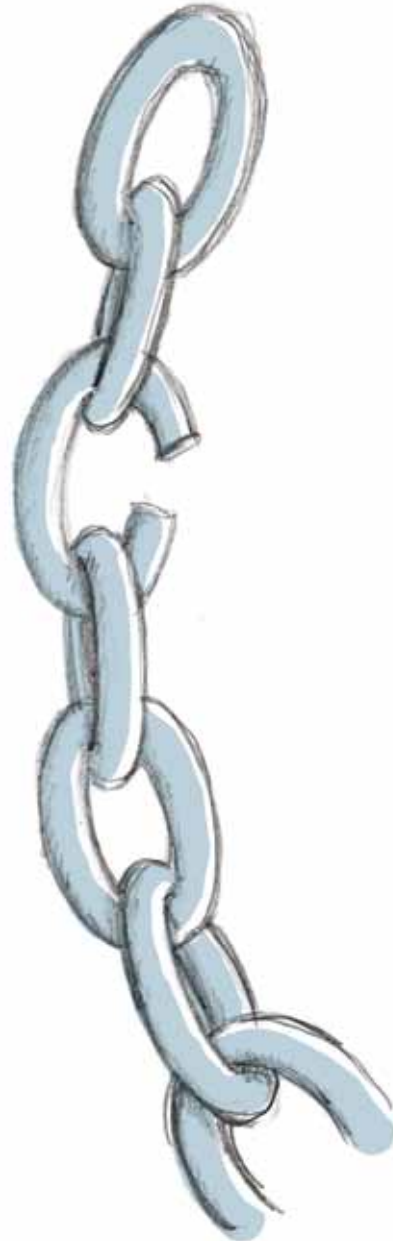


# The debt effect



### About the author



**Harris Smith**  
Managing Partner, Private Equity  
Grant Thornton LLP

Harris Smith possesses a deep understanding of the accounting and business issues of several industries, including manufacturing, distribution, construction and service, and has served clients ranging from large owner-managed organizations to publicly traded multinational corporations.

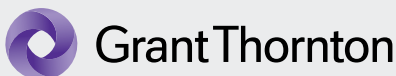
Smith is a member of Grant Thornton's national leadership team overseeing services to private equity firms. He is responsible for the development of strategic relationships for the firm, working closely with private equity firms and their portfolio companies.

Smith has more than 30 years of public accounting experience. He started his career in the Baltimore office of Grant Thornton in 1976. He was later promoted to partner, and in 1989 he relocated to the Southern California office to head up its Audit practice. In 1998, Smith was promoted to office managing partner of the Greater Bay Area offices, and in 2003 he became the West Region managing partner. In 2008, Harris became the Audit practice leader for Southern California and managing partner of private equity for the firm.

Smith is a director and immediate past chairman of the Association of Corporate Growth (ACG). He served as director of the San Francisco chapter of ACG beginning in 2000 and as president in 2003. He is a member of the California Society of Certified Public Accountants and the American Institute of Certified Public Accountants.

Smith graduated from the University of Baltimore with a bachelor of science degree in accounting.

### About the sponsors



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# Executive summary

The challenges that banks and other lending institutions continue to sort through have substantially impacted private equity deal-making. This white paper explores how the trouble in the banking industry is altering the way the private equity community conducts business.

To explore this issue, Grant Thornton decided to seek out experts who deal with private equity transactions every day. These experts include lenders, dealmakers and attorneys. In addition, Grant Thornton searched many data points including those of Association for Corporate Growth (ACG)-Thomson Reuters surveys, as well as *Dealogic* and Standard & Poor's Leveraged Commentary & Data (LCD). Through different sources and original reporting, Grant Thornton compiled this white paper, which gives readers a better understanding of how deal-making is surviving without readily available leverage and what dealmakers can expect from lenders in 2010 and beyond.

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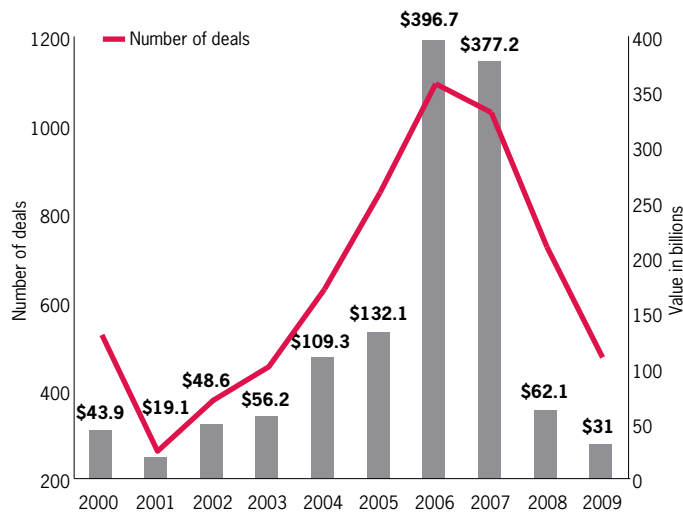
The challenges that banks and other lending institutions continue to sort through have substantially impacted private equity deal-making.

