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Feature | Middle-market review

THE PAIN TRICKLES DOWN

In the lower middle market, where financing options are limited, political and economic turmoil takes its toll by Thomas Zadvydas

POLITICAL TURMOIL FROM ABOVE IS putting a major strain on deals from below.

That's how it feels in the battered lower middle market these days. This segment of the market was just recovering from the financial crisis when more blows rained down. There's little doubt that wrangling over U.S. debt and deficits and anxieties over the euro zone seriously rattled global markets. The Dow Jones industrial average plunged 634.76 points, and some $2.5 trillion was erased from global equities on Aug. 8, the first trading session after Standard & Poor's downgraded the U.S. debt rating and right after the messy debt-ceiling drama in Congress. The fact that U.S. gross domestic product growth was slowing didn't help.

Since then, anxieties compounded by uncertainties continue to cascade. Dealmakers in the middle market argue that confusion and political infighting in the U.S. and Europe are jamming up dealflow and drying up lending for small and medium-sized businesses. "This is the topic getting discussed right now," says Paul Sperry, co-founder and president of New York-based Sperry, Mitchell & Co., an investment bank operating at the lower end of the middle market. "Everyone's very concerned about the next 12 months. I don't think a lot of people are looking at any kind of growth."

Sperry's firm, which typically does deals in the $25 million to $200 million range, is a generalist. The banker -- he's not alone -- believes that chaos in Congress is hindering growth and hobbling deals. "These guys in Washington just have no idea how this insane bickering and political maneuvering is impacting the economy," he says. "Obama hectors us to go out and hire people [yet] no one's going to spend millions and billions building a new plant until they have some idea where we're going."

Of course, it may not all be psychological. Quarton Partners LLC of Birmingham, Mich., the investment banking division of Troy, Mich., independent brokerage Leonard & Co., attributes sluggish growth to significant increases in food and energy costs, and declines in local construction spending and federal defense outlays.

And James Rybakoff, president and CEO of New York-based middle-market investment bank Akin Bay Co. LLC, argues that persistently sluggish demand as both consumers and businesses deleverage is restraining growth. "What does 1% [growth] really mean? When you make adjustments, it's probably less than that. That's a scary number," he says.

Sperry says the conventional wisdom about the middle market still holds true: Larger companies have more options when it comes to wrangling financing for either deals or organic growth, whether it's asset-based lending, access to debt and equity markets, private equity or a bank or specialty lender.

"It is true: the smaller the company, the smaller the amount of Ebitda; the smaller the cushion, the greater the risk," says Lloyd Greif, president and CEO of Los Angeles-based middle-market investment bank Greif & Co., which operates in the $25 million to $1 billion range (the firm's sweet spot is between $150 million and $400 million). "The bigger they are, the more ability they have to adjust, the less likely it's going to be a problem if they get into trouble. The bigger they are, the more diversified revenue streams are, the less likely they are to have product-line or customer concentration. It's a risk/reward equation. From a lender's standpoint, what they want to make sure about is that the bottom line is not too thin."

Greif doesn't see the political climate as the dominant factor, but he points to one issue that may be: a possible increase in the capital gains tax rate. "You've got all these major fiscal deficits. There's going to be a strong desire to have low capital gains tax rates expire. If they start mess-

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ing with capital gains, that is kind of the faucet. You have low capital gains tax rates, you turn on the deal faucet. You have high capital gains, you turn off the faucet."

He adds that the level of government intervention varies by industry and influences how easily deals get funded and closed. For instance, healthcare businesses that operate without Medicare or Medicaid have few problems closing. "You can make a healthcare deal until the cows come home," he says.

Greif's firm has, in fact, closed two healthcare deals recently, though he wouldn't offer prices on either. One was a recapitalization of Los Alamitos, Calif.-based Discovery Practice Management, which operates residential treatment centers focused on substance abuse and eating disorders, by Waltham, Mass., private equity firm Webster Capital. The second was the acquisition of Rancho Dominguez, Calif.-based wound care management, safe patient handling equipment and consulting company Dynamic Medical Systems Inc. by medical equipment and supplies maker Invacare Corp. of Elyria, Ohio.

