



PRIVATE  
CAPITAL  
SOLUTIONS  
GROUP

MARKET  
UPDATE

Debt Capital Markets

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## McColl Partners' Services

### Private Capital Solutions Group

MERGERS & ACQUISITIONS

PRIVATE CAPITAL SOLUTIONS

STRATEGIC ADVISORY

McColl Partners' Private Capital Solutions Group has the requisite experience to deliver optimal results to its clients, having raised over \$2.0 billion of senior debt, subordinated debt, and preferred equity in the last three years. Examples of past advisory transactions include a senior debt raise to provide for facilities expansion and growth capital for a rapidly growing janitorial/sanitation distribution and linen services company; a mezzanine raise to fund a buyout of a minority shareholder and to provide growth capital for an established, high-growth carbonated beverage company; and a senior debt, mezzanine debt, and minority equity raise for a consolidator of distribution companies.

McColl Partners' Private Capital Solutions Group leverages significant industry expertise to achieve premium outcomes for clients, with an emphasis on establishing long-term relationships. The Private Capital Solutions Group has also established a reputation for creating innovative financing structures and completing complex situations.

McColl Partners maintains regular dialogue with over 300 financing sources.



- International and U.S. commercial banks
- Finance companies
- Hedge funds
- Business development corporations
- Mezzanine funds
- Other unique sources of capital

### Uses of Capital Placed by McColl Partners

SHAREHOLDER DIVIDEND

ACQUISITION FINANCING

GROWTH CAPITAL

RESCUE FINANCING

DEBT RECAPITALIZATION

SHAREHOLDER BUYOUT

WORKING CAPITAL

DEBT RESTRUCTURING

## Debt Capital Markets Update

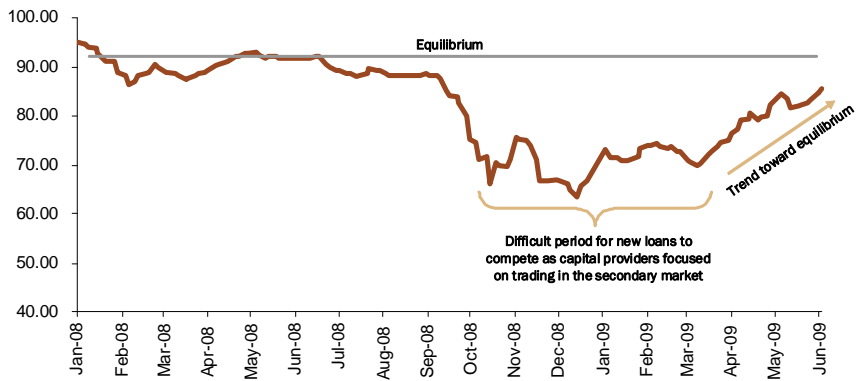
### Introduction

Today's credit markets continue to operate in an arduous environment. The middle market experienced a drastic decline in credit availability in October 2008 that led to a virtual freeze for the better part of the fourth quarter of 2008 and early 2009. Although access to capital remains challenging, the past few months have bestowed some benevolence on the credit markets. Overall, stabilization has begun to take place as high-quality companies have more access to capital, albeit through increased pricing, tighter covenants, and more credit scrutiny. Investors are taking their time evaluating credits, thereby extending the marketing period, and investors continue to demand tighter covenant levels than in years past. Senior debt availability remains largely tied to the asset base, with the cash flow debt market operating under conservative parameters. Banks are taking a cautious approach with all credits, maintaining a significant focus on quality and limiting overall exposure. Active players in the asset-based lending ("ABL") sector are carrying the day in the senior debt market.

Flexible junior capital continues to be put to work as mezzanine debt providers fill the gaps created by the absence of readily available bank debt. These capital providers have significant dry powder and are actively taking advantage of the marketplace by taking on investments with senior-level risk and maintaining aggressive pricing. Although active, mezzanine lenders continue to shy away from risky industries and companies experiencing material downward revenue and earnings before interest, taxes, depreciation, and amortization ("EBITDA") trends.

The best news for middle-market companies is that capital is available and lenders have gone back to fundamentals and settled on general pricing and leverage multiple parameters. The market for new loans is also being aided by the secondary market, which is now trading near 90% of par value as opposed to 65-70% at the beginning of 2009, making it much easier for banks and other lending sources to justify the origination of new loans. Figure 1 presents the changes in the secondary market index ("SMI") since the beginning of 2008.