# The current environment

2009 was a difficult year: America persevered in what many commentators consider the largest financial crisis in history. The U.S. banking system collapse led to the banking industry all but shutting its doors. This severely hampered every aspect of economic growth. Private equity firms and their portfolio companies were no exception. With very little leverage available to complete deals, private equity deal-making came close to a standstill last year. In 2009, U.S. deal value hit its lowest total since 2001. In 2009, only 474 private equity deals were completed for a total of \$31 billion. That pales in comparison to the 724 deals completed for a total of \$62 billion in 2008, which was also a less than stellar year for the industry. (Figure 1) Instead of working on new deals, because it was nearly an impossible feat, private equity firms focused on trying to keep their portfolio companies as healthy as possible.

Figure 1

## Private equity deal volume (U.S.)



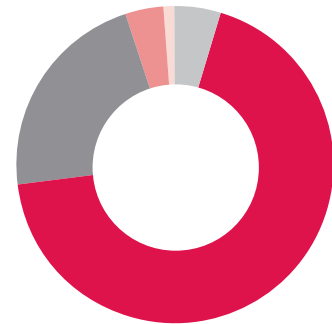
Source: Dealogic  
Excludes add-on acquisitions

It would be extremely difficult for the U.S. economy to withstand another consecutive year as grave as 2009. The same goes for private equity. The good news is that it seems unlikely that either will have to. A global recovery is under way, albeit slowly, and there are reasons to be cautiously optimistic about 2010 and beyond. In 2010, many lenders that were absent from deal-making in 2009 are expected to return to the market. (Figure 2)

Figure 2

## How favorable do you expect the debt markets to be six months from now?

- Much better 5%
- A little better 69%
- The same 22%
- A little worse 4%
- Much worse 1%



Source: ACG-Thomson Reuters DealMakers Survey<sup>1</sup>  
Note: Total does not equal 100% due to rounding.

<sup>1</sup> ACG-Thomson Reuters DealMakers Survey polled more than 920 investment bankers, private equity managers, corporate development officers, lawyers, accountants and business consultants in October and November 2009.

Many banks have begun to lend again cautiously, a handful have shut their doors for good, while others continue to work through challenges.

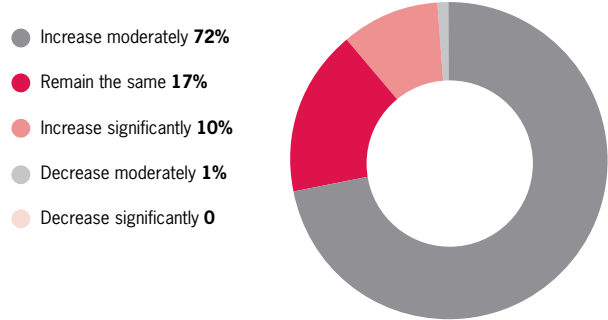


There have also been new entrants launching lending programs. In addition, sellers' pricing expectations seem to be falling more into line with buyers' offerings. These positive events, coupled with the overall economy slowly making a comeback, are expected to make 2010 a stronger year than 2009 for private equity firms. Dealmakers are counting on this. According to the ACG-Thomson Reuters DealMakers Survey<sup>1</sup>, 72 percent of respondents expect mergers and acquisitions (M&A) volume to increase over the next six months. (Figure 3)

However, neither the economy nor private equity is out of the woods yet. 2010 will still be challenging. The economy will remain fragile, and banks' performance and plans are still all over the map. Many banks have begun to lend again cautiously, a handful have shut their doors for good, while others continue to work through challenges. In addition, more than 600 banks took \$200 billion in Troubled Asset Relief Program (TARP) money. Some of those banks are still shoring up their balance sheets and clearing up bad loans, while others have already repaid the TARP money. All of this is preoccupying. In addition, private equity firms spent a good part of 2009 renegotiating loan agreements with lenders. According to LCD, there were more than 100 disclosed amend and extend agreements made from January 2009 through the end of November, though the number is certainly thought to be higher. The extensions may wind up saving companies from going under, but they also may be just delaying that fate, leading to an increase in number of defaults in 2010 and beyond.

Figure 3

**Compared with the previous six months, during the next six months the number of the M&A transactions will:**



Source: ACG-Thomson Reuters DealMakers Survey<sup>1</sup>

# In with the new

The lending environment will look different going forward for many reasons. First of all, the players have changed. Reuter's Loan Pricing Corp.'s U.S. traditional middle-market league tables show that some of the lenders that used to top the list no longer exist as they once did, and others that might previously have been considered smaller players are gaining market share. In 2007, for example, lenders that dominated included Wachovia, CIT Group Inc., Merrill Lynch & Co. and CapitalSource Finance. For the first three quarters of 2009, names like Golub Capital and BMO Capital Markets made their way onto the league tables, while others mentioned above are no longer there. (Figure 4)

In addition, new entrants like Cincinnati's Fifth Third Bancorp and New York's Amalgamated Bank launched sponsor finance groups in the second half of 2009. Additional players like Regions Financial Corp. have surfaced as potential new lenders.

