

Dealmaker

Providing business owners and managers with M&A market insight Winter 2010

FY 2009 credit market update: Moving from stabilization to recovery



Len Batsevitsy, Manager
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General credit environment

There are indications that a recovery in the financing market is currently under way. A confluence of government intervention, economic stabilization and increased liquidity has provided the necessary fuel to jump-start lending activity. That being said, the credit market remains highly susceptible to volatility. Factors such as the level of intermediate-term loan defaults, which have continued to eat away at lenders' available capital; the continued availability of unprecedented low-cost

funds to lenders as a result of the loose monetary policy established by the government; and the general strength of the macroeconomy are expected to have a direct impact on the overall health of the credit market in the near future.

Today, borrowers are finding it somewhat easier to secure new senior financing or modify existing credit facilities, since competition among lenders is beginning to intensify. However, borrowers can still expect higher pricing (although there are signs that this trend may be reversing as loan spreads have recently fallen) and more restrictive underwriting standards, including tighter covenants, greater security/collateral requirements, a greater need for personal guarantees, and an increased frequency of financial and compliance reporting. Based on Grant Thornton Corporate Finance (GTCF) research, current average senior loan pricing spreads have declined from their December 2008 high and are generally within 100 basis points of their December 2007 levels.

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FY 2009 credit market update: Moving from stabilization to recovery (continued)

According to the October 2009 *Senior Loan Officer Opinion Survey* conducted by the Federal Reserve Board, about 15% of domestic bank respondents reported having tightened lending standards on commercial and industrial (C&I) loans to large and middle-market firms over the past three months. In the survey slightly more than 40% of domestic banks indicated that they had increased spreads of loan rates over their cost of funds for C&I loans, while approximately 5 to 20% of banks reported decreasing the maximum maturity of loans or credit lines, decreasing the maximum size of credit lines, or tightening terms on loan covenants for loans to firms of all sizes. It is important to note that the survey covers the three-month period ended Oct. 31, 2009, thus presenting a lagging representation of senior lenders' market activity. Based on our research, the current financing market environment may be slightly more forgiving and somewhat looser than the survey suggests.

Regardless, some of the key characteristics of today's senior debt market are as follows:

1. There appears to be more, albeit still limited, liquidity in the credit market today than there was three months ago, as nearly all categories of financial institutions have resumed some level of lending activity.
2. Available leverage multiples have increased by nearly 1.0x of EBITDA as compared with December 2008.
3. Although the credit market is starting to ease, traditional senior lenders are actively seeking only higher-credit-quality borrowers with sustainable operations and cash flow, stable balance sheets, and significant collateral. Prospective borrowers with a more troubled credit history are still finding it difficult to secure adequate credit.
4. Many business owners are being forced to consider alternative or nontraditional financing sources. Such sources can include second-lien and mezzanine capital, both of which have become increasingly important — although more expensive — components of a company's total capital structure.
5. Although asset-based lending is still the preferred loan structure, senior lenders are once again beginning to increase cash flow lending activity. However, such cash flow lending is generally being granted on a very selective basis and only to borrowers with limited leverage and a demonstrated ability to cover debt service requirements.
6. As previously noted, loan spreads have declined from their high in December 2008. Currently, these spreads are approximately 100 basis points above 2007 levels. However, with historically low London Interbank Offered Rates (LIBOR), all-in-one loan pricing may be less expensive today despite these loans' higher spreads. In addition, many borrowers are seeing LIBOR floors of approximately 2.0%.

