Middle Market Metrics

DRESNER PARTNERS
INVESTMENT BANKING

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Our Perspective on the Middle Market

It is at times like these that the title of our newsletter, Middle Market Metrics, assumes greater import. The middle market is unique, populated with family-owned and closely-held private companies that form the backbone of our nation's economy.

The middle market is not about headlines, most middle market companies operate beneath the radar of the national press; and it is not about financial engineering, middle market companies rely on financing sources to grow and provide liquidity to their shareholders, not to turbo charge their financial returns. As a result, amid all the financial turbulence that is rocking our economy, the middle market is one place where financing and transaction opportunities are still available.

Financing

Middle market financing is not closed down. To repeat, middle market financing is not closed down. The problem issues that have made headlines in the financial press – sub-prime residential mortgages, overnight mergers of large banks, frozen credit markets – have certainly impacted the middle market, but not nearly to the extent that they have larger corporations and financial institutions.

As an example, in northern Indiana, one of the nation's largest regional banks has historically been an active middle market lender. Several years ago they made the decision to aggressively pursue the residential mortgage market. When the residential mortgage market went into a tail spin earlier this year, the bank became much less active in northern Indiana, and recently agreed to be acquired. While all of this was going on, two local banks, also focused on the middle market, continued to be very active. In its recent third quarter report, South Bend-based 1st Source Bank stated that "Our mortgage and lending businesses have always been conventional and conservative. We have no sub-prime loans." As a result, 1st Source Bank remains active in the middle market. At the same time, northern Indiana-based Lakeland Financial, the holding company that operates Lake City Bank, reported third quarter results that showed loan growth up more than 18% from the prior year. They too remain very active in northern Indiana's middle market.

The same situation exists in larger markets. In Chicago, large banks like JP Morgan Chase, Bank of America (and their recently-acquired LaSalle Bank), and Harris Bank have all been active lenders to the middle market. Today, this group has been augmented by smaller institutions like Private Bank and Cole Taylor that are now aggressively pursuing middle-market opportunities.

Distressed Situations

The speed and severity of the current downturn in the economy and financial markets was not anticipated by anyone, lenders or borrowers. In some cases, this has left middle market companies with solid operating plans but over-leveraged balance sheets in an extremely precarious position. Dresner Partners recognizes that time is of the essence in these situations, and we have teams in place to provide immediate assistance. In the last 18 months, we have seen an enormous amount of capital invested in funds that are focused on distressed situations. We are in regular contact with many of these funds and will access them, as appropriate, on behalf of our clients.

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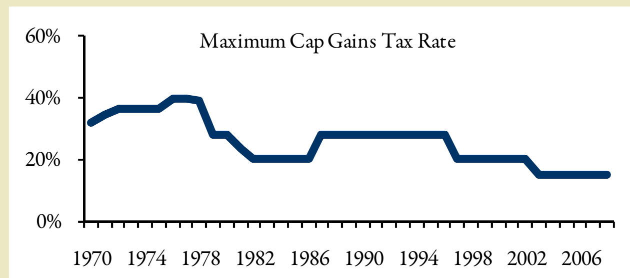
Capital Gains Taxes: A Temporary Reprieve and an Opportunity

For business owners, the capital gains tax rate is worth watching because it has fluctuated from a high of nearly 40% thirty years ago to an historic low of 15% today, and because it can have a very material effect on the after-tax proceeds from the sale of a business.
During the presidential elections, the Obama campaign spoke very clearly about its intent to raise the capital gains tax rate. However, given current economic conditions, it is looking increasingly unlikely that either President-elect Obama or the Democratic-controlled Congress will pursue an increase in the capital gains rate anytime in 2009.



This is a temporary reprieve because the current 15% rate will expire at the end of 2010, at which time the rate will jump to 20%, and because there is some likelihood that Congress and the President will raise the rate above 20% sometime in 2010 before the current rate expires. And, this is an opportunity because it allows business owners who are considering a liquidity event to complete the sale of their company next year at a tax rate that will likely remain at 15%.

The dollar benefit of a liquidity event today at a 15% tax rate vs. a sale in the future at higher tax rates is situation specific and dependent on a number of factors. However, most of the analyses we have performed comparing a sale today at 15% vs. a sale three years from now at rates of 20%, 25% or 28% indicate that a company would have to maintain existing operating margins and show double digit revenue growth over each of the next three years to achieve after-tax parity. We would never suggest that tax considerations should drive business decisions, but for owners contemplating retirement and an exit strategy in the next three years, we believe this analysis is well worth the time.

