

Keeping It Together

Middle-Market Companies,
Capital Markets
And the Recession

When Will It End?

Cascadia Asks the Lenders—But Nobody Knows for Sure

It has long been our view that the economic recovery will begin when some liquidity returns to the lending markets. Businesses rely on the ability to borrow cost-effective capital to underwrite their daily operations, and debt is an essential cog in leveraged transactions; purchase price multiples rely on it.

With debt generally unavailable, the transaction and capital markets have dried up. On a micro-level, many companies we talk to are currently unable to pursue compelling opportunities because of a lack of credit that that would have been available a year ago. Other firms are facing tougher “survival mode” decisions in which cash is squeezed from any and every available source.

We don’t anticipate a rapid return to normalcy, but we are seeing signs that the market is making incremental gains.

High-yield issuance volume has remained robust; premium-quality second lien deals are starting to find interested buyers; the Federal Reserve’s intervention at the long end of the yield curve has diminished the opportunity for banks to buy loans on the secondary market at yields more attractive than those on new issuances; and The Toxic-Asset Relief Plan will also better position major lending institutions to recapitalize their balance sheets and begin new originations.

Unfortunately, these macro viewpoints are not much help to companies that need to make tactical decisions on how to fund their operations. In an effort to deliver better actionable information, Cascadia decided to go directly to the source and ask lenders what they’re up to, how the world has changed and, most importantly, when they think the market will improve.

As you might expect, some lenders were reluctant to make predictions or disclose information due to the fluctuating condition of the market and their business. Others were only willing to speak to us on an anonymous basis. Both of these factors are telling and, in our mind, do nothing to diminish the value of the content herein.

Read on for greater insight and—as always—let us know what you think.

Hugh Campbell

Debt Placement Group, Cascadia Capital

How do you anticipate the lending market changing over the next 12 months?

"There's no question things are tight right now and will remain so for a while. When you hear economists speak of 'deleveraging' on a macro-scale involving trillions of dollars, you have to translate that into the micro-level events that lenders and businesses are facing every day. We're seeing it in the form of pulled credit lines, increasing scrutiny of covenants, a lower tolerance for leverage, higher spreads, and ultimately fewer deals getting funded. When things start to pick up again, it will be from a much lower overall base of credit, and there may be a lot of pain between now and then.

As we go to press, the most compelling risk/return opportunity for many lenders is still to purchase loans on the secondary market. When you can get an 8% or 9% yield on a liquid investment in the senior debt of a blue-chip company, the alternative had better be pretty compelling. Between this situation and the fact that banks are hoarding any and all bailout funds they are given, the short-term outlook for lending is bleak. Secondary markets are priced for an Armageddon scenario, however, and we expect that the yields will come down as the panic subsides. Only once this happens will new debt origination begin to loosen. When it will happen is anyone's guess, but most credit providers seem to say things will begin to improve by the end of 2009."

Describe the prototype deal that will get done in 2009. What is off the table?

"One thing we hear across the board is that superstar companies will be able to get funding almost regardless of the climate. If your company is growing, profitable, and has a good collateral base, there are funds available. Overall leverage will be lower and the funds will be more expensive, but there are lenders willing to lend in this market.

Mezzanine lenders are in an excellent position and we expect that, as senior debt faces a refinancing bubble over the coming years, mezzanine funds will come in to fill the gap. Mezzanine fundraising was relatively strong last year and the funds that raised capital are eager to put it to work. It does not come without a cost, however. Overall IRR expectations for mezzanine lenders have gone up, in some cases reaching 25-30% for hybrid debt/equity deals. The reason they can command these returns are several fold: there is a lower overall supply of capital, but more importantly, pure equity return expectations are 35%+ and equity valuations are often not compelling for shareholders looking to raise capital.

Finally, in general, lenders are more skittish about owners taking money off the table in any form. Recapitalizations and leveraged dividend deals are getting done (particularly by mezzanine lenders), but they are scrutinized much more carefully than before. For a company with low overall leverage, these can still be a compelling alternative for creating owner liquidity."

How have your own credit evaluation processes changed since the crisis began?

“A phrase we hear repeatedly is a return to the four C’s of lending: Character, Capital, Collateral, and Capacity. In the last few years, Capacity was the main driver of credit availability. Lenders are now talking much more about the other three, with particular emphasis on Character, e.g. the quality of the management team.

If we could add a 5th ‘C’ to the list, it would be Covenants. Both lenders and companies are paying much more attention to covenants that received little scrutiny before. Lenders unfortunately have covenants top-of-mind because of day-to-day trouble in their current portfolios; they will err on the side of caution with regard to covenants for originations.”

When (if at all) will we see the return of cash flow loans, leveraged dividends, accordion features and facility extensions for add-ons without re-pricing?

