

FINANCING ALTERNATIVES FOR SMALL AND MEDIUM BUSINESS

Executive Summary

In this time of financial stress many companies no longer have easy access to their traditional sources of financing, typically the commercial banks.

Focus has created the Financial Alternatives Team to help companies find alternatives. These include:

1. Junior Capital, including mezzanine
2. Non-Bank Commercial Lenders
3. Asset Based Lenders
4. Growth Equity

These financing sources require a level of information and type of presentation that private companies that have traditionally relied on banks may not have had to provide in the past. Focus's experienced professionals have been through these types of transactions many times and can assist in locating the right financing source for the deal, presenting it in a way that sells and forcefully negotiating the transaction on behalf of the client.

NEED: In times of financial stress small and medium sized businesses frequently find that their access to traditional bank financing is seriously curtailed. Without alternative sources of financing these firms must curtail business growth or even retrench their operations.

SOLUTION: The past five years have witnessed dramatic growth in the number of non-bank lenders serving this market including:

- **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 40-50% of inventory values and 75-80% of current receivables. In general asset based lenders 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.** Junior capital is frequently referred to as mezzanine debt. We estimate that there are between 150 and 200 funds in the United States that provide mezzanine debt and this market has been growing rapidly since mid-2008. Perhaps half to two thirds of these participate in the lower middle market with junior capital funding requirements under \$10 million. Mezzanine debt providers typically charge a fixed interest rate of 12-13% 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 18-30% per annum (depending on deal size and perceived risk) or, (2) a fixed accrual yield of an additional 6-10% 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.
- **Whole Balance Sheet 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. These investors are frequently 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.

CRITERIA:

Candidates for alternative financing structures will generally have some or all of the following characteristics.

- **Asset Based Loans:**
 - High levels of working capital assets
 - Profitable or unprofitable
 - New economy or old economy
 - Lending requirements of \$1 million +
 - Frequently being forced out of a banking relationship due to earnings hiccup or changing banking environment

- **Junior Capital:**
 - Historical EBITDA of \$2 million +
 - Opportunities for growth
 - Relatively high profit margins
 - Frequently new economy without substantial assets to support traditional lending
 - Financing need for recapitalization, growth or acquisitions
 - Alternatively, but more difficult, the borrower may have been forced from its existing lending relationship due to tightening of bank lending standards. True turnaround situations are not of interest to most junior capital providers
 - Revenues generally \$12 million or higher
 - Supportable junior capital requirement of \$3 million + (a much smaller subset of investors are willing to fund requirements of \$1.5-3 million)

- **Whole Balance Sheet:**
 - Revenues \$15 million +
 - New or old economy
 - May include turnaround situations and even bankruptcy sales where there is a clear path to profitability

- **Growth Equity:**
 - Revenues of \$5 million - \$30 million
 - Growth 25%+ per annum
 - High gross margins

- EBITDA positive, but not necessarily profitable
- Generally new economy businesses

FOCUS ROLE: Alternative financings typically involve complexity that makes them more difficult to arrange than traditional bank loans:

- **Complex Market:** The providers of alternative financing typically market on a regional or national basis and often do not have representatives in the borrower's local market. As a result most small businesses find it very difficult to identify the appropriate candidates on their own.
- **Complex Story:** Candidates for alternative financings are frequently in a period of business transition either because of internal operational issues or because they are involved in complex transactions such as family buyouts and generational transfers. Often success in arranging an alternative financing hinges on the ability of the borrower to demonstrate to the satisfaction of the lender/investor that its actual prospects are better than its historical financial performance would indicate.

FOCUS brings to bear decades of experience in arranging complex financings. Our services include:

- Objective analysis of the client's situation and prospects for funding.
- Assistance in building interactive financial models to serve as the basis for presentation and negotiation of the financing.
- Presentation of the client's "story" in a creative and engaging way to demonstrate to the lenders/investors the positive aspects of the client's situation.
- Identification of multiple funding sources targeted to the client's specific situation.
- Negotiation of the financing arrangements with the lender/investor.
- Coordination of documentation and closing to assure the transaction is not broken by lawyers seeking unreasonable terms and conditions.