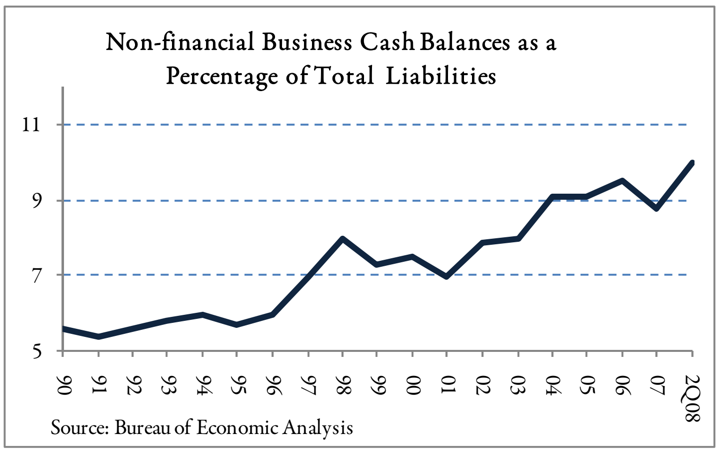
Our Perspective on the Middle Market (cont.)

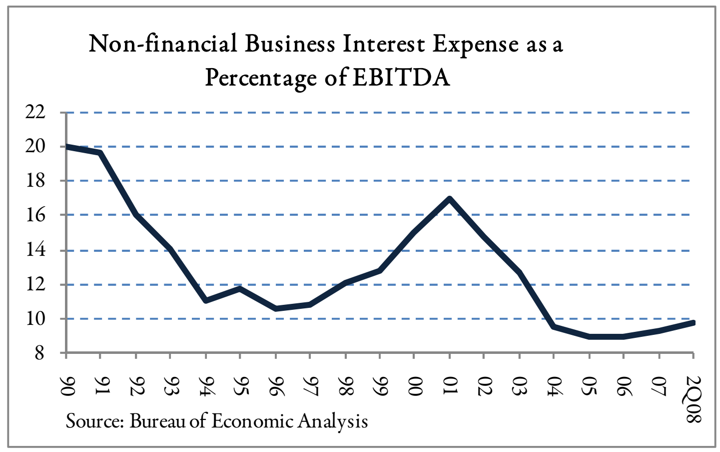
Transactions

In the middle market, transactions are not opportunistic. They do not take place because there is a window of opportunity to achieve a premium valuation. Instead, transactions are driven by shareholder objectives that relate to issues like liquidity, risk and succession. These issues exist and need to be addressed in both good times and bad. Today, liquidity is an important objective for some family-owned and closely-held private companies, particularly with an anticipated increase in the capital gains tax rate in the not-too-distant future (see accompanying article), and it is an objective that can be met.

Transactions are still taking place in the middle market. Again, to repeat, transactions are taking place in the middle market.

Do strategic acquirers have sufficient cash and financing availability on their balance sheets to pursue middle-market acquisitions to meet their strategic objectives and growth requirements? Yes. Strategic buyers are certainly taking a cautious approach to potential acquisition opportunities given the current economic environment, but as the following charts show, cash balances as a percentage of total liabilities for corporations not involved in the financial sector are at historically high levels; while interest expense, as a percentage of earnings before interest, taxes, depreciation and amortization ("EBITDA") is at historically low levels.





Do private equity investors in the middle market have capital available to continue to pursue their stated mission of acquiring family-owned and closely-held private companies? Yes, they do. Is financing available to support these acquisitions? Yes, it is, but on different terms than what were in place 18 months ago. The days of aggressive lending and "covenant lite" transaction financing are over. Transaction financing today is more expensive, with wider spreads and higher fees, and it is more restrictive, with higher coverage ratios and lower advance rates. But, financing is available and transactions are getting completed.

Conclusion

The middle market financing and transaction markets, while not nearly as active as they were 18 months ago, are still open for business. And for middle market companies seeking financing, restructuring or liquidity, there are opportunities available to meet your objectives. If one of our professionals at Dresner Partners can help guide you through these opportunities, please do not hesitate to call.

Steven Dresner
sdresner@dresnerco.com

Timothy Coleman
tcoleman@dresnerco.com

Gregg Pollack
gpollack@dresnerco.com

Vince Pappalardo
vpappalardo@dresnerco.com

DRESNER PARTNERS
INVESTMENT BANKING

20 N. Clark Street, Suite 3550 | Chicago, IL 60602 | T: 312.726.3600 | F: 312.726.7448 | www.dresnerpartners.com