

US Market Report Overview

After destroying the market for big private equity deals, the credit crunch is now taking its toll with smaller deals.

Lenders are increasingly unwilling to finance acquisitions by middle-market firms, the ranks of private equity buyers have thinned even more and strategic buyers are adding on more terms to protect themselves amid the credit crisis.

"A year ago, it was the large cap deal that was mostly affected by the credit crunch," said Mary Lou Malanoski, Managing Director of Capital Markets for **Morgan Joseph & Co.** "It's definitely pinching the mid-market at this point."

Worldwide, the value of middle-market deals in the third quarter fell 23% to \$109 billion, according to

Mid-market Deals

Date Period Ending	Base Eq. Price (\$mm)	No. of Deals	Price Disclosed	Price Not Disclosed	% of Total
*02-Oct-2008	2,070.1	40	40	0	0.33
30-Sep-2008	109,504.9	2,070	2,070	0	17.41
30-Jun-2008	110,736.7	2,296	2,296	0	17.61
31-Mar-2008	114,564.5	2,383	2,383	0	18.21
31-Dec-2007	149,428.1	3,132	3,132	0	23.76
*30-Sep-2007	142,677.9	3,191	3,191	0	22.68
Total	628,982.1	13,112	13,112	0	

* May represent incomplete date periods

FactSet Mergerstat. The number of deals during the quarter was down even more, falling 34% from a year ago.

To be sure, it's the high profile deals that are bearing the brunt with more transactions ending on worries about credit. Cigarette maker **Altria Group** Inc. said it would not close its \$10.3 billion acquisition of **UST** Inc. until next year. Altria had wanted to access the public markets to help refinance its debt, but the credit crunch has made any kind of debt offering more difficult.

But smaller deals, too, are feeling the toll. Video conferencing gear maker **Tandberg** ended talks with a private equity group over a possible sale as it was "impossible to achieve acceptable pricing and financing conditions," the company said. The management-led buyout of California real estate management company **SonomaWest Holdings** Inc. was put on hold due to problems in the credit markets.

The decline in mid-market M&A stems from the wariness of buyers to expand in the current economy and sellers to accept lower prices. When the two parties can agree, it's the third party – the lender – that is showing more problems.

The troubles at **Wachovia** Corp., which is now being sold to **Wells Fargo & Co.**, has cast uncertainty over whether its middle-market lending unit, **Wachovia Capital Finance**, will be in the market to provide deal financing. Mid-sized banks which were also commercial

lenders – **Fifth Third Bancorp**, **National City Corp.**, and **U.S. Bancorp** – are also reining in some of their commercial lending as they deal with mortgage-related issues on their balance sheets.

Malanoski has had to deal with the fallout first hand after five potential lenders pulled term sheets on a recent deal.

“They must have got a memo from higher up,” Malanoski said. “It’s really been in the last three weeks that lenders have said, ‘I need to stop’.”

Those that are still lending are reining in the leverage they are willing to tolerate. At best, lenders will only finance around three to four times EBITDA, compared with up to five times EBITDA during the first half of the year.

Tightening credit hits private equity buyers the most. While financial bidders once outnumbered strategic bidders on middle-market deals, the number of strategic bidders now matches private equity bidders. For those financial buyers that can get debt financing, they have to put 60% or more equity into a deal.

As potential buyers hit their credit limit, sellers have to put in some of their own financing to help close a deal, says Charlene Davidson, Senior Managing Director at **McGladrey Capital Markets** LLC.

“We are seeing seller financing being used more often, either because the buyer requests it or the seller offers it,” Davidson said.

Davidson said that many lenders are still able to provide financing, yet they are becoming much more stringent to whom they lend. Financing commitments have

tighter covenants and lenders are scrutinizing inventories and other physical property more closely in asset-based loans.

Buyers, too, are putting in more protection on deals, with earn-outs becoming more common as a way to keep sellers on their toes after a deal. And material adverse change clauses are being written more specifically so buyers will have better ammunition to get out of a deal. For their part, sellers are calling for more break-up fees, especially in light of the many buyouts that have already gone awry.

Davidson says that deals, while they are still happening, are taking longer due to the increased diligence and more careful scrutiny from all sides.

“The volatility in the market is not normal,” Davidson said. “It can make somebody miserable one day, then happy the next. You want to be sure you have a tightly written deal so people can be satisfied with the outcome.”

Michael Angell, New York, mangell@factset.com, 212-476-8643