



PRICOA PRIVATE CAPITAL INSIGHTS

More than Meets the Eye:
*A Closer Look at the Most
Commonly Used Type of Capital*

The Pricoa Private Capital
Guide to Senior Debt Capital

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Senior Debt Capital Sources

With senior debt capital, there are more choices and variations than meets the eye.

Senior debt capital is the least expensive and most common way for companies to obtain substantial amounts of capital. However, what many CEOs and CFOs may not know is the variety of options available, including how senior debt capital can be sourced.

Just as it sounds, senior debt capital assumes priority over other forms of capital and is generally repaid first. It can be secured or unsecured, asset-based or cash flow-based, depending on the size and strength of a company. The term (short or long) for the senior debt capital will be dictated based on the nature of the funding need and the company's credit quality. Senior debt capital is also available from multiple lending markets.

Companies primarily source senior debt capital from these three markets:

1 Bank Market

Bank loans are typically shorter-term (3-5 years), secured or unsecured, and revolving or term based. For smaller or asset-based businesses, companies can utilise secured, asset-based bank loans (such as ABL revolvers or finance leases) with borrowing capacity determined by the size and quality of the assets. Larger businesses (typically investment grade) can access bank funding on a fully unsecured basis. **Since bank loans are shorter-term in nature and can be drawn and repaid as needed, they are better-suited to help finance working capital needs, smaller capital projects and other ongoing operational expenses.** Bank loans also usually have floating interest rates, and sometimes companies will artificially 'fix' these floating rates with a financing derivative, such as a swap.

2 Private Placement Market

A private placement is a private sale (or 'issue') of corporate debt or equity securities by a company, to a select number of investors. The most common type of private placement is long-term, fixed-rate senior debt capital that sits equally (or 'pari-passu') with other senior debt. Due to the nature of the investor (or lender base) private placements can be flexible in tenors (between 5-30 years, depending on financing need and credit quality) as well as size (as low as \$15 million in a bilateral transaction with a single investor, to \$2.5 billion in a 'mega'-syndicated transaction).

Traditionally, companies issue private placements with institutional investors, such as large insurance companies. **A private placement issuance is a way for institutional investors to lend with a 'buy-and-hold' approach, and with no required rating or public disclosures.** Private placements are typically fixed rate, offering interest rate protection to the issuer over the term of its debt. This is a more intimate, relationship-based market where borrowers will commonly get to know the private placement lenders well, similarly to their banks.

3 Public Bond Market

Companies will often issue a corporate bond in the public bond market to raise long-term senior debt capital; the preparation process can be time-consuming due to the time and resources required to create the necessary prospectus and register with an exchange commission. With bond issuances, ratings and minimum issuance size are typically required. Amounts raised in the public bond markets are often more than \$300 million (to qualify for index-eligibility), and in many instances, public bonds are issued by a company with publicly traded stock. **Like private placements, the purchasers of public bonds also include institutional investors, but unlike private placements, public debt is more likely to be traded and has a more opaque investor composition.** A benefit of the public bond market is that covenants are typically much looser than bank and private placement debt, which are typically aligned.

Bank Market vs. Private Placement Market vs. Public Bond Market

	Banks	Private Placements	Public Bonds
Registration	Exempt from registering with an exchange commission	Exempt from registering with an exchange commission	Required to be registered with an exchange commission
Tenor	Typically short term (3-5 years) Bullets or amortizing structure	Long term (up to 25+ years) Bullets or amortizing structure	Long term (up to 25+ years) Bullets with standard maturities
Amount	US\$20 million - US\$500 million in single or multiple issuances	Wide range (US\$15 million in a bilateral transaction with a single investor - US\$2.5 billion in a 'mega'-syndicated transaction)	>US\$300 million in a single issuance to assure index eligibility
Rate	Typically floating	Fixed or floating	Typically fixed
Callability	Floating: Reducing schedule	Fixed: Make-whole (T+50 bps) Floating: Reducing schedule	Make-whole (T+20 to 50 bps; ~15% of credit spread)
Public Ratings	None required	None required	Typically required
Fees	Ongoing fees	Minimal if direct Placement fees if agented	Registration/ratings fees Underwriting fees
Investors	Local, regional and national banks	Accredited Investors, typically institutional Single, clubs or larger groups Buy-and-hold nature Smaller investor base allows for amending structure as needed	Institutional investors Sizable groups Can be active traders Broad investor base with limited relationship
Covenants	Covenants associated with a traditional bank facility	Similar to traditional bank facility	Largely no financial covenants
Execution	Shorter time to funding	4-8 weeks; flexible with regard to locking in a rate	Shorter time to funding for seasoned issuer; can fund three days after commitment

Businesses are not limited to any one of these markets but can obtain senior debt capital with differing structures from multiple sources. For example, companies can achieve structural parity when combining private placement and bank loans, in addition to other benefits.

