# Middle Market

## The State of Middle Market Financing in the U.S.


**Trump Card** Page 13
Potential policy changes under the Trump administration could make 2017 a pivotal year for the middle market.

**Borrower's Market** Page 31
Liquidity remains robust as alternative lenders continue to jockey for market share. Competition for assets has pushed enterprise values and leverage multiples to historical high levels.

**Outlook** Page 36
Lenders are predicting a more opportunistic environment for M&A against a backdrop of lower taxes, potential regulatory changes, and economic growth.



**January 2017**



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Inside the Middle Market is published by Brown Gibbons Lang & Company, a leading independent investment bank serving middle market companies throughout the U.S. and internationally.

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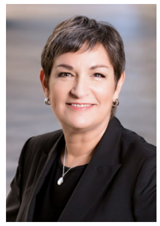

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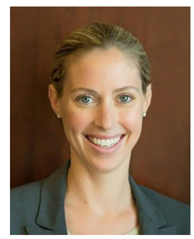

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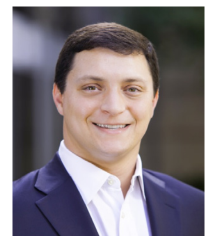

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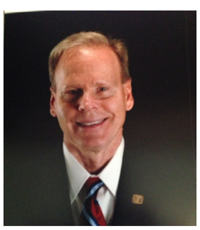

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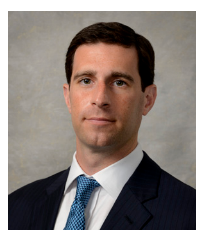

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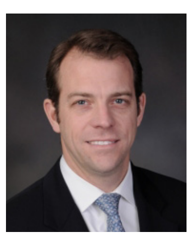

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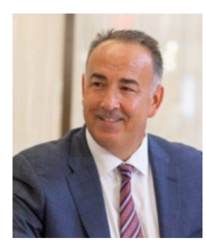

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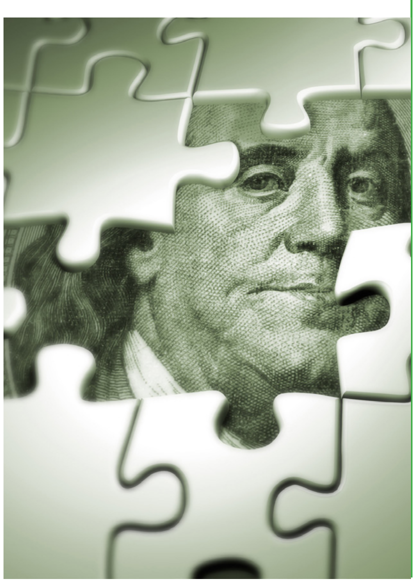
# Highlights

| | |
|---|---|
| DEAL FLOW | • Sectors that are seeing the highest activity levels are among those cited for growth, including Healthcare, Software, Technology, and Business Services.<br>• Lenders spoke of deterioration in credit quality and a higher turn down rate in 2016.<br>• "A" companies are hotly contested in a bifurcated market where a flight to quality is ever present.<br>• Corporate acquirers are leveraging their buying power and synergies and successfully displacing private equity sponsors in competitive auctions. |
| CAPACITY | • Middle market loan fund raising remains robust, fueled by growing interest from institutional investors in private credit.<br>• Alternative lenders continue to jockey for market share in the wake of regulatory oversight and market volatility which have hampered lending by banks and BDCs.<br>• The prospect of reduced regulation and higher interest rates could provide additional liquidity if banks step back into the middle market. |
| COMPANY PERFORMANCE | • Middle market business owners are reporting growth and an improving outlook. Fifty percent of middle market companies are projecting positive revenue growth over the next 12 months, according to the National Center for the Middle Market.<br>• Lenders indicate credit quality remains strong but topline growth has been moderate.<br>• Recession resistant business models are more attractive today, although there isn't a discernable shift or bias toward those plays in the market. |
| VALUATION | • Multiple inflation persists and doesn't discriminate by company size. Smaller companies with the right attributes are commanding comparable "large company" multiples.<br>• "Market" enterprise value multiples are hovering around 9-10x in the current environment. Opportunities involving EBITDA businesses starting in the low- to mid-teens continue to be aggressive.<br>• Sponsors are specializing to rationalize higher valuations for platform buys. |
| TERMS AND STRUCTURE | • Leverage parameters remained at elevated levels in 2016 with modest multiple expansion of 1/4 to 1/2 turn.<br>• Competition, on the margin, has become more aggressive on the perceived "high quality" deals where leverage is getting pushed, and for companies with more than $20 million of EBITDA.<br>• Covenants are seeing the most pushback as cov-lite and cov-wide features push further down market. |
| OUTLOOK | • Prospects of fiscal stimulus and deregulation under the new administration are fueling a fairly high level of optimism, which is counterbalanced by uncertainty around the impact of policy changes on healthcare and international trade.<br>• Robust availability of credit should mean continued high leverage and borrower-friendly terms. Lending spreads could tighten unless there is a meaningful pick up in M&A volume.<br>• Lenders are predicting a more opportunistic environment for M&A against a backdrop of lower taxes, potential regulatory changes, and economic growth. |



# Deal Flow

Lenders characterized 2016 as choppy, brought about by volatility from the spillover of weak commodity prices and global economic uncertainty which contributed to lighter than anticipated sponsor-backed M&A deal flow. Brexit produced no more than a "hiccup", surprising lenders as almost a non-event in the equity and loan markets, and transactions pushed through the U.S. presidential election business as usual.

Recent statistics evidenced a slowdown in middle market private equity buyout activity. In 2016, $366.8 billion in capital was invested in 1,889 deals, reported PitchBook, which represents a 12.5 percent decline in transaction volume and a corresponding 8.1 percent decrease in enterprise value.

Lenders were busy in the third quarter following a quiet first half, with the fourth quarter continuing the positive trend. Not able to deploy as much capital into new money buyouts, lenders were forced to look at opportunistic financings. Survey participants reported a spike in dividends in December.

"2016 was a tale of two markets. The first half of the year was relatively quiet, as the markets slowly recovered from poor market conditions that began in late 2015. By late spring and into early summer, we started to see liquidity come back into our markets which really opened up things," commented Scott Reeds, a managing director at Citizens Financial Group. "Since then, the markets have been moving in a very positive manner. There are still fewer really attractive new money deals, and around those transactions you have a lot of competition so the terms naturally get aggressive."

"I wouldn't say that you could make a comment about the year in totality. It was definitely a mixed bag based on where we were in the year given overall market tone and trends," observed Katie Jones, a managing director at BMO Capital Markets.

*"There are still fewer really attractive new money deals, and around those transactions you have a lot of competition so the terms naturally get aggressive."*

*—Scott Reeds Citizens Financial Group*

"Dividends and other opportunistic transactions were a huge part of the market in the back half of 2016 in the absence of strong M&A activity. It is necessary for lenders to continue to book assets," added Reeds. "However, lenders look at dividend deals through a slightly different lens. They continue to get scrutinized more than new money M&A related transactions."

"M&A volume for the mid market continues to be down year-over-year in 2016 from 2015 which was down from 2014 levels. Despite the debt markets by and large being open for business, sponsors were not bringing the deals to market," Jones said. "Either sponsors wanted to create additional value with add-on acquisitions or assets were not ready as the process improvements were not yet implemented."

"Liquidity started to percolate into the marketplace in the third quarter. M&A started to perk up," said Bob Marcotte, president at Gladstone Capital. Competitive dynamics increased dramatically in the fourth quarter, Marcotte indicated. "You've got huge amounts of capital from private debt funds in the marketplace which is beginning to impact both leverage metrics and pricing levels going into 4Q 16."

"2016 was not a robust year for deal flow. I would characterize it as steady," said Jeri Harman, chief executive officer at Avante Mezzanine Partners. "The real issue is a lower hit rate from our sponsors which we attribute to higher valuations. Sponsors may be outbid or diligence doesn't support the multiple. When you do find a deal you like, there is so much money chasing fewer deals, sometimes the structure or pricing gets irrational in our view. In an environment like this, we want to stay disciplined and pick our battles."

"Most of the commentary says that lending volume is down for the broader middle market. Volumes have been consistent where we are focusing," remarked Chris Williams, a partner at Twin Brook Capital Partners. "We are typically focusing on the lower half of the middle market, below $30 million of EBITDA."

"Financing volume that gets reported for sponsored transactions has been down modestly relative to last year; however, for privately reported transactions, we've seen the opposite. We've seen deal flow improving," said Randy Schwimmer, senior managing director and head of originations and capital markets at Churchill Asset Management. "Part of that is the way that the market has morphed from a syndicated market to a club market, so more and more transactions are being clubbed up in the early stages." Schwimmer continued, "There has been a well-balanced blend of new money buyouts, acquisition/add-on financings, and recaps. The deal quality has held up well, though we saw some deterioration in structures as we approached year end."

Ira Kreft, a Senior Vice President at Bank of America Merrill Lynch summarized: "As we are in the late stages of a long M&A cycle, there are fewer opportunities and generally lower quality. Traditional private equity sponsors have faced competition from strategic buyers and family offices. In addition, $1 billion-plus private equity funds have come down market into the middle market pursuing deals."

## Strategic Buyers

Corporate buyers have been successful displacing private equity sponsors in competitive auctions, lenders say, contributing to the slowdown in leveraged buyout volume. "Strategic buyers are winning a lot of auctions right now. That is part of our problem on quality deal flow," said Scott Reeds at Citizens Financial Group. "Given the first two quarters of the year were light, a lot of deals were getting sold to strategics," agreed Bob Marcotte at Gladstone Capital. "Buyout volumes lagged the broader M&A market because capital was more expensive, and the strategics had it."

*"The strategics are boxing out the sponsors a lot earlier in the process because they have so much more buying power and synergies that make the prices they can pay that much more compelling."*

*—Katie Jones BMO Capital Markets*

"We have seen a lot of M&A transactions taken off the table by corporates (versus private equity). These companies have finally come off the sidelines and are using their liquidity warchest to be more active in the middle market picking up assets that sponsors otherwise would have had," offered Katie Jones at BMO Capital Markets. "The strategics are boxing out the sponsors a lot earlier in the process because they have so much more buying power and synergies that make the prices they can pay that much more compelling."

## Quality

Survey respondents spoke of deterioration in credit quality and a higher turn down rate in 2016. Lenders are exhibiting a higher degree of selectivity. "The big story for us is the quality, which is materially down from 2015. It could be long-in-the-tooth businesses that haven't really rebounded or cyclical businesses that are being marketed off all-time peak performance. We find something about the business which makes it difficult to underwrite the sustainability of current cash flows," offered Dan Letizia, a director at THL Credit. "We think the businesses are leverageable at some level, but we're not willing to be as aggressive as some participants given what headwinds we foresee within our investment horizon."

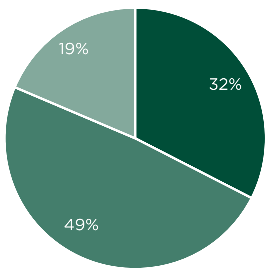
The market is bifurcated by the "haves" and "have nots"—the high quality "A" and "B" businesses are still attracting full valuation and debt multiples, and those of poor credit quality struggle to get lender interest. "We are picking our spots. We are chasing some of the high quality assets that are still at structures where we feel comfortable. Others that might not be that "A" or "B" business, we are structuring right so we can weather whatever storm may come," Letizia added.

"I always look at the broad market to take cues, and we're seeing credit, credit, credit, being the top three things lenders are focused on," commented Jones. "When the broader market is so focused on credit

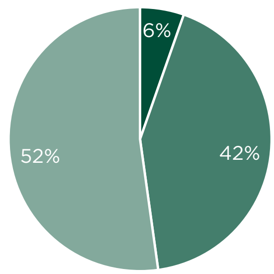
# The Deals

## Share of the Middle Market - 2016

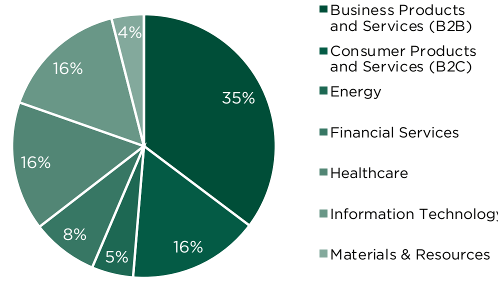
### Deal Flow




### Capital Investment



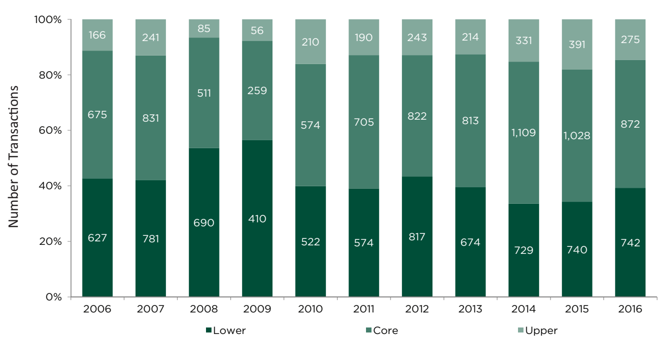

### Industry




■ The Lower Middle Market $25M-$100M ■ The Core Middle Market $100M-$500M ■ The Upper Middle Market $500M-$1B

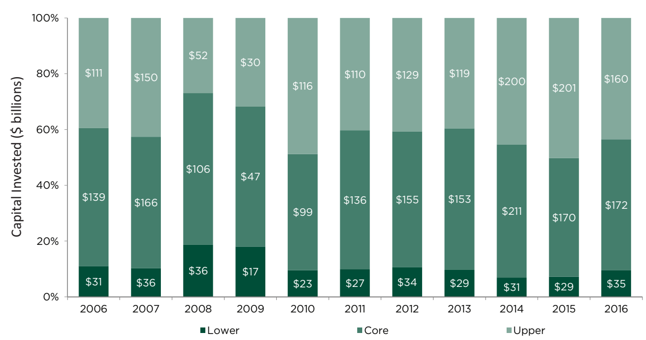
* Aggregate deal volume and value for 4Q 16.

## Deal Flow by Year



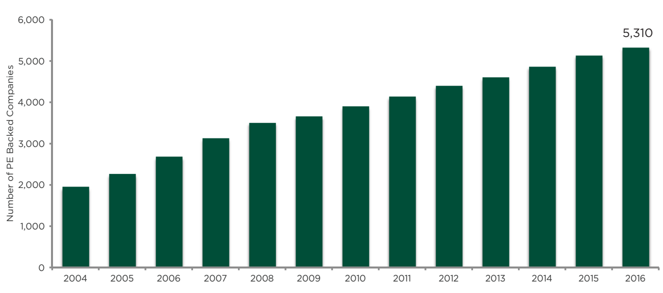

*Deal counts and values reflect private equity buyout transaction activity only.*

## Capital Investment by Year



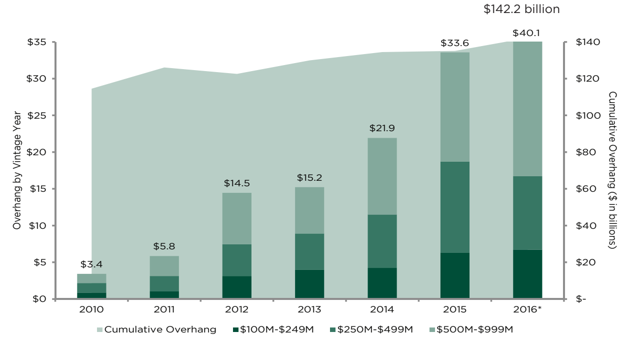

# The Overhang

## Middle Market Company Inventory




## Middle Market Capital Overhang

$142.2 billion




*Private equity funds of $100 million - $1.0 billion
* As of June 30, 2016.

