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THE ROAD AHEAD

Show Me the Money:
Financing Options for Small and Middle Market Companies

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While corporate bond markets have enjoyed a remarkable resurgence in recent months, the bank lending on which small and middle market companies rely remains scarce. However, even in the current climate a number of creative options are available for capital-starved small and middle market businesses.

Credit seized up for small and large companies alike at the height of the financial crisis in late 2008; since then, however, their fortunes have diverged (**Figures 1 and 2**). In 2009, larger companies with access to the capital markets were beneficiaries of investors' renewed appetite for risk and yield, sparking a rally in bond markets. In the second week of January 2010, companies raised $11.7 billion in high-yield bonds, eclipsing a record set in November 2006.

Many of the companies that have recently raised capital were last year's restructuring candidates. Proving the adage about investors' short memories, the rally even witnessed the revival of the dividend recapitalization, a technique that until recently was viewed as a poster child of mid-decade easy credit. After a Greece-induced lull in February, bond markets resumed their torrid pace of new issuance in March. Meanwhile, the great mass of small and mid-size firms that employ the majority of American workers faced extremely tight lending conditions.

Without access to the capital markets, such firms are heavily reliant on an ever-fewer number of banks for financing (**Figure 3**). Despite the White House's calls for increased lending, regulators at the same time insist on prudence. Thus, for small to mid-market companies credit remains scarce. Some commentators claim there is not a shortage of loans, but a shortage of customers. "The only ones trying to get loans are those struggling to stay in business, not looking to grow their business," argues Bill Dunkelberg of the National Federation of Independent Business (NFIB).

It's hard to blame them for that. Although the NFIB reports that small-business optimism and borrowing both remain at historical lows, there are some innovative options for cash-strapped small and mid-market companies that do not qualify for plain-vanilla bank loans. While the need for capital may be self-evident, determining which capital sources are appropriate for a given company and connecting with those sources requires specialized expertise. The following is a brief summary of some of these sources.

Credit on the Come

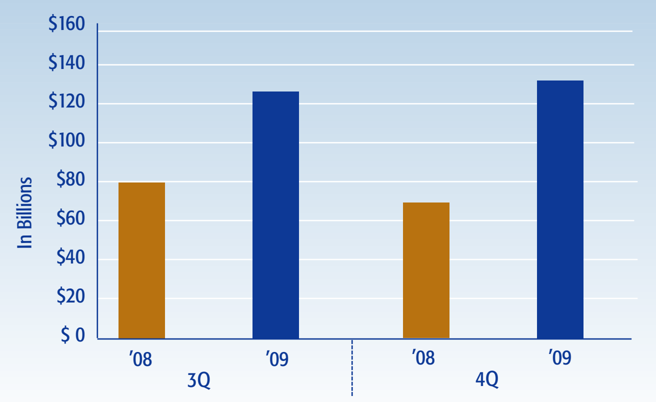
• ***Contingent Revolvers:*** When a lender is wary of becoming overextended, it sometimes will place milestones on the revolving credit facility. These can be tied to sales; earnings before interest, taxes, depreciation, and amortization (EBITDA); winning a certain contract; or any other indicative metric. Thus, if the company achieves objectives that legitimately require additional capital, it is available, but funds are not deployed merely to postpone the inevitable for struggling companies. The contingent revolver is a variant of an accordion feature, under which a company entering a credit agreement purchases an option to increase the principal outstanding in anticipation of expansion opportunities.

Drawback: A contingent revolver is not an option for firms that need a bridge until macroeconomic factors turn around.

• ***Factoring:*** A centuries-old practice, factoring involves buying receivables from companies. For example, if a company is owed money but cannot wait until invoices are paid, it can sell the invoices to a factor, who will immediately advance the company a certain percentage (*e.g.*, 80 percent) of the invoiced amount. The factor then collects the money from the obligor over time and remits it to the company, minus a fee.

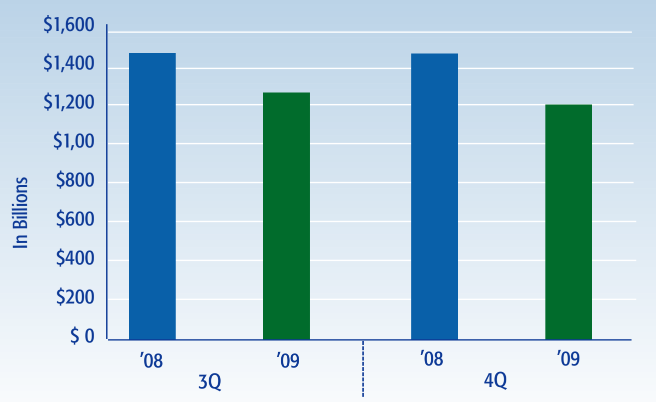
Drawback: This can be expensive money, and if it takes longer than anticipated to collect the invoice, additional charges may accrue.