“Many lenders feel that the return to a vanilla lending environment, without exotic structures or pricing, is the new reality from here on out. Of those who expect them to make a comeback, it won’t be in 2009 and probably not 2010.”

Cascadia Capital, LLC, is a Seattle-based national investment banking firm that is focused on financing the future for middle-market companies

Jason Cosso

Director, Wells Fargo Foothill

How do you anticipate the lending market changing over the next 12 months?

"The short answer is that I expect the current uncertainty to continue in the near-term, but I'm hopeful that within 12 months we will see the credit markets stabilize as investor confidence is restored throughout our economy. However, the reality is that visibility for the next one or two quarters is still difficult.

The longer answer is that the financial services sector/lending market is undergoing significant structural changes. So far, we have seen lenders consolidate, exit markets and succumb to capital restraints. Given the dramatic nature of these changes, it is expected that the lending market will continue to be choppy in the near future as we digest what has already occurred over the past several quarters. That said, I anticipate the pace of change will begin to slow, which will bring stability back to the market. Of course, this is assuming that we are able to weather the current recession, high unemployment rates and consumer and corporate deleveraging."

Describe the prototype deal that will get done in 2009. What is off the table?

"At its core, Wells Fargo Foothill is a traditional asset-based lender. As such, a typical deal for us is financing a company with strong working capital assets and good liquidity. Liquidity is of particular importance to us, as it assures the lender that the company (1) has a sufficient cushion to manage through the current economic environment, and (2) is most likely operating with the appropriate amount of leverage. In addition to traditional asset-based loans, we also lend to software and technology companies where our primary collateral is the company's recurring revenue, and we continue to feel comfortable with these types of opportunities. For both traditional asset-based and non-traditional hybrid cash-flow loans, club deals and single-lender deals will be more common than large, syndicated transactions.

Although buyout opportunities have slowed, we are still seeing strategic deals getting done. The current buyout environment has produced attractive valuations that, when coupled with available synergies, has made strategic acquisitions more appealing than private equity platform acquisitions. Given the challenging environment for buyouts, which suffer from wide bid/ask differentials for valuations, strategic buyouts are more likely to attract a willing buyer and seller than a private equity counterpart.

So, what's off the table? Large, syndicated cash-flow loans, large underwriting exposure, heavy fixed-asset exposure, covenant-light loans and equity cures are all harder to come by in this market."

How have your own credit evaluation processes changed since the crisis began?

"We are spending more time early in the process analyzing opportunities, which means

it takes longer for us to issue term sheets. Specifically, we are spending more time understanding appraisals and liquidation scenarios, sensitizing projection models, and confirming forecasted revenue, liquidity and cash-flow assumptions. Our rationale is that by spending more time early on, we prevent any surprises that might occur down the road in the underwriting phase.”

When (if at all) will we see the return of cash flow loans, leveraged dividends, accordion features and facility extensions for add-ons without re-pricing?

“As I mentioned earlier, Wells Fargo Foothill is a traditional asset-based lender for the most part, but we are still making hybrid/cash-flow loans to software and technology companies with strong recurring revenue—albeit, at lower leverage and higher pricing points than six months ago. It is definitely harder, however, to find participants on deals that require more than one lender right now.

Many companies already have too much leverage on their balance sheets, so leveraged dividends will continue to be tough to support in this market. You will likely need to see deleveraging from companies before leveraged dividends become more available. We will also need to see a more stable economic environment, which will probably be the precursor to overall deleveraging. That said, and while not exactly tantamount to a leveraged dividend, we have provided financing for a few well-capitalized and performing public companies that used the funds for stock buybacks.

With the scarcity of capital, it is hard to justify committed, non-yielding accordion features. I don’t see any material accordion features being committed to anytime soon.

Re-pricings have been a part of lending since I’ve been a lender. For example, a few years ago, borrowers were benefiting from a market that dictated lower spreads. Currently, the opposite is happening. One of the causes for the increase in spreads is that the secondary market for loans is offering attractive yields for lenders. As a result, many lenders have focused their efforts and capital on buying loans in the secondary market. Those loans not only yield better, but they are more liquid than what is available to originate. Until yields for loans in secondary market decline, pricing for new loans will remain high

I believe the real question is, “When will we begin to see spreads improve for borrowers?” While I don’t know the exact answer to this, I do believe that most companies have loans priced at spreads below what is offered today, so I expect deals will continue to be priced higher when companies look at a refinancing, covenant relief, extensions, etc. My guess is that when spreads improve for borrowers, underlying interest rates—LIBOR or Prime—will have increased, so the net interest expense impact might not actually be beneficial to borrowers.”

Wells Fargo Foothill is a leading provider of senior secured financing from \$10 million to \$1 billion and more to companies in a wide range of industries. Part of Wells Fargo Wholesale Banking, its credit facilities are available to companies across the United States and in Canada

Leonard H. Lillard

Principal, Merit Capital Partners

How do you anticipate the lending market changing over the next 12 months?

