



Financing alternatives: You've got options. Pick the right ones.

Another step on the Grant Thornton Road to Recovery

Companies need access to capital as they take their first steps on the road to recovery, but today's financing is more difficult to find and provided with more stringent terms and conditions. There *is* capital available, but there is a flight to quality, and the time and effort required to find the right financing can be trying.

Financing may be needed for working capital; capital expenditures; hiring and expansion; shareholder liquidity; or to restructure the balance sheet. The maturity of existing revolver or term loan instruments will also trigger the need for new financing arrangements. The nature of the need will determine the most appropriate type of financing that should be sought.

Likewise, the size of the financing need, the profile of the company and the dynamics of the sector in which the company operates will all play a role in determining the kinds of financial institutions you should approach.

Today's capital requirements will be met through a wider array of sources and structures than those available in the recent past. Financing options are well-known, but the subtleties and complexities that characterize these options are not as well-understood, despite their significant effect on businesses.



We've asked several of our Advisory Services leaders to provide their perspective on the benefits and drawbacks of several major financing options that can help companies secure the capital they require on the long road to recovery.

We will cover the following topics:

- Senior secured debt
- Junior debt
- Private equity
- Alternative financing vehicles
- Divestiture of noncore assets
- IPOs
- Special situations funds
- Debtor-in-possession (DIP) financing

Senior secured debt

Perspective provided by Jack DiFranco, Transaction Services Group national managing principal



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Senior financing is available, but it may be more difficult to obtain in today's challenging credit environment, as lenders increasingly seek borrowers who meet a higher standard of credit quality. However, as the senior debt market continues to recover with both liquidity and competition again intensifying, borrowers with more storied credit histories may be able to gain increasing access to senior debt.

There are two principal kinds of senior debt available: asset-based lines of credit (ABLs), where the bank has a secured interest in the collateral provided by the company (e.g., accounts receivable, fixed assets, inventory), and cash flow lending, where the collateral available to the bank is less than the credit being requested and the loan is supported by the operations of the business. Currently, most banks are comfortable with providing ABL-type facilities, but cash flow lending remains limited.

Pros

Senior debt generally provides the most financing flexibility and is the most cost-effective as compared with other financing structures. Typically, pricing is floating (LIBOR plus credit spread) and is based on the borrower's credit profile. Today, typical pricing for middle-market borrowers can range from LIBOR plus 200–500 basis points. ABL facilities are typically priced lower than cash flow deals, where the bank is taking on more risk.

Cons

Currently, senior debt leverage multiples remain relatively restrictive (2.0x–3.0x EBITDA for most middle-market borrowers). Additionally, senior lenders are providing three- to five-year maturity structures which require significant amortization of term debt over the period as well as availability limitations on revolving credit. Borrowers can anticipate tighter loan covenants and greater collateral requirements (and lower advance rates on assets); a greater need for personal guarantees; and an increased focus on financial reporting that demonstrates compliance with covenants.

Junior debt

Perspective provided by Stephen McGee, Corporate Finance practice leader



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Junior debt can come in a variety of structures, including second lien and mezzanine debt. Typically, junior debt is issued in the form of subordinated notes or preferred equity. Of course, the ultimate structure is based on the specific objectives of the transaction and the capital structure already in place at the company. In fact, junior debt has become an increasingly important component of the balance sheets of many middle-market companies, as senior lenders are typically unwilling to lend beyond 3.0x EBITDA. As a result, middle-market companies that rely on higher leverage levels may require junior financing as a supplement to other forms of debt.

Pros

Covenants for junior debt can be somewhat less restrictive than those for senior debt. Most middle-market borrowers can typically add incremental leverage of 1.0x–1.5x EBITDA on top of maximum senior debt levels using junior or mezzanine financing. With junior debt, the use of funds may be less restrictive and may provide a means to execute transactions such as dividend recapitalizations or leveraged buyouts which may not be possible with senior-only financing.

Cons

Because junior debt is lower in repayment priority than other debt in the event of the borrower's default, lenders need to be compensated for the additional risk. As a result, junior debt is typically more costly than senior debt. In today's credit market, middle-market companies can expect pricing of 10% and up for second lien debt, while pricing for mezzanine financing can range from 14% to 19%. Additionally, lenders may request large up-front fees, incorporate prepayment penalties and require warrants (which the lender can then use to convert into shares of the company's equity) generating all-in returns in excess of 20%.