*Source: PitchBook.*

# Deal Flow

quality, resulting in the "haves" and "have nots", that gives more ammunition to the middle market to be more discerning and follow suit."

"Quality levels are certainly down. You've seen a number of quality businesses exited over the course of 2014 and 2015, particularly private equity portfolio companies, and the inventory certainly has been reduced over time," commented Mark Hollis, a partner at Centerfield Capital Partners. Hollis spoke of more "B" and "C" quality manufacturing businesses in the market, citing issues of low to no growth, lower margins, and cyclicality.

"You see more cyclical companies where sponsors are asking for more leverage against cyclical cash flows that are harder to underwrite. In that context, quality is down," observed Robert Radway, chief executive officer at NXT Capital. "You're being asked to finance companies that should have at most 3x - 3.25x senior leverage and the ask is 4x or 4.25x. It is quality typical of the later stages of the cycle."

## Sectors

Sectors that are seeing the highest activity levels are among those cited for growth, including Healthcare, Software, Technology, and Business Services. Industry "darlings", according to Katie Jones at BMO Capital Markets, have business models with a strong recurring revenue story. "We first look at the revenue model, how much is predictable and sustainable, and as you model out a recession, what is going to be the impact." Software is cited for high customer retention and subscription-based revenue models.

"Anything within IT has been active," offered Justin Kaplan, a partner at Balance Point Capital. "Within IT, I would highlight two areas—companies that focus on small-business IT infrastructure and those that touch the word 'cyber'—are really hot."

*"Anything within IT has been active. Companies that focus on small-business IT infrastructure and those that touch the word 'cyber'—are really hot. "*

*—Justin Kaplan*
*Balance Point Capital*

Madison Capital Funding formalized its Technology vertical in 1Q 16 and includes software-as-a-service (SaaS), healthcare IT, financial technology, hosting services, database services, and related markets among the focus areas. "Anything with recurring, contractual revenues is a big part of what we want to build in that portfolio," commented Jared Halajian, a director at the firm. The middle market lender is looking to double its technology assets under management to $1.6 billion over the next three to four years," according to *Buyouts*.

Food was the most cited defensive industry that continues to attract broad market interest today. "I think a lot of that is perceptions about lack of cyclicality in a market where everyone believes we are one day closer to the next downturn," offered Rich Jander, a managing director at Maranon Capital. Maranon invested in four food-related businesses in 2016, ranging in scope from branded products to ingredients.

In Healthcare, the fragmented, local retail model of outpatient services is attractive, indicated lenders, citing such areas as dental, dermatology, physical therapy, pain management, and behavioral therapy among the desirable platforms.

Automotive Aftermarket has performed well across cycles and is very attractive in the debt markets, according to lenders.

Growth-oriented logistics and eCommerce businesses are becoming more accepted, indicated Bob Marcotte at Gladstone Capital, saying, "Online volumes continue to grow, and they are growing faster than the underlying industry categories."

Key themes are influencing sponsor and lender interest, according to Brian Schneider, a managing partner at Northstar Capital, some of which apply across industries. Schneider identified low-cost healthcare, emphasizing services, and food and agribusiness, for stability. "Government outsourcing has always been a hot topic and will continue to be with the new administration," Schneider said. "Channel disruption is a major development we see now—the elimination of wholesale or distribution channels, in addition to near shoring—bringing manufacturing back to the U.S."

## Manufacturing

Broadly, manufacturing continues to exhibit slower growth, said survey participants. Lenders carved out aerospace and specialty chemicals as bright spots, citing higher growth which is driving increased transaction activity. "Specialty chemicals has been an area that is attractive for us, not only in terms of deal activity, but also because those businesses seem to be growing steadily as well," offered Chris Williams at Twin Brook Capital Partners.

Some lenders are taking more of a wait-and-see approach to manufacturing to determine the potential impact of any policy changes on businesses with significant international trade. "There are deal opportunities that we feel have less volatility that are in the manufacturing space—those that are less correlated to some of the major exporting and technology-related manufacturing operations," said Kyle Goss, a principal at Elm Park Capital. "We don't look at any manufacturing opportunities in a vacuum with any certain disposition as of right now."

"We are more bearish on Industrials generally—particularly manufacturers with high fixed costs or volatile raw material inputs," said Dan Letizia at THL Credit. "I would include manufacturers of capital equipment, where you would expect to see more lumpiness in revenue and purchases that might be deferred by customers. We've already seen some softness in these opportunities, so we continue to be cautious."

Deals are getting done for cyclical industrial businesses but at the right leverage levels and the right structures, said survey participants. "We did see a slight rebound in old economy manufacturing businesses, although they are more difficult to finance," commented Jeff Kilrea, managing director and group head of CIT Corporate Finance. "Multiples have come back to realistic levels reflective of the perceived volatility in the sector, closer to 7x versus the top end of 9x. Businesses that have more of a technology bent to them typically will have higher growth prospects and can therefore garner higher multiples."

Customer and end market diversification are paramount to lessen any cyclical impact. In Industrials, lenders like differentiated, specialized products with high engineering content and a strong base of replacement business. "There is a value-add proposition, and you get paid for it. Barriers to switching are higher," observed Jeri Harman at Avante Mezzanine Partners.

*"Channel disruption is a major development we see now—the elimination of wholesale or distribution channels, in addition to near shoring—bringing manufacturing back to the U.S."*

*—Brian Schneider Northstar Capital*

Abacus Finance invested in a number of niche manufacturers in 2016, confident in the moats around the business models. "The manufacturing sector was an area where we wanted better diversification," said Tim Clifford, chief executive officer at Abacus Finance. "The companies we invested in have long operating histories and are leaders in their niches. Either they had a significant market share in their space or their offering was very unique and difficult to replicate."

## Caution Ahead

While some lenders contest there are no "redlined" industries, several were commonly cited by survey respondents as continuing to be out of favor, among them Energy, Education, Ag, Retail, and Restaurants. Energy was included in broader Resources, underscoring an aversion to commodity-oriented businesses, with lenders adding Metals & Mining in the sectors to avoid. Lenders indicated that in and out of favor sectors might change depending on what happens with respect to future policy changes.

# Deal Flow

Oil & Gas remained a challenged sector in 2016. Survey participants are reporting continuing weakness which is having a spillover effect on companies that provide products and services into the sector. Lenders see some reasons to be optimistic in 2017, but the industry continues to remain out of favor.

Lenders say the retail environment is very difficult to underwrite today. “The migration towards internet-based retailing is certainly in full bloom, so specialty retail is very tough to underwrite,” commented Robert Radway at NXT Capital. “It certainly is a portion of the economy that is changing pretty rapidly. Consumer spending is at about the same level, but how those dollars are spent has changed significantly over the past several years. Retail today is very tough.”

Lenders will still look at Restaurant opportunities but are being highly selective, saying the cyclical sector has few winners. “Restaurants had a difficult year. Same store sales across the broader restaurant sector are stagnant,” said Dan Letizia at THL Credit. “In the middle market, it is more difficult to structure restaurant chains. Those are very capital intensive.” Kyle Goss at Elm Park Capital added, “Across the board, most of the opportunities coming our way have been negative performers to plan with significantly negative same store sales comps, despite any planned capex.”

Lenders are exhibiting heightened sensitivity to cyclical businesses and conservatism when approaching new opportunities. Ira Kreft at Bank of America Merrill Lynch said: “In more cyclical sectors, there has been more caution regarding leverage levels as those industries are regarded as having more downside potential than upside potential.” “If still investing, lenders will reduce the leverage profile,” said Steve Kuhn, a managing director at Fifth Third Bank. “We are avoiding sectors that would cycle hard in the next recession—sectors that saw a big drop off in the last recession.” Automotive, Heavy Truck, Heavy Manufacturing, and Building Products were cited among the sectors receiving increased scrutiny.

*“In more cyclical sectors, there has been more caution regarding leverage levels as those industries are regarded as having more downside potential than upside potential.”*

*—Ira Kreft*

*Bank of America Merrill Lynch*

“OEM auto is something we are all very cautious about,” said Scott Reeds at Citizens Financial Group. Survey respondents believe the automotive market has likely reached a peak and is not expected to see significant growth. “The automotive market is probably as good as it is going to get,” remarked Bob Marcotte at Gladstone Capital. “We are very cognizant of the peak level of auto production domestically.” “We think that auto peaked probably in 2015 but is still relatively healthy. So we certainly have not redlined auto, but we do expect some possible softening,” said a surveyed lender. “Auto seems to have peaked from an OEM new build perspective,” added Letizia. “I feel like we’ve seen fewer auto opportunities than in the past, but when we do, we like aftermarket more than being tied to new build platforms.”

Lenders are showing more caution around building products, a sector that has recently seen deal flow surge with some lenders calling the market overheated. “Low interest rates should have been stimulative; however, housing formation rates and demand for single family homes has been very muted,” indicated Marcotte. “Multifamily has dominated the new home construction market undermining the growth outlook for the building products sector.” Rising mortgage rates could have the effect to further dampen single family home demand. “We feel that we continue to be on a two- to three-year tear in an upswing. We’ve seen how quickly those upswings can end,” observed Goss. “From a new building and new construction related perspective, we’re probably more conservative than other lenders. Our sense is that we may be near some degree of a cyclical high.”

"We look for some kind of sustainable differentiation, whether it's scale, regional market share, access to unique products," said Letizia.

"It would have to be the right structure and the right leverage level, but we are still pretty cautious," commented Scott Reeds at Citizens Financial Group.

Building products has performed well, but in a rising interest rate environment, the sector could see some pressure, indicated Brian Schneider at Northstar Capital. "There will be some disruption in that market, whether it is residential faltering or commercial faltering. There is uncertainty there so we're staying away."

"You are seeing a lot of activity in the cyclical industries because the owners of those assets recognize it is a good time to exit in anticipation of something that could be around the corner," remarked Mark Hollis at Centerfield Capital Partners. "As a lender or investor, you just need the right approach. People are thinking about cyclicality, but its relative impact on valuation has been fairly muted. It is still a seller's market even if you do have a cyclical asset."

Healthcare is seeing greater scrutiny in light of looming policy changes under the Trump administration. "We've seen more caution and fewer deals year over year," said Rich Jander at Maranon Capital. "Over the last year, we've taken a harder look at the companies we've financed and what their exposure is to government reimbursement. That is probably a little bit more of a focus for us right now until there is more visibility," said Jared Halajian at Madison Capital Funding. "In heavily regulated industries, lenders are playing cautious in anticipation of potential changes under a new administration. That has impacted the ability to sell those businesses," added Jander.

*"There has been a flight to quality, and it is every bit as much today as it was before, if not more so. That may not appear the case with leverage multiples so high, but that is because they are being driven high by the good deals."*

*—Jeri Harman Avante Mezzanine Partners*

"With the exception of Healthcare, I'm not seeing caution by sector. There is caution on story deals," said Jeri Harman at Avante Mezzanine Partners. "When you get into a company that has a mixed financial history, customer concentration, or an industry in flux—these are the kind of issues that lenders are concerned about and more so than they used to be. There has been a flight to quality, and it is every bit as much today as it was before, if not more so. That may not appear the case with leverage multiples so high, but that is because they are being driven high by the good deals."

"There are no sectors that I would say are taboo from a lending perspective," commented Jeff Kilrea at CIT Corporate Finance. "The leverage profile we propose will reflect our industry risk appetite because we have a different thought process around value."

"Despite the enthusiasm for the Trump administration, there is still a perception that we are near a down cycle and perhaps a recession on the come," said Tim Clifford at Abacus Finance. "So I think most people are still attracted to noncyclical businesses. As a result, our sponsors are continuing to invest in software and healthcare—recession resilient industries with recurring revenue business models."

# Process

*Private equity groups are looking for ways to differentiate themselves in competitive auctions against formidable corporates that are armed with cash, synergies, and pricing flexibility. Sponsors are turning to specialization to supply a strategic angle, since "tricks" of exclusivity, financing certainty, and speed of execution have all been "pulled out of the hat". Lenders are being forced to stay aggressive, moving in lock step and ready to extend full leverage as valuations push up to historical highs.*

"We have observed many sale processes being pre-empted by a buyer; and private equity firms and family offices are working hard to find an angle to differentiate themselves in sale processes."
*Ira Kreft, Bank of America Merrill Lynch*

"Bankers are going broad and running full auction processes requiring multiple bids and significant upfront due diligence, which until now we had not seen as regularly in the lower middle market, particularly for companies with $4-6 million of EBITDA. Our private equity clients are investing more time and money upfront, particularly on accounting and market studies, and lenders are often being asked to provide commitment letters."
*Tim Clifford, Abacus Finance*

"Private equity groups are showing a greater willingness to participate alongside multiple bidders through the full diligence process. You are seeing in auctions for smaller companies that you never saw before. Bankers recognize sponsors are desperate to put money out the door. If it is the only way they can get to the next step in a process, their view is a 50 percent chance of winning is better than a zero percent chance in today's market."
*Chris Williams, Twin Brook Capital Partners*

"The theme that I am seeing repeated is, because of limited resources, people are shying away from participating in broad auctions and taking aim at getting an angle in fireside chats."
*Justin Kaplan, Balance Point Capital*

"You are starting to see attorneys that have participated in large market transactions try to push pricing grids down into the lower middle market. The sponsor then tries to aggregate key structural terms into the most aggressive proposal possible to pick the lender."
*Chris Williams, Twin Brook Capital Partners*

"Sponsors are specializing and investing more front end time than they have in the past. They are willing to do more upfront due diligence and are trying to get more time with the management team outside of a process to differentiate themselves."
*Brian Schneider, Northstar Capital*

"Lenders are all being aggressive with their diligence. For the regulated lenders, it has probably been a bit more heightened because of regulatory oversight. Leverage structures are being scrutinized more. Proforma adjustments are being scrutinized more. Loan agreement covenant packages are being scrutinized more."
*Jeff Kilrea, CIT Corporate Finance*

*"Bankers are going broad and running full auction processes requiring multiple bids and significant upfront due diligence, which until now we had not seen as regularly in the lower middle market."*

*—Tim Clifford*
*Abacus Finance*

"Sponsors are backing off on highly competitive processes where the likelihood that they'll be selected is low. Resources are limited, and they don't want to pay broken deal costs. It was the interesting wrinkle to develop in 2016."
*Rich Jander, Maranon Capital*

"Bankers are are trying to consolidate the timing of the diligence process. Any time that starts to get compressed, lenders get a little concerned."
*Chris Williams, Twin Brook Capital Partners*