"The opportunities are there," says Andrew Hauck, senior vice president and senior commercial sales manager overseeing the new division at Fifth Third Bancorp. "There is less competition for lenders, and private equity firms certainly have a lot of money that is not working for them right now. Demand will pick up in 2010, and we want to take advantage of that."

Figure 4

## Middle-market league tables (number of deals)

### 2009

PNC Bank	88
BofA Merrill Lynch	80
Wells Fargo Securities, LLC	42
U.S. Bancorp	22
JP Morgan	19
GE Capital Corp.	12
BMO Capital Markets	11
Golub Capital	11
SunTrust Bank	10
KeyBank	10

### 2007

Bank of America	168
PNC Bank	125
Wells Fargo & Co.	82
JP Morgan	73
GE Capital Corp.	51
Wachovia Securities	40
CIT Group Inc.	34
Merrill Lynch & Co.	31
Madison Capital Funding LLC	18
CapitalSource Finance LLC	26

Source: Reuters Loan Pricing Corp.

Debt multiples contracted significantly last year and will remain contracted in 2010 and probably beyond. All lenders, the new entrants and the old players, are lending at more conservative levels.



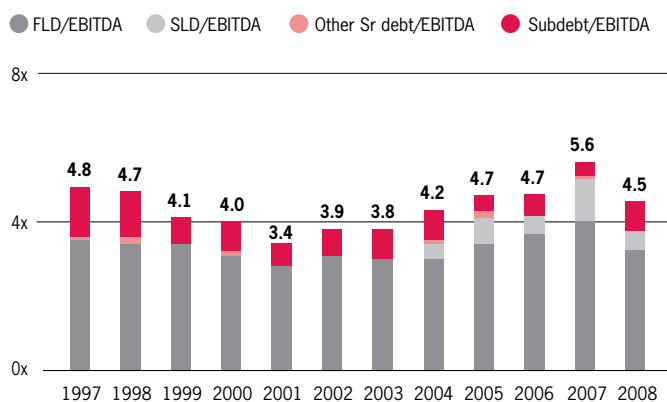
In addition to the big-name banks that are no longer lending, many lenders and asset backed securities — including collateralized debt obligations (CDOs) and collateralized loan obligations (CLOs) — that may not have been regulars on the league tables but helped churn out deals are not as prominent anymore. Some of the lenders that faced challenges in 2009 include Orix USA, CapitalSource, Churchill Capital, NewStar Financial and Freeport Capital. Allied Capital and Patriot Capital Funding were obviously hit hard, as well. In October 2009, Allied agreed to be acquired by Ares Capital Corp., a much smaller company, and Patriot Capital was acquired by Prospect Capital Corp. in December 2009. American Capital, which was a leading middle-market lender, is not even in a position to lend now because their portfolio suffered severely during the downturn. The firm recently shuttered its West Coast office.

“There are a lot of lenders that are in run-off mode and they just don’t care anymore,” says Christopher Williams, a senior managing director and co-founder with Madison Capital Funding. “They want to extract the last dollar out of every amendment or change to a deal because they are getting out of the business. We have had more problems with rogue lenders than with sponsors.”

In addition to the faces changing, the terms have morphed. Debt multiples contracted significantly last year and will remain contracted in 2010 and probably beyond. (Figure 5) All lenders, the new entrants and the old players, are lending at more conservative levels. “The mind-set has changed,” says Marti Kopacz, national managing principal of Corporate Advisory and Restructuring Services at Grant Thornton. “The banks are much more conservative with their coverage ratios.”

Figure 5

**Average debt multiples of middle-market LBO loans**



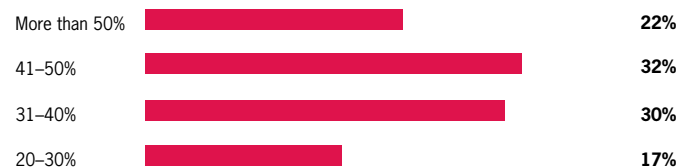
Source: Standard & Poor’s Leverage Commentary & Data  
 Defined as “Issuers with EBITDA of less than \$50M”

The good news is cash flow loans are making a comeback; the bad news is the number of institutions offering them has declined significantly from the 2005 to 2007 time frame.

The banks that still have TARP money are operating at even more conservative levels as loan officers operate under a microscope. In addition, in the old world, deals could be completed with as little as 10 percent of equity; in the new world, north of 40 percent equity is likely to be required to complete a deal. (Figures 6, 7)

Figure 6

**How much equity do you expect to put into an average deal in the next six months?**



Source: ACG-Thomson Reuters DealMakers Survey<sup>1</sup>  
 Note: Total does not equal 100% due to rounding.

Figure 7

**Compared to this time last year, the percentage of equity put into an average deal is:**



Source: ACG-Thomson Reuters DealMakers Survey<sup>1</sup>

“Every bank loan officer has to think about how to explain a loan,” says Dennis White, a senior attorney in the Boston office of McDermott Will & Emery LLP. “No one is going to lose their job for *not* making a loan today. Credit committees are risk adverse in the current environment and exercising closer scrutiny.”

