

The Deal

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ANATOMY OF A MIDDLE-MARKET LENDER

FOR
GOLUB CAPITAL,
THE CHANCE
TO PARTICIPATE
IN A
MIDDLE-MARKET
BUYOUT
MEANT WEEKS OF
PREPARATION,
THOUGHT AND
POSITIONING.
HERE'S HOW
THE PROCESS
WORKS

by MAX FRUMES

ON MARCH 16, Andrew Steuerman, a senior managing director at New York-based Golub Capital Inc., knew there was an excellent chance he and his team had won the mandate on a highly coveted loan. With the first quarter drawing to a close, lenders to the middle market like Golub were just beginning to glimpse a better deal market on the horizon. So many transactions had been slated for year-end 2010 because of what turned out to be a moot tax issue that the start of the New Year was frustratingly slow. Corporate lenders had already devoured more than enough refinancings and needed time to digest them. Refinancings in the middle market would account for \$20.6 billion in the quarter, compared with \$14.3 billion in new money, according to statistics from Thomson Reuters Loan Pricing Corp. And the debt market had become overheated, with investors coming into the loan market seeking yield wherever they could find it, even in the middle market or in exotic financing structures not seen since before the financial crisis.

However, debt investors salivated at the prospects of companies just beginning to show the earnings consistency that could attract acquisition interest.

March 16 was just a single day in the life of the middle market, but for Steuerman and his team at Golub Capital it represented the culmination of weeks of thinking, preparation and planning. Golub is a player in sponsored middle-market financing, much of which involves lending to companies with up to \$50 million of EBITDA. We had been following Golub for several weeks, focusing on the mechanism by which a single deal gets financed—and how lenders identify deals, compete for mandates, set terms and execute fundings.

Golub Capital has been around since 1994 and, like many of its competitors, saw volume fall during the financial crisis, credit crunch and recession. But markets were slowly reviving in 2010. By the first quarter of 2011, middle-market lending rose 61%, compared with the same quarter in 2010, to \$34.9 billion, according to Thomson Reuters LPC, after a record \$58 billion in the fourth quarter of 2010. The demand for these deals from investors in debt produced increasing inflows to funds committed to the middle market:



Within the U.S., upper midmarket funds—or those with between \$1 billion and \$5 billion in assets under management—raised \$8.7 billion during the first quarter of 2011, more than 3 times the amount during the same period in 2010, according to Dow Jones & Co.'s LP Source, outpacing their larger counterparts.

With a deluge of middle-market M&A expected, a consolidated group of lenders, including Golub Capital, developed

Golub
middle man

and exploited sophisticated systems and built sector specialties to stay competitive;

in particular data-sharing software has allowed them to provide loan terms and funding quicker than ever before. “The process has shortened” since the credit crunch, says Michael Ewald, a managing director at Sankaty Advisors LLC’s middle-market group, which invests in mezzanine or subordinated debt. “You have to narrow down the possibilities as soon as possible. That’s driven by middle-market investment bankers who want to make sure they can absolutely get the deal done.”

The top five middle-market lenders controlled 54% of the market by dollar volume in 2010 versus 42% in 2007. In general, fewer lead arrangers are getting multiple deals. One of them is Golub.

GOLUB CAPITAL IS BASED on the fifth, sixth and eighth floors of 551 Madison Ave., relatively modest Midtown Manhattan digs (the company is currently looking for new space). The ceilings are low; one wall of the lobby is lined with acrylic deal cubes commemorating various loans. Over the past year or so, Golub has diversified a bit. In January, it started a credit hedge fund. In March, its business development company, Golub Capital BDC Inc., went public. Like other lenders, Golub has begun to emphasize its increasing specialization across certain verticals. In Golub’s case, the focus is on healthcare, software and technology, restaurants, and retail.

The entrepreneur behind the privately funded firm, Lawrence Golub, a former White House fellow and veteran of Allen & Co., Wasserstein Perella & Co. and Bankers Trust, started the business primarily as a growth capital firm investing in debt. However, it switched tactics around 2000, finding more opportunities in mezzanine lending following the dot-com bust, and started building up the ability to make other subordinated loans. But it really made the switch to providing senior and one-stop loans in 2004 when Golub made several key moves.