Senior Debt Capital Variations

In addition to the options for sourcing senior debt capital, there are several security options as well as ways it can be structured.

Senior Debt Capital Security: Secured vs. Unsecured

Depending on a company's scale and track record, the senior debt capital they obtain will either be 'secured', via an asset-based loan or 'unsecured', like most cash flow-based loans. Here are the main differences between asset-based and cash flow-based loans:

Asset-Based Loans	Cash Flow-Based Loans
Secured; they always take some form of security (or 'collateral') to support the loan	Often unsecured
Can help companies with significant fixed assets find adequate liquidity to operate in their asset intensive market	May take security, typically in the form of 'all assets', to strengthen the credit quality of a security or improve pricing
Often have fewer covenants and may include collateral-based covenants	Even when secured, the primary consideration for cash flow-based loans is the cash flows of the company, as the covenants will reflect

Senior Debt Capital Security: Secured vs. Unsecured

Secured

To strengthen their credit quality, increase borrowing capacity or reduce their cost of capital, a company can pledge certain business assets to support a loan, making it secured.

Secured loans can be in the form of '**all assets**', where the investor has a lien on effectively all assets of the company in support of the debt issued. Where multiple investors are involved, they may share in the security on a 'pari-passu' basis.

A borrower can also pledge different types of collateral from their operating business, accounts receivable and inventory to specific plants/facilities or equipment on an '**asset-specific**' basis. Asset-specific loans often require appraisals, and the 'loan-to-value' can vary based on the type and age of the collateral.

Unsecured

Unsecured, cash flow-based loans are typically utilised once a middle-market company demonstrates meaningful scale and stability over an extended period. As a general rule, companies may graduate from secured, asset-based loans to unsecured, cash flow-based facilities once they are considered 'investment grade'. The determination of investment grade status is often based on the amount of sustained revenue and earnings a company can demonstrate, and the amount of debt that is already in place as a claim against that cash flow. Unsecured, cash flow-based loans are typically governed by a suite of financial covenants and can provide additional flexibility for the business, as compared with senior secured financing.

Senior Debt Capital Structures: Revolver vs. Term Debt

Revolver

Revolving loans (or lines of credit) are used by companies to maintain a steady flow of cash. What is 'revolving' about this type of loan is the amount of the loan itself, with balances that are able to be drawn down and repaid on an as-needed basis, often daily.

Specifications:

- Principally used to fund short-term working capital needs
- Term is usually 5 years or less
- Typically priced on a floating-rate basis
- Can be secured or unsecured
- If secured, they are typically secured by inventory and accounts-receivable but can also include fixed assets (machinery, facilities, real-estate, etc.)

Term Debt

Term Debt does not 'revolve' and instead has a set term of 3, 5 or 7 years (typically provided by banks), or a longer term of 5-25+ years (provided by institutional investor markets), during which interest is paid. Thus, it is often used by companies to finance the purchase of machinery or equipment, acquisitions or other growth initiatives. Term debt can amortise, requiring repayment of some or all of the principal during the term, or it can be non-amortising and have a single balloon payment at the end of the term.

Specifications:

- Principally used to fund longer-term investments in a business, like fixed assets, or term out a portion of 'core' revolving debt that is always outstanding
- Tenors ranging from ~2 years for bridge financing out to 25+ years for specific transactions (mortgages, project financing, etc.) or for large/stable companies
- Either fixed or floating rate
- Can be secured or unsecured
- If secured and asset based, it is typically secured by all fixed assets of the company or a specific fixed asset (like a machine or ship)

Here are the variations of securities and structures, based on each senior debt market:

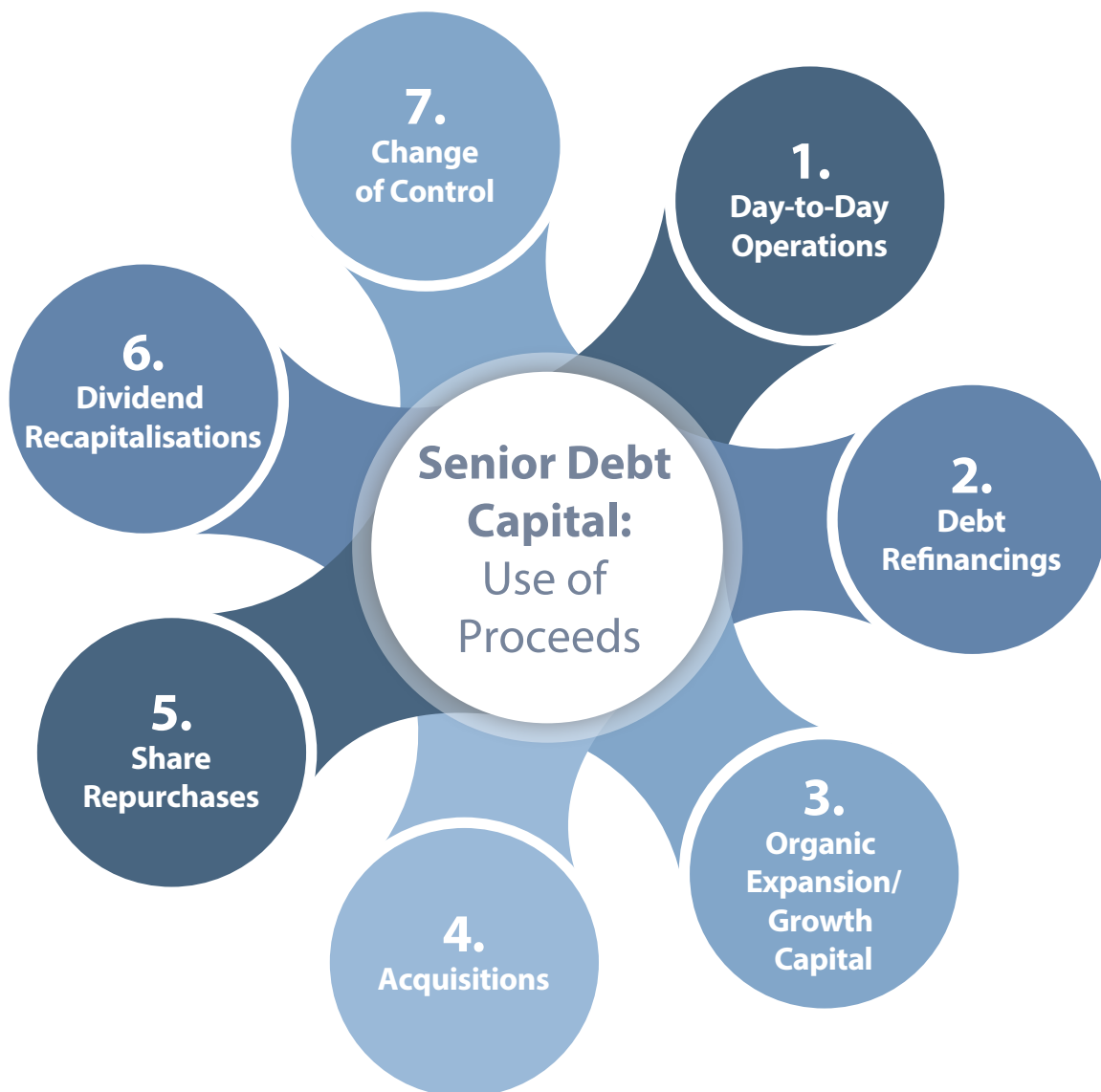
Senior Debt Capital Variations

	Secured	Unsecured	Revolver	Term Debt	Long Duration	Relationship Based
Bank Loans	✓	✓	✓	✓		✓
Private Placements	✓	✓	✓	✓	✓	✓
Public Bonds	✓	✓		✓	✓	

There are various senior debt capital options available to companies, however, you are not beholden to borrowing just *one* type of senior debt capital from *one* provider. **It is prudent to find the right balance and mix of long term versus short term, revolving versus term, and floating versus fixed rate to match your business profile;** the distinct types can be easily combined to suit your business needs. No matter which type or combination of senior debt capital you choose, it is the most cost-effective way to finance your company when using leverage on your balance sheet.

Uses for Senior Debt Capital

For most companies that take on leverage, the first and often only debt that they're going to raise is senior debt capital. Senior debt capital is versatile; it can be used for short-term purposes, such as day-to-day operations, or it can be used for longer-term purposes, like acquisitions or significant liquidity events.



1 Day-to-Day Operations

All companies need capital to fund **day-to-day operations**, or working capital, and if they aren't funded by internal cash flows alone, businesses often use short-term senior debt capital to meet their operational needs.