"Pressure is coming in the form of diligence outs. If the sponsor is comfortable with the diligence and is willing to fund in, then the lenders are going to be committed to funding as well. You are seeing these terms on the well-followed and attractive businesses, typically starting at $10-15 million of EBITDA."
*Rich Jander, Maranon Capital*

"As competition for assets goes up, sponsors are looking for ways to compete and differentiate their bids. While pricing and hold level are important, moving fast and being the incumbent lender are very important too."
*Scott Reeds, Citizens Financial Group*

"We are starting to see more financing grids in the middle market. Sponsors are taking a page from the capital markets and pulling forward that process earlier and earlier utilizing the grids as a tool to command the "best of" financing terms. Financing grids were always very prevalent in the large cap market, and now we are seeing from sponsors even in the teens and 20's of EBITDA. Lenders are being asked to not only provide leverage and pricing but to also define secondary and tertiary terms that are typically not addressed until after the lender meeting."
*Katie Jones, BMO Capital Markets*

"We are seeing more lenders pushing for quarterly calls with management. It is a recent development in the large cap market. Lenders want to be on top of company performance ahead of rising interest rates and any slowdown in the economy."
*Steve Robinson, Antares Capital*

"Lenders want a seat at the table. The middle market is taking a cue from the institutional market to formalize the process; they want quarterly financials, quarterly MD&A, quarterly calls. There is definitely a push towards more information, more transparency, more visibility, and more access. Lenders want to be in front of any developments and movements, especially since we've seen a lot more permissions come inside of a deal."
*Katie Jones, BMO Capital Markets*

*"Sponsors are backing off on highly competitive processes where the likelihood that they'll be selected is low. Resources are limited, and they don't want to pay broken deal costs. It was the interesting wrinkle to develop in 2016."*

*—Rich Jander*
*Maranon Capital*

# The Trump Card

Following November's surprise outcome in the U.S. presidential election, broader market sentiment is seemingly positive. Pundits point to potential tailwinds of a Trump administration for the middle market, citing economic and tax policies and deregulation which should benefit small business owners and boost economic growth. To be sure, uncertainty looms in healthcare, one of the largest markets in the U.S. economy. Resource-based industries such as energy and metals could see much needed lift, while the outlook is decidedly bullish for infrastructure. Lenders exude a tone of cautious optimism with the view that any positive momentum generated from policy changes could buy "extra innings" in the current business cycle, and in turn, inject the confidence needed to recharge the M&A market.

There was no evidence of the election causing a slowdown in deal activity, with not even as much as a "speedbump" decelerating momentum on deals in process. "Most people thought that Hillary Clinton was going to win and ultimately raise taxes next year so sellers definitely wanted their deals closed before year end when the tax rates were lower," commented Chris Williams at Twin Brook Capital Partners. Williams participated in a panel for the Texas Business Forum in November observing a positive sentiment among business owners and intermediaries attending the conference. "The general consensus was an improved environment for smaller businesses under Trump, if he is successful in taking away some of the regulatory constraints and lower the healthcare expense burdens on these companies." Williams continued, "If banks are able to provide more capital, it is going to create a better environment, and you will start to see transaction volumes pick up. We heard that from multiple parties, whether it was bankers, sellers, or potential buyers."

"People are feeling bullish because the central themes under Trump have been lower taxes, less regulation, and more infrastructure spending," remarked Justin Kaplan at Balance Point Capital. "The market has clearly rallied post-election, particularly in some of those underperforming segments in anticipation of recovery or better economic conditions," said Steve Gurgovits, a managing partner at Tecum Capital Partners. "The market is anticipating good news in terms of pro-growth strategies from the new administration. There is a lot of optimism in the small business community."

"The fact that you have a Republican-led Congress will make it easier to enact change than a divided government," commented Dan Letizia at THL Credit.

"Overall, there is a sentiment of cautious optimism on the basis of a fundamentally better environment that is more supportive of growth," said Robert Radway at NXT Capital, "...potentially less regulation and tax policies that would ultimately benefit the average middle market borrower and business owner."

> *"The market is anticipating good news in terms of pro-growth strategies from the new administration. There is a lot of optimism in the small business community."*
>
> *—Steve Gurgovits Tecum Capital Partners*

Optimism is counterbalanced by some healthy trepidation about a Trump presidency, notably the impact of policy changes on healthcare and international trade.

"Healthcare will not necessarily be under immediate pressure, because I don't think some of the changes will come fast," observed Robert Radway at NXT Capital. "You could potentially see some significant changes both to Obamacare and perhaps more importantly to Medicare. Those are very big programs and not easily changed overnight. Because of that people are hesitating and showing some restraint. There will be some drag on transaction activity because of lack of clarity."

"There is a lot of uncertainty around companies that operate in an international environment and what is going to happen with trade agreements," said Mark Hollis at Centerfield Capital Partners. "I don't know if you've necessarily seen it factoring into credit and valuation decisions at this point, but you may in 2017 as the new administration takes shape."

"I wouldn't be surprised that the immediate impact is a bit of a wait-and-see attitude, certainly on the part of some sponsors that otherwise would move full steam ahead," remarked Robert Radway at NXT Capital.

## Uncertainty Looms in Healthcare

Healthcare continues to see growth; however, lenders are proceeding with caution to understand who the winners and losers are going to be under changing regulations:

"Everyone is going to be a little bit more cautious until we understand Trump's agenda on the Affordable Care Act (ACA) and how that could impact any given sectors within Healthcare," said Jeri Harman at Avante Mezzanine Partners.

Kyle Goss at Elm Park Capital added: "Healthcare is clearly in for a change. If the ACA is dismantled and replaced with something that is a like-kind, there may be winners and losers within that space. Transactions involving providers and payors are likely going to get deferred until there is more clarity. Healthcare services is still ancillarily tied to reimbursement and/or stroke of pen risk, so you'll probably continue to see deals getting done albeit more cautiously."

"No one knows what is going to happen other than it is clear they are going to repeal Obamacare, which is causing investors to take a pause on Healthcare to see how the changes are going to play out, at least for the first few months of the administration," commented Justin Kaplan at Balance Point Capital.

Technology will continue to benefit irrespective of changing regulations, lenders said. "Most of Healthcare IT should remain strong, particularly businesses with leading technology to improve revenue cycle efficiency and collections management. There will always be demand for companies that are value based and outcomes focused," remarked Colleen Gurda, a senior vice president at Comvest Partners.

> *"Most of Healthcare IT should remain strong, particularly businesses with leading technology to improve revenue cycle efficiency and collections management. There will always be demand for companies that are value based and outcomes focuse."*
>
> *—Colleen Gurda Comvest Partners*

*Given the pledge to reduce Dodd-Frank, do you foresee banks becoming more competitive under the under Trump administration?*

"We haven't seen any change yet, but all the rhetoric out of the Trump administration is less regulation, not more. I don't believe that the regulatory environment is going to get any worse."
*Scott Reeds, Citizens Financial Group*

"The rhetoric of this new administration has emphasized supporting business. Bank financing, which has been choked off by regulations for the better part of three or four years, needs relief."
*Steve Gurgovits, Tecum Capital Partners*

"The amount of capital provided by regulated banks has continued to decline. A recent statistic reported that banks only provided 30 percent of capital towards middle market LBOs. It seems to me that they've really tied the hands of a certain class of lenders. I think they have to reevaluate that."
*Jeff Kilrea, CIT Corporate Finance*

"If Trump is successful in reducing regulation, that should improve the environment for banks to become more active. New entrants that do not have established relationships or a long history of working in the middle market are going to be the most impacted by a resurgence of the banks."
*Chris Williams, Twin Brook Capital Partners*

# The Trump Card

"You could see banks being more aggressive if regulations loosen. As a whole, you will find that banks never get to the position they once were before the financial crisis. Alternative lenders serve a different niche in the marketplace that is not going to be displaced by banks in the near future. All we are focused on is credit, which gives us a more streamlined approval process, and in many instances, speed and greater flexibility in our product offering."
*Tom Aronson, Monroe Capital*

"There are going to be more regional banks putting out capital—driven by less regulation and missteps made by the big banks. I think the regional banks are going to have success."
*Brian Schneider, Northstar Capital*

"To the extent there is less regulation, I absolutely see some of the community banks becoming active again. I don't necessarily see them roaring back in 2017. It could be a two- to four-year story that we hear about the small market banks coming back into the fold and financing some of these lower middle market M&A transactions."
*Kyle Goss, Elm Park Capital*

"Regulatory easing could have the potential to stimulate banks to lend more, which may make them more aggressive. It might make senior/mezz structures more attractive relative to unitranche."
*Jeri Harman, Avante Mezzanine Partners*

*"It could be a two- to four-year story that we hear about the small market banks coming back into the fold and financing some of these lower middle market M&A transactions."*

*—Kyle Goss*
*Elm Park Capital Management*

"As a firm, we don't think that the new administration is going to change the way banks participate in the leveraged loan market. Given the view that we are late in the credit cycle, it is not the time to loosen up the leveraged lending guidelines and have banks step on the gas. We do think it might have an impact on consumer finance businesses (i.e., credit cards and mortgages) that were being increasingly regulated."
*Rich Jander, Maranon Capital*

[From a published white paper] "It seems unlikely that the incoming administration will focus on (or have domestic or overseas support for) reducing bank capital requirements. Basel III is an international bank solvency standard and has a far greater impact on the middle market lending area. The gradual increase in these requirements has pushed banks (particularly the largest ones) further into investment banking and other fee-based activities and away from middle market lending—an arena that is today dominated by non-bank institutional investors. The consensus is that these capital requirements have strengthened U.S. banks and made it less likely that they would ever be imperiled by a global financial crisis."
*Randy Schwimmer, Churchill Asset Management*

"I think it is unlikely that risk allocation rules that have been driving the banks' behavior are likely to change in the near term. It is hard to see how a multi-trillion dollar money center bank is going to get more aggressive in middle market financing if they don't have the platform infrastructure and still have the capital charges to get into the business to provide leveraged finance."
*Bob Marcotte, Gladstone Capital*

# Capacity

Liquidity is robust with a reported $37 billion in middle market loan fund raising in 2016, according to Thomson Reuters LPC—up from $22 billion raised in 2015[1]. October alone brought in nearly $5 billion in additional capital for deployment, raised across new loan funds from lenders that included NXT Capital, Monroe Capital, Audax Group, and Bain Capital Credit[2].

- NXT Capital raised $312 million in equity for NXT Senior Loan Fund IV, and with targeted leverage will have $900 million to invest.[1]
- Monroe Capital closed $800 million Monroe Capital Private Credit Fund II LP, its largest investment vehicle to date, besting its $600 million target. The fund will have $1.5 billion to invest.[1]
- Audax Group closed Audax Senior Loan Fund III raising $500 million in equity and will have more than $1.6 billion in capital to invest.[1]
- Bain Capital Credit raised more than $500 million in equity for Bain Capital Specialty Finance, its newly-formed private BDC.[1]

After a volatile first half of 2016, some BDCs were able to access the equity market to raise additional capital, including Golub Capital, Monroe Capital, Triangle Capital, and Main Street Capital, among others, reported Thomson Reuters LPC.The difficult capital raising environment is highlighted by public equity fundraising, totaling $692 million through December 2016—the lowest level since 2009. Between 2010 and 2014, $12.8 billion in public equity issuance was recorded. The last BDC IPO was in 2009, according to Thomson Reuters LPC[1].

BDCs managing separate funding vehicles were also successful in capital raising efforts, among them Crescent Capital, Monroe Capital, Tennenbaum Capital, WhiteHorse Capital, and TPG Private Credit. Among the new private BDC platforms announced during the year were Owl Rock Capital, Goldman Sachs Private Middle Market Credit, and Bain Capital Credit BDC. Owl Rock reportedly has secured $2.2 billion for its BDC with a goal of raising $3.5 billion to $5.0 billion[1].

"Like us, a lot of lenders have had success in raising capital and have shown consistent lending practices which has given them the ability to raise more money. It kept 2016 a competitive year," offered Tom Aronson, managing director and head of originations at Monroe Capital.

Capital is flowing into the middle market. Market dynamics reflect a changing landscape as alternative lenders jockey for market share in the wake of regulatory oversight and market volatility which have hampered lending by banks and BDCs. Surveyed lenders shared their observations:

> *"Investors are turning to alternative credit in search of higher yield, better diversification, and lower risk than offered by traditional asset classes."*
>
> *—Randy Schwimmer*
> *Churchill Asset Management*

"Investors are turning to alternative credit in search of higher yield, better diversification, and lower risk than offered by traditional asset classes," said Randy Schwimmer at Churchill Asset Management, in a white paper published in November 2016. "Senior leveraged loans to middle market companies, in particular, are among the fastest growing private debt alternatives as banks curtail their exposure to riskier borrowers."

"Capital is readily available," offered Ira Kreft at Bank of America Merrill Lynch. "Bank and non-bank lenders are competing aggressively for opportunities. Asset-based lenders have been able to partner with non-bank lenders to provide a very competitive structure, with an attractive overall cost of capital, flexible covenants, and a relaxed amortization schedule."

"There is a lot of money chasing leveraged loans right now. People have to put that money to work," commented Jared Halajian at Madison Capital Funding. "A lot of it is interest rate driven. Trump was encouraging an increase in interest rates. When you loan money on a floating rate basis, it is an asset class that is really attractive to investors."

[1]GOLDSHEETS Middle Market, December 2016, Thomson Reuters LPC
[2]GOLDSHEETS Middle Market, November 2016, Thomson Reuters LPC

"Fund raising is strong. There is a lot of capital moving into the middle market. That is really helping direct lenders and other middle market buyside platforms get off the ground and grow quickly. We're seeing no shortage of middle market competition," said Scott Reeds at Citizens Financial Group. "In the broader market, we have witnessed stronger than anticipated CLO issuance and positive retail fund flows return to the market."

"There are quite a few new platforms and a lot of money that has been raised. The difference on the capital that has been raised is some of it has some higher yield targets," said Daniel Brazier, a director at Madison Capital Funding.

"There is plenty of capital flowing into the space," added Randy Schwimmer at Churchill Asset Management. "There has been active fundraising, particularly in the higher yield, more junior-capital-like funds. More significantly, there has been an increase in partnerships between originators and asset managers. Obviously, our affiliation with TIAA is a case in point. Larger firms are recognizing they can't access the class without experienced teams."

"I see no shortage of capital chasing opportunities in the middle market which is driving aggressive financing terms and making it more challenging for a regulated lender," said Jeff Kilrea at CIT Corporate Finance. "There is a lot less activity, so if there is a good asset on the market the nonregulated lenders are going to try to gobble it up. Whether it is a new asset or an existing portfolio asset that is trading from sponsor to sponsor, they want to keep it."

## Private Credit Funds

A prominent theme in 2016 was the growing awareness around private credit as an investable asset class for institutional investors.

"The interest in private credit continues. Investors are circling the market, trying to find an entry point. Many branded private equity firms are now thinking of themselves more broadly as asset management businesses, with the ability to do buyouts, distressed investments, and credit. All strategies are being hung off of those platforms," said Rich Jander at Maranon Capital. "While there is greater awareness, there is still a paucity of lenders that can directly originate and lead credit."