Tasked with growing the direct lending business was Andrew Steuerman, who joined

in January 2004 from Albion Alliance. The firm needed to combine the talents of rainmakers possessing private equity contacts with capital markets pros gathering real-time market information.

Steuerman fit the bill on the former requirement. He was trained at New York Life Insurance Co. from 1989 to 1997 in the private equity and mezzanine group. Part of his mission there was to invest money in funds and then market to drum up dealflow. But Steuerman had a theory: If he didn't put money in their funds, would they still show him a deal? In 1998, he would get a chance to test that at mezzanine lender Albion Alliance LLC, at the time a joint venture of Alliance Capital Management LP and Albion Asset Advisors LLC. It turned out that an intellectual understanding of what funds needed in a loan was enough to drum up business in lieu of a financial quid pro quo. "It worked," he says. "We were smart, focused and knew what we wanted to do."

At Albion, Steuerman financed deals for Lawrence's brother David Golub, who was then at New York private equity firm Centre Partners Management LLC. (He served as Centre's managing director from 1995 to 2003, then founded financing arm Centre Pacific LLC, renamed Churchill Pacific Asset Management LLC, before settling at Golub Capital in 2004.) Through this connection, Steuerman met Lawrence Golub. The firm brought on Steuerman as the front-end originations guy in January. In November 2004, Gregory Robbins joined the firm to build-out Golub's club business. Robbins, who joined from the merchant banking group at Indosuez Capital, is a magna cum laude Wharton undergraduate. Robbins was well-known among the leading senior lead arrangers and was able to develop Golub as a leading club partner. Steuerman's job was to reach out to clients in private equity funds, and, he says, create a "funnel of opportunities."

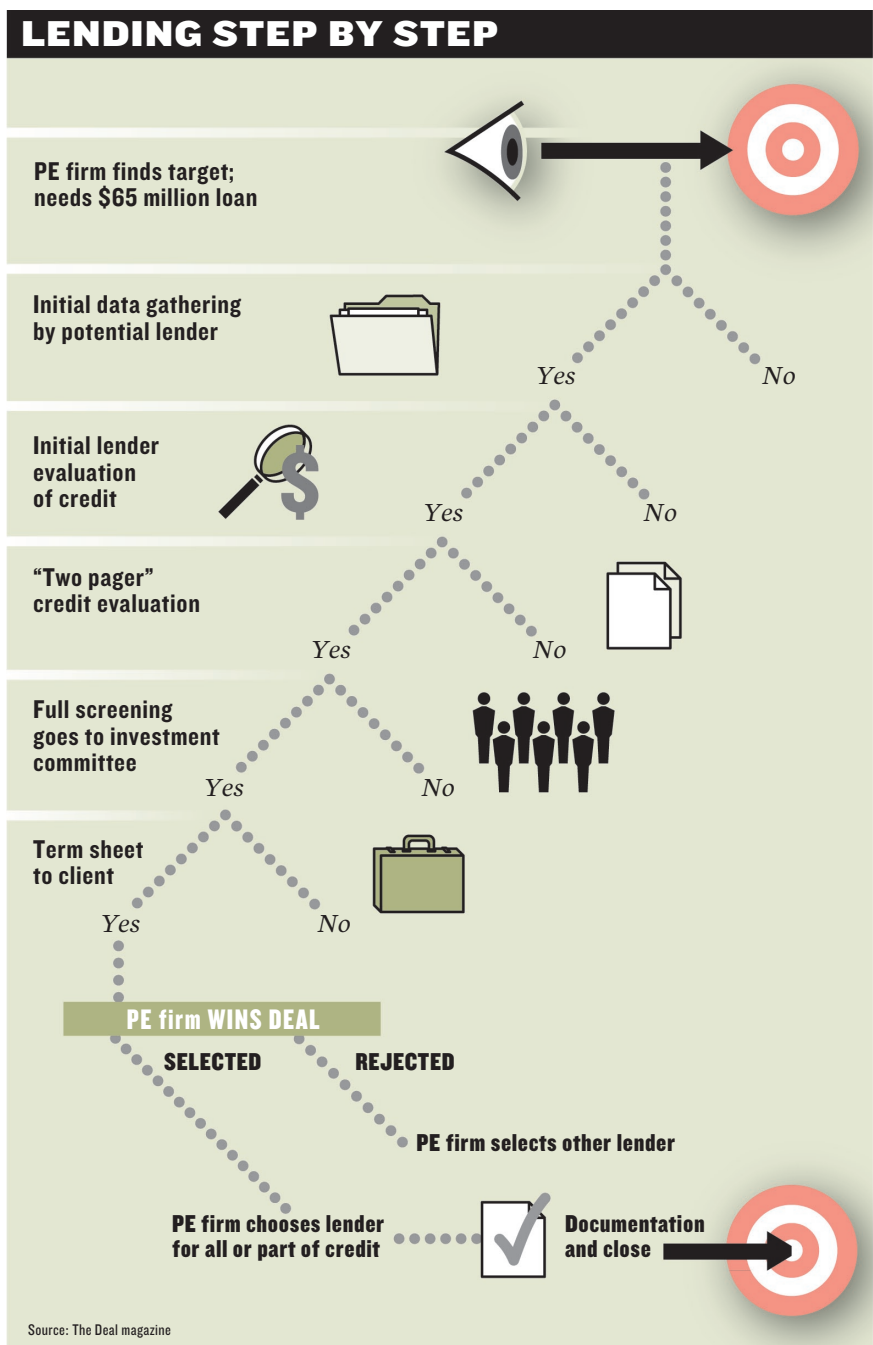
At that point, there were only 12 people at Golub. The firm became a regular senior lender for its own account that year and started lead arranging transactions in 2007. By 2008, it was third by deal volume for lead arrangers of sub-\$100 million leveraged buyout loans. During the 2009 downturn, the firm gained more ground by continuing to lend, "while virtually all of our competitors shut down for the first nine months of 2009," says Lawrence Golub.

