Leveraged Finance News

Middle Market Leverages Up
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By Allison Bisbey
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Lenders are sticking their necks out further to finance middle market LBOs, and, unlike buyouts of larger companies, financing for these deals is unlikely to be impacted by turmoil in Europe.

In recent weeks, the amount of debt private equity firms are able to borrow to acquire portfolio companies has increased, as a multiple of earnings before interest, taxes, depreciation and amortization, to levels some market participants describe as aggressive.

Through May 18, the average leverage multiple on middle market deals made public and tracked by Thomson Reuters LPC has jumped, to 3.4x senior debt and 4.7x total debt to Ebitda, up from 3.7x senior and 4.1x total debt to Ebitda in the first quarter.

The data include all kinds of middle market deals, including those refinancing existing debt and funding dividends, which were more common in the first quarter and tend to warrant lower levels of leverage. So to a certain extent, the increase in multiples in the second quarter represents a pickup in buyout activity.
But participants say the higher levels of leverage are also a function of the fact that there is too much capital chasing too few attractive companies. That puts pressure on private equity sponsors to borrow more – and banks to lend more – to compete for these deals.

“The deals that are getting done in the current market tend to be better quality deals with more consistent cash flow,” said Theodore Koenig, president and chief executive of Monroe Capital, an investment firm based in Chicago.

“They are being bid up in price by PE buyers, and lenders are getting more aggressive on terms and structure because there’s more equity being invested by the buyers, which creates more subordination,” Koenig said.

“There’s a significant overhang of private equity capital that’s not been put to work yet and that capital will be put to work or lost very soon.”

Several middle market deals have already been seen this quarter with total leverage over 5x Ebitda, including Plato Learning, Help/Systems, PRV Aerospace and Physiotherapy Associates, according to Thomson Reuters LPC.

Last week, the $345 million buyout loan for CAMP Systems, a seller of maintenance-tracking services to private aircraft owners based in Ronkonkoma, N.Y., was oversubscribed despite being covenant-lite and exhibiting what analysts at Thomson Reuters LPC described as “an extremely aggressive structure” of 5x senior debt and 7.5x total debt. “Investors say the highly recurring business model helps warrant the lofy leverage levels,” they wrote in a report last week.

The facility consisted of a $230 million first lien loan priced at Libor plus 525 at 99 cents on the dollar and a $115 million second lien loan priced at Libor plus 875 bps at 98 cents on the dollar, according to KDP Advisor. Deutsche Bank was on the left of the deal.

Chicago buyout shop GTCR reportedly acquired the business from fellow private equity firm Warburg Pincus.

Jeremy Swan, a principal with the Cohn Consulting Group of J.H. Cohn, said that leverage of 5x is a notable increase in a relatively short period of time. “Historically, we’ve seen senior leverage, measured by debt to Ebitda, in the 3.5x range [for middle market LBOs]; we saw it there early in the first quarter,” he said.

Swan said middle market private equity firms typically put between $10 million and $50 million of equity to work in each deal, not much more. “So they have to find other ways to get to these lofty valuations… since the senior debt markets are not able to keep pace with valuations, PE firms are making up the difference with increased subordinated debt such as, high yield and mezzanine in the capital structure.”

To be sure, lenders still aren’t willing to stomach as much leverage in middle market deals as they will in buyouts of large-cap companies. “A smaller business is more risky from a bank’s perspective,” Swan said.

“If you look at multi-billion-dollar buyouts versus a traditional, middle market buyout, a large cap deal might get to 6x total debt to Ebitda … versus a middle market deal that will probably get half turn to a full turn less,” he said.

“It doesn’t matter if it’s senior debt, mezzanine debt, or equity, there’s always been more flexibility for firms to determine the capital structure for large businesses with more cash flow, usually more [operating] history, more stability,” he said.

Still, middle market financing isn’t as vulnerable to macro-economic turmoil as high yield bonds or even more broadly syndicated loans. “The leveraged loan market, especially the middle market, is not as correlated to Europe, Greece, and Asia,” Koenig said. “It’s not readily traded so it’s not liquid. Most all the investors in this space are originate-and-hold investors that are long credit. Therefore what happens in Europe, Greece and Asia is not as relevant to them.”

Koenig added that deals tend to be more “opportunistic” in the middle market. “For example, in the larger markets, not many deals are getting done in out-of-favor industries such as media, homebuilders, or any real discretionary spending industries like restaurants,” he said. “The middle market is more diverse, because buy-and-hold investors are not wholly focused on macro trends.”