets. Without the consumer driving the economy, we will face double-digit unemployment, economic contraction not seen since the Great Depression and minimal real asset appreciation over the next 24 - 36 months due to the anticipated decline in the value of the dollar, even if the stock market rallies in 2009.

A Silver Lining in the Credit Markets

Surprisingly, the silver lining, if there is one, can be found in the credit markets. Credit spreads have narrowed due to yield-hungry investors snapping up new high-quality issuances. Corporations were able to place \$41 billion for the week ended January 10th, the best volume in eight months. Contrary to our view on the overall economy, we do see the borrowing environment improving incrementally in 2009. Currently, debt of private-equity-backed companies is available in the secondary markets at prices that bake in catastrophic default assumptions. As capital flows into this asset class and risk factors dissipate, prices will increase, making this a less attractive alternative to new originations for lenders. Alternatively, the U.S. government could intervene at the long end of the yield curve, driving prices up and yields down, thus making it more cost-effective for companies to borrow. Unfortunately, improvements will take some time and potentially more federal funds.

Availability of Capital Versus Cost of Capital

This tsunami of circumstances has left companies to ponder how to finance operations and, in certain circumstances, achieve liquidity. Our view has become more pessimistic and we are advising most of our clients that this is an availability-of-capital market, not a cost-of-capital market. Put another way: you have to have a compelling need to engage in a financing or sale transaction and, absent the undeniable need, it is best to stay on the

sidelines until more of the economic uncertainty dissipates. We understand that could take some time. If you have a project with a highly compelling return on investment or you need the money to avoid adverse circumstances for the business and its shareholders, there is capital available.

So when should a lower-middle market company and its shareholders seek capital or liquidity? And what options are available in today's market?

Mezzanine Financing and Equity Infusions Are Still Possibilities

While traditional cash flow financing remains elusive, both equity and mezzanine debt remains selectively available for businesses to finance growth and acquisitions. Mezzanine lenders have significant liquidity available to them but are lending on a case-by-case basis, with deep company diligence preceding a commitment. Potential borrowers are best positioned if they currently possess more than \$3 million of EBITDA and debt-to-EBITDA ratios of less than 4.0x. Companies that fall outside these parameters will struggle to find suitors, as mezzanine lenders at the lowest end of the scale are showing considerable caution and many will not consider new deals prior to the second quarter. Return expectations for mezzanine, however, have ballooned to 20% across the board, especially on deals that lack equity co-invests. However, mezzanine continues to be a preferred alternative given the limited impact it has on governance and the ability of the borrower to avoid equity dilution – but the market is not as free flowing as advertised.

Equity providers remain in control of considerable pools of committed capital. While the so called "denominator effect" among large state-run and university pensions is slowing the velocity of capital deployment, the availability of cost-effective debt capital is a more significant barrier. Private equity has turned its attention to funding existing investments, including buying back portfolio company debt at attractive prices and acquiring positions through secondary market purchases; the prices here have fallen, on average, nearly 30% to 61% (net asset value) according to a recent Cogent Partners study. While we expect this behavior pattern to repeat itself until values are driven up, we are fielding

unprecedented inquiries looking for attractive portfolio companies and a willingness to enter into minority transactions. As such, if a company has a compelling business line expansion or acquisition opportunity, equity infusions remain a viable alternative, especially in niche segments that continue to have strong demand. While prices have fallen, the best deals are still getting done at attractive multiples.

M&A Will Be a Buyer's Market

As anticipated, merger and acquisition transaction volume plummeted in the second half of 2008. M&A volume was down a third for the year and 44% for 4Q08. Domestic leveraged buyout volume was down 84% for the year. Almost all of the fourth quarter deal volume occurred in October. Part of the reason deal volume fell so precipitously was the lack of availability of debt capital. Deal-related debt declined to 4.9x EBITDA from the prior year period of 6.2x for deals with greater than \$50 million of EBITDA and to 4.5x from 5.6x for deals below this EBITDA threshold. Surprisingly, prices didn't fall as anticipated. Deals involving sub-\$50 million EBITDA companies cleared at 8.3x on average, the third-highest quarterly observation recorded by Standard & Poor's Leveraged Commentary & Data group.

That said, 2009 will be a buyers' market. Companies that do not have a necessity for a transaction or lack clear value propositions for strategic buyers are advised to manage through the cycle. While there remains considerable cash on the balance sheets of large corporations, they will be price-sensitive shoppers until their ability to fund operations using debt has been restored. Sellers are advised to begin thinking about their strategic relevance to potential suitors well in advance of a transaction and, if possible, we suggest forming strategic relationships and closely tracking the acquisition priorities of this population. Absent having private equity as a competitive foil, companies will need to do more to justify their purchase price expectations. Leveraged buyouts are not a compelling alternative unless shareholders are willing to accept more structured agreements and, in most cases, underwrite the deal through seller subordinated financing.

A Decline in Transaction Velocity and Pricing

The coming year will bring unprecedented pain to the U.S. economy, its businesses and its consumers which will severely hamper transaction volume and deal pricing. We anticipate macroeconomic indicators at levels not seen since the Great Depression, as evidenced by double digit annualized contraction in retail sales and production based on fourth quarter 2008 numbers. In a best-case scenario, we see signs of economic growth in early 2010. While most companies are advised to sit tight, if you have a compelling business and the appropriate need, alternatives remain available. However, expect capital providers and buyers to be discerning.

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