Unfortunately, this also meant Golub was funding obligations at what became below-market prices. While two Golub staffers who left in 2003 profited wildly by shorting the subprime market at Cornwall Capital Inc., and were profiled in Michael Lewis' "The Big Short," the

firm may have been lending at a loss compared with opportunity costs. Financially, it would have been better to use money for investments other than lending in that environment, but reputationally, it was the right choice, according to Robbins.

"We don't look at it as a short-term trading operation," shrugs Robbins. "We would have been better off deploying all our capital in the liquid leveraged loan market." But continuing to lend "really solidified our place in the market."

Jason Van Dussen, a managing director in the capital markets group, came to Golub in 2009 after a dozen years at GE Capital Corp. in loan sales and structuring. Robbins met Van Dussen in 2004 when Golub started buying pieces of senior debt GE was syndicating. Van Dussen went on to head up the capital markets team at another midmarket lender, honing his ability to forecast how the market perceives deals, making him an ideal addition to be the "eyes and ears" in the market.



“Even if Golub [Capital] likes something, I need to make sure that the market will believe the reasons we like it and buy off on the same deal we structure,” says Van Dussen.

Today Golub has 120 employees. With over \$4.8 billion in capital for loans and investments, the firm takes on loans of \$200 million or less, and mainly \$100 million or below. With that criterion, it can work with firms with anywhere from \$200 million to \$3 billion in assets under management, such as Monitor Clipper Partners and Falconhead Capital LLC, two firms Golub provided loans to in 2010. The professional direct lending group now employs some 40 people, while the broadly syndicated group, which mainly looks to buy pieces of loans greater than \$200 million, has eight.