Lastly, during the heydays, cash-based lending ruled; however, asset-based paper has been very popular over the last 12 to 18 months due to the liquidity shortfall on the cash flow side. The good news is cash flow loans are making a comeback; the bad news is the number of institutions offering them has declined significantly from the 2005 to 2007 time frame. At this point, larger deals are the ones that are seeing these loans returning. According to multiple lending sources<sup>2</sup>, cash flow spreads for deals with over \$75 million in EBITDA got as low as the mid-300s over Libor during the 2005 to 2007 time frame. In 2009, those same deals were being priced in the Libor +600 range; since the end of 2009, the spreads have moved down to Libor +450 with a Libor floor of 200 basis points.



<sup>2</sup>This information was compiled by talking to various lending sources including, GE Antares Capital, Madison Capital Funding and Golub Capital, among others.



Although Regional Banks are stepping up, not enough firms have come in to fill the void. The pricing will return in this area when the lenders get healthier or when new entrants come into the market.

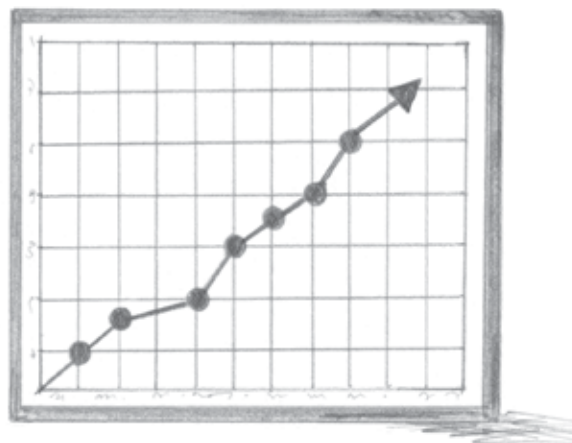
Pinnacle Foods' deal to acquire Birds Eye Foods is an example of how lenders are coming around. Pinnacle Foods, owned by The Blackstone Group, was able to garner \$900 million of covenant-lite loans to help finance its \$1.3 billion purchase of Birds Eye Foods. Senior secured credit facilities and senior unsecured bonds will be provided by Barclays Capital, Credit Suisse, BofA Merrill Lynch, HSBC and Macquarie Capital. This amount of debt could not have been raised just six months ago.

"The larger market is seeing a quicker recovery than the middle market," says David Brackett, a senior managing director with GE Antares Capital.

Indeed. It's a different story for deals with under \$75 million in EBITDA. According to multiple lending sources<sup>2</sup>, pricing for these smaller deals was at Libor +600 with a 3 percent floor in 2009. By early January 2010, pricing had come down slightly, to about Libor +550 with a 2 percent floor.

"We won't see as much movement in the lower end of the middle market," says Brackett. "The smaller base is populated by a lot of finance companies that are facing challenges. Although Regional Banks are stepping up, not enough firms have come in to fill the void. The pricing will return in this area when the lenders get healthier or when new entrants come into the market. I think we will see a little of both. Either way, I don't think multiples for this size deal will go north of 3.5 times EBITDA this year. I just don't see it."

In addition, for 2010 there will still be a reduced number of institutions providing cash flow loans, but the groups that do provide them should provide enough deal appetite to get the deals coming to market financed. "Banks are trying to get back on their feet," says Robert Gay, a managing director and co-founder of Huntsman Gay Global Capital. "We haven't seen a huge resurgence of cash flow lending, but things are rebounding. We had a letter of intent to complete in January; we have had 12 banks show interest. In July, only four banks showed interest."



# Grant Thornton's view



Assuming that loans that were extended through 2010 start getting repaid as expected and the economy continues to stabilize, lenders will continue to slowly put debt back into the market. In fact, by the fourth quarter of 2009, banks had underwritten more than \$6.5 billion in loans to back private equity deals. This comprised half the debt that was raised to fund all LBOs in 2009, according to LCD. At the end of the year, we did see a couple of larger deals that were able to access leverage. The Birds Eye deal, Clayton Dubilier & Rice's \$1 billion buyout of JohnsonDiversey, and TPG and Canadian Pension Plan Investment Board's \$1 billion buyout of IMA Health all garnered leverage.

Still, for the most part, banks and nonbank lending institutions will continue to lend at the multiples we are currently seeing. No one should expect lending levels to increase because in reality, lending multiples aren't that far off from before the leverage boom. And lenders are performing more due diligence than ever before. No lender wants to make a risky loan in today's environment. Banks that haven't repaid the TARP money are even more reluctant to make a wrong move with the government looking over their shoulders.

"There will be more due diligence," says Grant Thornton's Kopacz. "The error in the hyperliquidity market was that there was so much capital in the market that no one did due diligence. No one worried because there was always someone out there that would buy the loan. When the hyperliquidity started to deteriorate and there wasn't a market for every loan, trouble began."