Private equity

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The term *private equity* refers to equity capital invested in private companies. Typically, references to private equity encompass both early-stage (venture) and later-stage (buyouts, recapitalizations and growth equity) investing. Private equity capital is most commonly used to provide liquidity to shareholders (full or partial), however, companies are increasingly turning to private equity as a way to fill gaps in the capital structure to fund growth. Uses of growth equity include funding to develop new markets, products and technologies; to support growth through increases in working capital; to finance acquisitions; or to provide additional equity to strengthen a company's financial position (e.g., deleveraging a balance sheet).

Following record fundraising efforts in 2006 and 2007, moderate investment activity since 2008 has resulted in a large gap between private equity funds raised and funds invested. Consequently, a substantial amount of private equity remains sidelined. The decline in investment activity since 2008 is primarily the result of reduced liquidity in the credit markets, which has decreased the availability of debt and increased its cost.

Since many private equity investors rely on a substantial amount of leverage when making investments in order to improve potential returns, one can see why there has been such a large decline in sponsor-backed transactions over the past couple of years. However, as financial markets continue to

stabilize and improve, it is likely that we will see substantial activity from private equity investors as pent-up capital reserves are deployed.

Pros

Private equity can be an excellent way for entrepreneurs to diversify personal wealth that may be highly concentrated in the equity of the company. Owners electing to sell only a minority interest in their businesses may be able to find suitable private equity investors who will act as active partners. The private equity group can help existing ownership by identifying areas for operational improvement, providing an incremental layer of professional management, and supplying the financial or intellectual resources to grow the business to new heights.

Cons

Private equity investors have high return hurdles, typically in excess of 25%–30%. As previously noted, private equity investors normally make use of debt to help finance the transaction and leverage returns, which may not be palatable to existing owners. Furthermore, existing ownership may not be comfortable with giving up economic control of the business and at the same time being accountable to the new private equity investor through increased oversight. Finally, because private equity transactions involve a transfer of ownership, the potential tax consequences of such transactions need to be assessed.

Alternative financing vehicles

Perspective provided by Ian Cookson, Corporate Finance director



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In navigating today's complex and challenging credit environment, many middle-market business owners have found it necessary to consider alternative sources of financing. This is true in part because of the lack of credit availability from traditional providers such as banks. Alternative financing can come in many forms and structures, such as accounts receivable factoring, leasing, sale-leasebacks and customer-supplier financing.

Pros

In general, seeking certain types of alternative financing is easy to do in that such financing often can be obtained without significant difficulty or substantial due diligence, even with the current challenges in the credit markets. Alternative financing provides an effective means of supporting short-term capital requirements. Also, alternative financing can provide a means to monetize or remove certain less-efficient assets from a company's balance sheet.

Cons

Alternative financing is generally only a short-term solution to the long-term challenge of adequately funding the ongoing liquidity needs of a business. It should be used to augment other forms of more permanent financing. Additionally, transaction and interest costs can be high depending on the type of alternative financing structure used.

Divestiture of noncore assets

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With a stronger tactical need to focus on core business lines, more companies are considering sales of noncore assets, including but not limited to noncore business assets, excess inventory, underutilized fixed assets (including machinery and equipment), real estate and noncritical intellectual property.

Pros

This approach can be attractive from both a cash flow and a strategic perspective. Divesting noncore assets provides an inflow of cash that can improve a company's liquidity and financial profile. At the same time, the divestitures eliminate underperforming or nonessential assets that don't fit into the company's long-term strategy. Taking that action allows management to focus its energy elsewhere. The divestiture of noncore assets can also be a good tactic to generate cash when a company is in a distressed position.

Cons

Divesting noncore assets can have negative tax consequences. Additionally, these transactions can be complex and time-consuming in many cases. Accordingly, they may not always provide the best financing alternative for companies requiring immediate liquidity. To execute such transactions properly, companies should hire appropriate financial and legal advisors, which has a cost.

IPOs

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After a prolonged drought, the IPO market is beginning to show some signs of life. However, business owners must determine what is required to be a successful public company (e.g., size, revenue and earnings, depending on the industry) and methodically prepare to go public. Issuers should also weigh the benefits and drawbacks of such a decision, including the demands on the management's time to target and educate research analysts and investors. Once a company has gone public, the costs of compliance can be significant and reversing the public ownership process can be extremely difficult. The infusion of capital from an IPO offers businesses an opportunity to accelerate growth by hiring more people; investing in R&D; expanding the products and services that they currently offer; and increasing working capital. In addition, an IPO can provide a company with acquisition currency (publicly traded shares) and a lucrative and efficient means for existing owners to sell their equity in the company. An IPO can also be a significant marketing event for a company, helping attract or secure new customers. It can also be used as a stalking horse to improve pricing in the case of a parallel-path IPO, where management's preferred route is to sell the company to a strategic buyer. Nevertheless, IPOs are not without their challenges.

