Mid-Market Companies Find New Solutions With Alternative Financing

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Date: Mar 19, 2014 @ 07:00 AM
Filed Under: Specialty Finance

Related: Debt Financing, Middle Market, Specialty Finance, Turnaround

In today's environment, credit markets have been broadly characterized as yield-hungry and friendly to borrowers. In 2013, leveraged loan volume climbed to $509.6 billion, the highest volume on record either pre or post credit crunch and 55% higher than the year before. For a business with strong profits, a strong position in the market, and a solid asset base, it is a perfect time to refinance existing debt, as lenders are cutting prices and loosening covenants in order to place assets on their books.

However, for many middle-market businesses looking to refinance maturing debt, restructure balance sheets, or secure capital for growth, the experience can be diverse. Traditional sources of capital, such as banking institutions, which must comply with stringent federal regulatory requirements, are more inclined to lend to high-quality companies, as opposed to smaller borrowers that carry an increased level of risk. This is true even for those that offer the potential for greater profits down the line.

Such companies are often referred to by lenders as "storied credits," in recognition that each business has its own distinct story. In contrast to the traditional credit approach, a story-based solution takes an extremely wide-ranging set of factors into account, including those that are unique to a particular business. The story of how it arrived at its current state and where it is headed, profitability, historical and potential future cash flow, asset composition, size, amount of financing required, and importance of cost of capital vs. amount of capital are all considered.

The main challenge in this type of scenario is ensuring that the story of the business is properly matched with the appropriate financing option and lender.

Fortunately for the middle-market, new financing options are being generated, as those that were previously considered alternative capital sources are now becoming mainstream. Most recently, the best resources in the market include business development corporations (BDC), Small Business Investment Companies (SBIC), hedge funds, and specialty finance companies.

When considering these options, it's advantageous to understand which type of loan is best suited for the company at hand, how each of these specific financing vehicles works, and the types of financing that each provide. The readership here is familiar with the two most common forms of debt financing available to middle market companies -- asset-based loans and cash flow loans:

Outside of the most common forms of debt financing that have been readily available to middle-market firms, asset-based and cash flow loans, there are now a host of non-bank financing alternatives for companies in need.

For those that have negative net income, are in the early stages of a turnaround, or have a compelling story to accompany their financial situation, non-bank institutions can be a viable source of funding. These are often the only source of debt financing available for these borrowers, as they are more willing to lend aggressively against the liquidation value of the assets, despite a lack of historical profitability. Since these loans are provided at a greater risk to the lender, they often carry higher rates, currently in the high single to low double-digit range.

SECTOR/ECONOMIC DATA

U.S. Census Bureau – U.S. Department of Commerce

Advance Monthly Sales for Retail and Food Services – February 2014

U.S. Census Bureau – U.S. Department of Commerce

Manufacturing and Trade Inventories and Sales - January 2014

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The following is an outline of two types of alternative sources of financing that are now becoming much more mainstream in terms of availability for middle-market businesses.

1. Business Development Corporations (BDC) and Small Business Investment Corporations (SBIC)

Business development corporations represent what is perhaps the trendiest alternative financing option for the middle market right now. Although BDCs have been in existence since the 1980's, the current environment has caused them to flourish as an alternative source of capital. BDCs must meet certain statutory requirements that may impact their transaction profile. For example, total BDC debt cannot exceed its equity, no investment can exceed 25% of total holdings, and at least 90% of taxable earnings must be distributed quarterly. However, these publicly-traded companies have the flexibility to make both debt and equity investments, enabling them to offer one-stop capital shopping.

In addition, BDCs have an obligation to provide "significant managerial assistance" to portfolio companies. While there can be some risk of loss of control, this support and guidance can be extremely helpful to enterprise growth.

Small Business Investment Corporations (SBIC) are typically private partnerships authorized and regulated by the Small Business Administration (SBA) to provide loans to qualified small businesses in the United States. In order to qualify, borrowers must meet the SBA's definition of a small business, which commonly is a business that has a net worth of less than $18 million and, on average, less than $6 million after tax net income over the previous two years. Certain industries and sectors have special definitions of "small" that may consider aspects such as revenue and number of employees. For more information, visit http://www.sba.gov/content/sbic-program-0.

Both BDCs and SBICs have a much higher level of lending flexibility than a banking institution that must meet strict regulatory guidelines. Although rates are elevated, they are justified by the fact that they are available at a time when other forms of financing cannot be attained, especially at critical times. While these lenders occasionally make asset-based loans, most financings from BDCs and SBICs tend to be supported by cash flows.

2. Hedge Funds and Specialty Finance Companies

On one end of the spectrum there are BDCs and SBICs, which are regulated by the public markets and SBA. On the other end, hedge funds and specialty finance companies are the least regulated of the alternative debt capital producers. For hedge funds, this often translates into a relatively broad mandate to deploy assets up and down the capital structure, with loans priced according to their perceived risk level. While hedge funds are certainly not considered to be a low-cost source of financing, they are capable of taking a more holistic approach to the financing needs of a business and therefore can provide a broader range of solutions.

Specialty finance companies come in all shapes and colors. Many are experts in financing secured by a specific class of assets, such as accounts receivable, purchase orders, machinery and equipment, or property. Given their areas of specific expertise, these companies rarely step outside of their comfort zone. If a company fits the profile, these lenders are often quick to provide funds. If a business doesn't fit the mold, it's best for that company to move on and identify a different type of lender.

With unprecedented liquidity in today's debt markets, the hunt for yield among investors is creating a revolutionized environment. An entire class of debt financing vehicles that was once considered alternative is now seen as viable for the mainstream market.

Whether capital is needed to build a healthy business, turn a company around, restructure a troubled balance sheet, launch an aggressive growth strategy, or invest the assets necessary to meet new purchase orders, these needs can now be effectively matched to creditor-specific risk criteria. When the appropriate option and lender (or lenders) are properly paired with the right business story, recent evolutions in the credit markets can help businesses seize tomorrow's opportunities.

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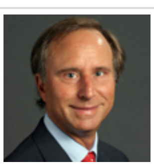

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Warren Feder is the co-founder of the investment banking group at Carl Marks Advisory Group LLC. He has more than 30 years of experience directing and advising on corporate mergers, acquisitions, restructurings, leveraged buyouts, sourcing of capital, and investing. As a former owner and operator of a family business, Feder brings unique insight and perspective to owners of privately-held businesses with regard to helping assess their strategic options.

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