Debt metrics:	Dec 09	Dec 08	Dec 07
Senior debt/EBITDA	1.75x–2.5x	1.0x–1.5x	2.5x–3.25x
Total debt/EBITDA	3.5x–4.0x	3.0x–4.0x	3.5x–4.5x
Senior debt pricing	L+2.50–5.00%	L+5.00–7.00%	L+3.00–4.00%
Subordinated debt pricing	16–20%	15–19%	14–17%
LIBOR floors	Typical (2.00%)	Typical (3.50–4.50%)	Atypical
Minimum equity component	35–45%	35–45%	25–30%
Recap availability	Available but limited by leverage (generally 2.0x pro-forma max)	Available	Limited
Covenants and guarantees			
Personal guarantees	Generally required	Generally required	Preferable
Interest coverage	High (>2.50x)	High (>2.75x)	Moderate (>1.75x)
Fixed charges coverage	High (>1.30x)	High (>1.50x)	Moderate (>1.25x)
Debt service coverage	High (>1.30x)	High (>1.50x)	Moderate (>1.25x)

Source: GTCF research

The chart opposite summarizes key terms prospective borrowers can expect in today's credit environment. These metrics are based on typical leveraged cash flow loans made to a middle-market borrower.

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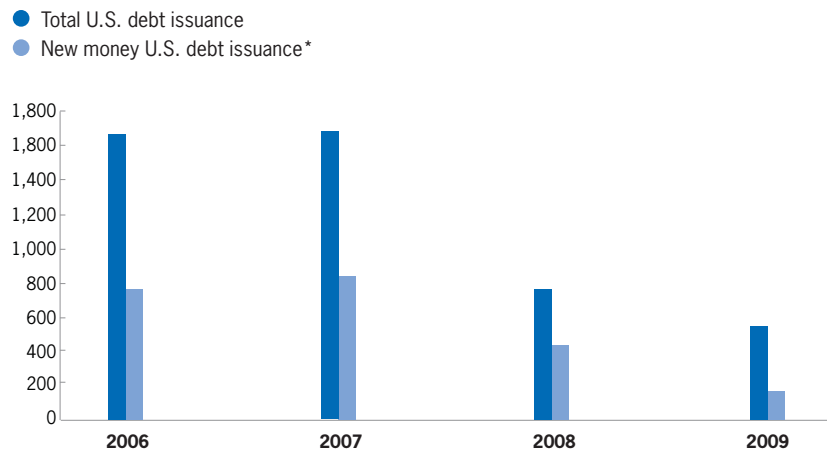
FY 2009 credit market update: Moving from stabilization to recovery (continued)

According to Reuters Loan Pricing Corp., actual issuances of debt continued to contract during 2009. In fact, as compared with 2008 — also a historically low year for debt issuances — total U.S. debt issuances declined by more than 28% in 2009. Moreover, new U.S. debt issuances, which include only new financings, declined over 62% during 2009 as compared with 2008. However, based on our discussions with several lenders and loan syndication professionals, there are some early indications that a reprieve from further contraction will take place during 2010. Such a reprieve may spark a resurgence in the secondary debt market as well as growth in issuances resulting from an increasingly compelling refinancing market. The chart to the right shows U.S. debt issuances over the past four years.

Refinancing to spark debt issuances in 2010

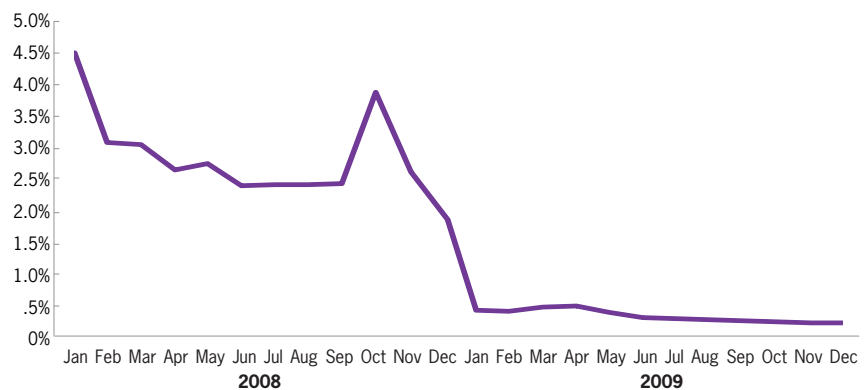
The simple truth is that in today's low-interest-rate environment, where the current one-month LIBOR is approximately 0.23%, many CFOs and corporate treasurers are actively seeking to refinance existing credit facilities and/or lock in interest rates (i.e., swap their floating-rate exposure for fixed-rate exposure) on a significant portion of debt. Floating rates (such as LIBOR and U.S. Treasury rates) remain at all-time lows; even considering a 2% LIBOR floor, these rates present a historically low-cost alternative. In addition, today's relatively steep yield curve — coupled with huge deficit spending by the U.S. government — indicates that such low floating rates are simply not sustainable over the long term. As a result of this,

U.S. debt issuance



*Includes only new financings, such as M&A, LBO, dividend payments and incremental fundraising
Source: Reuters Loan Pricing Corp.