In addition, buyers need to be careful about whom they tap as their debt provider. There has been shakeout in the lending market already, and more changes are expected. Every day the lending community is changing. While CDOs and CLOs were largely sidelined in 2009, some firms are trying to raise them again. JPMorgan Chase, Wells Fargo & Co., Bank of America and Citigroup are being asked to underwrite new CLOs for firms such as NewStar Financial; Silvermine Capital

Management, a hedge fund; and Caixa de Catalunya, a Spanish bank. Wells Fargo Securities expects new issuances of CLOs to reach \$3 billion to \$6 billion this year, which are still small numbers considering CLO issuances swelled to about \$100 billion in 2007, according to Credit Suisse. CLOs bought nearly two-thirds of the debt that financed leveraged buyouts in the first half of 2007. According to *The Wall Street Journal*, that had shrunk to about 20 percent by the middle of last year as issuance of new CLOs fizzled out when the credit crunch made it difficult for investors to borrow money to create these vehicles.

The return of these vehicles is not surprising. Banks are still in the process of deleveraging, and their lending capacity is limited so there is opportunity once again for alternative credit vehicles to satisfy loan demand. However, there is still uncertainty about what type of reception these vehicles will receive from investors in today's market.

Additionally, it is important to note that CDOs and CLOs at their core are not a problem. Collateralizing and packaging loans isn't more risky than other instruments — the problem was that these instruments kept getting more and more exotic in hopes of providing a return without the risk, which is impossible. Over the past 10 years, these products became more complex, more of a gamble and less of an investment. Investors never planned on the collateralized assets to depreciate and for there to be more junk than high-quality assets bundled together.

Overall, lenders will be more choosy about whom they do business with. Lenders will seek out sponsors that will let them know about portfolio problems immediately and that will work with them to figure out the best solution. During 2008 and 2009, sponsors waited too long to alert their lenders of problems, leaving lenders in a very precarious position. Lenders will also be carefully considering with whom they will syndicate loans. They do not want to get into a deal with a lender that will not be in business 12 months after completing a deal. "We only want to do business with other lenders that are thinking long term," admits Madison Capital's Williams. "We have become very vocal about which lenders we will partner with now."

## Recent lender consolidation

Sept. 2008	JPMorgan Chase acquires Washington Mutual
Oct. 2008	Wells Fargo acquires Wachovia
Jan. 2009	Bank of America buys Merrill Lynch for \$50 billion
Oct. 2009	Ares Capital Corp. agrees to buy Allied Capital for \$648M
Nov. 2009	CIT files bankruptcy
Dec. 2009	PNC Bank acquires National City Bank for roughly \$6.5B
Dec. 2009	Prospect Capital agrees to acquire Patriot Capital Funding
Jan. 2010	CIT emerges from bankruptcy

Compiled by Grant Thornton

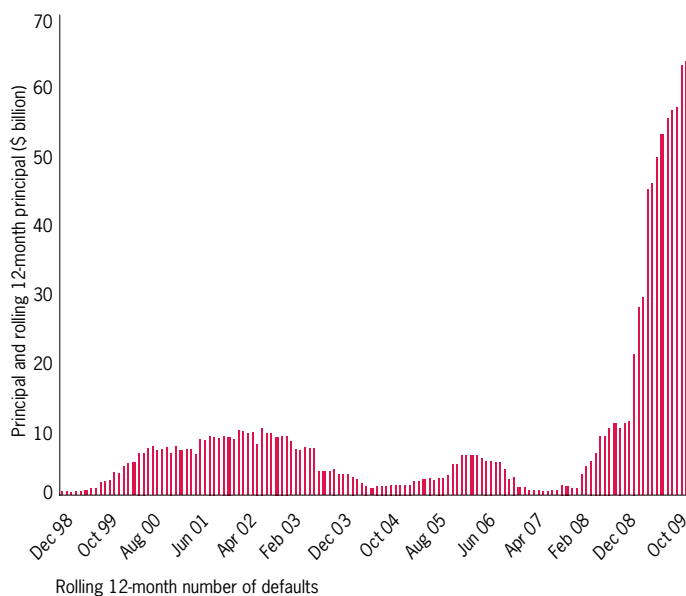
# The good, the bad and the ugly

In the years prior to the financial market collapse, deal structures simply became too lenient. Covenant-lite loans removed lenders' ability to see the warning signs of a deal going south, amortization rates became excessively low, and competition to fund deals fueled the private equity market to reach for unwarranted levels of leverage. At some point this had to come to an end. Unfortunately, it came to a crashing end. 2009 saw a lot of carnage brought on by prior years of excessive lending.

According to Moody's, over 50 percent of the deals done between 2004 and 2007 by big private equity funds are now either in default or distress. In addition, according to LCD, the default rates continue to climb. (Figure 8) Dealmakers also expect to see many distressed deals in the first half of this year. (Figure 9)

Figure 8

## 12-month default rate



Source: Standard & Poor's Leverage Commentary & Data and S&P/LSTA Leveraged Loan Index

"We aren't through the bankruptcy cycle yet," says Huntsman Gay's Gay. "There are companies that have hung on. We looked at a lot of weaker companies for add-ons, and there's a lot off distress. The stronger players will be able to take advantage of that in 2010."

