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Alternative Financing Options Go Mainstream For Middle Market Businesses

By Warren H. Feder

Warren H. Feder, Partner, Carl Marks Advisory Group

Today's credit markets have been widely characterized as hot, yield-hungry and borrower-friendly. In the first quarter of 2013, leveraged loan volume climbed to a post-credit-crunch high of $185.2 billion, a hair under the record high hit in the second quarter of 2007. For a healthy company with strong profits, a good market niche and a solid asset base, this is an ideal time to refinance existing debt, as lenders are cutting prices and loosening covenants in order to put assets on their books. But, for many middle market businesses seeking to refinance maturing debt, restructure their balance sheet or secure growth capital, the experience can be quite different. Traditional sources of capital, such as banks, which must comply with more stringent requirements of federal regulators, prefer lending to higher quality companies and frequently turn away riskier, smaller middle market borrowers, even though they offer the potential for greater profits.

Many of these companies are commonly referred to by capital providers as "storied credits" in recognition that each business has its own story. Unlike the traditional credit approach, a story-based solution considers a myriad of factors unique to a particular business, including its story (how it got to where it is and where it is going), profitability, historical and likely future cash flow, asset composition, size of company, amount of financing needed, and importance of cost of capital vs. amount of capital, among others. The challenge, of course, is ensuring the story of the business is carefully matched with the right financing option and lending partners.

Fortunately, the current state of the credit markets is fueling creation of new financing options for middle market businesses, as what were once considered alternative capital sources are becoming more mainstream. In our recent experience at Carl Marks, the hottest choices in today's market include business development corporations (BDC), Small Business Investment Companies (SBIC), hedge funds and specialty finance companies.

In considering these options, it is helpful to better understand which type of loan is best suited for your company, how each of these financing vehicles works and what types of financing they provide. In broad strokes, the two most common forms of debt financing available to middle market companies are asset based loans and cash flow loans:

Asset-Based Loans

Asset-based loans (ABL) primarily consist of revolving credit facilities, with borrowing availability determined by the amount of underlying collateral securing the loan. Accounts receivables and inventory generally serve as primary underlying collateral for a revolving line of credit with machinery and equipment, real estate and, sometimes, intellectual property supporting a term loan. Lenders discount these collateral amounts using advance rates to determine the final borrowing availability. Typically, ABL loan agreements feature covenants requiring the borrower to meet a minimum level of EBITDA, debt service coverage, and/or have minimum availability. ABL loans are generally more conducive to borrowers with weaker cash flow, but strong asset quality, as lenders generally can feel more comfortable with their collateral security. These loans benefit the borrower, as their collateral can attract needed liquidity at a relatively low cost. Underscoring how "mainstream" this alternative funding source has become, ABL lenders today include a veritable who's who of national and regional banks, specialty finance companies and hedge funds.

Cash Flow Loans

Cash flow loans are predominantly issued to companies with a proven ability to generate strong cash flow. While these loans generally place a first lien on all assets, the lender is not looking to the assets as primary support for the loan. Rather, these are business loans dependent on the overall strength of the borrower's operations and its ability to generate cash to pay down the loan. Interest rates on cash flow loans are typically higher than their ABL counterparts. However, borrowers still find rates on these loans generally attractive. Maturities on cash flow loans are generally 5 years, with other common structuring features, including quarterly amortization payments and annual excess cash flow recapture provisions.

Non-Bank Financing Alternatives

Companies with negative net income, in the early stages of a turnaround, or that have more of a story behind their financial situation, will often turn to non-bank institutions for financing. ABLs by non-bank financing alternatives are often the only source of debt financing available for these borrowers, as these lenders are more willing to lend more aggressively against the liquidation value of the assets, despite a lack of historical profitability. Since these loans provide a greater risk to the lender, alternative financing sources charge borrowers higher rates, currently in the high single to low double digit range.

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Business Development Corporations (BDC) and Small Business Investment Corporations (SBIC)
Business development corporations represent what is perhaps the trendiest alternative financing option for middle market businesses today. While BDCs have been around since the 1980s, in this yield-hungry environment they have proliferated as an alternative capital source. BDCs must meet certain statutory requirements that can affect their transaction profile (e.g., total BDC debt cannot exceed its equity; no investment can exceed 25% of total holdings; 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, giving BDCs the ability 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 assistance and guidance can be very helpful to growing the enterprise.

Small Business Investment Corporations (SBIC) are generally private partnerships authorized and regulated by the Small Business Administration (SBA) to make loans to qualifying U.S. small businesses. To qualify, borrowers must meet the SBA's definition of small business, which generally is a business with net worth less than $18 million and, on average, less than $6 million after net income for the last two years. Certain industries and sectors have special definitions of "small" for this purpose that may consider such things as revenue and number of employees. The following link to the SBA website provides more information: http://www.sba.gov/content/sbic-program-0.

Both BDCs and SBICs have much greater flexibility with lending money to companies that would not fit the profile that more regulated banks require. Their rates tend to be in the low double digits but are justified by either providing greater availability than a bank, or by simply providing needed financing when others do not. While these lenders occasionally make asset based loans, most financings from BDCs and SBICs tend to be supported by cash flows.

Hedge Funds and Specialty Finance Companies
While BDCs and SBICs are regulated by the public markets and SBA, respectively, hedge funds and specialty finance companies are the least regulated of the alternative debt capital producers. For hedge funds, this often translates into a fairly broad mandate to deploy capital up and down the capital structure with loans being priced according to their perceived risk. While not the lowest cost source of financing, hedge funds can take a more holistic approach to the financing needs of a business and provide a broader range of solutions.

Specialty finance companies come in a variety of sizes and flavors. 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 finance companies rarely venture out of their comfort zone. If you fit their profile, finance companies can often act quickly to fund a loan. If you don't, then move on to a different type of lender.
Case Study – Distressed Debt Purchase
Carl Marks recently represented a 55-year-old family business that was battered by the great recession and found itself over-leveraged with too much debt and in the midst of a turnaround. The company's existing lender, facing its own challenges as well as a large loss on the credit, froze the line but gave the company time to find replacement financing. Carl Marks was retained and approached over fifty financing sources including banks, BDCs, SBICs, finance companies and hedge funds. Banks were quick to pass given the company's negative net income. BDCs and SBICs also passed based more on the difficulty in getting comfortable with the company's cash flow. However, we were successful in creating two different financing paths, one from the specialty finance company world and the other from a hedge fund.

The company owned two facilities and had an asset base consisting of accounts receivable, inventory and machinery and equipment. After updating real estate appraisals and clearing any environmental concerns, we approached a number of bridge mortgage lenders and received three term sheets. At the same time, we received term sheets from working capital lenders including two that were willing to provide a term loan against the fixed assets. Taken together, this provided sufficient capital to buy out the existing lender at an agreed discount. (Getting the bank to commit to a buy-out in advance is unusual and took some very creative structuring). As an alternative, a hedge fund stepped up and offered one-stop financing to both buy out the bank and provide growth capital. Their proposal provided about 30% more capital to the company, but came with higher closing and exit fees. Balancing increased liquidity against cost from different types of financing sources was a welcome choice for the client. In either case, the company would emerge with a much healthier balance sheet with the family remaining in control of the business.

With unprecedented liquidity in today's debt markets, investors' search for yield is revolutionizing the debt markets. An entire class of debt financing vehicles that were once considered alternative are increasingly becoming more mainstream.

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