“Liquidity and risk taking will begin to increase in 2010 assuming forward visibility on earnings improves. However, credit standards will remain high and ‘cash flow’ senior loans will continue to be very difficult to obtain.”

Describe the prototype deal that will get done in 2009. What is off the table?

“Successful niche companies will look to make strategic/tactical acquisitions later in 2009 and 2010. Some minority recaps may be done in conjunction with those acquisitions if the borrower is willing to accept more modest valuations and payouts.”

How have your own credit evaluation processes changed since the crisis began?

“We have traditionally used capital structures with lower senior debt ratios to provide additional liquidity (no principal repayments required) and operating flexibility so our structuring has not changed significantly. Our biggest credit issue remains lack of visibility on 2009 results/2010 projections.”

When (if at all) will we see the return of cash flow loans, leveraged dividends, accordion features and facility extensions for add-ons without re-pricing?

“Tough to call, but I think these products will begin to return at modest levels in the 2011 time frame.”

Merit Capital Partners manages over \$1 billion of capital through four institutionally-sponsored limited partnerships. The firm invests mezzanine and equity capital in middle-market companies principally in manufacturing, distribution and services industries

Chris McKernan

Vice President, Marquette Business Credit

How do you anticipate the lending market changing over the next 12 months?

“The economic and regulatory environment will dictate whether credit will tighten even further. Cash-flow loans will continue to be almost non-existent. Access to capital will continue to be king and lenders will expect to be compensated appropriately for risk with an increase in interest margins. There will continue to be lenders failing and more consolidation of lenders. Regulators continue to dictate more conservative lending practices, in spite of the conversation coming from Capitol Hill. I anticipate a number of banks returning TARP funds even though new toxic assets will be uncovered in some banks.”

Describe the prototype deal that will get done in 2009. What is off the table?

“Fully secured transactions, with enough liquidity and historical cash flows sufficient to service pro-forma debt in the TTM and the last three to six months will get done. M&A transactions will be few and far between, but those that will be funded will have strong capital structures. There should hypothetically be more of a role for mezzanine in the middle market. What is off the table for Marquette? Housing related opportunities will continue to be closely scrutinized and close to off the table. Cash-flow deals appear to be off the table. Senior Stretch pieces (cash-flow-based term loans) will be very difficult to get done, if not impossible. Companies with poor recent trends are off the table at my shop and will be tough to get financed regardless of the amount of collateral.”

How have your own credit evaluation processes changed since the crisis began?

“Asset values have crashed lately. As an asset-based lender, this poses a great challenge. Up-to-date recent appraisals are required along with current financial statements. Recent trends are evaluated with more emphasis. We are also looking more closely at concentrations. We are looking for deals in the fairway and passing on deals on the fringe. We are also looking for personal guarantees more frequently. Retail and automotive transactions will be very tough but can get done with the right metrics. Closing time is taking longer as underwriting is drilling down further. Projections are difficult to put too much credence in, given the market conditions and the uncertainty of when the economy bottom out”

When (if at all) will we see the return of cash flow loans, leveraged dividends, accordion features and facility extensions for add-ons without re-pricing?

“I think in 18 months to two years those financing structures above will return, but more exotic lending programs/structures will take much longer. Some even sportier lending programs may not return for a very long time, if ever.”

Marquette Business Credit provides asset-based loans to middle-market companies in the United States with credit requirements between \$2 million and \$20 million

Patrick Rounds

Senior Vice President, GE Healthcare Financial Services

How do you anticipate the lending market changing over the next 12 months?

"M&A activity and leveraged loan volume for healthcare is down year-to-date 2009 vs. 2008. However, we anticipate a general improvement in the syndication market vs. 4Q08, and GE is active in the market to anchor and arrange corporate finance transactions.

As the year progresses, we expect a general improvement in the syndication market and plan to provide full underwritings for larger transactions as the market strengthens. That said, however, market headwinds and default rates (projected to hit highs of ~14% for 2009) could continue to impact market liquidity."

Describe the prototype deal that will get done in 2009. What is off the table?

"Currently, the market is supporting transactions with lower leverage and higher equity or junior capital contributions vs. 2008. We expect anchor and arrange transactions in the \$200MM range to be the norm for the early part of 2009, and a move back to a fully syndicated market later in the year.

Middle-market leverage for corporate finance is roughly 2x-3x senior debt and 3x-4x total debt right now. We do not expect high leverage, 'covenant lite,' 'PIK/toggle,' or transactions with a significant amount of second lien or subordinated debt to return to the new originations market in the near future."

How have your own credit evaluation processes changed since the crisis began?

"Our underwriting process remains unchanged, but we do anticipate transactions with lower leverage and tighter financial covenant structures vs. 2008."