In response to the increased number of distressed deals expected to come down the pike, some private equity firms have set up new funds to buy debt that can then be converted into equity when the company is restructured. "This will continue to be an opportunity because so many deals are getting kicked down the road, in hopes of an improvement in the overall economy," says Tim Skillman, a principal of Corporate Advisory and Restructuring Services at Grant Thornton. "Once the fund is the lender on the deal, they may exercise their rights as creditors and push the company toward a restructuring or even into bankruptcy. The restructuring or emergence from bankruptcy may include converting their debt into equity. They wind up owning the company for the value of the debt. Even without the debt for equity conversion, these loans tend to offer a much higher risk adjusted return than other investment options at this time."

Figure 9

## In the next six months, what percentage of M&A deals do you expect to be distressed sales?

- 0%–10% **6%**
- 11%–25% **46%**
- 26%–50% **40%**
- More than 50% **8%**



Source: ACG-Thomson Reuters DealMakers Survey<sup>1</sup>

Whether it's new funds or old funds, 2010 is just the beginning of what is expected to be a very busy time for buyers of both distressed and healthy assets.

Firms that are active in the space include American Securities Capital, Insight Equity, Silverpoint Capital, HIG Bayside, Highland Capital and Third Avenue, to name a few.

Whether it's new funds or old funds, 2010 is just the beginning of what is expected to be a very busy time for buyers of both distressed and healthy assets.

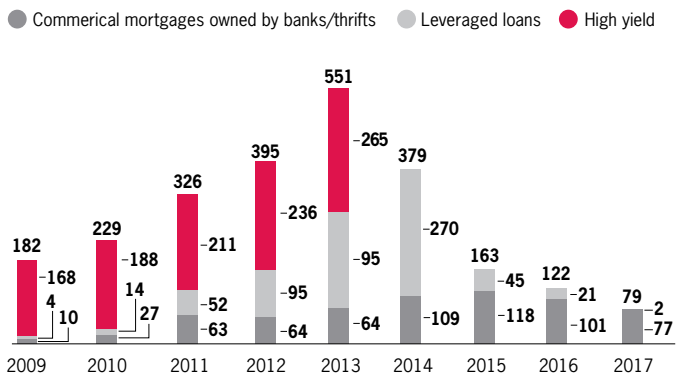
The number of maturing loans will steadily increase until it peaks in 2013. (Figure 10) The opportunities for distress buyers will continue to grow during this time because many companies will not be able to meet their debt obligations. "Some portion of these companies will be okay," says Grant Thornton's Kopacz. "There's still too much debt on them, but they will survive. Others will not make it. We expect the restructuring wave to be a three- to five-year wave. This is only the first year."

Corporates are also beginning to sell off non-core assets. Software company Phoenix Technologies is considering a number of divestitures. The company contemplates selling three product lines: FailSafe, a theft-loss protection solution for laptops; HyperSpace, another operating system upgrade solution provider; and eSupport, a collection of websites and diagnostic software products used to detect and fix computer operations issues. Each of the products is regarded as a non-core asset; the majority of Phoenix's revenues the last three fiscal years were derived from sales of other products and related services, according to *Mergers & Acquisitions Journal*.

"These are typical businesses that middle-market private equity guys would be interested in. This is just the beginning," says Skillman. "We will see a lot of companies divesting non-core assets."

Figure 10

**Maturity schedule**



Source: JP Morgan, Standard & Poor's Leverage Commentary & Data and LCD News



The Boston Consulting Group predicts that half of the companies that have loans coming due will default on their debt by the end of 2011. The results could be devastating.

Other companies trying to avoid bankruptcy have successfully amended their loans. We saw a large number of amend and extend agreements in 2009. (Figure 11) This trend is expected to continue. Skillman explains, “We have seen lenders provide support to companies, and that may have bought time. Now we are looking at the performance. If it doesn’t work out, bankruptcy or some other form of restructuring is where they head next.”

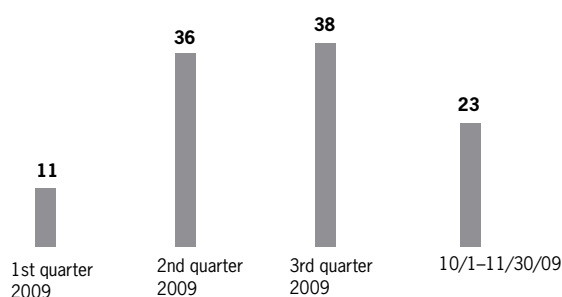
If extensions will save a lot of companies from bankruptcy, and if the economy continues to build momentum and businesses rebound, lenders and investors could make their money back, and in some cases, a profit.

However, the reality is that many of the amend and extend agreements could lead to bankruptcies down the road. A lot of the debt put into companies during the 2005 to 2007 time frame is starting to come due, and it will continue do so over the next few years. According to *The Financial Times*, \$400 billion in bank loans owed by private equity-owned companies will mature in the next five years. The Boston Consulting Group predicts that half of the companies that have loans coming due will default on their debt by the end of 2011. The results could be devastating.