***Example: Integrity Gaming** was looking to create more financial flexibility in their capital structure to support ongoing investments in their business. They ultimately received a 'one-stop' financing solution that consisted of a senior secured revolving credit facility, a senior secured capital expenditure facility, senior secured notes as well as senior subordinated notes. The new debt structure not only provided Integrity with the liquidity and flexibility they needed both on a day-to-day basis and for the long term, but it also freed up cash flows for their shareholders.*

2 Debt Refinancings

Debt Refinancings are commonly done using senior debt capital to pay off or replace existing, potentially high-cost debt. As companies grow, they may take advantage of lower interest rates or more attractive terms that the market could offer over time. Refinancings using senior debt capital can help decrease the financial burden on a company's debt capital structure, redirecting cash flows to other business needs, or terming out short-term bank maturities with longer-term obligations that may be a better match for the asset life or duration of forecasted cash flow. Long-term, fixed-rate senior debt capital can also be utilised to term out revolvers as well as help mitigate interest rate risk for the long term.

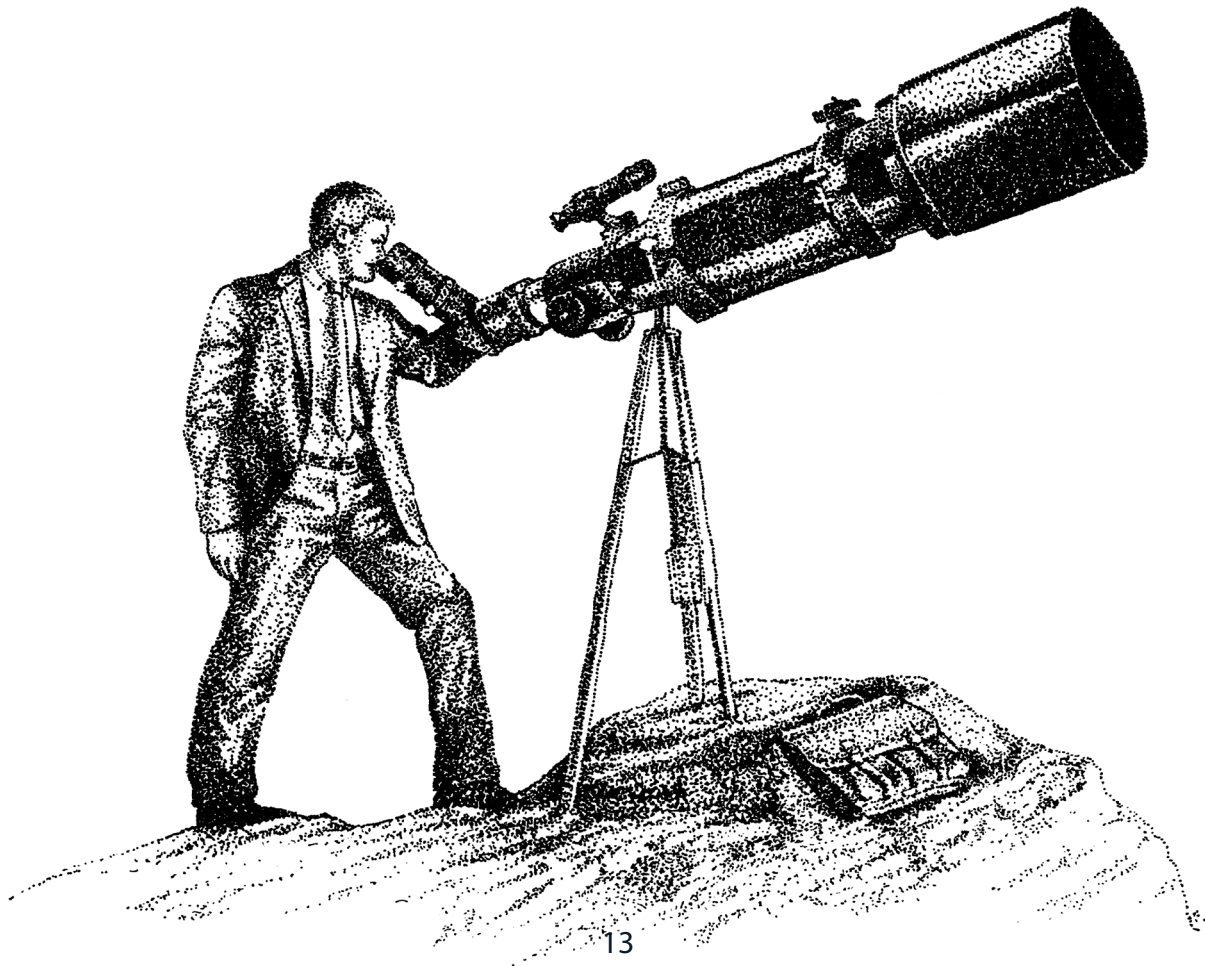
***Example: GPT Group**, a diversified Australian REIT, relies on long-term capital to support the long-term nature of its office and retail property portfolio. GPT Group had previously issued in the U.S. Private Placement market through agented transactions. On this occasion, they decided to obtain senior unsecured notes directly from Pricoa Private Capital as there was a debt maturity coming up and GPT wanted to use USPP notes for a one-off refinancing.*