Pros

A publicly traded company generally has access to a much broader universe of investors and capital than a private company would have. This means that public companies can generally obtain capital at lower costs (thus reducing the weighted average cost of capital) and will have a broader range of acquisition and employee compensation incentive alternatives available than a private company would have. The listing of a company on a public stock exchange creates liquidity for the company's shareholders, who are able to sell their stock within the parameters of the laws prescribed by the SEC.

Cons

Public offerings take time to execute, and the underwriting process can be costly to implement. Owners sell all or a portion of their shares to a new group of shareholders (i.e., the public); this transaction generally results in a reduction in ownership. There is also a reduction in management's control over the company's governance. Independent directors must be added to the board per stock exchange listing requirements, and certain actions require shareholder approval. Furthermore, publicly traded companies incur additional costs resulting from increased oversight and compliance with legal, financial and other regulations.

Special situations funds

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Special situations funds provide capital to privately held companies and, as their name implies, can take a variety of forms depending on the situation. These funds, because of their nature, are able to invest in companies and situations that may prove to be too risky for traditional private equity funds.

In fact, since they were not subject to any significant regulation, special situations funds may have employed considerable leverage (to the extent available), used derivatives strategically, engaged in short-selling, and invested in or lent to high-yield or distressed companies. As the credit markets continue to recover, these funds are playing an increasingly important role in filling gaps where traditional senior or junior lenders have been slow to resume lending activity. Additionally, as recent history has shown, special situations funds have a higher propensity to provide capital to distressed businesses and to businesses with more complex financing requirements. Now that the Dodd-Frank Wall Street Reform and Consumer Protection Act has been passed, private fund advisors will be required to register with the SEC, and new rules surrounding derivatives trading may have an effect on how these funds operate in the future. However, since the act leaves the specifics of the new rules to the regulators, it may be some time before we know the exact impact the new legislation will have on the funds.

Pros

Special situations funds may be a viable lender to certain prospective borrowers, especially those in distress. These funds may be able to provide credit to businesses when other forms of debt capital (e.g., senior, second lien and junior debt) are simply not available. In addition, these funds can act as a partner to many businesses and provide a level of oversight and professional management not available from other types of lenders. Fund managers typically have the ability to understand complicated financing structures and the technical know-how to arrange credit facilities that are tailored to meet the specific needs of borrowers.

Cons

These funds have high return hurdles, which are typically in excess of 20% and based on cash-on-cash returns in excess of 2.0x–3.0x. However, depending on the types of credit provided, there may be some flexibility in pricing structures. In today's financing market, special situations funds have been highly opportunistic. The complexity of intercreditor agreements may be further exaggerated when these funds are involved.

DIP financing

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DIP financing represents a unique form of financing offered to borrowers engaged in the Chapter 11 bankruptcy process. It provides a company in financial distress with the opportunity to receive funding based on the company's perceived value and its ability to complete a plan of reorganization. Given the current challenges in the macroeconomy and the vast number of companies already in bankruptcy or financial distress, the demand for DIP lending has expanded dramatically, while the supply of such necessary vehicles has contracted.

Pros

DIP financing may prove to be the only alternative — other than liquidation — that is available to companies in bankruptcy seeking financing in order to restructure. More importantly, obtaining DIP financing provides the immediate cash flow necessary to cover payroll and the up-front costs of stabilizing the business. At the same time, DIP financing helps companies maintain vendor and customer relationships (especially as they relates to the ability to maintain liquidity). As a result, companies can continue to sell and source products without significant interruption.

Cons

DIP lenders have extensive protections under the U.S. bankruptcy code, thus limiting financial flexibility for borrowers that use DIP financing. Moreover, a DIP lender will typically insist on a first-priority priming lien on the debtor's inventory, receivables and cash (whether or not previously encumbered); a second lien on any other encumbered property; and a first-priority lien on all of the debtor's unencumbered property.

Pricing on DIP loans can be expensive and borrowers can be subject to extensive fees, especially in the wake of the newly increased demand for this type of financing. However, as more participants enter the DIP lending space, competition should increase, thereby limiting growth in pricing levels.



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