“All the amendments we have seen, and will see, are not surprising,” says GE Antares Capital’s Brackett. “It’s to be expected. That’s why you have covenants, to help get things in line and get you back to the table. Here is where you see who the long-term lenders are versus the opportunistic ones. The CLO and hedge funds don’t think twice about holding up an amendment to get pricing.”

Figure 11

**Number of issuers seeking amend-to-extend, by quarter**



Source: S&P/Leveraged Commentary & Data and LCD News

In addition to distress and bankruptcy deals, 2010 should see a number of healthy assets come to market. Investments banks say their pipelines are becoming full again and buyers are optimistic. “Entrepreneurs have been waiting for earnings to stabilize and the capital markets to come back,” says Jonathan Lynch, a managing director with CCMP Capital. “No one wanted to sell at exactly the wrong time. The lack of debt financing and buyer uncertainty put many sellers on the sidelines. You have a large number of private businesses that were holding out for a better price. They understand they missed the height of the market, and they are thinking pricing might be more attractive now than it was at this time last year.”

However, these deals will not be had at bargain prices. “Pricing is very high for quality companies,” says Geoffrey Rehnert, co-CEO of The Audax Group. “If a company was able to perform through last year, they are demanding high multiples. 2009 didn’t see many quality companies come to market, so buyers are ready and sellers are demanding high prices.”



## Grant Thornton's view

With so many loans maturing, we are bound to see more distress. For many different reasons, banks were willing to push out maturity dates. Of course, it allows the banks to collect more interest, for one thing. In addition, some banks didn't want to be left holding an asset they would then have to manage, other banks believe that portfolio troubles are economy related — not a result of poor management — and lastly, some didn't want to deal with having to show losses. “One of the challenges we saw at the end of 2009 was that TARP borrowers were unwilling to write off debt,” says Kopacz. “They didn't want to show the losses, so they kicked the can down the road. From a restructuring standpoint, it makes it difficult to accomplish the restructuring with a preferred capital structure because the old debt hasn't been completely right sized.”

Businesses will not be able to save themselves if they don't show revenue growth. The economy will rebound, but the damage will have already been done. When things pick up, companies that cut costs to the bone and stopped investing in their companies and new products will be marginalized. This may not be relevant for a year or two, but businesses that remain stagnant will not make it and will wind up in distress. The bottom line is that competition for these assets is expected to be high.

When the economy rebounds, it will give investors a baseline to assess risk and to value companies. As a result, healthy companies will return to the market. 2010 will be a year to make deals, but buyers need to be careful. Pricing will be high for healthy, quality assets and competition will be fierce. Strategics are expected to be active in 2010, as well. They are flush with more than a \$1 trillion in capital, have been anxious to pick up quality assets, and don't depend as heavily on the credit markets to complete an acquisition.

**2010 will be a year to make deals, but buyers need to be careful. Pricing will be high for healthy, quality assets and competition will be fierce.**

# The TARP impact

Anyway you slice it, TARP has affected the lending environment. Some banks took TARP money because they were in dire straits, while others took it because it was an offer they couldn't refuse. Whatever the reason, about 700 banks accepted more than \$200 billion from TARP.

At this point, the nation's four largest banks have returned their TARP money, as have many smaller banks. Although the rush to repay the government was set in motion because compensation levels were going to be affected, repayment to the government is good news on all fronts. It signals that banks have access to more private capital and want to be able to operate more freely again. As Howard Marks, chairman of Oaktree Capital Management, writes in his recent "Touchstones" memo to clients, "First [people] trust the market to come up with solutions. Then the shortcomings of those solutions are laid bare and there's a call for regulation. Then the folly of government involvement becomes evident and people want the free market back ... Governments can't run economies or companies."



## Select banks that have repaid TARP

Bank of America	\$45.0 Billion
Citigroup Inc.	\$45.0 Billion
Wells Fargo & Co.	\$25.0 Billion
JPMorgan Chase & Co.	\$25.0 Billion
Goldman Sachs Group Inc.	\$10.0 Billion
Morgan Stanley	\$10.0 Billion
Bank of New York Mellon Corp.	\$3.0 Billion
State Street Corp.	\$2.0 Billion

Source: Reuters

With repayment under way, banks will be freer to make loans again. While President Obama was urging banks to increase their lending activity during the TARP era, the Treasury Department urged banks to increase their capital levels. This resulted in TARP recipients being gun-shy to lend. "They were not able to take on as much risk with the government involved," says Ben Gonzalez, a partner in Grant Thornton's Corporate Advisory and Restructuring Services division. "Now they can charge risk-based premiums based on a particular credit profile, which yields higher returns."