Historical one-month LIBOR rate



Source: British Bankers' Association

we expect to see significant refinancing-based debt issuance during 2010.

Of note: Because LIBOR has historically averaged approximately 3.5% and is now well below that level, it is not unreasonable that many business managers are seeking to lock in their interest rate exposure via derivative

instruments. According to GTCF research, recent swap spreads have been approximately 50 to 100 basis points. Displayed in the chart above are historical one-month LIBOR rates over the past two years.

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Potential reasons for concern

Despite an increasing appetite for lending and improving credit market conditions overall, many lenders remain cautious about the road ahead. As noted, the financing market remains susceptible to a host of factors which may once again affect its near-term health. In fact, there is the potential for more bad news on the credit horizon. Such news could include rising loan defaults, which are currently approximately 10% for leveraged loans according to S&P loan statistics; continued high unemployment levels (currently at 10% nationally); a growing national debt and burgeoning deficit spending (the national debt stands at about \$12.3 trillion, and the Congressional Budget Office has estimated that the 2010 deficit will reach approximately \$1.35 trillion); and a long, drawn-out U-shaped recovery in consumer spending and the GDP. More importantly, the credit market could be affected by unpredictable or unforeseen events which could swing the market back into crisis. Such events could range from a major terrorist attack to the growing possibility of a collapse in the commercial real estate market.

Lurking in the shadows — credit losses on commercial real estate may have a significant impact on banks' ability to lend

According to an article in *The Wall Street Journal*, "Commercial Real Estate's \$1 Trillion Time Bomb," U.S. banks hold more than \$1 trillion of mortgages backed by commercial property that is fast losing value. Although a slumping real estate market is now an undisputed reality, the breadth of potential credit losses on loans backed by commercial real estate is somewhat startling.

During the credit-fueled real estate spending that occurred between 2005 and 2007, a great number of lenders provided mortgages on all types of property — residential and commercial. Home loans (residential property loans) were generally made by a small group of ten or so colossal financial institutions: Countrywide, Wells Fargo, Bank of America and J.P. Morgan, to name a few. In comparison, thousands of small and regional banks provided massive amounts of commercial property debt during the same period. As a result, it is reasonable to infer that given the bubble in commercial real estate property values, credit losses on associated debt may be

significant — with the pain substantially more widespread compared with the losses experienced in the residential property markets. *The Wall Street Journal* asserts that more than 3,000 banks and savings institutions have more than 300% of their risk-based capital in commercial real estate loans at present.

Why does this matter? First of all, after beginning to emerge from a credit crisis which wiped out several lenders completely, many banks are reluctant to recognize losses on commercial real estate loans. They simply prefer to delay the recognition of these loan losses, either hoping for a near-term rebound in the commercial property markets or betting that enough time will pass to allow them to earn out of their woes and strengthen their balance sheets to absorb the losses. The reality is, however, that many of these small and regional banks are not set up to absorb large credit losses and may falter unless they can sell off the problem loans.

In either case, it is becoming more evident that lenders that have large exposure to commercial real estate are generally reluctant to issue new loans. Therefore, small businesses are finding it more difficult to secure debt from these small community and regional banks. Unfortunately, these are exactly the types of institutions most small businesses rely on for their financing needs. We hope these risks in the commercial real estate market will never actually materialize, but as of now, it is just too early to tell. •

M&A year in review — 2009



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Merger and acquisition (M&A) activity began to rebound in the second quarter, with deal volume rising in each of the last three quarters of 2009. Buyers were particularly active in the fourth quarter, announcing 3,255 deals — the highest quarterly amount in over two years and a 46% increase over the first quarter of 2009. Despite this rebound, total M&A activity declined 7% in 2009 compared with the prior year; activity among larger deals (transactions greater than \$250 million) was most affected, declining 24%.