Robert Radway at NXT Capital added, "There has been a continued very strong influx of institutional capital into what is generally referred to as the private debt space. People are clamoring for yield. Middle market leveraged loans is one area where you can get a good yield, a good history of performance in terms of defaults and write-offs, and where you're getting a risk adjusted return that is quite attractive."

*"People are clamoring for yield. Middle market leveraged loans is one area where you can get a good yield, a good history of performance in terms of defaults and write-offs, and where you're getting a risk adjusted return that is quite attractive."*

*—Robert Radway*
*NXT Capital*

"The growth in large scale private debt funds backed by institutional investors seeking to capture some of the yield of the leveraged loan market is impacting the unitranche lender landscape," commented Bob Marcotte at Gladstone Capital. "More yield-driven senior capital has expanded the players that can cover a $30-50 million deal today."

## Banks

Banks are picking their spots, but for companies and industries they know and like, they can be aggressive. Leveraged Lending Guidelines continue to be a governor, according to Schwimmer, observing that, "Regulated lenders are staying disciplined below the 6x total leverage limit."

Rich Jander added: "If a transaction fits comfortably within the guidelines, then banks will participate. However, in many instances, banks are limited not only by pure leverage but on other key terms like amortization—that is what is really tripping them up. Market terms in many deals today are 1 percent amortization with an excess cash flow recapture. Banks just can't take that. It is not so much leverage; it is other terms where private credit can compete in a different way against the banks."

# Capacity

Regulatory oversight was not any more pronounced in 2016, said bank lenders, calling it a lingering malaise. "The regulatory oversight makes it more difficult to chase that high leverage aggressive structure, limited covenant deal. It doesn't mean it is not a good asset; it just means with the additional oversight, we need to be more aware of the impact higher leveraged deals have on our balance sheet," said Jeff Kilrea at CIT Corporate Finance. "There needs to be more common exchange with the regulatory bodies. They need to understand the markets that we lend to better."

Banks continue to be mindful of the capital they allocate, deploying it for the best clients or where they are able to put their entire institution to work, indicated Katie Jones at BMO Capital Markets. "The difficult thing is it's guidance, not rules, and it is going to look very different for each bank depending on the size of their balance sheet, how much capital they already have deployed, the quality of their book, and the opportunity on any given asset."

"Institutions are more focused now on the total leveraged loan exposure, and as a result, they have become more selective on which assets they invest in," commented Steve Kuhn at Fifth Third Bank. "I've seen banks be more selective and reduce their hold limits. I haven't run across any that have said, we're not doing deals."

"Banks have so much liquidity, and they are thrilled that interest rates are finally increasing because they have been trying to put that money to work for years," said Jones. "For credits that they know and like, we are seeing banks really lean in and get more aggressive because they don't want to lose assets or market share."

There is stronger demand from banks, agreed Scott Reeds at Citizens Financial Group. "To us, it feels like banks are continuing to try to deploy assets. Every bank has its own policies around leveraged lending, but they seem to be pretty well-defined at this point. When it makes strategic sense, banks will find ways to play. The direct lender community is continuing to take share, but I am not necessarily seeing less participation from the banks overall. It is relatively stable."

"We continue to see the banks pull back in certain instances and in certain instances they continue to get aggressive," said Dan Letizia at THL Credit. "That is probably where we see the most opportunity. We partner with banks a lot and are able to jointly propose unitranche solutions that are more flexible and cost competitive."

The implementation of Basel III is going to have a significant impact on banks going forward. "It has gotten a lot more expensive to be a bank, and that has put a lot of pressure on the regional players," Jones said. "Under Basel III, banks will be required to hold more capital making it more expensive to do any given deal. Banks are going to be very selective, and as you look at the hit rate, it is going to be a lot lower."

> *"We have seen a number of regionally focused banks enter the lower middle market leveraged lending business, while some of the long time players are taking a step back."*
>
> *—Mark Hollis*
> *Centerfield Capital Partners*

Some lenders observed an increasing level of interest from regional players in cash flow lending, typically cited as active participants in the lower middle market. Others observed less consistency in the marketplace.

"We have seen a number of regionally focused banks enter the lower middle market leveraged lending business, while some of the long time players are taking a step back," commented Mark Hollis at Centerfield Capital Partners. "I think some of these regional banks see this as an attractive opportunity, and given the size of their institutions they may not be subject to same amount of regulatory scrutiny larger banks have encountered."

"For the smaller deals, the regional banks are really stepping up," echoed Brian Schneider at Northstar Capital.

Dan Letizia at THL Credit added: “The regional banks with a cash flow book that is a relatively small percentage of their total assets have an appetite for leveraged transactions, but they structure them right. They want to be close to the assets when they can be.”

Some lenders speak to a real push back in cash flow lending from banks that previously were very active in the lower middle market. “It is pencils down,” said a surveyed lender. “We just don’t see them in our space anymore.” “If you see a deal that is 2.5x senior, you may see one or two regional banks. If it gets to 3x or higher, you’re not going to see a bank. It is going to be a nonregulated entity. Where we see the banks is usually in asset rich companies.”

## BDCs

A significant number of BDCs are still hampered by relatively low stock prices which has made capital raising difficult. Many have been recycling capital through loan repayments. Lenders shared their insight on BDC capacity and lending activity:

“A number of BDCs struggled through a period and continue to trade below book value, restricting growth through those vehicles. Those with diversified funding sources have been relatively successful at raising private capital outside the BDC,” observed Letizia. Daniel Brazier at Madison Capital Funding added, “At the beginning of 2016, BDCs were really struggling to raise capital and put money out the door in cost effective ways. That certainly has turned around.” “BDCs that have traded at or above net asset value or have multi-strategy platforms have remained active,” said Colleen Gurda at Comvest Partners. “We are partnering with the BDCs, and they are continuing to source and invest in good opportunities.”

*“BDCs that have traded at or above net asset value or have multi-strategy platforms have remained active.”*

*—Colleen Gurda Comvest Partners*

“There are some BDCs that have capacity, there are others that don’t,” offered Bob Marcotte at Gladstone Capital. “A number of public BDCs have recently raised capital so they are no longer as constrained. In addition, the amount of capital raised by private BDCs contracted significantly in 2016, and I don’t expect that to change. The private BDCs have largely been shut off.”

“BDCs, with the exception of a handful, simply haven’t had the liquidity available to go carte blanche and write new loans. They’ve had to wait for existing portfolio companies to be realized to reinvest the capital,” said Kyle Goss at Elm Park Capital. “It is difficult to raise new equity when you’re trading below net asset value. Their activities have been hindered based on where they have been trading. It is more of two year story for the BDCs.”

“BDCs were not really players in the middle market throughout 2016. We didn’t see them play with any consistency,” observed Rich Jander at Maranon Capital. “Lenders with a BDC as their sole business were not a factor in 2016 at all.”

“BDCs in the mid- to upper middle market have been very active,” commented Justin Kaplan at Balance Point Capital. “I do think there has been pullback from lower middle market BDCs.”

“Two to three years ago, the BDCs were readily able to raise capital. They were creating vehicles for straight senior debt and became much more active in that product than any time before,” said Robert Radway at NXT Capital, summarizing the shift in BDC lending activity. “Today, there are very few BDCs with significant appetite for straight senior debt, so they have either moved back to the unitranche product, mezzanine, second lien, or last out products because those produce the kind of return they need to make their math work.”

# Capacity

## Lower Middle Market

Lenders indicate there is adequate liquidity in the lower middle market, with the line of demarcation a moving target in a thin deal market. Most lenders still peg $10 million where there is greater lender interest and depth, although most will dip to $7 or $8 million for growing businesses. Mezzanine lenders demonstrate strong interest even dipping below $5 million for companies with attractive credit profiles, good growth prospects, and interesting equity stories.

"We see healthy competition in the sub $10 million EBITDA market. There are fewer lenders once you go below $5 million, but still decent competition. However, borrowers need to be flexible on price and structure," said Tim Clifford at Abacus Finance.

"For good businesses and good sponsors that have a track record within an industry, there is plenty of capital for those opportunities. The credit bar is higher, but there doesn't seem to be much slowdown in lender interest for lower middle market businesses," said Dan Letizia at THL Credit. While selectivity may be higher and structures more conservative, Jeff Kilrea at CIT Corporate Finance, offered, "There seems to be a real opportunity to entrench with certain sponsors in this area."

"There is a lot less competition in the sub $10 million EBITDA space. People will tout that they participate in that market, but there are few who actually do it," remarked Chris Williams at Twin Brook Capital Partners. "There is liquidity because there is a good stable of lenders that have consistently worked down in that space. You don't see many new entrants coming down into that part of the market."

"There is still competition in that space, but when you go below $10 million, there is a pretty meaningful drop off in interested lenders," said Jared Halajian at Madison Capital Funding. "We go down to $3.5 million, but the credit bar is high." Halajian indicated that the primary competition is banks. "They have a pretty good foothold on the lower market. People are not inclined to put a lot of leverage on those businesses."

"Demand is there. Deals are getting done," commented Brian Schneider at Northstar Capital.

"There is still adequate availability, and it has not been as impacted by recent capital inflows up market," remarked Bob Marcotte at Gladstone Capital.

*Is there a continuing supply demand imbalance and what has been the market impact?*

The supply demand imbalance is continuing with not enough good lending opportunities. It is more pronounced in the larger market with supply unable to meet the needs of loan fund investors.

*"We see healthy competition in the sub $10 million EBITDA market. There are fewer lenders once you go below $5 million, but still decent competition. However, borrowers need to be flexible on price and structure."*

*—Tim Clifford*
*Abacus Finance*

"Lenders have so much money that they want to put to work, it is getting harder to deploy it," said Katie Jones at BMO Capital Markets. "Part of it is market conditions; the other part is the liquidity position that people are in."

"There is probably more supply of capital than we need, and it is putting pressure on quality as opposed to purely on pricing," observed Robert Radway at NXT Capital. "Deals that shouldn't get done with high leverage are getting done because there is a lot of capital chasing transactions. That is a more frequent result than pricing compression."

2015 was a high water mark of supply demand imbalance, believes Kyle Goss at Elm Park Capital. "2016 has improved slightly, but there is still a lot more supply than there was three to four years ago. The last three months has been fairly frothy."

While the headlines speak to too much capital chasing too few deals, the discrepancy is not as dramatic as it seems, according to Randy

Schwimmer at Churchill Asset Management. "Much of the headline cash is going outside the first-lien/senior stretch asset class. Also, direct lending deal volume, due to its private nature, tends to be undercounted. This is reflected to some extent in the relatively stable spreads we've seen this year," Schwimmer said. "It is a Goldilocks market—not too hot, not too cold, just about right."

Rich Jander at Maranon Capital concurred, "I don't think there is excess liquidity leading larger managers to dip down and do unnatural things in smaller deals than they typically would. By the same token, I don't think you have so much liquidity in the middle market that lenders are cutting each other's throats with regard to pricing and terms. I would say that the market is relatively balanced."

"The middle market doesn't react quite as quickly to the supply demand imbalance as the broad market does. They pick their spots where they want to be aggressive," commented Scott Reeds at Citizens Financial Group. "When I see push back on certain deals, it tells me that the middle market lenders are trying to be more disciplined and are not feeling as much pressure to put that money to work. It is a more balanced market."

## Mezzanine

Mezzanine lenders are continuing to see investment opportunities despite the growing preponderance of stretch senior and full leverage unitranche solutions, with traditional funds looking across the balance sheet to grow assets.

Maranon Capital has been tracking volume statistics since 2006, which point to a market that has been relatively stable in terms of capital deployment, leverage, and pricing. "It is relatively consistent that a third of all opportunities in the middle market use mezzanine. Pricing has been relatively consistent as well," said Rich Jander. Maranon aggregates volume data for companies with EBITDA up to $30 million.

*"The biggest change is that we are all doing more things up and down the balance sheet than we used to do."*

*—Jeri Harman*

*Avante Mezzanine Partners*

"We're seeing the same amount of volume, but we've had to spend more dollars on "feet on the street" sourcing deals," said Brian Schneider at Northstar Capital. "Within the sponsor market, there is probably a preference for a unitranche security, but we haven't seen a decrease in mezz opportunities. Mezz has been stable," offered Justin Kaplan at Balance Point Capital.

While unitranche may be the "flavor du jour" in sponsored middle market deals, mezzanine is not dead, said Jeri Harman at Avante Mezzanine Partners. "Some sponsors prefer two tranche structures, and there are some deals where it makes more sense," Harman said. "Mezzanine has always had a pretty big role in nonsponsored deals and will continue to do so. Unitranche has not become as prevalent in nonsponsored deals."

As purchase price multiples continue to get stretched, mezz lenders are stepping up and filling the gap. "With purchase price multiples in that 9-11x range, on average, the ability to get to a leverage number that looks like 5.5x to 6x through a junior capital tranche is meaningful," Jander commented. "Mezzanine will go a quarter to a half turn deeper than a comparable unitranche structure."

Mezzanine players are now doing traditional sponsored mezz, as well as second lien and selectively some unitranche, indicated Harman. "I think the biggest change is that we are all doing more things up and down the balance sheet than we used to do."

Mezzanine is active in the small deal market, driven by lower bank senior leverage. "On the smaller deals, a bank will basically draw a line in the sand on leverage. The sponsor can fill in the capital structure with sub debt," said Steve Kuhn at Fifth Third Bank. "Our competition isn't commercial banks. If anything they are partners for us when we do senior/mezzanine or synthetic unitranche. The alternative credit funds have become our competition," Harman said.

# Capacity

"In the lower end of the market, I don't think I've seen as many mezz firms truly affected by swings in the overarching market," said Kyle Goss at Elm Park Capital. "Unitranche certainly can solve for part or all of mezz. So what you see is the continued rise of groups that price in subordinated debt along with preferred equity. Notably, those are the SBIC vehicles that come in and take a minority stake and a board seat alongside management teams or sponsors. In our view, they have been fairly busy and generally successful at putting that capital to work. I wouldn't consider them traditional mezz groups."

"Clearly we haven't been crowded out. I think with valuations stretched there is plenty of room for mezzanine even if regulations ease and the banks get back to their historical norms for lending to business," said Steve Gurgovits at Tecum Capital Partners, which closed a record year in 2016. Since its spinoff from F.N.B. Corporation in 2013, the lender has deployed roughly $165 million in 25 companies. In December, Tecum Capital Partners formally applied for its license with the SBA for its second fund.

Tecum Capital Partners has been successful tapping the nontraditional sponsor market—one that Gurgovits views as an emerging buying class. "They are looking for financial partners," Gurgovits said. "We are very much relationship-oriented investors. We truly like to partner with buyers and management teams and create win-win scenarios."

*"Clearly we haven't been crowded out. I With valuations stretched, there is plenty of room for mezzanine even if regulations ease and the banks get back to their historical norms for lending to business."*

*—Steve Gurgovits*
*Tecum Capital Partners*

"Independent sponsors are clearly an accepted part of the market now," agreed Jeri Harman at Avante Mezzanine Partners. "In the lower end of the middle market, independent sponsors are more active. If you look at their partners, mezz funds are one of the go-to sources of capital."

