The Deal Pipeline

Sense of the Markets: Mid-Market Lenders Stand Fast

by Paula Schaap, *The Daily Deal*
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With the Federal Open Market Committee's Tuesday statement that it foresees the federal funds rate remaining at nearly zero through mid-2013, many market watchers see financial Armageddon.

From consumers to Wall Street, the weeping and teeth gnashing over the deficit standoff in Washington and the corollary Standard & Poor's downgrade of American debt was deafening.

Meanwhile, middle-market M&A activity has continued to chug along. Year-to-date, announced deals in the sector stood at 1,358, with a total deal value of almost $31 billion, according to Capital IQ. If that level keeps up, the year could be easily in line with 2010's figures of 2,135 announced deals valued at $55.1 billion.

But economic stagnation and, more to the point, a lack of available lending facilities, may mean problems for middle--market companies seeking to expand through mergers.

In addition to a potential dearth of lenders, tighter regulation will not only require banks to boost their reserves, but also scrutinize their lending processes more closely.

Stephen Czech, partner and portfolio manager for $1.1 billion direct lending hedge fund SJC Onshore Direct Lending Fund LP, says he saw two middle-market deals fall apart last week when buyers pulled their bids. (Czech's fund was formerly with FrontPoint Partners LLC, but is finalizing a spinoff, according to a person with knowledge of the situation.)

"The economy is at stall speed right now; there's a 50% chance of a negative GDP," Czech says.

"Buyers will wait until things stabilize, while sellers are thinking, 'Why would I take 5 times Ebitda when I think [the company] is worth 8 times?' " he explains.

Nonetheless, Czech's fund — and other alternative lenders — continues to work with the middle market. SJC's direct lending fund is now 60% deployed, Czech notes.

Two to three months ago, the market belonged to borrowers, according to Leonard Tannenbaum, chief executive of business development corporation Fifth Street Finance Corp.

"Banks were shifting to commercial and industrial exposure, which increased the supply of capital," Tannenbaum says, "while alternative lenders also had plenty of money to put to work."

Market volatility, however, will likely make it harder for alternative lenders to raise capital, he says.

Still, Tannenbaum takes a contrarian view to the doomsday scenario ushered in by the Fed's depiction of an economy stuck on reboot for two years. Before the FOMC statement, Tannenbaum had to price into his calculations an expectation that interest rates would go up.

The Fed move, however, "allows firms like us to understand what the cost of capital is above a longer time — certainty helps," he says.?