Figure 1: U.S. Corporate Bond New Issuance



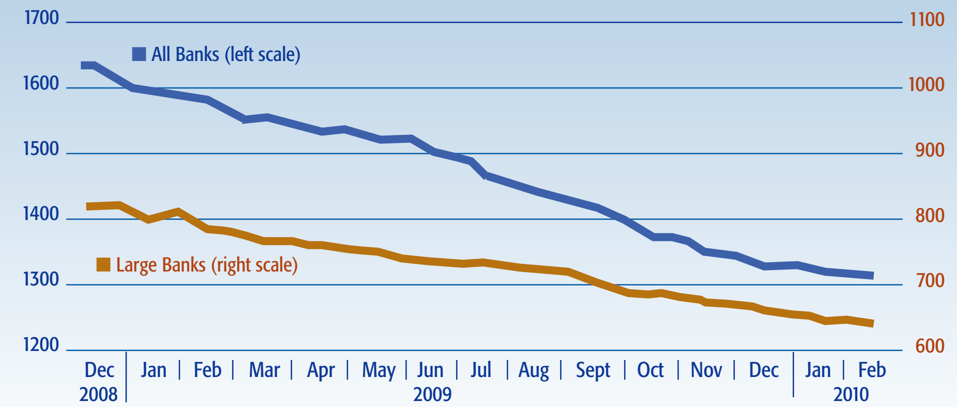
Source: Fitch: US Corporate Bond Market 4th Quarter Review

Figure 2: U.S. Commercial and Industrial Lending



Source: Fitch: Quarterly Banking Profile

Figure 3: Commercial and Industrial Loans (Seasonally Adjusted.)



Source: Federal Reserve Bank of St. Louis

• ***Purchase Order Financing:*** If a manufacturer is working capital-constrained but has purchase orders on hand, this type of financing enables the company to purchase the materials necessary to produce products to fulfill the purchase orders. It is typically a short-term financing source under which the lender is paid either from the proceeds of the sale or when a factoring company buys the invoice.

Drawback: Purchase order finance interest rates can be high.

• ***Litigation Finance:*** Companies with viable litigation claims can often turn to investors who invest in lawsuits in exchange for a share of any winnings. This enables capital-constrained firms that might not otherwise have the resources to do so to pursue promising litigation. Several hedge funds and divisions of investment banks engage in this business. The investors do not take control of the lawsuit from the company; they just finance it.

Drawback: The practice raises tricky legal questions and is not permitted in all states. Additionally, investors avoid inherently uncertain cases, such as those that raise novel legal questions or will end up before a jury.

Shopping in the Closet

• ***Brands, Other Intellectual Property (IP).*** Companies with recognized brand names and trademarks can often borrow a percentage of the value of such IP. Typically the trademarks and brands are contributed to newly formed special purpose entities (SPEs) that are bankruptcy-remote. The loans are then made to the SPEs. These can be stand-alone loans from new lenders or provide support for increases in availability from existing asset-based sources.

Drawback: A company risks potential loss of control over its brand or trademarks, and a fragmented lending market means there is little standardization of the lending product.

• ***Sale-Leaseback:*** This is an arrangement in which one party sells property to a buyer, who then immediately leases the property back to the seller. This enables the seller to use the asset while not having capital tied up in it, allowing a company to pay down debt or provide capital for operations or expansion. Additionally, the arrangement often provides certain tax benefits because rent payments are tax-deductible.

Drawback: The company no longer owns the property and doesn't have the right to use it with unfettered discretion. Moreover, over the long run, leasing property may be more expensive than owning it.

• ***Employee Life Insurance Policies:*** Company-owned life insurance (COLI) covers an employee and pays off if the person dies. Often referred to as key man insurance, COLI most commonly is used for key employees and executives to hedge against the myriad financial costs of losing such employees to unexpected death. But it also sometimes is used for general employees. New York Life Insurance Company estimates that 68 percent of Fortune 1000 companies have COLI programs. The proceeds enjoy certain tax benefits, including tax-free payouts upon the employee's death. Companies can sometimes raise capital either by selling these policies outright or taking out tax-free loans against them.