"What they are really looking for is access to equity," said Rich Jander at Maranon Capital. "If your mezzanine fund has a strategy to invest equity and potentially even overweight equity for a deal, that flexibility for the independent sponsor is really key. It helps validate their standing as a qualified buyer in a process. All mezz lenders are increasingly looking at the independent sponsor channel as a real viable source of deal flow."

"We have always been supportive of independent sponsors and family offices," commented Hollis. "I do think you're seeing a much more vibrant space and activity level from nontraditional sponsors, particularly in the lower middle market for companies under $5 or $6 million of EBITDA. It is a trend that is going to continue to grow."

As interest in middle market private credit has grown, more institutional investors are looking for areas in which to invest, Jander indicated. "Middle market private credit to nonsponsored deals or deals where there is an independent sponsor—that is the new leading edge in terms of interest in private credit. They are looking for firms that have the ability to back independent sponsors or work with management teams in nonsponsored deals."

# Company Performance

Middle market business owners are reporting growth and an improving outlook, according to the *4Q 16 Middle Market Indicator* released by the National Center for the Middle Market. According to the survey findings, more middle market company executives reported improving performance year-over-year. The biggest revenue gains were seen in large middle market companies (revenues between $100 million and $1 billion), with 78 percent reporting growth at a mean rate of 8.1 percent. More than half (56 percent) of middle market companies are projecting positive revenue growth over the next 12 months.

Lenders indicate credit quality remains strong, and portfolios are performing. Companies are reporting low but steady growth.

“The portfolio is performing; we just don’t see really strong organic growth, which is an indication of how spotty overall economic activity has been,” commented Steve Gurgovits at Tecum Capital Partners, which he described as starts and fits over the past several years. “Most of the growth is coming from acquisitions.”

“We typically don’t see aggressive growth projections in the companies that we are evaluating,” said Chris Williams at Twin Brook Capital Partners. “Companies are conservatively projecting flat to moderate growth.”

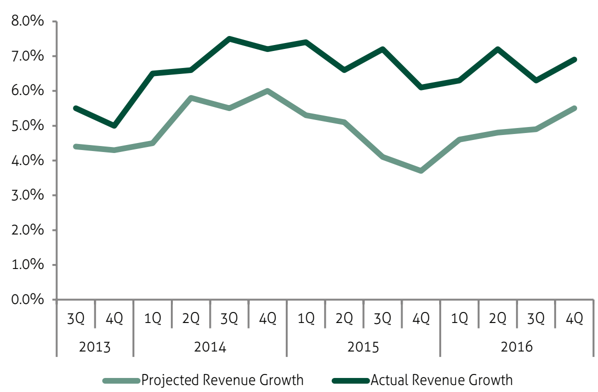
“We’re not seeing enormous topline growth,” offered Scott Reeds at Citizens Financial Group. “Where we see above-average growth is in certain technology-related businesses and in outsourced business services where a differentiated value proposition is allowing customers to save money.”

“We’ve seen modest topline growth across the portfolio and EBITDA that has remained fairly constant, which suggests a modest amount of margin erosion,” offered Robert Radway at NXT Capital.

“Overall portfolio quality is good, so that isn’t an issue from a lending standpoint. For companies, however, growth in revenues and EBITDA has been more challenging in 2016. This caused the owners and management teams of some general industrial companies to refrain from bringing their companies to market in a sales process or to engage in an opportunistic refinancing,” said Ira Kreft at Bank of America Merrill Lynch. “Following the election, many companies are more optimistic about the prospects for increased growth in 2017 which could bolster both the M&A and debt refinancing markets.”

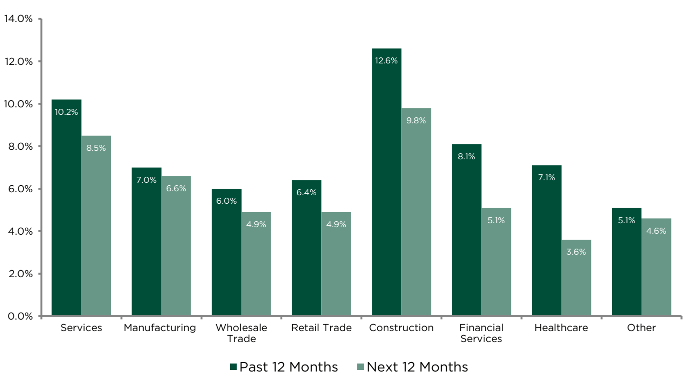
U.S. Middle Market Companies - Recent and Expected Growth

*Revenue Performance versus Forecast*




*Source: National Center for the Middle Market.*

*Revenue Growth by Industry*




*Source: National Center for the Middle Market from Dun & Bradstreet.*

Lenders are not seeing deterioration in leveraged loan portfolios. “Everyone knows that we are long-in-the-tooth in the credit cycle, but we’re not seeing the turn,” observed Justin Kaplan at Balance Point Capital. “I think all lenders would probably say we’ve reached a peak in the financing cycle. People are taking a more cautious approach,” added Jeff Kilrea at CIT Corporate Finance.

“There is so much capital overhang that it would take material softness in performance for defaults to really become an issue. Leverage and pricing continue to be very favorable,” said Dan Letizia at THL Credit.

“We’re not expecting debt service issues. I think we are more likely to see cracks in the underlying businesses than issues dictated by the capital structure,” commented Bob Marcotte at Gladstone Capital.

## Hot Buttons

### Economy

Recessionary pressure is in the minds of lenders, leading to heightened caution in the debt markets. Lenders have not changed their underwriting criteria but are modeling a recession—an event that some had predicted in 2017 or 2018—in their loan analysis. While lenders do not anticipate the severity of the last downturn, it is just a matter of when.

“We are definitely having conversations,” said Scott Reeds at Citizens Financial Group. “I don’t know what inning we are in, but we’re in the back half of the game. We’re being very cautious around heavy cyclicals and are cognizant of how even modestly cyclical businesses may perform. That being said, you have to be careful not to compare everything to 2009. It is probably an unlikely scenario to happen in the near term.”

*“Clearly, with a potential pullback in regulation and change in the tax structure, that could heed off a recession that I think most people were anticipating in 2017 or 2018.”*

*—Tim Clifford*
*Abacus Finance*

“I don’t think we’ll have a 2008 event,” remarked Rich Jander at Maranon Capital. Jander pointed to segments of the economy that are already in recession, such as oil & gas, “...and have been for all of 2016.”

“We are always sensitive to companies that had a tough time through the last cycle. It is something that we continue to focus on, particularly as move further away from that last downturn,” said Mark Hollis at Centerfield Capital Partners. “It is on balance with a relatively positive outlook for business on a go-forward basis. It is not a deal killer but more of a step back on the leverage pedal.”

Policy changes and the repatriation of $2 trillion in foreign cash could supercharge the economy, said some lenders, extending the current cycle. “Clearly, a potential pullback in regulation and change in the tax structure, could heed off a recession that I think most people were anticipating in 2017 or 2018,” observed Tim Clifford at Abacus Finance.

Ira Kreft at Bank of America Merrill Lynch added: “Prior to the election, there was a greater focus on a potential downturn in the economy. In January 2016, according to Lehmann Livian Fridson Advisors LLC, the high yield market was indicating a 44 percent probability of a recession within one year. By the end of April, the probability had decreased to 9 percent. Many commodity prices recovered from their lows and are more stable.”

“If we are truly going to get fiscal stimulus, I think the economy will likely get a little hotter before it slows down. The wild card is rising interest rates,” said Steve Gurgovits at Tecum Capital Partners, adding, “We’re optimistic that we’ll get more growth before we get a downturn.”

Recession resistant business models look even more attractive today, though lenders say there isn’t a discernable shift or bias toward those plays in the market.

# Company Performance

"I wouldn't say that there is a policy shift towards recession resistant businesses," Reeds said, "but there is certainly a willingness to lean in on those types of businesses versus others."

"You could say we are very cautious lending to companies that are tied to cyclical industries because we do think there is a correction coming in the next couple of years," offered Steve Kuhn at Fifth Third Bank. "As a result, we are avoiding the industries that are tied to construction or ones that cycled hard during the last downturn."

"Our economists definitely see a recession on the horizon. It is not imminent," said Katie Jones at BMO Capital Markets. "It has become more prevalent in lenders' thinking but has not been a deterrent as it relates to leverage or availability by way of issuers. Lenders are looking more closely at secondary and tertiary terms and really focusing on having an adequately protected document to the extent something does move sideways."

## Quality of EBITDA

Aggressive addbacks or proforma adjustments are tainting the quality of reporting earnings, said lenders in our survey.

"We're particularly focused on quality of EBITDA," said Randy Schwimmer at Churchill Asset Management. "There has been erosion around addbacks and adjustments, as sponsors are stretching leverage to justify higher purchase price multiples and to meet return hurdles. That seems to be at the top of people's concerns."

*"[A recession] has become more prevalent in lenders' thinking but has not been a deterrent as it relates to leverage or availability by way of issuers."*

*—Katie Jones BMO Capital Markets*

Robert Radway at NXT Capital added, "As you look at the quality of the deal flow, where you are seeing erosion is with addbacks. They are hard to justify or underwrite, and some people are more aggressive on it than others. It is a typical phenomenon late in the credit cycle."

## International Exposure

The imposition of trade barriers could have a significant impact on certain industries. As a result, lenders are taking a closer look at companies with meaningful international exposure.

Foreign exchange rates and geopolitical risk were also cited as areas of heightened sensitivity.

# Valuation

Lenders concur it remains a seller's market with valuations expected to stay at current elevated levels, a function of the low interest rate environment, robust comparable equity markets, a healthy debt market, and deal scarcity.

"I think we continue to be surprised at businesses that are trading for high single digits that in a normalized environment or through the last cycle were two or more turns lower," said Dan Letizia at THL Credit. "There is still quite a multiple premium across all sectors. What used to be a 5x deal is maybe 6x or 7x. What used to be 9x might be 11x or 12x."

"We are seeing as high of multiples as I can recall at any time during this cycle," said Scott Reeds at Citizens Financial Group. "We are regularly seeing businesses in Healthcare (pre-Trump), Technology, and Business Services—recurring revenue models with some growth—trade north of 10x. We are seeing attractive Industrial businesses valued in that range as well."

*"We are seeing as high of multiples as I can recall at any time during this cycle."*

*—Scott Reeds Citizens Financial Group*

"Purchase price multiples are at a very high level compared to historical norms," agreed Robert Radway at NXT Capital. Radway said the observed range is wide—7x-12x EBITDA—depending on industry and company profile. "Our typical deal probably has a 9-10x EBITDA multiple."

"We are routinely seeing businesses that are valued at 10-12x. And we are seeing 9x in smaller companies as well," offered Rich Jander at Maranon Capital. "For healthy companies with good management teams, strong margins, and high free cash flow, you haven't seen purchase price multiples back up in 2016. You haven't seen them really blow out either. Purchase price multiples were in the double digits last year—around 10x in the middle market."

EBITDA multiples for the middle market — whose enterprise values are between $25 million and $500 million — have remained within a tight band. They averaged 8x to 9x throughout 2016, according to Standard & Poors Leveraged Commentary & Data. In December, median EBITDA multiples for strategic and financial buyers were 7.4x and 8.9x, respectively, on transactions valued less than $250 million, and 11.3x and 7.9x on transactions valued between $250 and $500 million.

Lenders expressed concern at the high levels given heightened sensitivity to EBITDA adjustments. "Multiples are being undermined by deals with large EBITDA adjustments and synergies," said Bob Marcotte at Gladstone Capital. "Addbacks could be 15 to 30 percent or more of a deal which dramatically impacts the risk profile and true cash flow of a deal."

## Is there a meaningful premium for size?

All else being equal, size still equates to a step up in valuation, although smaller companies can still command comparable "large company" multiples lenders said. "Market" enterprise value multiples today are hovering around 9-10x said many surveyed lenders. "EBITDA in the low- to mid-teens, those opportunities have been aggressive and continue to be aggressive," Letizia said.

"Nine to 10 times is where we are seeing a lot of companies trade," said Katie Jones at BMO Capital Markets. "It is usually 10x and up, especially for properties with $15 million or more of EBITDA. We are seeing high single digits for companies with EBITDA of $10 million to $15 million. Below $10 million, you can see as high as 10x-plus, but it depends on the asset. If it is not as well-developed of an asset with sufficient diversification, that is where you start to see the single digit multiples."

"It is less likely that small companies can command the double-digit multiples," Radway said. "We don't see a lot of $5-7 million EBITDA businesses command 11-12x unless they're growing very rapidly.

Generally speaking, they don't have enough critical mass to get the quality company premium."

Randy Schwimmer at Churchill Asset Management shared his observations on market segmentation, indicating that multiples for the larger middle market (over $50 million of EBITDA) still remain close to 10x; for the traditional middle market ($25-50 million), 8-10x; and for companies with less than $25 million of EBITDA, 6-8x. "We've seen these ranges as being pretty consistent over the last few years and don't expect much change going into next year," Schwimmer said.

"We are seeing relatively high multiples in the lower middle market," said Jeri Harman at Avante Mezzanine Partners. "For small companies with the right attributes, we are not seeing much below 7x and up to 10x when there is strong sponsor interest. It is not unusual for nicer properties in the lower middle market to get what seem like middle market multiples."

Bob Marcotte at Gladstone Capital offered, "We certainly don't see a lot of deals trading in the 6's. Most of them trade north of that. And if there is a clear path to growth, 8-9x is relatively common." Gladstone is active in the lower middle market, financing companies with $3-6 million of EBITDA.

"We saw a lot more valuations at 5.5-6x in 2011 and 2012," commented Tim Clifford at Abacus Finance. "Today, any decent company is going for 7-8x-plus." Abacus typically works with companies that have $3-15 million of EBITDA.

## Platform for growth

Sponsors are paying up for platforms with the right structure and team to manage the buy-and-build. According to Brian Schneider at Northstar Capital, transactions reflect that sponsors are becoming less generalists and more specialists, which is how they rationalize higher valuations. "Sponsors are less worried about multiples. They are more worried about whether a company is a good platform for future growth," said Schneider. Chris Williams at Twin Brook Capital Partners agrees, "They will pay up for that initial platform if they feel like it has the right structure to be able to build around going forward. Outside of growth, that is where you see sponsors willing to pay up more frequently." "We've seen private equity sponsors really pay up for what they believe to be the ideal platform with the assumption that they are going to be buying down that multiple over time with cheap bolt-ons," added Kyle Goss at Elm Park Capital.

"Sponsors now have to pay double-digit multiples for the companies that exhibit sustainable growth, strong margins, and strong cash flow dynamics. So they are going to their wheelhouse of experience and saying, how do we rationalize a double-digit valuation?" added Schneider. "I think they look at themselves in the mirror and say, we've done this a number of times. This is now going to be a core competency for us."

*"A company with a defensible market position, strong margins, and high free cash flow that is not asset intensive can command a double-digit multiple, even if the expected growth isn't spectacular."*

*— Robert Radway NXT Capital*

"We are seeing sponsors really having to pick their spots—on where they have conviction, on where they have an angle, on where they have experience," remarked Scott Reeds at Citizens Financial Group. "If they want to put money to work, they know they have to pay up, and they are trying to justify it by protecting their downside in areas that they have expertise."