3

Organic Expansion/Growth Capital

Using senior debt capital for **expansion and growth capital** could help companies achieve their goals for organic growth in a capital and cost-efficient way. Senior debt is often the lowest-cost alternative for raising capital to spend on new production facilities, new technology implementation and other investments. It can also be employed to enter new markets by financing new product developments, broadening its customer base or expanding into new geographies.

***Example: MGP Ingredients** had previously used a combination of cash flow generation and borrowings under its bank credit line, or revolver, to fund a warehouse expansion project and build up an aged whiskey inventory. MGP decided to source capital that would better correspond with the long-term lives of these investments as well as term out a portion of their revolver borrowings. Thus, MGP opted to establish a shelf facility with Pricoa Private Capital, consisting of long-term, fixed-rate senior debt. The shelf facility provided additional capacity beyond the initial borrowing to support the company's continued long-term growth investments.*



“We are very pleased that the new credit facility and fixed-rate term loan will provide MGP with additional flexibility to support our long-term growth initiatives and enhance shareholder value.”

**Gus Griffin, President and CEO,
MGP Ingredients, Inc.**

4 Acquisitions

Senior debt capital can also fund **acquisitions**. Through acquisitions, companies can access adjacent markets, diversify their customer base, or acquire complementary products or technology. Raising senior debt for acquisitions is an inexpensive and efficient way to enhance the return on equity of the acquisition as well as reduce the equity capital expenditure required.

***Example: Mesilla Valley Transportation ('MVT')** sought to reduce their number of lenders and simplify their debt structure to better prepare for potential acquisitions. To accomplish this, MVT set up a senior secured term loan with Pricoa Private Capital, secured by tractors and trailers. As a result, MVT now has the funding needed to carry out their acquisition strategy with a more streamlined capital structure.*

5 Share Repurchases

Share Repurchases, or stock buybacks, can be appealing to both publicly-listed companies targeting EPS accretion as well as privately-held businesses who want to repurchase shares that have fallen out of the hands of the majority owners. These transactions are easily accomplished using senior debt capital.

***Example: Copart** was looking to obtain senior debt financing for a share repurchase and execute the transaction quickly. They approached Pricoa Private Capital with their financing need, who worked with them to provide a substantial dollar amount with a flexible structure. Copart ultimately completed the transaction with its bank group, Pricoa Private Capital as well as one additional institutional investor, and received the capital required to repurchase the shares.*

6 Dividend Recapitalisations

Dividend recapitalisations involve raising new capital to restructure the debt and equity mixture on a company's balance sheet and are an ideal use case for senior debt capital. Senior debt can also be used as a capital-efficient means to fund a special dividend for personal liquidity or estate-planning needs (for private companies) or to return capital to shareholders in the absence of good acquisition prospects or capital projects (for publicly-listed companies).

***Example:** In response to a new federal tax law, **Great Clips** wanted to convert from an S-corp to a C-corp, which would allow them to make a one-time, tax-free dividend. Great Clips required a quick turnaround to meet the federal deadline on the opportunity. In the end, Pricoa Private Capital provided Great Clips with senior secured notes, enabling them to meet their deadline as well as further diversify their capital structure.*

7 Change of Control

In a company, **change of control** can occur when the majority of shares or assets are purchased by management (MBO), the employees (via an ESOP transition) or by another purchaser.

***Example:** After having created an employee stock ownership plan (ESOP) to hold a minority stake in the company's stock, the founder of **Hypertherm** made the decision to transition the company to 100% ESOP ownership, for the purpose of succession planning. Hypertherm was then introduced to Pricoa Private Capital, who structured a financing package that included a senior secured term note and a Pricoa Shelf facility. Hypertherm also obtained a shorter-tenor financing from their bank, which provided a senior secured revolver and an additional term loan. As a result, Hypertherm received the capital needed to finance the 100% ESOP conversion that would help solidify its long-term leadership and ownership strategy.*

While senior debt capital is usually the most cost-effective source of financing for a company, it can also be the most versatile, satisfying a wide variety of needs.

The Benefits of Senior Debt Capital

Companies often choose to use senior debt capital because of the variety of advantages it offers over other types of capital.