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Smaller-company valuations remain stable

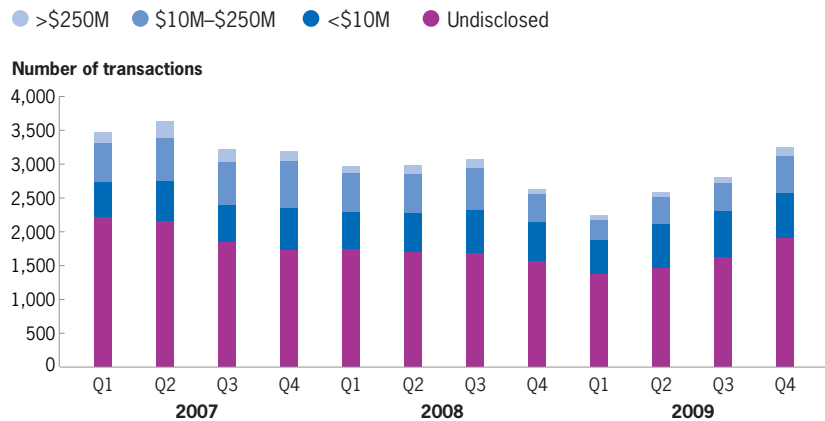
Although median valuation multiples (enterprise value/EBITDA) for all deals fell for the second consecutive year, valuation levels for smaller companies were far less affected. Valuation multiples of companies with revenues under \$50 million declined from 6.1x to 5.3x, compared with companies whose revenues were greater than \$250 million whose valuation multiples declined from 9.8x to 7.8x. Historically, valuations of smaller-sized companies have been considerably less volatile.

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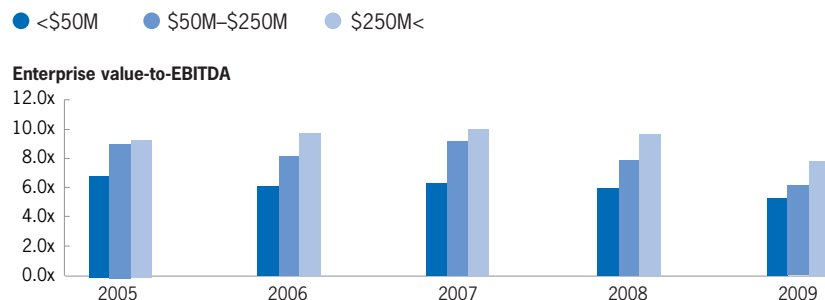
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U.S. M&A activity by deal size



Sources: GTCF research; certain information taken from Capital IQ

U.S. median valuation multiples by size



Sources: GTCF research; certain information taken from Capital IQ

Private equity activity declines in 2009

Leverage buyout (LBO) activity fell in 2009, while credit for financial acquirers remained limited as a result of reduced liquidity in the credit markets, tighter underwriting standards and higher pricing on debt. Grant Thornton Corporate Finance estimates that sponsor-backed acquisitions accounted for only 15% of total activity in 2009, down from 23% in 2008 and 27% in 2007. However, sponsor-backed deal volume increased in each of the last three quarters — a possible sign that credit markets may be thawing.

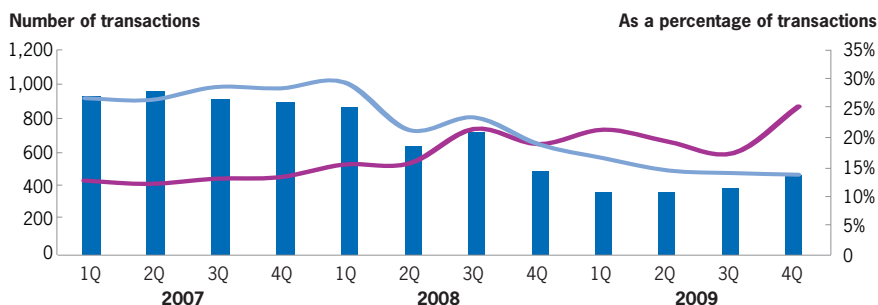
Private equity overhang reaches unprecedented highs — sponsors seek new ways to deploy capital