## What drives a premium valuation today?

While growth is the most cited value driver, cash is still king, with recurring revenue and high free cash flow often the trump cards. "A company with a defensible market position, strong margins, and high free cash flow that is not asset intensive can command a double-digit multiple, even if the expected growth isn't spectacular," said Robert Radway at NXT Capital. Asset-light businesses that demonstrated less volatility in the last recession are attracting higher multiples.

# Valuation

"The fundamentals still apply—solid growth prospects and market share or niche, strong management team, sticky revenues, and consistent earnings and cash flow," said Ira Kreft at Bank of America Merrill Lynch.

"Those attributes of highly visible and predictable revenue, with high organic growth and preferably high cash flow (high EBITDA margin and low capex), easily command double digits," said Dan Letizia at THL Credit.

## Sector

Industry, fragmentation, and projected growth are key drivers of value. "Darling" sectors see the highest competition from buyers and lenders and with them attract premium multiples. Today's darlings include healthcare, technology, software, business services, and branded consumer products—areas where buyers are finding growth and strong recurring revenue. "When you can find a business that has a high percentage of solid contracted revenue, people are going to pay up for that," offered Chris Williams at Twin Brook Capital Partners. "If they can grow the business, it is going to provide some multiple accretion." "Buyers are paying high prices for strong cash-flowing businesses with subscription-based revenues," added Jeri Harman at Avante Mezzanine Partners.

"Technology is typically viewed as a growth area so we are seeing double-digit multiples being paid for businesses," commented Kyle Goss at Elm Park Capital. "People are looking at forward one- and two-year multiples to substantiate their purchase price multiples today." Goss continued, "In 2016 particularly, we saw healthcare services companies effectively name their price. It has been a great seller's market, and there really is not much of a bid-ask spread there."

*"When you can find a business that has a high percentage of solid contracted revenue, people are going to pay up for that."*

*—Chris Williams Twin Brook Capital Partners*

Broadly, manufacturing tends to fall on the lower end of the value range with multiples closer to 6x or 7x, on average, versus asset-light industries like software, that can be closer to 10x. "We are not seeing rich multiples in manufacturing," said Goss. "We are seeing anywhere from 5-7x even for nice stable businesses. You're not seeing any sort of safety premium coming into that." Lenders carve out aerospace and specialty chemicals, which are considered to be more desirable segments, with some calling them "bright spots" and areas of differentiation. "Aerospace is still 7-9x, due to the continued globalization of air travel and improving market conditions for military and defense," said Mark Hollis at Centerfield Capital Partners.

Discounts aren't being factored into valuations for cyclical industries, said some surveyed lenders. "Cyclicality doesn't seem to be factored into people's valuation thoughts lately," said a BDC in our survey. "Sectors that historically would have gotten particularly low multiples like automotive suppliers are getting valued in a manner that does not reflect their cyclicality. I would include general manufacturers as well."

"Even some cyclical businesses are being valued in the 8-9x range which is very healthy compared to what you might see in different markets," said Scott Reeds at Citizens Financial Group. "We are still seeing what feels like very high multiples across the board. Even companies that we would view as cyclical are getting premiums," commented Jared Halajian at Madison Capital Funding. "It gets back to the lack of supply and the demand that is out there. Multiples feel like they continue to be elevated."

## Are valuations at a peak?

Middle market companies have enjoyed the spoils of a seller's market for a sustained period, as supply hasn't been able to soak up the liquidity in the market. While capital availability is expected to sustain multiples in the near-term, the wild card is Trump, as policy changes will decidedly impact the direction of the economy, interest rates, and the capital markets, all of which can sway investor confidence and influence corporate acquisition strategies.

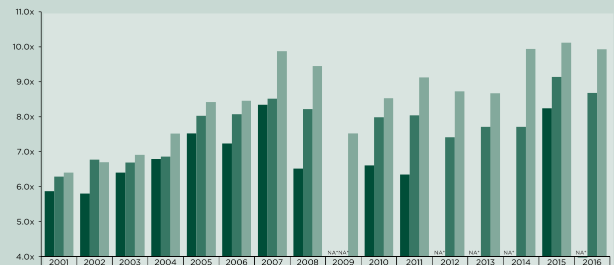
"Multiples are still at relatively lofty levels. If interest rates are going up, it is really hard for me to see people pushing them much beyond the current levels. I see more downside than upside," remarked Bob Marcotte at Gladstone Capital. "We've got to be topping out," added Williams. "You'll see people paying more than 10x for some high growth businesses. I can't imagine you are going to continue to see multiples move up."

"I don't know if there is a specific catalyst that is going to rein in these kinds of valuations," observed Kyle Goss at Elm Park Capital. "It does feel as if buyers are going to be challenged to create value when they're paying up for what they believe to be growth in the next two or three years. If the growth doesn't come to fruition, they're likely to be some degree under water, if there is a return to the norms of most lower middle market M&A multiples."

"We've been at a "peak" for several years now. To a large extent, that's being driven by low rates and plenty of buyer cash," said Randy Schwimmer at Churchill Asset Management. "Sponsors are stretching in this low rate environment to make their returns. Until we get a major correction, and until rates normalize, higher valuations should be sustained."

Purchase Price Multiples in Middle Market LBO Transactions

*EBITDA Valuation Multiples by Transaction Size*




| | 2001 | 2002 | 2003 | 2004 | 2005 | 2006 | 2007 | 2008 | 2009 | 2010 | 2011 | 2012 | 2013 | 2014 | 2015 | 2016 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| <$250 million | 5.9x | 5.8x | 6.4x | 6.8x | 7.5x | 7.2x | 8.3x | 6.5x | NA* | 6.6x | 6.3x | NA* | NA* | NA* | 8.2x | NA* |
| $250-$499 million | 6.3x | 6.8x | 6.7x | 6.9x | 8.0x | 8.1x | 8.5x | 8.2x | NA* | 8.0x | 8.0x | 7.4x | 7.7x | 7.7x | 9.1x | 8.7x |
| $500 million+ | 6.4x | 6.7x | 6.9x | 7.5x | 8.4x | 8.5x | 9.9x | 9.4x | 7.5x | 8.5x | 9.1x | 8.7x | 8.7x | 9.9x | 10.1x | 9.9x |

**NOTE: Data not reported due to limited number of observations for period.*

*Source: Standard & Poors LCD.*

"It would appear that valuations have peaked," offered Ira Kreft at Bank of America Merrill Lynch. "However, if corporations have the opportunity to repatriate foreign cash at more advantageous tax rates, this could increase the capital to be available to be deployed in the U.S. and drive up valuations."

*"We've been at a "peak" for several years now. To a large extent, that's being driven by low rates and plenty of buyer cash. Until we get a major correction, and until rates normalize, higher valuations should be sustained."*

*—Randy Schwimmer Churchill Asset Management*

## Have there been signs of multiple contraction?

Sectors that are viewed as cyclical or in distress are beginning to see multiple contraction. "The sectors where there has been pushback—auto, energy, metals and mining—those sectors are clearly under pressure," said Schwimmer. "Notably in oil & gas, there is probably a 25 percent bid-ask spread across most areas," said Goss, adding, "Unless you're in the SCOOP, the STACK, or the Permian basin, at which point you can more or less name your price despite the fact that the market is 50 percent lower than it was two years ago."

# Valuation

Muted growth prospects are contributing to downward pressure on multiples. “This year there has been a quarter to a half turn chilling impact on purchase price multiples,” said Justin Kaplan at Balance Point Capital. “I think sponsors generally realize that to pay 8x for a business that is growing 3 percent a year, it is going to be challenging to make your return hurdles,” Kaplan offered. “Everything has to go right, and when you’re investing in a sub $6 million EBITDA company, rarely everything goes right.”

Kaplan excludes Healthcare and Technology, which he said continue to trade at very high multiples relative to the rest of the market. “I don’t see any cooling or chilling effect on those multiples, except now under Trump, we are seeing people pausing on Healthcare.”

## Is there a buyer/seller gap?

An abundance of capital and pent up demand have narrowed the value gap, said most lenders in our survey. Tim Clifford at Abacus Finance offered, “Everything ends up trading. Very rarely do we see a broken auction today.” “It just feels like it’s still a seller’s market,” agreed Bob Marcotte at Gladstone Capital. “As long as you’re within the right band, it is not an environment where a lot of deals are falling apart because of unmet expectations.”

“Sponsors have raised plenty of capital, and strategics have plenty of cash, but purchase price multiples are very company dependent. Some less worthy sellers see the competition achieving certain prices and expect the same,” remarked Randy Schwimmer at Churchill Asset Management.

*“It feels like it’s still a seller’s market. As long as you’re within the right band, it is not an environment where a lot of deals are falling apart because of unmet expectations.”*

*—Bob Marcotte*
*Gladstone Capital*

Lofty valuations may be keeping some would-be buyers on the sidelines, according to Ira Kreft at Bank of America Merrill Lynch. “There is a gap in the sense that there is a limited supply of deals, and many more value oriented buyers have been forced to the sideline. Many have opted to be sellers in this market not buyers,” Kreft said.

“Private equity sponsors have to buy right, and they have to plan for economic softness and underachievement of growth expectations,” remarked Jeff Kilrea at CIT Corporate Finance. “They are not expecting to play the multiple arbitrage game.”

## Strategic Buyers

The market premium widens when there is strategic interest in an asset, with corporates winning more auctions in the current environment, said some lenders. “Strategic buyers, challenged by more anemic organic growth, have been a buyer of choice for many industrial companies,” said Kreft. “Corporates are awash with cash and looking for topline growth. They can justify paying the high multiples more than a standalone sponsor could,” added Scott Reeds at Citizens Financial Group. “They have synergies that help them justify the high multiple. I would say that has been a big issue this year.”

“We are seeing a lot of deals with double-digit valuations. It has to be a good growth story and/or a strategic acquisition to realize some synergies,” added Steve Robinson at Antares Capital.

# Terms and Structure

Leverage remains high relative to historical standards, with sponsors pushing for low to no covenants and low to no amortization, said survey participants, characterizing current conditions as a borrower's market.

Leverage parameters remained at elevated levels in 2016 with modest multiple expansion of a quarter to a half turn, said surveyed lenders. Competition, on the margin, has become more aggressive on the perceived "high quality" deals where leverage is getting pushed, and for companies with more than $20 million of EBITDA.

"The starting point for an LBO transaction is 5-5.5x total leverage. The smaller deals are even getting that leverage," commented Katie Jones at BMO Capital Markets. "If the leverage read is not 3 by 5, typically there is a credit reason why it is not garnering a more robust level of debt. And if there is a credit reason, to many lenders it is binary—they only want to follow the quality companies, so the tougher deals are getting a desk kill."

"The ask has moved up. Many syndicated deals are clearing in the range of 6x leverage," commented Bob Marcotte at Gladstone Capital. "Given no deals cleared in 4Q 15 above 6x leverage due to OCC guidelines, it's fair to credit non-bank lenders with the elevation of leverage metrics on a year-over-year basis."

"The takeaway, we used to look at the market as 3.5x by 5x for a high quality deal; that high quality deal is now 4x by 6x, with upside to that," commented Daniel Brazier at Madison Capital Funding. "We've seen a number of deals close in the 6.25x – 6.5x total leverage range for companies with EBITDA above $25-30 million. These are levels you didn't see five years ago."

Cyclical sectors saw a pullback in leverage in 2016 as enterprise values declined and lenders maintained a consistent level of loan-to-value, according to Ira Kreft at Bank of America Merrill Lynch. "In the automotive industry, where enterprise value to EBITDA declined by a full turn of EBITDA from late 2015 through the first half of 2016, lenders brought their lending multiple down accordingly."

*"If the leverage read is not 3 by 5, typically there is a credit reason why it is not garnering a more robust level of debt. And if there is a credit reason, to many lenders it is binary—they only want to follow the quality companies, so the tougher deals are getting a desk kill."*

*—Katie Jones BMO Capital Markets*

Broadly, the lower middle market continues to see a bias towards lower leverage and higher pricing. As more liquidity moves into the market, it is not uncommon to see small companies get large company deal terms, lenders said. "The sub $10 million market is always much slower to respond and is somewhat insulated, but we have begun to see some more liquidity even entering the sub $10 million and sub $7 million segments of the market, both in terms of leverage asks as well as pricing pressures," commented Kyle Goss at Elm Park Capital. "It is not pervasive, but we have seen it begin creeping in." Some lenders have pegged the market demarcation at around $5 million or $6 million of EBITDA, evidencing growing lender interest in lower middle market companies.

Banks remain focused on 3x senior leverage but can stretch to 3.25 - 3.5x. Institutions with leveraged lending or sponsor finance practices might lean in at higher levels of leverage, said bank participants in our survey. Pricing is typically in the L+400-450 range with no Libor floors.