These days Golub finds itself in a competitive market with some big rivals. No matter how you slice it, the top middle-market lender by both dollar value and deal volume for PE-sponsored middle-market deals is GE Capital. Bank of America Merrill Lynch tops commercial bank representation for sponsored middle-market lenders. Investment banks such as RBC Capital Markets and financial companies such as Madison Capital Funding LLC make up the rest of the volume. Generally, financial companies can provide more flexibility for deals, desired by private equity firms that need to make dramatic changes in their portfolio companies. Commercial banks have more amortization requirements but lower rates.

STEUERMAN SPORTS a pair of New York Mets cufflinks and speaks in excited bursts of precise information. He’s talking about the then-current M&A markets. “They’re not frothy,” he says. “They’re not at ’06, ’07 levels.” Because of the paucity of M&A, some deals draw a lot of attention. “It’s kind of a joke, but every week or every other week, there’s ‘the deal’—the book that comes out that everybody is excited about,” he says.

On March 16, Vision Source LP is that deal. In the months leading up to March, close to 10 private equity firms began circling Vision Source, a supplier for optometry and dental businesses from Kingwood, Texas. Charlesbank Capital Partners LLC and H.I.G. Capital LLC were spinning Vision Source out of its parent company, TLC Laser Eye Centers Inc., which they had bought out of bankruptcy for \$134.4 million in May 2010. To make matters more competitive, each of the firms was working with several potential lenders. “I think every lender in the industry was probably on this deal and liked it,” says Van Dussen.

Golub Capital trawls the great sea of the middle market for lending opportunities by essentially creating a giant brain trust through software. It tries to balance the

need for rapid exchanges of information among multiple parties with retaining and protecting proprietary information.

Each of Golub’s 52 investment professionals—based in Chicago, Atlanta and New York—methodically uses a specially modified version of SalesLogix, software made by Sage Software Inc., to enter data on capital structures, deal notes and deal histories that they can then share with one another. In syndicated deals, Golub’s professionals share data with potential debt buyers via SyndTrak, a specialized system for syndications that tracks income, fees, interest levels, commitments and administrative details.

This information circulates to everyone at Golub working on a deal and allows them to post documents and distribute content to lenders that may also be looking at it. They track how many books and what industries they’ve seen, what size companies and what size PE firms they’re looking at.

To keep tabs on clients, Steuerman has a report in a spreadsheet called “touches and books.” He pulls a table with Golub’s client base from SalesLogix and then tracks their interactions. “Touches” are a meeting or a visit, and “books” are deals they’ve shown Golub. This way, Steuerman determines which clients give them the most business—or if that client shows deals but has never closed one with the firm.

**From top
Steuerman,
Robbins,
Van Dussen**

In 10 years of being in the lending business, the firm has closed deals with more than 100 private equity firms and multiple deals with more than 50.

Golub is a lender that focuses on being the lead arranger of deals, where they provide at least \$35 million to \$40 million and invite two or three other lenders into their club to take the balance. The notion of a club also has another connotation. “It’s a clubby environment; you’re either in or you’re out,” says Robbins.

If you have a larger senior deal of \$200 million, it could involve six or seven banks. That means there’s a lead agent, or two, who then recruit other lenders. The more lenders you need, the more complex it becomes. Very occasionally, a loan of more than \$150 million will need a rating, which is helpful if you need to sell parts of it to loan buyers like collateralized debt obligation funds.

But these are not standard ratings. There are three sets of ratings, provided nominally by Moody’s Investors Service and Standard & Poor’s. The most common are public ratings, which everyone can get access to. Private-letter ratings are available just to the bank group. And a so-called shadow rating is where each lender submits a packet of information, from most expensive to least expensive, on a post-closing basis. Shadow ratings predominate in the middle market.

Ratings also highlight the difference



between the middle market and the larger syndicated market run by major investment banks. For rated deals, there's a larger secondary market. That's how investment banks are able to get away with holding only small pieces of loans they're underwriting.

"We don't go into a deal thinking, 'Is this deal good enough that we can sell it? ... Even if it's a marginal deal we can make money.' That's the investment bank model," says Van Dussen.

From beginning to end, the team often refers to the lending process as "art and science." That is, mechanization and parameters are involved, but so much comes down to a feeling about the deal.