Business brokers and other sources who operate at the low end of the middle market also believe politics constrains funding. They agree that the further you drop, the tougher it is to get financing. "Essentially, a company that has $1 million or less in Ebitda is not attractive to people who have the most money to do deals, and that's PE firms with private capital," says William Lange, a principal at San Diego-based Vanguard Resource Group, an affiliate of VR Business Brokers. The funding is considerably easier than it is for banks doing [Small Business Administration] loans."

The SBA, notes Lange, is a key, but problematic, piece of the puzzle. "The principal lender in the world of small business has always been the Small Business Administration," he says. "And the SBA is very tight right now."

Lange says the SBA recently raised its loan limit to $5 million, which should accommodate most Main Street and lower-middle-market businesses. But, he adds, the agency has gotten more stringent on loan approvals.

Some brokers have avoided using banks or outside lenders, working only with all-cash or seller-financed deals. Mel Lisiten, founder and president of New York business brokerage Lisiten Associates, has a sweet spot for deals around $25 million, although his firm has worked on some, usually for hotels, valued at up to $100 million. The banks have proved to be difficult to deal with. "For many years we've been against doing business with banks," he says. "What happens with a bank, or what used to happen, is that a bank officer, to get the deal, would represent himself to be the final authority. We'd wait months and then we'd find out there was a committee to pass on any deal. In that time period, we could have sold a business over and over."

Lisiten requires any business listed with his firm to have seller financing already in place. "We've had absolutely no problems in the last couple of years doing that," he says, adding that his firm averages about a deal a week and that prospective buyers register on his website at a rate of about 150 a week. He says his firm has sold a major temp staffing company, a large liquor distributor and a medical billing company in the past few weeks. And he has just taken on one of the northeast distributors for Ozark, Mo., senior citizen home modification and products company Aging in the Comfort of Home as a client, a deal that could be worth more than $100 million, one of the firm's largest.

Diane Thomas, president of Scottsdale, Ariz., business brokerage Premier Sales Inc., also notes the negative psychological effect of the political climate on the local economy. Her shop works with mostly manufacturing and service businesses with some technology component, and on sales of small construction companies and professional service shops like accounting firms. Purchase prices for most of her firm's deals this year have been around $1 million.

"I think one of the biggest barriers for us is that just when we start getting momentum on various transactions, we have this horrible news hit and everything stops," she says.

"You know we're looking at financials of a lot of these companies," says Thomas. "Pretty much the entire metro Phoenix area. We're seeing balance sheets get better. We're seeing cash flow improve. And then this horrible news comes and hits, gets blasted out there, and it kills the activity in the marketplace."

Adds managing director Kevin Loud of Scottsdale-based lower-middle-market investment bank Windstone Capital Partners Inc.: "There's no confidence there. You see these gigantic swings that really shouldn't be occurring but are because people have no faith in where we're going."

Thomas and Loud note a preference for seller financing. If an outside lender is involved, notes Thomas, "we're talking about 10% or 15% down from the buyer, 10% carryback from the seller. The main balance is financed through a bank." If all cash is used, a typical deal structure is 75% of the main balance due at closing, with the rest deferred into a future earnout or an equity stake in the target.

Greif says persistence is necessary to get bank funding in the middle market in a tumultuous economy. "Banks aren't standing in a queue waiting to throw money at your deal. You've got to cajole them. You've got to hold their hand and not let go until the money's in your client's bank," he says.

Certain business models may make banks and other lenders more willing to hand out cash whether the deal is big or small, says Thierry Monjauze, managing director and head of European operations for Richmond, Va., midmarket investment bank Harris Williams & Co. "Banks get the most comfort from a company that has a higher recurring-revenue component. I think the business model is probably more relevant than the actual vertical, in terms of the way banks perceive risk on the debt."

To many, the panic of 2008 still haunts middle-market financiers. "It's not too much of an overstatement to say that the experienced lender who wants to push the envelope on a cash flow-based loan is putting his career in jeopardy," says Fairmount Partners LP managing director Andrew Greenberg. "It's a tough environment. And I think the remedy is time. The banking industry, not just in the United States but globally, went through a near-death experience. It will continue to take time [for] lenders who focus on the smaller and therefore riskiest tiers of the market to normalize."