**EBITDA below $10 million**

- 1/4 to 1/2 turn reduction in total leverage
- Capping out at 5x total leverage
- $5 million is the line of demarcation for lenders, down from $10 million, where structure and pricing reset
- Increasing use of senior stretch and unitranche financing
- 25 to 50 basis point premium on pricing

Bank execution

- Senior and total leverage 2x-2.75x/3x-3.5x.
- Max leverage is 3x/4x depending on credit profile
- L+400 with 1% floor
- L+425-450 without a floor

Non-bank execution

- Strike zone for most senior leverage is 3x-3.5x
- Total leverage 4x-4.75x
- Max leverage is 3.5x/5x
- Senior pricing L+500-550, 1% floor

Senior stretch

- 3x–4.5x L+500-650, 1% floor

Unitranche

- 3.75x-4.5x; L+700-850

Sub 6

- Sponsored is 3x-3.5x, L+800-900
- Nonsponsored is 3x–3.25x; pricing 100-200 basis points higher

**EBITDA between $10 million and $25 million**

Bank execution

- Senior and total leverage 3x-3.25x/4x-4.5x
- L+400-450

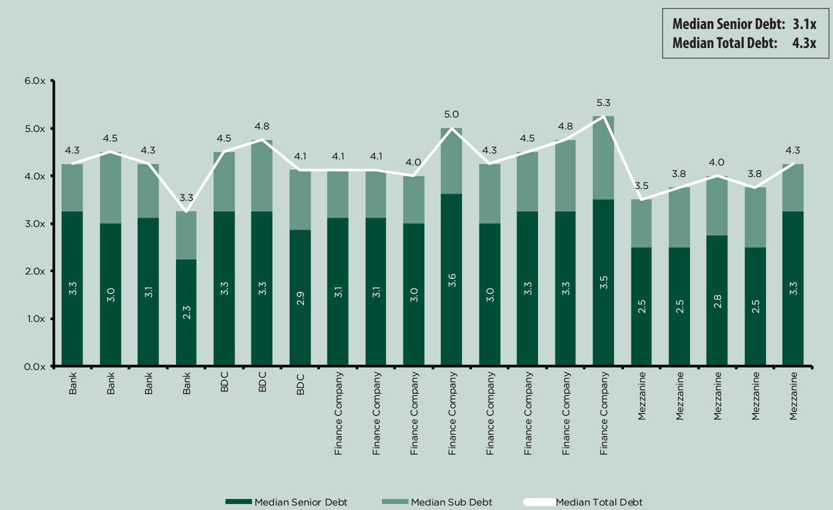
Non-bank execution

- Strike zone for most senior leverage is 3x-3.75x
- Total leverage 4.5x-5.0x
- Capping out at 4x/5.5x senior and total leverage
- Senior pricing L+475-525, 1% floor

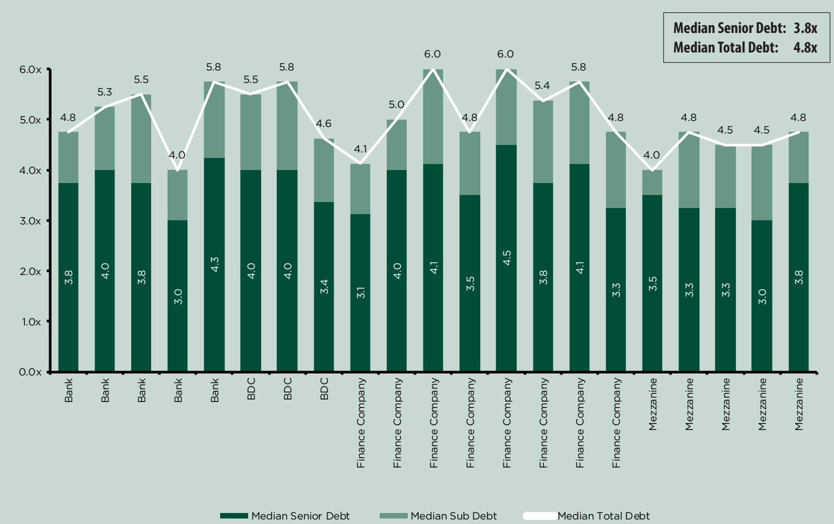
## Survey of Capital Providers

*Leverage Multiples (Debt to EBITDA)*

*EBITDA below $10 million*




*EBITDA between $10 million and $25 million*




*Source: BGL Research.*

# Terms and Structure

### EBITDA between $10 million and $25 million

Stretch Senior

- 4x- 4.75x
- L+500-600, 1% floor
- Banks 3.5x – 3.75x

Unitranche

- 4.5x to 5.5x, L650-L750

### EBITDA above $25 million

- Leverage profile 3.75x-4x/5.5x-5.75x
- Max leverage 4x/6x
- Senior pricing L+425-525, 1% floor

Unitranche

- 5.75x – 6x total leverage
- L+625-650, 1% floor

### Second Lien

Second lien came back strong in the second half of 2016, according to survey participants. The product continues to be more prevalent in larger transactions for companies with at least $20 million of EBITDA. Pricing is 400 – 450 basis points behind first lien. The pricing range is wide depending on company size, from L+825-950.

### Mezzanine

Leverage of 1-1.5x. Current pricing metrics are 10-12 percent coupon and 1.0–2.0 percent PIK. In the lower middle market, mezz lenders point to 11 percent as the floor on the cash rate.

| | |
|---|---|
| EBITDA below $7 million | 12-14% |
| EBITDA $7-15 million | 10-13% |
| EBITDA above $15 million | 10-12% (pushing more to 10-11%) |

Warrants are typically only available in nonsponsored deals and in story deals.

Nonsponsored leverage is 1/4 to 1/2 turn lower, and pricing is 100-200 basis points higher.

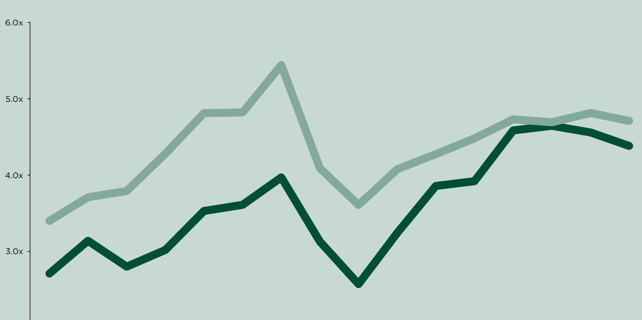
### Equity

Forty to 50 percent equity remains the benchmark for transactions structured as cash flow loans and 25-40 percent for those structured with ABL facilities. In those cases where the sponsors are stretching on valuation, equity contribution is significantly higher. Lenders are seeing more outliers at 60 or 70 percent.

“As purchase price multiples continue to be stretched, sponsors will maintain higher levels of equity contributions as a percent of capital. Our sense is that 50 percent will remain a good benchmark for new leveraged buyouts,” said Randy Schwimmer at Churchill Asset Management.

## Acquisition Financing Trends

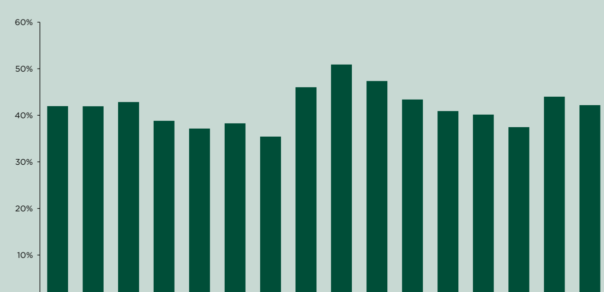
*Leverage*




| | 2001 | 2002 | 2003 | 2004 | 2005 | 2006 | 2007 | 2008 | 2009 | 2010 | 2011 | 2012 | 2013 | 2014 | 2015 | 2016 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Senior Debt/EBITDA | 2.7x | 3.1x | 2.8x | 3.0x | 3.5x | 3.6x | 4.0x | 3.1x | 2.6x | 3.2x | 3.9x | 3.9x | 4.6x | 4.6x | 4.6x | 4.4x |
| Total Debt/EBITDA | 3.4x | 3.7x | 3.8x | 4.3x | 4.8x | 4.8x | 5.4x | 4.1x | 3.6x | 4.1x | 4.3x | 4.5x | 4.7x | 4.7x | 4.8x | 4.7x |

*Middle market enterprise values between $25 million and $500 million.*
Source: Standard & Poors LCD.

*Equity Contribution*




| | 2001 | 2002 | 2003 | 2004 | 2005 | 2006 | 2007 | 2008 | 2009 | 2010 | 2011 | 2012 | 2013 | 2014 | 2015 | 2016 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Equity Contribution | 42% | 42% | 43% | 39% | 37% | 38% | 35% | 46% | 51% | 47% | 43% | 41% | 40% | 37% | 44% | 42% |

## Terms

Covenants are seeing the most pushback as cov-lite and cov-wide features push further down market. More common today, cov-lite used to be reserved for the large market ($50 million EBITDA-plus) and is moving down market closer to $15-20 million. Where there are covenants, cushions are wider or "cov-loose". Typical covenant cushions of 15-20 percent are stretching to 20-25 percent as a common starting ask. Some lenders are seeing 25-30 percent covenant cushions from a sponsor base case.

"For deals north of $30-40 million of EBITDA, you are definitely seeing features in the credit agreement that are less lender-oriented and more borrower-oriented," said Robert Radway at NXT Capital.

"At $55-60 million of EBITDA you are seeing cov-lite deals get done. Below that, you are seeing more cov-loose structures, because of the lenders who are providing it," offered Scott Reeds at Citizens Financial Group. "The middle market direct lenders and finance companies are more willing to support certain deals with wider cushions than you might have seen in the past in an effort to be competitive with each other."

"Cov-lite used to be reserved for $25 million of EBITDA and up, said a BDC in our survey. "Sponsors are now asking for cov-lite in $10-25 million EBITDA deals. It is moving down market."

"Many of the large deal structures have come down into the lower middle market," offered Steve Kuhn at Fifth Third Bank. "Looser covenant structures or definitions, builder baskets, acquisition lines, or flex facilities—features you saw in larger EBITDA transactions (over $50 million EBITDA)—have come down now into the $10-20 million EBITDA space."

"Transactions where there is a lot of competition, and people view the credit to be really strong, that is where you see the most stretching of covenant levels," said Jared Halajian at Madison Capital Funding.

*"Transactions where there is a lot of competition, and people view the credit to be really strong, that is where you see the most stretching of covenant levels."*

*—Jared Halajian Madison Capital Funding*

"We are always trying to stay on top of terms, both sponsor asks and what the market may push back on. Terms around incrementals, accordion free and clears, and restricted payments permissions are getting a lot more scrutiny today," said Steve Robinson at Antares Capital. "Sponsors are trying to work in so many more concepts and permissions that historically had never been factored into the middle market," echoed Katie Jones at BMO Capital Markets.

"It is not uncommon to see a flex take place to tighten some of those terms," Robinson added. "Terms that moved in the borrower's direction are seeing a little bit of a pullback."

Amortization and covenant-lite continue to be a problem for banks.

"Some banks are very adamant about straight line amortization or having form of some meaningful amortization," said Tim Clifford at Abacus Finance. "Scheduled amortization for finance companies might only be 1 or 2 percent, as they are getting the majority of the debt repayment through the excess cash flow recapture." "The banks that will do a 3.5-4x stretch deal are now asking for 5-7 year straight-line amortization," commented Kyle Goss at Elm Park Capital. "We've seen aggressive amortization asks from banks across the board, specifically in 2016. That is a major change."

Banks are stretching and offering stepped up amortization in order to stay competitive. A bank lender in our survey offered: "Typically, we are seeing as much as 10 percent amortization on $10 million of EBITDA, 5 percent on $20-30 million, and over $30 million amortization can be 1-5 percent. Over $50 million, it is 1 percent amortization."

The lower middle market is feeling less pressure, said lenders, indicating there has been very little deterioration of credit structures. The average middle market deal will have very similar covenant structures to those that were observed three or four years ago. Cushions might be slightly wider but not materially.

# Terms and Structure

"The biggest change for the smaller deals is the number of covenants. Two to three covenants would be a pretty full covenant package today; it used to be three or four," said Jared Halajian at Madison Capital Funding. Lenders are keeping fixed charge, capex, and total leverage. Larger transactions are often limited to a total leverage covenant.

"The middle market is always going to have covenants," commented Rich Jander at Maranon Capital. "Depending on the deal, there may be pressure to limit the deal to one covenant or the buyer is asking for flexibility on covenant cushions. Generally, the middle market deals are going to have 20-25 percent cushions."

"You may see a single covenant in a $10 million EBITDA deal, but it is not an indication of where the overall market is moving," said Robert Radway at NXT Capital.

Aggressive EBITDA addbacks and equity cures are solidly in the lower middle market.

## Holds

Hold size remains a distinguishing factor between arrangers vying for leads in transactions. "You have to be able to hold a sizable amount if you are competing a 2-3 bank club. You want to be able to hold $30-40 million in a deal to be able to secure the lead,"commented Chris Williams at Twin Brook Capital Partners. "That helps you win lead agencies and retain deals that trade sponsor to sponsor," added Jeff Kilrea at CIT Corporate Finance.

Sponsors like the simplicity of dealing with fewer lenders. Lenders like the economics that come with being the sole lender. "That is why larger hold size is attractive," said Jander. "Lenders are absolutely looking to differentiate themselves on the scale of their platform and hold size."

Hold levels will continue to increase, according to Randy Schwimmer at Churchill Capital Management, a trend he has called the "cargo pants strategy", as lenders bulk up with side pockets of capital. "The overall trend has been towards lead lenders taking down more of any one deal by maintaining and increasing their distribution," said Radway. NXT Capital continues to raise capital for its asset management program, closing on Senior Loan Fund IV in 4Q 16. "It is an ongoing capital raising effort that is leading to fewer lead lenders that can speak for larger and larger shares of any one deal, because they control significant amounts of capital that wants to invest in middle market leveraged loans."

*"Lenders are absolutely looking to differentiate themselves on the scale of their platform and hold size."*

*—Rich Jander*
*Maranon Capital*

Lenders begin thinking of a syndication at a transaction size of around $150 million, although recent history has shown even larger facilities can get done on a club basis. Today, a $300 million deal can get clubbed, while a $100 million deal can get done as a sole lender deal. "Today, a sponsor will seek out maybe two or three lenders with significant capacity for a $150 million deal. That execution is more common today than at any time before in our industry," Radway said.

There is a large segment of the market that used to be syndicated that is now clubbed, indicated Dan Letizia at THL Credit. "Years ago you saw syndicated deals at $100 million. Now you have single lenders wanting to hold that or more. To grow assets under management, lenders are taking big bite sizes and allocating them to multiple vehicles. The universe of lenders that can write $100 million checks has grown."

"The club market is certainly an alternative to the syndicated market on larger and larger deals," added Scott Reeds at Citizens Financial Group.

Radway calls it an ongoing increase in the "horsepower" of the lead lenders and expects the trend will continue. "I think that is where the market is headed. It is probably the biggest shift or change in the business that we've seen in a long time."

# Outlook

A pro-business administration means pro-growth, with prospects of economic stimulus and an improving regulatory landscape fueling a fairly high level of optimism. "There is a sense of enthusiasm in the market—a bullishness about the prospects of a business person at the helm," remarked Tim Clifford at Abacus Finance.

Lenders also project uncertainty. There will continue to be some caution based on cyclical pressures. Lenders expressed some concern that a Republican-controlled Congress might lead to deterioration of trade relationships and imposition of new trade barriers. Continued global macro uncertainty will lead to caution on borrowers with significant international exposure.

"There could be some fits of uncertainty around policies that Trump may try to implement, as his administration seems to be viewing the world through a different lens than the traditional Democrats or Republicans have," commented Scott Reeds at Citizens Financial Group. "That could be positive in certain circumstances and cause uncertainty in others. You have the prospect of more macro volatility caused by events where Trump may behave differently from past administrations."

Lenders do anticipate volatility, but it is not expected to trigger any pull back in the market.

## On the Economy

*Themes of less regulation and lower taxes are expected to help boost the economy.*

"With tax policy changes and greater emphasis on fiscal stimulus and spending, I think we have a backdrop of very positive trends. It is clearly being reflected in the stock market and in valuations. I think that will translate into higher levels of transactional activity. It is just a degree of optimism around economic growth that will fuel continued deployment of capital by sponsors into the middle market. I don't see an economic outlook that is either constrained or negative for the market.