FOCUS TEAM:

Additional information concerning Focus Investment Banking can be found at www.focusbankers.com. The FOCUS Financial Alternatives Team has more than ninety years of collective experience in providing and arranging financing transactions for small and medium sized businesses.



John Slater, Partner and Board Member

John Slater has advised and assisted private and public companies implement financial transactions for more than 35 years, initially as a practicing attorney and since 1982 as an investment banker. His experience includes business sales, mergers and acquisitions, 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.

John serves as Team Head of Focus's Financial Alternatives Team, which assists companies caught up in the credit squeeze in arranging alternative sources of financing and liquidity. He publishes the *Tough Times* blog at www.mergers.com/toughtimes, providing information resources to business owners and their advisors to help them address the challenges of the unfolding financial crisis.

John graduated from Princeton University with a degree in economics in 1970 and obtained his J.D. from the University of Virginia Law School in 1973.



Stan Cutter, Managing Director

Mr. Cutter has represented small and medium sized businesses since raising \$5 million for a regional pipeline company over thirty years ago as a merchant banker for Citicorp. During the intervening years Mr. Cutter has raised over \$6 billion for clients in the US and international markets. During the early 1980's, Mr. Cutter completed a number of cross currency hedging and capital transactions for business in the Pacific Rim. These complex transactions allowed the

companies to borrow in one currency and repay the debt in another currency.

During the early 1990's Mr. Cutter operated, then sold his own business and since he has worked exclusively with small and medium sized business raising capital and completing merger transactions. His clients have ranged from growth stage high tech companies to successful old economy businesses across the country and clients have benefited from his deep capital market knowledge.



James V. Millar, Managing Director

Mr. Millar has over 20 years of financial and business expertise plus extensive management and business development experience as a senior executive with both large and earlier stage companies. Mr. Millar has advised, managed or led over 100 transactions with an aggregate value of over \$2 billion. His expertise includes private placement of debt and equity, mergers, acquisitions and divestitures, international transactions, early stage financing, asset based and mezzanine financing, and traditional corporate finance.

Before joining FOCUS, Mr. Millar was founder and Managing Principal of The Vine Group, a business advisory firm focused on the early-stage and middle market healthcare and medical device industry. There he led more than \$150 million in private placement activities as well as both buy side and sell side transactions. He also successfully executed several asset based lending financings including a \$20+ million refinancing of a closely held wholesale distribution company. Mr. Millar assisted several middle market clients through the challenges of shareholder buyouts through the use of mezzanine financing. From, 1993 to 1998, Mr. Millar was employed at TheraTx, Inc., a healthcare services company. His positions included Corporate Vice President of Strategic Development where he was involved in the identification, valuation and integration of strategic acquisitions for the company.

Mr. Millar received his B.A. in Economics from the University of Virginia and both a Masters of Health Administration and a Masters of Business Administration with a concentration in Finance from The University of Chicago.



Douglas E. Rodgers, President and Board Member

Doug Rodgers has been CEO and Managing Partner of **FOCUS** since early 2002. He has led the firm's growth from one office in Washington, DC, to four offices across the US. He has executive level management experience in software, information technology, aerospace, e-commerce, real estate and construction, manufacturing and distribution, serving both commercial and government clients. He serves FOCUS clients across many industries emphasizing merger and acquisitions opportunities.

Before joining FOCUS, Mr. Rodgers was Vice President of the Strategic Business Consulting unit of Holland & Knight Consulting LLC. At Holland & Knight Consulting he had management responsibility in the firm and delivered consulting services including M&A, corporate finance, and assistance to offshore companies entering the U.S. market.

Mr. Rodgers served as the President and CEO of Corcentric, Inc, an e-commerce services provider spin off from Litton Enterprise Solutions. As the first CEO of the company, he raised both venture and debt capital and led the company to achieve 500,000 electronic transactions annually with a transaction volume of \$180 million, including over 30 Fortune 1000 trading partners. As CEO of Global Software Corporation, which served the government public safety market, Mr. Rodgers raised venture and debt capital, guided the development of initial software products and sales to reference clients. As President and CEO of Perfection Equipment Company, a distributor and manufacturer of industrial goods to the oilfield services and transportation industry, he was instrumental in the merger and IPO into a NYSE industry consolidation play. Mr. Rodgers is also a founding director of a National Bank and a manufacturing company. Prior to Perfection Equipment, he was Vice President of business development for a \$150 million real estate developer.

