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The Current State of the Debt Markets for Middle Market Companies

Q1 2007 was record-setting for the leveraged loan market besting the short-lived record Q4 2006.

The phrase "middle market" is widely used, but how do we define a "middle market" company? Standard & Poor's, when compiling statistics on the loan markets, defines the middle market as companies with $50 million or less of EBITDA. Revenue is not used as a parameter, as it is ultimately operating cash flow that defines the size of a company. Our firm, Global Leveraged Capital (GLC), a specialty lender to non-sponsor and sponsor-based middle market companies, defines the overall middle market in the same way as Standard & Poor's. However, I would break the middle market into three sub-segments:

1. companies with $20 million to $50 million of EBITDA ("MM1");
2. companies with $10 million to $20 million of EBITDA ("MM2");
3. companies with $5 million to $10 million of EBITDA (what some may call the lower middle market, "MM3"); and
4. companies with EBITDA below $5 million ("Micro-Market").

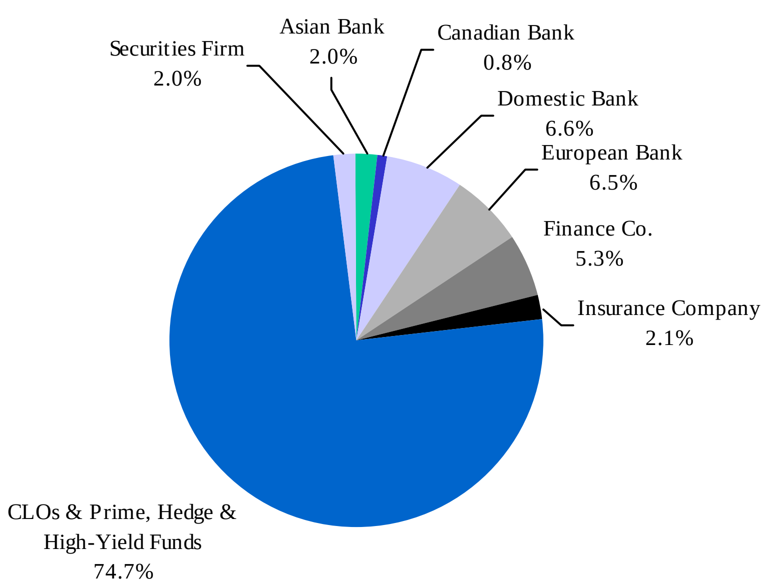
I will explain the purpose for creating these sub-segments and the implications for each type as the respective companies seek to raise debt capital in today's market.

<u>An update on the leveraged loan markets</u>

"Leveraged loans" is a term that generally refers to sub-investment grade loans, with the majority today comprising debt issuers rated in the single-B range (by S&P's or Moody's). In almost all cases, given their smaller size, middle market issuers will be considered to be part of the leveraged loan markets (regardless of the actual debt/EBITDA ratios of these companies). In the aggregate, however, much larger companies (including most of the recent mega-LBOs) comprise the majority of debt issued in the leveraged loan markets (>90%).

Q1 2007 was record-setting for the leveraged loan market, with new-issue volume climbing to $183 billion, besting the short-lived record of $148 billion in Q4 2006. Of the Q1 2007 volume, $89 billion was driven by sponsor-backed LBOs and dividend recaps, and this high volume was underpinned by substantial investment activity by private equity groups ("PEGs") in conjunction with institutional lenders such as Collateralized Loan Obligations ("CLOs"), hedge funds that have entered the lending space, and other specialty finance companies. In recent years there has been a significant emergence of new firms formed to provide debt capital to middle market companies, including our own firm, GLC.

This growth in activity by alternative providers of credit capital has occurred as many (if not most) of the traditional middle market lenders of the 1990s have been consolidated away, (remember Fleet Bank, Bank of Boston, Heller Financial, CoreStates Financial, etc.), and others have exited the market in pursuit of large market opportunities. In fact, in the mid-1990s, traditional bank lenders comprised approximately 66% of total loan volume to middle market companies, and as of Q1 2007 this figure is down to under 25%. The chart below shows the breakout of investors in the primary leveraged loan market for Q1 2007. When the current period of extreme liquidity will end is anybody's guess, but it seems that these patterns have tended to follow roughly 10-year cycles – notable by downturns in the 2000-2001 period and the late-1980s/early 1990s before that.



Pricing and terms of leveraged loans

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For the PEG community, conditions in the credit markets today are "as good as it gets." LIBOR margins for single-B credits are near all-time lows, at approximately 220 bps, and in addition to attractive pricing, loan structures have also become more aggressive than ever. PEGs are now able to take out increasingly large dividends from their portfolio companies, without changes in equity ownership, and are completing such deals in a shorter period of time than before. It is also interesting to note the increasing replacement of high yield bonds by senior secured debt – often second-lien loans – in the capital structure:

- back in 2002, nearly half of the debt issued to execute dividend recaps was subordinated debt;
- year-to-date 2007, that number is 8%, while 92% of the debt in recapitalization transactions consists of 1st and 2nd lien secured loans.