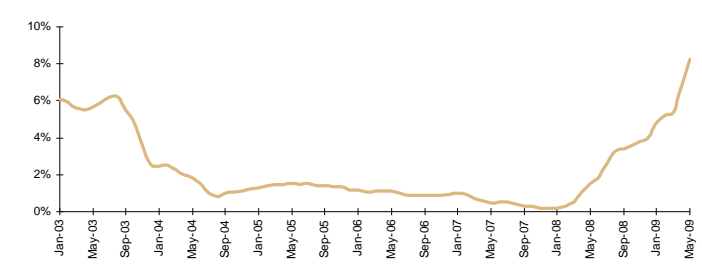
Figure 1: Secondary Market Index



Source: Standard & Poor's.

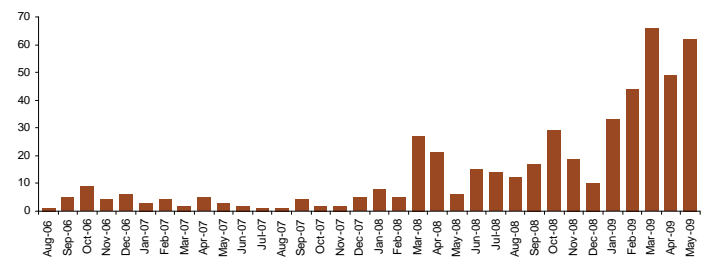
The recessionary economic environment has resulted in a significant increase in the number of corporate defaults, as displayed in Figure 2. Furthermore, the number of defaults has been compounded by the rampant overleveraging that characterized the previous free-flowing credit environment. Companies are feeling these effects as lenders continue to improve their positions through amendments and forbearance agreements, yielding upfront amendment fees, interest rate increases, and stricter cash flow recapture requirements, among other provisions. Figure 3 displays the increase in amendment activity apparent in recent months.

Figure 2: Default Rates



Source: Standard & Poor's.

Figure 3: Amendment Activity



Source: Standard & Poor's.

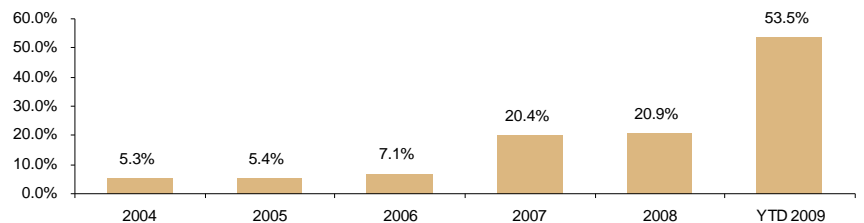
Senior Debt

Asset-Based Lending

ABL deals are currently driving liquidity in the senior debt market, with traditional banks continuing to participate and new market entrants filling the holes left by previous providers currently sitting on the sidelines, providing a stable debt financing option for quality companies. Despite continued activity, pricing has increased, advance rates have declined, and senior debt leverage for the middle market is at a five-year low. Advance rates have particularly decreased for fixed asset loans as lenders cannot rely on past appraisal values and often require new appraisals at the expense of potential borrowers. In many cases, lenders are requiring full asset appraisals for both fixed assets and current assets. Airballs are limited as fully-secured ABL structures are no longer in stiff competition with cash flow loans.

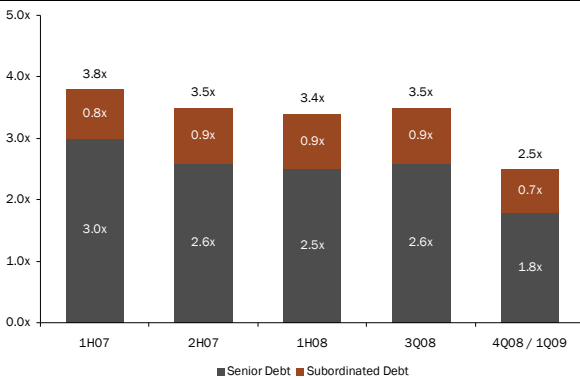
The ABL market provides an attractive financing option for companies with strong asset bases but provides little support to companies where the asset base is limited. Additionally, companies requiring greater than \$100 million of capital through an ABL deal will have difficulty, as syndicated deals are more trying than ever with active lenders limiting exposure to \$20 to \$30 million per credit. Furthermore, the decreased universe of lenders makes larger deals even more challenging to finance. Figure 4 presents the increase in the percentage of ABL leveraged loans over the past five years.

Figure 4: Asset-Based Lending as a Percentage of Total Leveraged Loans



Source: Standard & Poor's.

Figure 5: Leverage Multiples



Source: Capital IQ.

