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Investment Banking

**FOCUS Newsletter**

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**Where to Go When the Bank Says No**

By John Slater, Partner, FOCUS LLC

*(The characters in this story are fictional, but unfortunately, the experience described below is all too real.)*

For more than twenty years, Al Rodriguez lived the American Dream. Recently, his dream became a nightmare. Al and his family had immigrated as political refugees to the United States from Nicaragua in the early 1980's following the Sandinista revolt of 1979. A top student in his university in Managua, Al was nearing graduation when his family was forced to flee. His family arrived in the U S penniless and Al struggled for several years to help support his parents as he completed his bachelor's degree at the University of Miami with a concentration in computer science.

While working in the medical school to help pay his way through college, Al discovered a glaring need for medical transcription services targeted to emigrant physicians for whom English was a difficult second language. By the time he graduated, Al was the proprietor of a small, but growing medical transcription business, managing a dozen transcriptionists with native fluency in seven languages.

The business grew steadily and diversified into a provider of numerous back office services for medical professionals, including IT, accounting and billing and collections. In 2007 Dade Professional Support Corporation (DPSC) had its best year ever, generating revenues of \$18 million and pre-tax profits of \$2,400,000.

Al's problems started in 2006 when he bought out his partner, James West. Prior to that time, the business had carried about \$2 million in debt to fund its receivables. When Al approached his bank, First Granite National, about assisting in the buyout, his loan officer, Suzie Clifton, encouraged him to utilize the bank's new enterprise value loan product. She told him that to remain competitive the formerly very conservative institution was aggressively pursuing loans based on the cash flow and sale value of their customers and that she would be able to increase his line of credit to \$7 million, far above the level of assets available to support the loan.

Unfortunately, First Granite also had moved aggressively into the subprime home equity loan business and in March of 2008, the former bank management was replaced by a new team recruited by a group of private equity investors who recently had made an emergency capital injection to save the bank. Unaware of the change, Al called Suzie to tell her about a tremendous business opportunity that had recently been presented to DPSC.

A local competitor, Medical Transcription Corp. (MTC), had been hit with the bankruptcy of an important customer and was forced to sell. For an investment of \$500,000, DPSC could acquire

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from MTC: a going business with \$5 million of revenues, book assets of \$1.1 million and an additional product line that would be very attractive to DSPC's existing customers. Al estimated that the acquisition would add \$600,000 to his 2008 pre-tax earnings, with significant growth potential thereafter.

Rather than the warm reception he expected, Al learned that Suzie was no longer with First Granite. His account was now being handled by Erhard Muller in the Special Assets Department. Mr. Muller showed no interest in the acquisition. Despite the fact that DSPC's loan had never been in default and the company was performing well above all covenant requirements in the loan agreement, Mr. Muller advised Al that the bank was preparing to send a notice under the "adequacy of collateral clause" in the loan agreement demanding that DSPC post additional collateral in the amount of \$2.5 million or repay the loan immediately.

Since we're into happy endings, the story will not be left with a devastated Al Rodriguez or with a trip to the bankruptcy court. Fortunately, in recent years new business models have developed and old ones expanded to provide financing alternatives to traditional bank loans.

American banks are in their third period of dramatic credit tightening since 1990. Liberal loan structures that were commonplace from 2005 to 2007 no longer will be tolerated at most banks. Collateral coverage increasingly will become the watchword: cash flow, enterprise value and over-advance loans will increasingly be a fading memory of the bubble times. For now, companies caught in the crossfire must look to alternative financing sources, particularly including the following:

**Asset Based Lenders.** These firms traditionally fund businesses with relatively large working capital needs for financing of receivables and inventory. This market ebbs and flows, but for the past few years it has been fairly competitive. The difficulty with asset based financing is that the borrowers' funding requirements frequently exceed the amount supported by asset coverage formulas, which generally limit funding to 40 to 50 percent of inventory values and 75 to 80 percent of current receivables.

Asset based lenders typically have limited interest in funding longer lived assets such as equipment and real estate, though many will accommodate such needs as part of a larger working capital line. Interest rates charged by asset based lenders are quite competitive with banks for sound borrowers with good collateral, though they can range significantly higher for risky borrowers with collateral, but credit too weak for bank financing.

**Junior Capital Providers.** In the middle market, junior capital is frequently thought to be synonymous with mezzanine debt. We estimate that there are between 150 and 200 funds in the United States that provide mezzanine debt. Perhaps half to two thirds of these participate in the lower middle market with junior capital funding requirements under \$10 million.

In the middle market, mezzanine loans often are interest only with rates some hundreds of basis point above senior bank rates for the same credit, mirroring the high yield bond market for

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comparable credits. In the lower middle market, mezzanine debt providers typically charge a fixed interest rate of 12 to 13 percent per annum plus additional consideration in one of two forms:

1. An equity kicker in the form of warrants priced to yield a total return of 18 to 30 percent per annum (depending on deal size and perceived risk) or,
2. A fixed accrual yield of an additional 6 to 10 percent per annum.

Deal structures range from interest only five year bullets to various amortizing structures that must be negotiated between the mezzanine provider and senior lenders. The loans may be unsecured, but mezzanine lenders increasingly look to a second lien position to bolster the safety of their investments.

Mezzanine debt providers will provide funding for financing needs where there is not adequate collateral to fully support the funding requirements through traditional bank or asset based lenders. They provide this on the assumption that they will be paid out of the cash flow of the business. Thus companies that do not have substantial operating cash flows are not candidates for mezzanine lenders.

**Flexible Lenders.** In the past few years, a new category of lenders has entered the market that promote their flexibility to “play” anywhere in the capital structure from senior debt to equity, including “unitranche” structures that cover the full financing requirements of a business. These investors frequently are backed by hedge funds and trade on their flexibility to achieve somewhat higher yields than those offered by traditional sources such as banks.

**Growth Equity Providers.** Growth equity providers fund companies that have grown past their startup and early stage phases, but which do not have adequate cash flow to support a mezzanine financing. These investors target companies with strong growth prospects that have proven their ability to generate substantial sales revenue, but are often at or near cash flow breakeven. Growth equity financings may be structured as common stock purchases, convertible debt offerings or preferred stock. Not all growth equity investors seek control of the borrower.

### Bottom Line?

To end our saga: Al had the good judgment to bring in an investment banking firm to act as his financial advisor to assist in exploring the often confusing world of alternative financing sources. He was able to locate a lender that proposed a unitranche loan structure to take out First Granite and to fund the proposed acquisition. While the interest rates were a little higher than DSPC had experienced at First Granite, the additional profits from the acquisition of MTC covered the additional interest cost by a factor of several hundred percent.

*This article originally appeared at [www.focusbankers.com](http://www.focusbankers.com). John Slater is a partner of Focus, LLC and a member of its Board of Directors. He has spent more than thirty-five years addressing the financial*

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*needs of entrepreneurial businesses. His experience includes mergers, acquisitions and divestitures, private placement of debt and equity, transition planning for family businesses, business valuation, going private transactions, industrial revenue bond financings, Section 363 sales in Chapter XI bankruptcy and initial public offerings. As Team Leader of Focus's Financial Alternatives Team, Mr. Slater strives to help companies avoid financial crises through arranging senior and junior debt financings. He and the Financial Alternatives Team also assist with planning and negotiating debt restructurings and the sale or merger of financially troubled firms.*

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