While most of these statistics, and the low pricing records, are skewed by the large, highly leveraged, PEG-backed LBOs, there is a significant "trickle-down" effect that has benefited middle market borrowers of all sizes, especially those that are backed by PEGs. Pricing has compressed for all middle market borrowers, as will be detailed below in the context of middle market sub-segments previously defined. (It should be noted that this discussion on pricing is focused solely on "cash flow" loans – as opposed to asset based loans that are specifically backed by accounts receivable and/or inventory or certain other assets such as equipment or real estate. These asset based loans operate under different lending parameters and are beyond the scope of this article).

Middle market pricing levels

There is a significant "trickle-down" effect that has benefited middle market borrowers of all sizes, especially those that are backed by private equity funds.

MM1

These companies have benefited the most from the strong credit market conditions. Companies of this size are heavily targeted by PEGs, and pricing levels have blurred between the MM1 segment and much larger ones. For MM1 companies backed by a well-known PEG, LIBOR margins are roughly as follows:

Type	**LIBOR spread**
Sponsored deals:	
1st lien	2.50% - 3.25% (Avg ~ 2.80%)
2nd lien	5.50% - 6.50% (Avg ~ 6.10%)
Unsecured sub debt	11.0% - 14.0% fixed cash+PIK
Non-sponsored:	
1st lien	2.75% - 3.75%
2nd lien	6.00% - 7.25%
Unsecured sub debt	13.0% - 17.0% fixed cash+PIK

Notes:

- 1st lien paper priced at a higher level than 3.25% often implies that the credit has some challenges or the industry sector is out of favor with a large pool of potential lenders. Smaller companies will also skew towards the higher end of the range.

- Unsecured subordinated loans (or mezzanine debt) will be structured with a combination of cash and PIK interest.
- Non-sponsored transactions will generally carry a pricing premium as the absence of a "deep-pocket" reflects a lesser credit quality and increases the "institutional sponsorship" role of the lender (in terms of due diligence and any future work-out scenarios). A larger, well-known non-sponsor company (or a company with a long track record of success) in MM1 may be able to secure pricing similar to sponsor deals.
- I have not included upfront, underwriting, arrangement or other fees paid by the borrower at closing. These fees can vary widely depending on the type of transaction (underwriting, best efforts, "club" transaction) and credit risk, and a discussion on these matters are beyond the scope of this article.

For non-sponsor deals, there will be a larger premium and higher variability as well.

MM2

We have also seen an increased interest by PEGs in this segment of the market, and middle market lenders have eagerly followed sponsors to these smaller targets. Pricing levels in many cases will overlap with those for MM1, but overall pricing on average will be higher. For non-sponsor deals, there will be a larger premium than in MM1 and higher variability as well.

Type	LIBOR spread
Sponsored deals:	
1st lien	2.75% - 3.50%
2nd lien	6.00% - 7.25%
Unsecured sub debt	12.0% - 15.0% fixed cash+PIK
Non-sponsored:	
1st lien	3.25% - 4.00%
2nd lien	6.50% - 8.00%
Unsecured sub debt	14.0% - 20%+, in a combination of cash interest, PIK interest and sometimes warrants

Well known and large private equity funds are dipping down to invest in sub-$10 million EBITDA companies.

MM3

Companies in this segment will have a tougher time securing debt capital, (except for those being acquired by well known PEGs, and we are seeing more instances of well known and large PEGs dipping down to sub-$10 million EBITDA companies). For sponsor-backed companies in this segment, there are a numerous specialized lenders that will provide credit finance for PEG relationship purposes. Pricing is generally higher, but still attractive for the borrower, as these PEGs can usually secure multiple bidders and rely on the "relationship" to drive down pricing.

Type	**LIBOR spread**
Sponsored deals:	
1st lien	3.25%+
2nd lien	6.50%+
Unsecured sub debt	12.0% - 16.0% total return
Non-sponsored:	
1st lien	3.50%+
2nd lien	n/a
Unsecured sub debt	16% - 20.0%+ total return

For companies with less than $5 million of EBITDA, the number of lenders is significantly smaller.

Notes:
- Pricing in general for companies in MM3 can vary widely, for both sponsor and non-sponsor transactions.
- 2nd lien loans are unlikely to be part of the capital structure in non-sponsored deals at this size level, with mezzanine debt the more likely choice.

Micro-Market

For companies with less than $5 million of EBITDA, there are no general parameters. Once again, PEG based deals will command the most interest and best terms, although the number of lenders serving this space is significantly smaller. Non-sponsor companies in this segment will need to find the right niche lender that will consider their situation, which can be a specialty financing company that focuses on companies of this size, a local bank, a specialized industry lender, a hedge fund or a "venture lender" that targets emerging companies.

I urge the reader to use these pricing ranges as a general guide, as each situation is truly unique and demands a separate leverage and pricing analysis. Many examples can be provided of exceptions to the pricing parameters discussed above, for specific credits and transaction situations. It is the quality of the credit that ultimately drives a lender's interest level in providing financing and pricing parameters. And "credit quality" of course, is completely subjective.

By Salo Aizenberg
Global Leveraged Capital Management, LLC

Salo Aizenberg is a Principal at Global Leveraged Capital (www.glcllc.com), a middle-market specialty lender with over $600 million under management. GLC provides 1st lien, 2nd lien and mezzanine loans as a one-stop shop to sponsored and non-sponsored, middle market companies in all industries, with target EBITDA of at least $4 million. Please contact Salo Aizenberg at sa@glcllc.com or 212-835-9950 for additional information.