Cash Flow Senior Debt Market

Although the cash flow lending market is no longer in disarray as was the case several months ago, cash flow lenders continue to operate under conservative parameters, often limited to companies with strong fundamentals or tied to sponsor relationships. EBITDA thresholds for cash flow loans have increased as well, with banks often requiring \$15 million of consistent EBITDA over two to three years for consideration. Credit size is also playing a significant factor in the cash flow market, as the underwriting market is extremely fickle and structuring a credit facility over \$100 million is more than a challenge. Thus, a company must fit a defined profile to strike a cash flow deal. For those companies that do fit the mold, total senior leverage is settling near 2.0x EBITDA. Figure 5 presents average leverage levels for middle-market leveraged buyouts (“LBOs”) since 2007.

Pricing

Pricing for both ABL and cash flow loans is much higher than in years past but has improved in recent months. ABL deals are being priced at LIBOR + 275 - 450 with floors of 1.5% to 3.0%. Cash flow loans are requiring LIBOR floors of 3.0% to 4.0% and spreads of LIBOR + 450 - 600. The market for all-in leverage is holding steady at 3.0x EBITDA. Figure 6 outlines current senior debt structures and pricing.

Figure 6: Current Senior Debt Structures

	Interest Rate	Leverage Level	Closing Fee	Fixed Charge
<b>ABL</b>	Spread: L+ 275 - 450 Floor: 1.5% - 3.0%	80% - 85% of A/R 50% - 60% of Inventory	1.0% - 2.0%	1.25x
<b>Cash Flow</b>	Spread: L+ 450 - 600 Floor: 3.0% - 4.0%	2.0x EBITDA	1.0% - 2.0%	1.40x

Subordinated Debt

Mezzanine Debt Driving Capital Availability in the Market

With senior debt fairly limited outside of the asset base, mezzanine capital is currently in high demand, especially for companies with limited assets. This flexible capital is driving liquidity in the marketplace and has become all but essential in completing any financing structure. As a result, mezzanine lenders can afford to increase return requirements and be selective in evaluating deal flow. Many junior capital providers are sticking to sponsored-deals and other groups continue to fill the gap in the non-sponsored senior financing market by taking on investments with senior-level risk and still obtaining traditional mezzanine terms. In many cases, these groups will act as senior cash flow lenders but still require all-in returns of 14-16%. Other mezzanine lenders are acting as deleveraging tools to reduce levels of senior debt.

Figure 7: Current Mezzanine Debt Structure

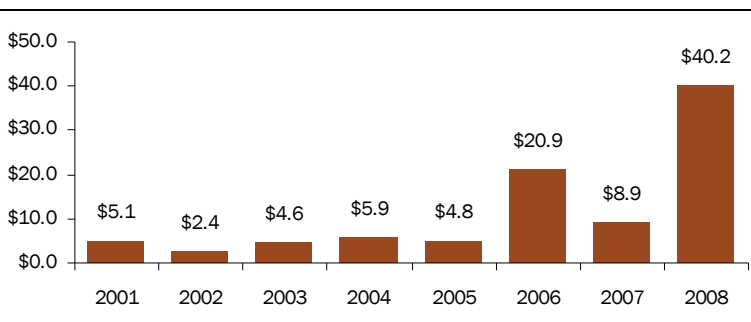
Mezzanine Debt	Interest Rate	Total Leverage	Closing Fee	All-In Return
	Cash: 12.0% - 13.0% PIK: 2.0% - 3.0%	3.0x EBITDA	1.5% - 3.0%	16.0% - 22.0%

As a result of the demand for flexible capital, mezzanine return requirements have increased and junior capital lenders are looking at more of their investment as an equity investor, requiring warrant positions based on equity value at close rather than using projections to calculate a required internal rate of return. Figure 7 outlines the current pricing and structure of mezzanine investments.

Mezzanine Debt Fundraising

Mezzanine lenders took advantage of the anticipated need for junior capital by raising more funding in 2008 than ever before. Figure 8 presents mezzanine debt raised over the past six years. The \$40.2 billion of mezzanine capital raised in 2008 will continue to be put to work and drive available capital in the marketplace.

Figure 8: Mezzanine Debt Fundraising, 2001–2008



Source: Dow Jones Private Equity Analyst.