Mr. Rodgers is an active pilot, with ATP and jet ratings, a BS in Aerospace Engineering and MBA coursework. He was educated at the U.S. Air Force Academy and the University of Kansas, and was a 13 year member and local President of YPO, and currently is a member of the World Presidents Organization.



Keith Walz, Managing Director

Keith Walz has more than fifteen years experience in private equity investing. Mr. Walz has focused on providing growth capital to privately held businesses, specializing in Enterprise Software, Network Infrastructure, and technology-aided Niche Manufacturing investments. He has served on the board of directors of over a dozen portfolio companies adding strategic planning and advice to maximize shareholder value. Prior to joining FOCUS, Mr. Walz co-founded and was a Managing Partner of Kinsale Capital Partners, a leveraged buy-out private equity investment firm focused on acquiring and enhancing the value of lower-middle market businesses.

Prior to the formation of Kinsale Capital Partners, Mr. Walz had been a Managing Director at ABN ARMO Capital, ABN AMRO's Global Private Equity division with over \$2 billion in invested capital. As a senior partner with the firm, Mr. Walz participated in the sourcing, evaluation, and monitoring of over 35 investments with a total enterprise value exceeding \$1.5 billion, representing \$200 million of capital invested. As an active investor, Mr. Walz served on the board of directors and held operating roles with ABN AMRO portfolio companies in the interest of enhancing shareholder value and accelerating growth. Prior to joining ABN AMRO Capital, Mr. Walz was a Vice President in ABN AMRO's Investment Banking division, responsible for financial reporting, analysis, and systems.

Mr. Walz was also President and CFO of Sand Hill IT Security, a special purpose acquisition company. Sand Hill raised \$24 million through an initial public offering for the purpose of acquiring an information technology security business. Mr. Walz participated in the sourcing and evaluation of over 100 acquisition candidates, commencing with the \$60 million acquisition of St. Bernard software. Mr. Walz was also a member of the Board of Directors of Community Bankers Acquisition Corporation, a \$70 million special purpose acquisition company established to acquire regional banks.

Mr. Walz holds a M.B.A. from DePaul University and a Bachelor of Science degree in finance from the University of Arkansas.



Michael Zook, Managing Director

Mr. Zook has served the owners of privately held businesses as a commercial lender and senior credit officer of The Northern Trust Company in both Illinois and Florida.

Mr. Zook, together with a group of investors, purchased Capital Investments, Inc. in 1989, a Small Business Investment Company ("SBIC") located in Milwaukee, Wisconsin. He served as President of Capital Investments, Inc., which made mezzanine investments in the form of subordinated notes with nominal warrants in over twenty small companies in Wisconsin and Northern Illinois. Typically, these companies had \$5 to \$10 million in annual revenues and were manufacturers and distributors.

Later, Mr. Zook represented Capital For Business, Inc., a wholly owned subsidiary of Commerce BancShares of Missouri, as the head of their Chicago office. Here the mezzanine products were more equity oriented and often involved larger companies. During this time Mr. Zook was an annual speaker on mezzanine lending to the annual educational conference sponsored by the National Association of Small Business Investment Companies ("NASBIC") and National Venture Capital Association ("NVCA"). He also served as President of the Midwest NASBIC Chapter.

**FOR MORE
INFORMATION
CONTACT:**

Stan Cutter

312-794-7888

847-971-0814 (cell)

stanley.cutter@focusbankers.com

Jim Millar

404-963-8254

70-330-1593 (cell)

jim.millar@focusbankers.com

John Slater

901-684-1274

901-230-5062 (cell)

john.slater@focusbankers.com

Keith Walz

(312) 794-7888

(312) 593-7172

keith.walz@focusbankers.com

Michael Zook

(312) 794-7888

(312) 371-6981 (cell)

michael.zook@focusbankers.com

or [your local FOCUS representative](#).