1

Cost

Senior debt capital is a cost-effective way to finance a company. It is the debt in a capital structure that gets paid first, so it is less risky from a lenders point of view, making it the cheapest form of funding for a business. Because of this, senior debt capital is a practical choice for financing operations as well as more strategic initiatives. If a company takes on low cost debt and reinvests it into relatively high return capital projects, they are going to create more value for the business.

2

Growth

Senior debt capital allows a company to invest in its business in excess of cash-on-hand. When a company is growing rapidly, they are typically consuming capital as opposed to generating cash flow, thus, they don't have extra cash flow to invest. However, bringing on a senior debt capital partner can enable companies to pursue growth opportunities they may not otherwise be able to, such as making an acquisition.

3

Control

As opposed to taking on equity, senior debt capital allows a business owner to invest in their business, continue to grow and add value to their business, while also maintaining ownership.

“Senior debt capital can add value to a company mainly in that it allows a company to continue to invest in its business, in excess of the cash flow that’s coming off of the business.”

**Brooke Ansel, Director,
Pricoa Private Capital**

4

Flexibility

Senior debt capital has the flexibility to be sourced and placed on standby for the unexpected, whether it's in the form of a revolving credit facility or a shelf facility. It is important for companies to maintain liquidity for the known and for the unknown.

5

Volume

The senior debt market is the largest of all the capital markets. As you work your way down the capital markets into more junior levels of capital, there is simply less capital available. The capital markets are the deepest and most liquid at the senior debt level because that is where most dollars are invested by institutional investors and banks. Thus, companies can access deeper pools of capital from the senior debt market.

If a company is going to substantially increase in scale, they need external capital. Utilising senior debt capital is the most affordable, flexible and effective way for companies to improve their growth rate while maintaining control.

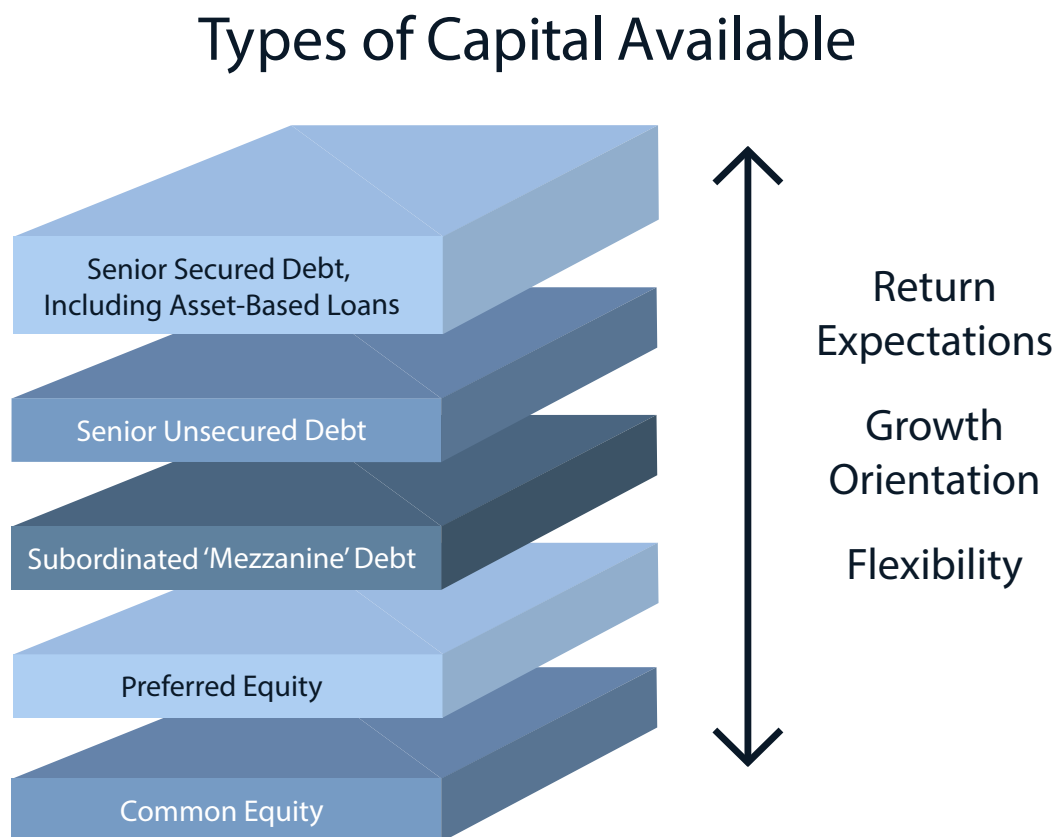
Using Senior Debt Capital for Strategic Growth

Many companies realise the importance of setting strategic goals, especially regarding growth. While businesses commonly finance operating expenses with senior debt capital, it is also a viable resource to facilitate *strategic* growth.