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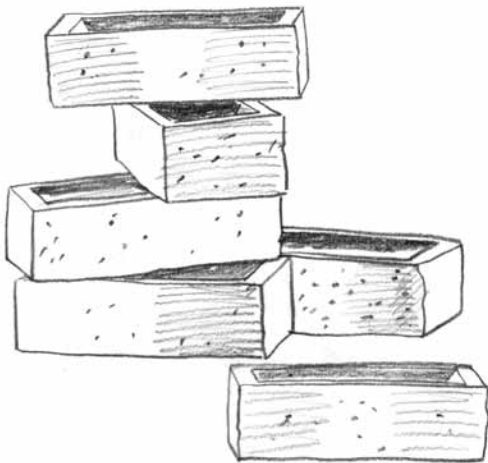
Some bankers whose banks took TARP say that while they haven't been using it to make new loans, borrowers should be comforted by the fact that these banks are more financially sound.

Banks that took TARP money and have not paid it back are at a disadvantage because they have more regulatory hoops to jump through, making them slower to commit to a deal. "In a lot of processes we can start at the same time, and we can sign the deal up before they can even get credit approvals," says Lawrence Golub, president of Golub Capital.

Huntsman Gay's Gay agrees. "Banks that didn't take TARP tend to be more responsive."

Still, the majority of banks that needed and took TARP money will be stronger going forward. In fact, some bankers whose banks took TARP say that while they haven't been using it to make new loans, borrowers should be comforted by the fact that these banks are more financially sound. "There's no doubt we are stronger now, and that should be reassuring," says one lender.

It certainly helped these banks survive. "The flood of liquidity infused by the Federal Reserve has to a certain extent prevented further distress," says Anjan Thakor, John E. Simon Professor of Finance and Senior Associate Dean of Programs at Washington University's Olin School of Business. "TARP unclogged the credit markets somewhat. Providing capital and liquidity to financial institutions facilitated the survival of these institutions, which helped calm the markets down."







## Grant Thornton's view

With the exception of a few banks, TARP successfully helped stabilize banks' financial position. CIT Group, which took \$2.3 billion of TARP money, filed for bankruptcy protection in November of 2009. This was a devastating blow to middle-market businesses, sponsors and the government, which is said to have lost its whole investment in the bank. CIT was a mainstay on the U.S. middle-market league tables. Its bankruptcy created panic and fear because it is one of the biggest commercial lenders to small and middle-market companies. However, the bank's ability to emerge from bankruptcy after just 38 days underscores the recovery in the markets. Perhaps telling, under its restructuring plan the bank said it is relying on capital from private investors and no aid from regulators.

The banks that still have TARP money are more reluctant to lend because they have been put on notice from the government. "The issue with government involvement is that the rules can change at any time and you can't fight City Hall," says The Audax Group's Rehnert. "Until these lenders pay back the government, they do not want to cause conflict or be accused of any misconduct."

Still, it's better for dealmakers to work with a bank that took TARP money and has paid the money back, than with a bank that is still struggling.

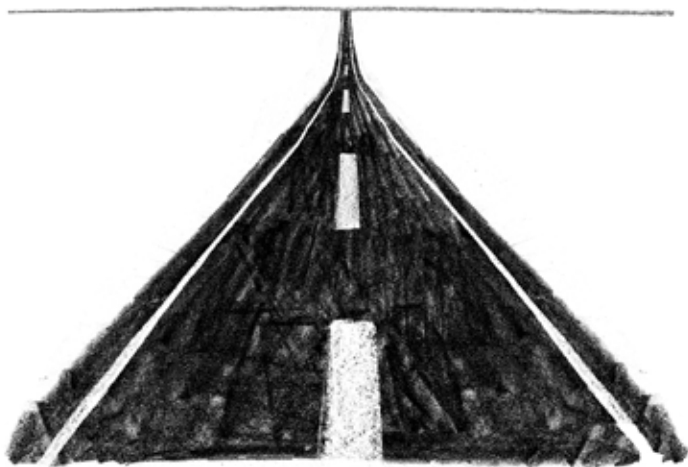
Every private equity firm should be doing due diligence to make sure it partners with solid lenders. The fact that a bank took TARP money should not be a deterrent. "We don't draw a distinction. We know the lenders we trust and want to work with," says CCMP Capital's Lynch. "Instead of finding one bank to underwrite all of a transaction's leverage, you now need to work with multiple lenders. This has made the lending process more complex, but the market has been like this over periods of time before and we have successfully dealt with it."

Going forward, if banks are not lending and are looking for government handouts, borrowers should remain wary. "If banks are not lending, there is a reason — excess leverage that has not been shed yet and the lack of good credit opportunities," says Thakor. "Trying to loosen credit markets through government intervention is simply inviting the same problem to return — excess liquidity and excess leverage that combined to produce an unsustainable price bubble."

**Going forward, if banks are not lending and are looking for government handouts, borrowers should remain wary.**

# Conclusion

We project a slow, gradual increase in deal volume. 2010 is not the year to be overly optimistic, but we expect it to be stronger than last year. The economy is not robust, the job market is still off-kilter, and there hasn't been any huge lending surge in the private equity market, but things are quietly picking up. With all the distressed companies in need of capital, pent-up demand for sales of healthy assets, and the slight thawing of the lending markets, 2010 could prove to be a solid year to start making deals that yield strong returns.



The economy is not robust, the job market is still off-kilter, and there hasn't been any huge lending surge in the private equity market, but things are quietly picking up.

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