Cumulative overhang, the gap between funds raised and equity invested, increased by 5% to \$400 billion in 2009, despite a 57% decline in private equity (PE) fundraising. PE funds usually have a limited life and must be either deployed or returned to investors. Therefore, financial sponsors are seeking alternative ways to invest capital that are less reliant on leverage, such as all-equity buyouts (EBOs), minority transactions (purchases of less than 50%), and generally overequitized traditional LBOs.

PE activity has increased over the past few quarters, but as a percentage of total M&A it is still at a three-year low.

U.S. private equity activity by quarter

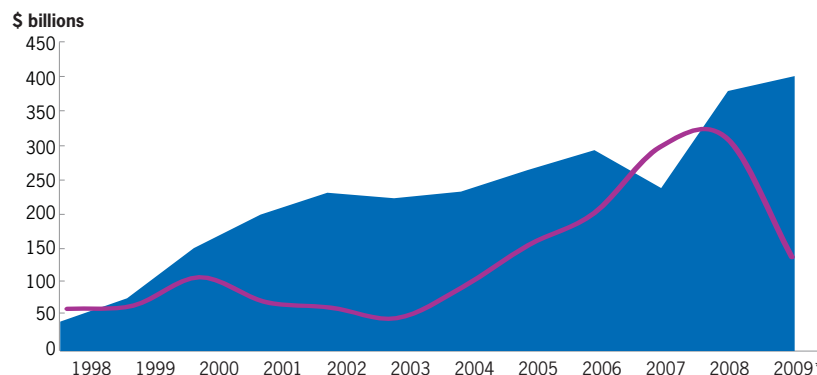
- Private equity volume (Capital IQ)
- Minority deals as a percentage of private equity (Pitchbook.com)
- Private equity as a percentage of total M&A (GTCF estimate)



Sources: PitchBook Data Inc. and GTCF research; certain information taken from Capital IQ

U.S. private equity overhang and funds raised

- Overhang
- Funds raised



*Overhang value through April 30, 2009

Source: PitchBook Data Inc.

Key take-aways from 2009

- After bottoming out in the first quarter, deal volume has trended upward, with activity in the fourth quarter of 2009 reaching its highest quarterly level in more than two years.
- PE activity has increased over the past few quarters, but as a percentage of total M&A it is still at a three-year low.
- PE overhang reached an all-time high in 2009; most of these amounts must be either deployed over the next few years or returned to investors.
- Financial sponsors are seeking alternative ways to invest capital, including EBOs, minority investments, or generally overequitized deals.
- Thawing credit markets combined with large quantities of sidelined capital will likely result in financial buyers re-emerging as active M&A participants, thus creating additional competition for strategic players and increasing valuations for businesses across the board.

Some guiding principles for making your acquisition process a success



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Despite the challenges and risks, companies continue to seek acquisitions as a route to fulfilling their vision — whether that is securing new capabilities, entering new geographies, acquiring market share or leveraging existing capabilities across a larger footprint. There are armies of experts and volumes of advice available on making successful acquisitions, as well as plentiful examinations of the factors that lead to failure. While time and space may prevent a comprehensive discussion of all the complex issues, Grant Thornton Corporate Finance has identified a few simple guiding principles that we — and our clients — have found to be extremely helpful.

Start thinking of acquisitions as a process rather than an event

By completing a thorough, from-the-bottom-up analysis of your desired business landscape (which can be vast), you will be able to prioritize those targets that best fit your needs. With this kind of robust analysis, you can contact only those companies that fit your criteria, rather than taking the shotgun approach that many businesses employ when they embark on an acquisition program. Depending on the sector, this may mean that you formally approach only 10 to 20 companies. However, the companies you do contact will be of higher value as targets and may be more likely to respond in a favorable manner.