Being well-versed on the types of capital available, along with the total potential availability of capital under various scenarios, enables management to improve strategic planning at the board level as well as create or quickly respond to opportunities, such as the pursuit of an attractive acquisition target.

Common Types of Capital Available to Companies

The image below illustrates the common types of capital available to companies, shown in order of priority. As a general rule, capital with higher priority has lower risk, and therefore, lower return expectations to the capital provider and cost to the company. Conversely, capital with lower priority has higher risk, and higher return expectations for the investor and cost to the company.



Overview of Capital Structuring

A company's capital structure should balance both short-term and long-term needs — optimised to fit the long-term vision for the business as well as position the company to take advantage of investment opportunities that could arise 3-5 years down the road. Companies that adopt this mindset will implement a capital structure strategy that reserves borrowing capacity for large or near-term expenditures and preserves capital structure flexibility.

Additionally, the appropriate capital structure for a company often evolves with changes to their overall strategy, the market environment, the competitive environment and their short-term strategic business plan.

Leverage

When determining how much debt or leverage to take on, companies should ask themselves these questions:

How much debt capacity can my company service?

How much risk am I willing to put on my business?

In determining how a company can structure their balance sheet to maximise returns and balance risks, general qualitative factors include:

1. Operating Leverage – Defined as the level of fixed costs in a business model; the higher the fixed-cost base, the higher the risk (i.e. variable earnings). Pairing high operational fixed costs with high leverage increases risk.

2. Cyclicality – Defined as the normal variation of demand experienced by a business (vs. seasonality). Pairing highly variable earnings with high leverage increases risk.

3. Concentration – Defined as a significant portion of revenue/earnings derived from a customer, product, location or operation. Pairing highly concentrated businesses with high leverage increases risk.

When making decisions on capital structure and leverage, financial leaders are also faced with balancing multiple (and sometimes conflicting) objectives of corporate constituents, juggling the goals of the company, the shareholders as well as debtholders:



Capital Structure Strategy Scenarios



The Acquisitive Business

Challenge: Typically, acquisitive companies need to maintain debt funding capacity and access to a variety of markets that can quickly provide cost-effective capital. A common covenant threshold is to maintain senior debt at less than 3x EBITDA, and companies may prefer to operate comfortably within that range through cycles; however, sometimes opportunities arise to spike above that for strategic acquisitions or capital projects. This is the issue ‘Junior Snacks’ came up against when looking to acquire competitor, ‘Tiny Snacks’.

Solution: Junior Snacks chose to optimise their target return on equity by using an appropriate amount of leverage to finance the acquisition. When raising debt to 3.5x to 4.5x for acquisitions, a company needs to be prepared to incorporate step-down covenants to make lenders feel comfortable that they will be returning to run-rate leverage to maximise their potential funding for future opportunities.

Result: Junior Snacks is now able to max out their usage of senior debt (to the extent possible) in acquisitions to drive accretion. By increasing the proportion of senior debt, Junior Snacks can lower its cost of capital return hurdle rate, thereby increasing the potential return of the acquisition.



The Seasonal Business

Challenge: ‘Wicker Sensations’ is a manufacturer and seller of outdoor furniture. Being that most of their sales take place in the spring and summer seasons, Wicker Sensations needs access to a large amount of working capital. It is typical to use revolving bank debt to manage short-term working capital needs such as this; however, Wicker Sensations observed that a working capital facility always has a drawn portion which seems to be permanent in nature and constrains potential liquidity for longer-term investments (e.g. acquisitions, capex projects, etc.).

Solution: Wicker Sensations obtained long-term senior debt financing to term out the amount of debt drawn under the revolving bank facility. By only terming out the core amount, Wicker Sensations retains the flexibility to de-lever through seasonal swings, while maintaining ‘dry powder’ for opportunistic financing needs in the future.

Result: Wicker Sensations has the capital they need to sustain themselves through seasonal swings while also enabling them to achieve their longer-term strategic goals.



The Cyclical Business

Challenge: The revenue of 'Big Automotive Company' closely correlates to economic cycles and new car purchase activity. Thus, Big Automotive needs to ensure it has access to capital when the demand for cars is there as well as when it is not, through varying market cycles.

Solution: Big Automotive diversified its senior debt by tapping into the bank market, the public bond market and the private placement market. Diversification of debt markets, rather than the number of lenders, is key for this type of business as different markets respond differently during cycles, and companies need to retain uninterrupted access to capital throughout market cycles.