First, requiring some art, Golub's seven originators, such as Steuerman, source deals from private equity clients—sometimes working directly with a target company itself. When a credit comes in that looks promising—realistic leverage, viable business—the investment team puts together a "two-pager," which identifies the key information about the company, and a financial snapshot, also known as a pre-screen.

A key part of the "two pager" is the "fatal flaw" section, including customer concentration, cyclicity, seasonality or big capital expenditures, any of which could torpedo a deal. It will be routed to anywhere from 10 to 15 people on the investment team, which goes off and does more work, tapping their networks, talking with sponsors, the market, doing modeling and research. The prescreen includes information about where it came from, the name of the lending incumbent, the deal history, business and the team's recommendation.

If the deal passes muster, the team puts together a screening, a thick packet of information that is the equivalent of a confidential information memo. The science part includes in-putting all the information into an LBO Excel model that accounts for cash flows and interest payments. The model calculates margins and capital expenditures, and brings to the fore any tax shield carried forward from previous M&A deals.

The team then assesses whether a company can service the debt with an appropriate cushion. Van Dussen describes the lender's eternal dilemma: "Does your Excel model show you there's enough cash flow to service this debt, or are you making a good company all of a sudden have a bad balance sheet?"

The team takes the screening to the investment committee, which consists of senior originators, senior underwriters and capital markets heads. At least one of the four principals of the firm, along with the four voting members of the investment committee, comprising Steuerman, his direct lending co-head Greg Cashman and the Golubs, will see every deal.

If it's a syndicated deal, and if the team thinks Golub will be the lead underwriter, Van Dussen or Robbins send out five- to 10-page teasers to other lenders they might bring along, loan buyers, collateralized loan obligation funds and business development companies.

How Van Dussen and Robbins gauge the price of a deal is key to how this market works: Again, they talk with people. They go into the market and compare notes with competitors, clients, contacts. Much of the pricing information comes from GE, which will have a bead on just about everything, directly sending information through the large number of its own alumni. Standard & Poor's Leveraged Commentary and Data, which serves as an informal listing service for market terms, also frequently provides pricing terms, according to Robbins.

If the investment committee signs off, the team will recommend the structure and pricing in conjunction with capital markets. Then they hand out term sheets to their clients—they could have several PE clients bidding for the same company—and pray that they win. If they do, the sponsor starts doing more work, including more diligence and hiring consultants and accountants. The team goes back to final committee to highlight outstanding issues. If Golub is selected by the sponsor, the firm closes the deal.

That leaves the funding itself, which is pretty much a non-event by now—the equity funds first, junior funds second and senior funds last. "Everything happens in nanoseconds," says Steuerman.

IN EARLY MARCH, the Vision Source sales process seemed to have come down to two sponsors. Steuerman, who had been continuously checking with others that might be involved—lenders, sponsors, investment banks—finally put the last piece of information together on March 16. Able to triangulate from who was clearly no longer involved, it finally dawned on him: Golub Capital had won.

Technically, Golub's client, Brazos Private Equity Partners LLC out of Dallas, emerged victorious. Golub had worked on a 2010 deal for Brazos that had been withdrawn; Vision Source was thus its first direct involvement with the PE firm. Golub brought in one other lender to take part in the debt, but the package wasn't so large that it needed to be syndicated—and in fact Golub's ability to hold the entire amount if necessary was part of what helped it to win.

The Vision Source deal would eventually close April 13. Brazos and Golub announced it publicly in separate press releases the next day, and the sellers issued an announcement a week later. Golub's release included a laudatory quote from Jeff Fronterhouse, co-CEO and co-founder of Brazos, revealing that Golub helped to win the bid by committing to an aggressively priced fixed-rate loan that "helped us differentiate our offer and win the confidence of the seller," finishing with a tip as to how these deals are supposed to work: "After we were signed up, they worked hard to help us close quickly. We look forward to doing more deals with Golub in the future."

For Steuerman and the rest of the Golub crew, that was music to their ears. Tomorrow would dawn to the prospect of more deals, more talk, more rumors and more closings. ■



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