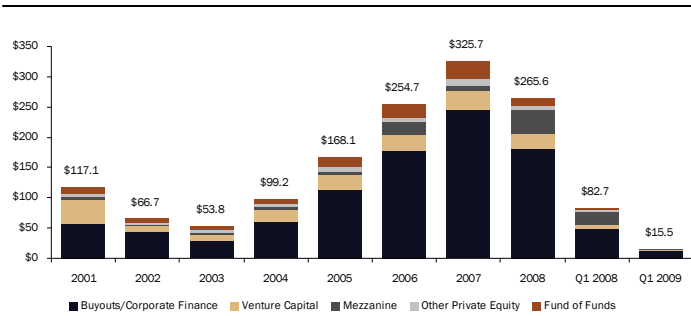
Other Sources of Subordinated Debt

The large gap in the capital structure between conservative senior debt providers and aggressive mezzanine debt holders leaves room for other sources of capital to take advantage. New Business Development Corporations (“BDCs”) are expected to emerge to effectively compete with the major existing BDCs that have been saddled with recent losses. In addition, second lien loans, which had all but disappeared over the past nine months, are seeing opportunities when matched with a conservative asset-based structure that leaves adequate collateral value for second lien lenders. Other capital providers are getting creative with fundamentally sound companies hit by recent market dynamics through the offering of debt securities convertible into equity, allowing investors to take advantage of a significant potential equity upside. All of this means that opportunities exist in the market for subordinated debt providers to capitalize on selective opportunities and certain providers are beginning to take advantage of the opportunities presented in the market.

## Leveraged Buyouts

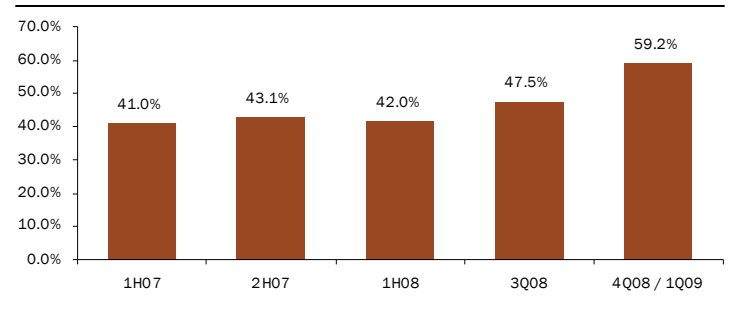
As financial sponsors attempt to put to work the estimated \$1.0 trillion of committed but uninvested capital, private equity groups are contributing more equity dollars to LBOs. In fact, financial sponsors contributed nearly 60% of the capital structure for middle-market deals over the past two quarters. In many cases, groups are purchasing companies with all equity and planning to refinance when the credit markets return. Figure 9 illustrates the significant private equity capital raised in recent years, and Figure 10 presents the average equity contribution to middle-market LBOs since 2007.

Figure 9: Private Equity Fundraising



Source: Dow Jones Private Equity Analyst.

Figure 10: Financial Sponsor Equity Contribution



Source: Capital IQ.

The recent increase in equity contribution indicates that financial sponsors are “starved” for new deals. Furthermore, as the gap between seller and buyer expectations converges, deal volume will begin to increase. Although this process will take time, increased equity contribution indicates that private equity buyers are beginning to accept the changes in leverage levels apparent in the market.

Private equity groups also continue to find creative ways of investing to offset lower leverage multiples. These structures include minority deals, distressed investments, seller notes, and earn outs. Seller financing has become a key trend, assisting sponsors in financing transactions at the expense of sellers, who receive less cash at close as a result. In distressed structures, sponsors invest equity in an over-leveraged company, resulting in a post-transaction capital structure that utilizes existing leverage where the sponsor still garners a significant equity stake by paying down a piece of existing debt. These “reverse-LBO” structures have become increasingly more prevalent in the market.

## Conclusion

As we move forward in the remainder of 2009, we anticipate a slow and steady ease in the credit markets that will make capital more available, although the financing options for most companies will be limited and more expensive than those in years past. Banks will continue to increase overall activity in evaluating credits but maintain a conservative attitude and cautious approach to evaluating and committing to new deals, requiring longer due diligence periods to complete transactions. The senior debt market will rely heavily on the asset base, and the availability of flexible mezzanine capital will drive deal activity. The most common capital structure for deals getting done in the market right now and in the next few months will combine an asset-based credit facility with a mezzanine tranche.

In this environment, extensive knowledge of appropriate capital structures that meet market expectations and relationships with active participants are essential for getting deals done. For further information on McColl Partners’ capital raising capabilities, please contact John Deering at (704) 333 - 0574 or at [jdeering@mccollpartners.com](mailto:jdeering@mccollpartners.com).



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McColl Partners provides investment banking services to owners and management of middle-market businesses and financial sponsors by combining experienced, dedicated professionals, unparalleled access to decision makers, and focused industry expertise.

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