Drawback: For selling policies, the market typically starts at 65 years of age, and acquirers will demand a significant discount for assuming the actuarial risk.

• ***Financial Restructuring:*** Instead of providing new capital, a financial restructuring reduces the debt service obligation. This can be limited, as in an interest rate forbearance for a limited period (where the interest may be paid in-kind), or more expansive, with a portion of the debt being forgiven and/or converted into equity, permanently reducing the debt service requirements. While creditors usually will not consent to a haircut until all other avenues have been explored, raising new capital often is contingent upon some financial restructuring. Thus, it is wise to pursue restructuring options in conjunction with other financing possibilities.

Drawback: Negotiations can be protracted and the degree of difficulty increases exponentially with the number of parties involved. Additionally, companies may face cancellation of indebtedness income when the debt obligation is reduced.

Doing Deals

• *M&A:* Some companies with limited access to capital have merged with cash-rich companies to obtain access to capital. These can take the form of full-fledged mergers with combined balance sheets, sales of divisions for cash or cash and stock, or asset sales.

Drawback: With stock deals, equity dilution can result in the loss of a substantial stake and/or control for current owners. With asset transactions, those assets are no longer available to generate income.

• *Distressed Investors:* When the bond and syndicated debt markets surge and distressed investors see fewer bargains in that arena, they will look farther afield for returns. This often benefits smaller companies to which banks won't lend. The recent run-up in the capital markets will drive distressed investors to refocus their attention on capital-starved small to mid-market companies.

Drawback: This is typically expensive capital, and distressed investors are not as forgiving as banks in the event of covenant breaches.

Getting Creative

• *Credit Unions:* Sensing growth opportunities, credit unions have made a big push into the small-business market in recent years. Indeed, credit unions are one of the few institutions that have increased lending over the past year. Credit unions are sharply limited by federal legislation in how much they can loan and typically grant smaller loans than banks do. However, given that they are nonprofits that are community-oriented, they have less stringent criteria than banks.

Drawback: The business owner must be a member of the credit union. Membership may be based on where an applicant lives, works, or attended school.

• *Credit Cards:* With other sources of credit so constrained in the wake of the financial crisis, many small business owners are resorting to plastic. According to a National Small Business Association poll conducted in April 2009, 59 percent of respondents had used credit card financing for purchases in the last 12 months versus 49 percent in a December 2008 survey. Many small business owners take advantage of low teaser rates and continually roll balances to other cards as low rates expire.

Drawback: Balances and rates must be tracked vigilantly. If a payment is missed, credit card companies may curtail the credit line and raise rates. Additionally, such financing is generally only sized for smaller businesses.

• *Go West:* While California's budget is in a precarious state and its businesses face high tax burdens, the California Capital Access Program (CalCAP) encourages banks and other financial institutions to make loans to small businesses that fall just outside of banks' conventional underwriting standards. CalCAP is a form of loan portfolio insurance that may provide up to 100 percent coverage on certain loan defaults. To qualify, a business must be "near bankable," and the primary business and 50 percent of its employees, income, sales, or payroll must be in California.

Drawback: A borrower must pay an insurance premium, typically 2 percent of the enrolled loan amount. Few lenders are as yet members of CalCAP, and the $1.5 million cap on loan size makes this appropriate only for small businesses.

Break the Glass

• *Bankruptcy:* If a company cannot meet its debt service obligations, bankruptcy is one option to consider. Filing for bankruptcy provides a company with temporary relief through the court-mandated automatic stay, which prevents creditors from collecting on their debts while the business reorganizes. In bankruptcy, a company can often obtain financing through debtor-in-possession (DIP) loans that have super-priority status and use cash in the business to fund operations (instead of paying pre-petition creditors).

Drawback: Typically equity holders lose most of their stake unless the creditors are paid in full, and bankruptcy is very costly.

The Need for Speed

Obtaining financing from alternative sources and/or executing a financial restructuring requires specialized expertise and is more time-consuming than renegotiating a credit facility with an existing lender. Moreover, time is a scarce commodity for companies facing a liquidity crunch. Executing these complex transactions in a short period of time requires several competencies:

- Awareness of current market dynamics
- Knowledge of who makes which types of loans
- Understanding of financial restructuring mechanics
- Developed sense for which options are feasible for a given company
- Understanding of a company's business plan
- Sense of urgency

For most companies, the intensive and integrative demands of this process favor retention of outside advisors. While a number of firms can do this work, those that have expertise both in understanding companies' operations and executing transactions will be best-suited to achieve positive results. CR

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