I think we are probably in for a good couple years of additional economic growth based on the political landscape, which would suggest instead of being in the eighth or ninth inning of the credit cycle, we have probably bought ourselves either a couple more innings or a rewind into the sixth."
*Robert Radway, NXT Capital*

*"We are probably in for a good couple years of additional economic growth based on the political landscape, which would suggest instead of being in the eighth or ninth inning of the credit cycle, we have probably bought ourselves either a couple more innings or a rewind into the sixth."*

*—Robert Radway*
*NXT Capital*

"We are cautiously optimistic for accelerating U.S. and global economic growth, improving corporate fundamentals, and higher interest rates. It is tempered by the prospect of the effects of rising inflation, a stronger dollar, uncertain commodity pricing, and game-changing political events. Nominal growth in the U.S. could rise from 3 percent to 4 percent, with a real GDP gain of 2 percent. Slower growth is expected in the first half of the year, picking up in the second half once fiscal stimulus measures kick in."
*Ira Kreft, Bank of America Merrill Lynch*

"The same forces pushing interest rates up should create support for better GDP next year. That will benefit small and medium businesses."
*Randy Schwimmer, Churchill Asset Management*

"The economic environment is going to be choppy until some of these deregulation trends materialize. If you are going totally change to alternative healthcare framework for 2017, that is a massive part of the economy. Restrictions on imports will create significant changes. We have been outsourcing to China and Mexico for years."
*Bob Marcotte, Gladstone Capital*

## On Interest Rates

*Lenders predict interest rates are heading up. The Fed raised rates 25 basis points in December 2016, setting a positive tone for the prospects of economic growth. The move marks only the second rate increase in 10 years. The last rate hike was in December 2015.*

"I expect interest rates to continue to go up, which will cause more fund flows into the loan market."
*Scott Reeds, Citizens Financial Group*

"I see interest rates potentially going up slightly. That might be 50 basis points firming."
*Kyle Goss, Elm Park Capital*

"Everyone assumes interest rates are going to go up, and the new administration seems to be giving indications that would encourage it to happen as well. I think it is a good thing, because it will put some rationality into the market."
*Jeri Harman, Avante Mezzanine Partners*

"My sense is the Fed does not have the fortitude to raise rates at a rapid pace unless we see strong economic growth or inflation. That being said, I believe strong liquidity will continue in the debt markets as investors seek current income and yield, and private equity will continue draw investors given increased portfolio allocations."
*Mark Hollis, Centerfield Capital Partners*

"Interest rates are going to move up. We are probably going to get a 25 basis point increase in 4Q 16. I think you're definitely going to see that continuing to take place."
*Chris Williams, Twin Brook Capital Partners*

"More interest rate hikes are anticipated in 2017 and 2018. Heightened uncertainty at the beginning of the year combined with tighter financial conditions should result in only one rate hike by the Fed in 2H 2017."
*Ira Kreft, Bank of America Merrill Lynch*

## On Liquidity

*On the heels of fresh middle market loan fund raising, capital stores will keep the market liquid in 2017. The prospect of reduced regulation and higher interest rates could provide additional liquidity if banks step back into the middle market. Lenders are anticipating it to stay a borrower's market for the foreseeable future.*

*"There has been a lot of capital that has come into the market that has been dedicated specifically to this asset class. There are no signs that it is going to take a downturn, other than we are at historical high levels in terms of enterprise values and leverage multiples."*

*—Daniel Brazier Madison Capital Funding*

"I think that the private debt floating rate asset class is going to grow for the next couple of years. There are enough people in the marketplace that are going to be putting out money to try to generate returns that I think availability is going to be there."
*Bob Marcotte, Gladstone Capital*

"There has been a lot of capital that has come into the market that has been dedicated specifically to this asset class. The market is mature and much more efficient than it was 8-10 years ago. There are no signs that it is going to take a downturn, other than we are at historical high levels in terms of enterprise values and leverage multiples."
*Daniel Brazier, Madison Capital Funding*

"There will be more interest in private credit which tends to be floating rate and therefore attractive in a rising interest rate environment relative to other types of fixed income. I think that will continue to drive interest in our market."
*Rich Jander, Maranon Capital*

"I expect there to be no shortage of capital for middle market sponsor backed leveraged buyouts, whether it is regulated or unregulated deals."
*Jeff Kilrea, CIT Corporate Finance*

"The debt markets are expected to remain liquid for 2017. The market could benefit from less regulation."
*Ira Kreft, Bank of America Merrill Lynch*

"We expect the lending market to remain liquid for the foreseeable future. Private lenders have raised significant capacity and also created joint ventures with other asset managers. Those relationships often provide one-stop capability that enhances the lenders to provide credit solutions. The middle market should also remain liquid despite any overall volatility in the broader markets."
*Randy Schwimmer, Churchill Asset Management*

# Outlook

"There is going to continue to be a trend toward quality direct lenders, but there are also going to be the "haves" and "have nots". The direct lenders are placing money quickly. Those that don't have robust portfolio functions will likely experience some hiccups."
*Brian Schneider, Northstar Capital*

"Given the higher regulation that has limited traditional banking activities, there is a lot less systemic risk currently in the sector that could create a run on liquidity that could truly change yields overnight, whereas you might have more of a fundamental earnings recession that creates a higher risk premium across the board. So much capital is private and committed for a long term, it just doesn't seem like there is any sort of catalyst that could really create a flight of all capital out of the market."
*Kyle Goss, Elm Park Capital*

## On Leverage & Pricing

*Strong liquidity should mean continued high leverage and borrower-friendly terms.*

"We may see continued modest erosion in leverage. I think pricing will likely hold. By and large, the market today is dominated by lenders with very similar cost of capital. When you don't have banks as the predominant provider of capital with their cost of funds driving the market, I think you can expect continued pricing stability."
*Robert Radway, NXT Capital*

"If liquidity remains strong, I would expect terms will continue to loosen, leverage to creep up, and pricing to contract. If the volume of new money deal flow does pick up, that should allow for a more balanced market."
*Scott Reeds, Citizens Financial Group*

"I don't think you're going to see a whole lot of movement. It is going to be a pretty consistent market."
*Chris Williams, Twin Brook Capital Partners*

*"Leverage is already at high levels. I don't see multiples moving given strong interest in loans. I anticipate lending spreads will come down unless M&A picks up dramatically."*

*—Steve Robinson*

*Antares Capital*

"Leverage is already at high levels. I don't see multiples moving given strong interest in loans. I anticipate lending spreads will come down unless M&A picks up dramatically."
*Steve Robinson, Antares Capital*

"Pricing will remain range-bound; leverage will continue to edge upwards for the better credits, particularly on the senior side."
*Randy Schwimmer, Churchill Asset Management*

"Leverage is expected to remain reasonably steady compared to 2016."
*Ira Kreft, Bank of America Merrill Lynch*

"I think we are going to see a modestly tightening credit environment which should result in more modestly conservative credit structures. Uncertainty driven, most people feel there will be a market correction. There will be some softening in businesses. Lenders don't want to get caught financing those companies at the peak."
*Jeff Kilrea, CIT Corporate Finance*

"Even with overall economic softness, capital availability is still going to keep things relatively competitive. I wouldn't see pricing changing in either direction. Leverage isn't going to go up. We'll need to see more defaults before we see leverage come down."
*Dan Letizia, THL Credit*

"Leverage levels are going to be higher and pricing is going to be compressed where the liquidity is the greatest, and that is going to be the institutional money and large scale funds that have to put the money to work in large sums."
*Bob Marcotte, Gladstone Capital*

## On M&A

*Heading into 2017, it is "wait and see" as the M&A market digests the impact of a changing political climate on the economy, interest rates, and the capital markets.*

*The forward calendar suggests a building pipeline. Many lenders are anticipating a more active M&A environment with healthy liquidity in the market. Conditions continue to be very favorable for owners of middle market assets that want to generate liquidity.*

"I think the outlook is strong, especially with the Trump administration. We have seen steady deal flow since mid-2016, and going into 2017 our backlog is stronger than this same time last year. I expect there to be consistent deal flow at least in 2017 and maybe into 2018."
*Tom Aronson, Monroe Capital*

"The sponsor M&A market hasn't fully caught up to the flows into the leveraged asset classes yet. It feels like it is about to. I think we're going to see a much busier M&A market in 2017, which we have all been waiting for. It feels like there is consensus on the direction of the economy, an administration that appears to be pro-business, strong public equity valuations, and a very hot debt market. When you add all that up, I think you are going to start to see people say, I don't want miss this open window to sell, whether it is entrepreneurs or private equity-backed companies.
*Scott Reeds, Citizens Financial Group*

"The backdrop is one of a more positive sentiment with respect to economic growth over the coming year or two. To me that means a higher degree of confidence; therefore, transactional activity should follow suit. Volume should improve in 2017 over 2016."
*Robert Radway, NXT Capital*

*"The continued motivation to create synergies and improve margins will drive a resurgence in M&A, and without the overarching regulatory burdens that were prevalent in the last administration, it will embolden people to do more. It is a more opportunistic environment for M&A than you might have seen in the past."*

*—Bob Marcotte Gladstone Capital*

"I am expecting a better M&A market in 2017. There is pent up demand from buyers and sellers. Sponsors are sitting on a lot of capital that they need to put to work. Sellers have waited a year longer. Sponsors have had money to invest for a year longer. The combination of these factors, along with favorable credit markets and anticipated growth in the U.S. economy, will lead to a meaningful increase in M&A."
*Steve Robinson, Antares Capital*

"M&A volumes are going to move up, assuming the economy stays fairly stable. There is still an abundance of equity and debt capital in the market."
*Chris Williams, Twin Brook Capital Partners*

"While it remains to be seen what policies will be implemented, the prospects for M&A are expected to increase in 2017 due to availability of capital, the expectation of growth, lower taxes, and potential regulatory changes.

An increase in corporate merger and acquisition activity could result in the divestiture of non-core businesses and present opportunities for private equity firms. We've also seen increased interest in distressed opportunities."
*Ira Kreft, Bank of America Merrill Lynch*

"So many private equity firms have raised funds. The funds have a finite life, and those dollars need to be put to work. Eventually, that is going to translate into more M&A volume."
*Jared Halajian, Madison Capital Funding*

"I think there is a clear opportunity for M&A. Companies have been scaling and squeezing margins and leveraging automation to drive earnings growth. The continued motivation to create synergies and improve margins will drive a resurgence in M&A, and without the overarching regulatory burdens that were prevalent in the last administration, it will embolden people to do more. It is a more opportunistic environment for M&A than you might have seen in the past."
*Bob Marcotte, Gladstone Capital*

# Global Leaders

## Who We Are

### Leading Independent Firm

- Independent investment banking advisory firm focused on the middle market
- Senior bankers with significant experience and tenure; partners average over 20 years of experience
- Offices in Chicago, Cleveland, and Philadelphia
- Real Estate offices in Chicago, Cleveland, Irvine, and San Antonio
- Exclusive U.S. member of Global M&A Partners Ltd., the world's leading partnership of investment banking firms focusing on middle market transactions
- Deep industry experience across core sectors of focus, including: Business Services, Consumer, Environmental & Industrial Services, Healthcare & Life Sciences, Industrials, and Real Estate

### Comprehensive Capabilities

**M&A ADVISORY**

Sell-Side Advisory
Acquisitions & Divestitures
Public & Private Mergers
Special Committee Advice
Strategic Partnerships & Joint Ventures
Fairness Opinions & Fair Value Opinions

**PRIVATE PLACEMENTS**

All Tranches of
Debt & Equity Capital for:
Growth
Acquisitions
Recapitalizations
Dividends

**FINANCIAL ADVISORY**

General Financial & Strategic Advice
Balance Sheet
Restructurings
Sales of Non-Core Assets or Businesses
§363 Auctions

**RESEARCH**

Primary Research
Industry Benchmarking
Operating Advisor Network
White Papers
Industry Surveys

For questions about content and circulation, please contact Editor and Director of Research, Rebecca Dickenscheidt, at rdickenscheidt@bglco.com or 312-513-7476.

# Global Leaders

## Representative Transactions

GROOT — acquired by — Waste Connections, Inc. (Connect with the Future) — Brown Gibbons Lang & Company
ENVIRONMENTAL SERVICES

The Kitchen Division of Focus — a portfolio company of — Centre Lane Partners, composed of amco houseware, chicago metallic, Swing-A-Way — acquired by — LifetimeBrands — Brown Gibbons Lang & Company
CONSUMER

Snappy — a portfolio company of — Blue Wolf — acquired by — MiTek — a subsidiary of — Berkshire Hathaway — Brown Gibbons Lang & Company
INDUSTRIALS

cyprotex — acquired by — evotec — Brown Gibbons Lang & Company
HEALTHCARE

NYO Property Group, Pan Brothers Associates Real Estate Services — has obtained $32,100,000 of financing for the Stambaugh Building conversion in Youngstown, OH — Brown Gibbons Lang & Company Real Estate Advisors
REAL ESTATE

IndependenceTube Corporation — acquired by — Nucor — Brown Gibbons Lang & Company
METALS

Fomo Products, Inc. — acquired by — ICP — a portfolio company of — Audax Private Equity — Brown Gibbons Lang & Company
INDUSTRIALS

Fortune Industries, Inc. comprised of Century II, ESG, Professional Management — acquired by — Oasis Outsourcing — a portfolio company of — Stone Point Capital — Brown Gibbons Lang & Company
BUSINESS SERVICES

Riverside Pain Physicians — acquired by — Surgery Partners — Brown Gibbons Lang & Company
HEALTHCARE

So.F.Te.R. — acquired by — Celanese (The chemistry inside innovation) — Cross Border — Brown Gibbons Lang & Company
PLASTICS & PACKAGING

RiverBend Medical Group — acquired by — Sisters of Providence Health System — Trinity Health — Brown Gibbons Lang & Company
HEALTHCARE

Personnel Management Systems — acquired by — Asure Software — Brown Gibbons Lang & Company
BUSINESS SERVICES

The Dermatology Group — recapitalized by — Riverside — Brown Gibbons Lang & Company
HEALTHCARE

Snavely Group, Orlean Company — has obtained $60,000,000 of financing — First Merchants Bank, Citizens Bank, Enterprise, Capital One, Port Cleveland, Finance Fund, First National Bank, Village Capital, Novogradac & Company — Brown Gibbons Lang & Company Real Estate Advisors
REAL ESTATE

DeBusk Services Group — recapitalized by — Turnbridge Capital — Brown Gibbons Lang & Company
INDUSTRIAL SERVICES

HiHR — acquired by — ProService Hawaii — Brown Gibbons Lang & Company
BUSINESS SERVICES

City Carting & Recycling — acquired by — Tunnel Hill Partners — Brown Gibbons Lang & Company
ENVIRONMENTAL SERVICES

Ceres, Orlean Company — has obtained $20,757,000 of financing — Heartland Bank, The Peoples Bank Co., Choice Hotels, Citizens National Bank — Brown Gibbons Lang & Company Real Estate Advisors
REAL ESTATE

FFO — a portfolio company of — Alpine Investors — acquired by — Sun Capital Partners, Inc. — Brown Gibbons Lang & Company
CONSUMER

Surgical Institute of Reading — has partnered with — United Surgical Partners International — and its affiliate — Reading Surgery Center — Brown Gibbons Lang & Company
HEALTHCARE

Wallover Metalworking Fluids — acquired by — Houghton — a subsidiary of — Gulf — Gulf Oil International Ltd — Brown Gibbons Lang & Company
INDUSTRIALS

Sellside Advisor to SouthWaste — a portfolio company of — Rock Hill Capital — Brown Gibbons Lang & Company
ENVIRONMENTAL SERVICES

TDC Filter, an MFRI business — acquired by — Clarcor — Brown Gibbons Lang & Company
INDUSTRIALS

PerfectFit — a portfolio company of — The Anderson Group — acquired by — Cross River, LLC — a subsidiary of — Shanghai Shenda Co. Ltd. — Brown Gibbons Lang & Company
CONSUMER

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