When (if at all) will we see the return of cash flow loans, leveraged dividends, accordion features and facility extensions for add-ons without re-pricing?

"We are underwriting cash flow loans and dividend deals as long as the transaction leverage is appropriate and returns are commensurate with the risk. We expect most, if not all, deals that were priced in 2006-2007 to be reset to current market levels when significant changes or amendments are requested. Over the last six months, lenders have experienced a significant increase in their cost of funds, and any new deal will need to reflect current risk-return parameters."

GE Healthcare Financial Services offers a comprehensive collection of resources and business and financial solutions for healthcare customers around the world

Marty Steele

Relationship Manager, The Commerce Bank of Washington

How do you anticipate the lending market changing over the next 12 months?

"We would expect the current trends to continue for at least 12 months. Lenders are looking at worst-case scenarios when choosing companies to fund. Many lenders in the marketplace are concerned with their current portfolios, and their time is consumed by this (and workouts, in some cases) rather than marketing new loans. We would also expect more losses coming from the banks in addition to those in 4Q08, and we'll also see a lot more reserves for credit losses.

All of this leads to obvious conclusions: the tightening of lending standards, increases in pricing, and a very little credit available to certain sectors and industries that are particularly vulnerable to a downturn."

Describe the prototype deal that will get done in 2009. What is off the table?

"One key piece of data is Total Debt/EBITDA of 2x—3x. Projections will be made using a pessimistic scenario, and more attention will be paid to quality and continuity of management. Covenants will be tighter, and we'll likely see more recourse and credit enhancements.

Equity recaps where owners take money off the table will be unlikely. Enterprise value and airball deals will be very rare, as will thinly capitalized LBO's.

That said, superstar companies will always get financing in any market."

How have your own credit evaluation processes changed since the crisis began?

"We tend to use our own assumptions about the economy and industry rather than those of the companies that we're funding. We take a much closer look at the documentation from a legal perspective. Quality of management is paramount, more than ever. Not only will we look at what they've done, but also who they are from a character standpoint. Finally, we want to see a company's Plan B. What is your worst-case scenario and what is your specific plan, down to a granular level, for dealing with it? Companies can help themselves immensely in the process by preparing those scenarios in advance. We have funded several companies recently who are experiencing operational difficulty, mostly because we believe in the management and they came to us with a line-by-line plan of how they were cutting costs."

When (if at all) will we see the return of cash flow loans, leveraged dividends, accordion features and facility extensions for add-ons without re-pricing?

"Maybe 2010, and maybe never."

Founded in 1988, The Commerce Bank of Washington has enriched local businesses with highly personalized banking from local, experienced bankers dedicated to long-term relationships

Anonymous

Senior Vice President, Large National Lending Institution

How do you anticipate the lending market changing over the next 12 months?

“Commercial paper and syndicated lending will be non-existent, and club deals will be very difficult to do. Many players are rethinking their entire position in the market. Liquidity will continue to be tight, and banks need more TARP funds in order to have any hope of loosening credit. The problems in the mortgage market, the conflicted ratings agencies, and the SEC’s failures on enforcement do not help to create confidence.”

Describe the prototype deal that will get done in 2009. What is off the table?

“There is no prototype deal—every deal will be a one-off. Our policies have not changed much, but since the market has changed, there are fewer companies that fit our criteria. I would expect that the federal government will be taking a much closer look at our activities given the TARP funds, so we may be constrained or incentivized to do a certain type of deal. Regarding industries, we will stay away from obvious difficult ones (real estate, retail, anything very cyclical), but otherwise it will be the same focus as before. We’re always looking for good companies to fund in any market.”

How have your own credit evaluation processes changed since the crisis began?

“Again, our process has not changed, but the market has obviously changed a lot. Our process involves collateral, cash flow and character. We’re seeing a lot more borrowers in a tough situation, and we’re taking a closer look at top-line growth and, of course, how it flows to the bottom-line. We are underwriting for a recession. No one knows how the stimulus will impact us. Pricing is what the market will pay—there is very little transparency.”

When (if at all) will we see the return of cash flow loans, leveraged dividends, accordion features and facility extensions for add-ons without re-pricing?

“I see things returning back to the typical mezzanine + senior debt structure. We’ll see fewer, if any, airballs, and cash flow loans will be very unlikely. We’ll also see senior multiples coming down to 2x and always covered by collateral.”

Cascadia Capital, LLC

701 Fifth Avenue, Suite 2600
Seattle, WA 98104
(206) 436-2500
www.cascadiacapital.com

Bryan Jaffe
Senior Vice President
Middle Market Practice
(206) 436-2534
bjaffe@cascadiacapital.com

Christian Schiller
Managing Director
Middle Market Practice
(206) 436-2554
cschiller@cascadiacapital.com