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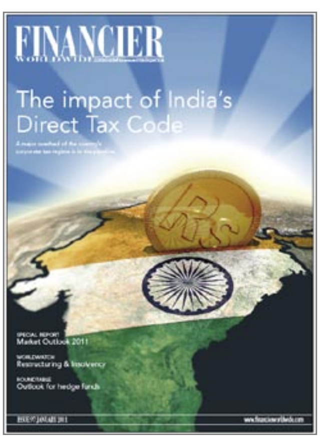
FROM THE BRINK AND BACK: THE MIDDLE MARKET IN 2010 AND BEYOND



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From the brink and back: the middle market in 2010 and beyond

BY MICHAEL J. GORMAN, TERRY KOHLER AND LUIS A. PILLICH

Riding the wave of momentum which started in the second half of 2009, capital markets continued to show signs of improvement in 2010, driven in large part by increased levels of liquidity provided by market participants. Lenders who were consumed by problem portfolios in 2008 and 2009 began to re-engage with middle market companies in 2010. As revenues stabilised and operating margins improved for these middle market companies, loan valuations rallied and lenders grew increasingly confident that the worst of the economic turmoil was over. Senior loan volume, especially asset based facilities, improved significantly during the year, with cash flow based loans for quality credits continuing a modest rebound as well. The return of market participants led to loosened credit standards and loan terms, an increase in leverage multiples and an overall decrease in the cost of capital for companies. Second lien loan volume remained weak in 2010, with a modest recovery over 2009 levels, but with additional promise for 2011.

Continuing a trend from 2009, issuance of high yield bonds by below investment grade issuers strengthened in 2010, reaching an all time high of $176bn through the third quarter. Investment grade issues, which were below 2009 levels in the first half of the year, had a strong third quarter and are now on pace to be flat year-over-year. Spreads for both investment grade and high yield issuances tightened during 2010 as credit quality continued to stabilise.

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As a result of the overall improved credit markets, total middle market M&A transaction volume (those under $500m) increased considerably during 2010 as private equity firms sought to employ large amounts of uncommitted capital. According to the Private Equity Growth Capital Council report released in the fall of 2010, private equity firms increased their invested capital from $17.8bn in the first quarter 2010 to $40.1bn in the third quarter. However, even with an increase in leverage multiples, the average equity investment needed to complete a leveraged buyout transaction remained high at approximately 40 percent of the total transaction value, when compared to historical norms. Although valuation multiples themselves remained below those seen from 2004 to Q1 2008, the premium paid by sponsors for above average financial performers remained above historical norms as the flight to quality trend continued.

For distressed middle market M&A activity, 2010 was marked by a significant slowdown in reported deals from the high of the previous two years. This decreased activity can be attributed to the rebound in the economy and its resultant effect on the capital markets. Whereas over the last two years the capital markets were inaccessible for middle market companies, the easing of credit restrictions and access to capital created alternatives other than a sale for these companies. In addition, middle market companies benefitted from improved relations with lenders, who were more inclined to work with troubled portfolio companies to restructure their debt obligations. Although distressed M&A deal volume decreased in 2010, transaction multiples began to increase. After being on the sidelines for two years, financial buyers aggressively pursued distressed M&A opportunities in 2010. Given the finite life cycle of private equity funds, managers actively sought to deploy capital into transactions instead of returning cash to their limited partners. Strategic buyers, flush with cash on their balance sheets and growing more comfortable with the distressed M&A process, were also actively looking to make acquisitions as a way of increasing market share.

Improved market conditions and the resurgence of the high yield loan market, which enabled restructurings and refinancings to take place, led to an overall decrease in Chapter 11 filings in 2010 and distressed M&A activity. According to the American Bankruptcy Institute, 43,016 businesses filed for bankruptcy, representing a 6 percent decrease from 2009. The US default rate, once at a high of 15 percent in November 2009, according to Moody's Investor Service, decreased to 4 percent. Despite the overall increased access to public markets in 2010, certain middle market sectors, including the manufacturing, retail, restaurant and real estate sectors, continued to struggle. For these sectors, increases in the cost of raw material, labour and energy resulted in decreased profitability and constrained liquidity. The ability to access the public debt and equity markets for middle market companies within these sectors remained an elusive proposition. Diminishing cash flows and insufficient asset coverage made cash flow and asset based loans either unavailable or too expensive. As such, Chapter 11 filings in the fourth quarter of 2010, which have not been reported yet, should be a telling barometer as to the state of the restructuring market in 2011.

Distressed middle market M&A trends established in 2010 will likely continue during the first half of 2011. Transaction volume should remain consistent with levels seen during 2010 as middle market companies will not enjoy the positive impact of the global recovery as quickly as larger companies, and the rising interest rate environment may make the refinancing of existing obligations difficult, if not untenable. Therefore, the second half of 2011 may be marked by an increase in Chapter 11 filings as the window to refinance or repay debt narrows. This will result in key differences between distressed M&A activity in 2011 as compared to 2010.

First, the solution structure for senior lenders should transition to a preference for going concern sales versus effectuating a transaction through a restructuring of existing debt obligations. As the general economy improves, senior lenders will likely take advantage of a more receptive marketplace and should transact via a sale process as the fear of selling low leaves the market. During 2010, we have seen a number of transactions in which the senior ▸▸

lenders restructured their existing obligations versus pursuing a sale transaction to a third party. As the requisite value was not provided by the market so as to warrant a sale to a third party, lenders instead chose to restructure their obligations rather than sell at a fire sale price. However, if the macroeconomic environment continues to improve and lenders sense robust interest from the market, an increase in distressed sale transactions will likely occur.

Second, the improving economic environment will likely generate broader interest among corporate and institutional buyers at higher transaction multiples. Higher valuations will follow. As economic conditions improve, distressed companies and companies with impaired balance sheets will represent opportunities for buyers to acquire assets at valuations that are attractive relative to the overall market. This trend began in the second half of 2010 and will likely continue throughout 2011.

Although the majority of forecasts predict a continued, albeit gradual, recovery for many global economies during 2011, the translation of this recovery to the bottom line of domestic US middle market companies will not occur until the second half of 2011. As the environment for senior lenders and other stakeholders to transact through a sale becomes increasingly favourable for distressed middle market companies, distressed M&A activity should become increasingly robust in 2011. ■

Michael J. Gorman
Vice President
Philadelphia, United States
T: +1 (610) 940 3615
E: mgorman@ssgca.com

Michael Gorman is a vice president of SSG Capital Advisors, LLC. He joined SSG in 2005 and has completed numerous assignments providing M&A advisory, valuation services and private placement of debt and equity to middle market companies in distressed and turnaround situations. He is a member of the TMA and ABI.

Terry Kohler
Vice President
Philadelphia, United States
T: +1 (610) 940 5808
E: tkohler@ssgca.com

Terry Kohler is a vice president of SSG Capital Advisors, LLC. He has 10+ years experience in investment banking and corporate finance. He works with investment banking clients on a wide range of transactions, including mergers and acquisitions, divestitures, recapitalisations and the private placement of senior debt, subordinated debt and equity. He is a member of ABI, ACG and TMA.

Luis A. Pillich
Vice President
Philadelphia, United States
T: +1 (610) 940 3637
E: lpillich@ssgca.com

Luis Pillich is a vice president of SSG Capital Advisors, LLC. He brings extensive experience providing financial solutions to companies in transition, which include successful transactions representing debtors, creditor groups and lenders, both domestically and internationally. He is a member of the TMA and ABI.