Regardless of the numbers involved, one thing is certain: The companies you approach receive countless similar offers each month, so you need to differentiate yourself. One effective way to accomplish this is to personalize your approach and take the time to construct a compelling business proposition for your target. Approaching people in this way not only demonstrates that you are serious and have done your homework, but also works to build trust, particularly if you show a willingness to share information about your own company and what you are trying to achieve through making an acquisition.

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We have found that roughly two-thirds of targets engage in pre-merger conversations with our clients. This personal and customized approach can be a lot of work, but if you are serious about making an acquisition and want to have as many options as possible, simple arithmetic says you must engage with multiple parties. And don't be discouraged if you don't receive instant results. For many targets, the timing will not be right, or specific factors may mean it is not appropriate for them to pursue a transaction.

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Despite the challenges and risks, companies continue to seek acquisitions as a route to fulfilling their vision.

Some guiding principles for making your acquisition process a success (continued)

Buying is selling: Making someone want to sell to you is an art

The process of making an acquisition can paradoxically be viewed as making a sale; what you are selling is money, a commodity. As discussed in the previous point, you have to differentiate yourself from your competition — and help your target understand what distinguishes your money from someone else's. This means you'll need to sell a vision of what the target business can become under your stewardship.

Consider this: In many cases, you are asking an entrepreneur to part with more than just a business. Potentially, the company is something he or she has conceived, nurtured and grown over many years — or possibly multiple generations — and has become a source of identity and meaning, as well as income. Such decisions will not be made lightly, and a business owner typically will not engage in discussions with a potential buyer unless he or she thinks it is a good fit for the business and its people.

Entrepreneurs rarely view money as an end in itself. They want to look in the mirror after a transaction and be proud of what happened to their business and their legacy. Successful acquirers are cognizant of this and respond effectively to it; they are genuine, respectful and straightforward in their approach. Those who fail to understand the emotional element of the transaction generally fail in their attempts to make meaningful acquisitions.

Keep your eye on the bigger objective and maintain perspective during negotiations

This is where the advantage of approaching multiple targets really bears fruit; you know what the other alternatives to this transaction look like, how much they would cost and what they would be like to live with. By keeping the transaction in this context, you'll find it's easier to step back from the emotional bravado of negotiations and focus on those battles which really matter. The danger in this phase of the process lies in becoming emotionally attached to a position not because it is important, but because you have entrenched yourself there and are stuck.

If you are successful, you and the seller will likely have to work closely together in the future. Ultimately, success will be dependent upon the relationship between the two of you. You should not behave in a way which would jeopardize that. Many acquirers know themselves well enough to focus only on the relationship and the endpoint, leaving the details of negotiation and point-scoring to others.

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Those who fail to understand the emotional element of the transaction generally fail in their attempts to make meaningful acquisitions.

Some guiding principles for making your acquisition process a success (continued)

Aim for constructive integration and build on what makes the target business successful

Your challenge is to figure out how to help the acquired business do more of what made it successful in the first place, and thus benefit from the acquisition yourself. Your top priority should be to develop an understanding of what it is that makes this company special, rather than automatically transitioning them to your way of doing things. Of course, some of your processes will need to be adopted — you bring advantages in specific areas, and your target will want to capture those benefits, too. As a result, acquisitions in your core business will likely be highly integrated, while those in new areas will be left to operate more autonomously.

In all circumstances, though, you must try to avoid the downward spiral of key people leaving, customers following and attention focusing increasingly inward. Communication skills and making people feel valued and recognized can suddenly become a lot more important than you may have anticipated; you need to be prepared to communicate before the acquisition is even announced.

It may come as a surprise to you that our guidelines for success are largely focused on people-oriented issues instead of facts, figures and finances. There are few buyers who will start the acquisition process without some sense of what capital and operational resources are required, but you should not overlook the human element. While it may be less tangible, it is no less critical to a successful outcome. •

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- Grant Thornton Corporate Finance *Food & Beverage Industry Snapshot – 2009 year in review*
- Grant Thornton International 2010 *International Business Report – global M&A issue*

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Who should attend: Owners, shareholders, CEOs, CFOs and board members of private companies

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