Result: Big Automotive can access the private placement market if the bank or public bond markets tighten up during downturns, maintaining consistent access to capital.

When developing a capital structure strategy, it's in the interest of the financial leaders of a company to familiarise themselves with the types of capital available, enabling them to make more tactical decisions about their company's capital structure and better positioning them to accomplish both short-term and long-term strategic goals.

“I think it’s important for companies to have some senior debt on standby, whether it’s in the form of a revolving credit facility or perhaps a shelf facility, just for the unexpected. It’s important for companies to maintain liquidity for the known and for the unknown.”

**Ashley Dexter, Vice President,
Pricoa Private Capital**

Senior Debt Covenants: What to Expect

Most companies we work with aren't necessarily *crazy* about financial covenants. However, covenants are a typical attribute of debt financing. To satisfy senior lenders and qualify for the cheapest capital, companies often agree to maintain certain financial ratios that serve as indicators of liquidity, profitability and capital adequacy. Here is an illustration of what companies can expect with senior debt covenants, and ultimately, how covenants can be used to help both the lender and the borrower:

Overview of Debt Covenants

Once a company has achieved the type of scale that allows for leverage, it will typically have to commit to certain covenants, whether working with a bank or institutional investor. However, there are a few things to be aware of:

Covenants are *not* meant to...

- Restrict a company's day-to-day business operations
- Direct a company's strategy
- Generate lender fees

Covenants *are* meant to...

- Strike the right balance that allows a lender to be assured of steady performance and enables a management team to focus on business execution
- Assist the company in building and maintaining a responsible financial structure, to more easily navigate new capital needs ahead
- Establish an 'early indicator' that communicates financial challenges before a more serious issue emerges

Covenants differ based on the business, whether the financing at hand is secured or unsecured, and cash flow-based or asset-based. Companies can usually expect covenants to be categorised as either 'affirmative' or 'negative'. By becoming familiar with the most frequently-used covenants in the lending markets, borrowers can negotiate ratios that work for their specific business, identifying a common series of metrics by which they can discuss performance with lenders and investors alike.

We have highlighted a few covenants below (both 'affirmative' and 'negative') that borrowers can expect to see. This is not an exhaustive list but rather an illustration of the types of terms included in senior debt agreements.

'Affirmative' Covenants

Affirmative covenants are standards that the borrower agrees to maintain throughout the term of the loan. Common affirmative covenants include the following:

1. Information Requirements - Companies are typically asked to provide basic information about the business, such as financial statements (which include the balance sheet, income and cash flow statements) as well as their auditor's 'no default and compliance certificate.' This information is often required quarterly.

2. Maintain Priority of Obligation - A primary goal of senior lenders is to maintain their status as senior lenders and rank 'pari passu', or on an equal level, with other senior lenders. Limitations and prohibitions on incurring 'super senior' debt is typically specified within the 'Most Favored Lender' provision, in the 'Negative' Covenants section below.

3. Maintain Insurance Coverage - It is often requested that a company maintain insurance that is satisfactory to the lender. Asset collateral is protected by insurance and is expected to be managed by the borrower.

'Negative' Covenants

Negative covenants generally limit or prohibit the borrower from doing something that could be detrimental to the lender. They can be financial or non-financial in nature, but for the purposes of this article, we will address financial covenants in a separate section on page 32. Typical negative covenants strive to limit or prohibit the following activities:

1. Transactions with Affiliates - This term limits the amount of related-party transactions that the borrower can incur to protect the original intent of the use of proceeds and reduce value leakage to third party entities.

2. Asset Sales - This covenant establishes a limit on the amount of assets a borrower can sell, transfer or lease in a year. This term exists to protect the core assets within the obligor group to maintain the integrity and value of the entity being financed.

3. Most Favored Lender - This term automatically drafts any covenant that may be more restrictive than what was included in the referenced loan documents to ensure that senior lenders maintain equal footing over the life of the loan.

Financial Covenants

Financial covenants measure the financial position of the company against its debt obligations – although tested most frequently on a quarterly basis, it is common for borrowers to maintain compliance with these covenants ‘at all times’. These ratios assist a lender in understanding the operating health of a borrower and provide an early indication if changes in performance merit a deeper review.

The following list includes the most common financial ratios that borrowers are often asked to maintain; many involve the relationship between Earning Before Interest, Taxes, Depreciation and Amortisation (‘EBITDA’) as well as debt levels:

1. Senior/Total Debt to EBITDA - The ratio of senior or total debt to EBITDA cannot exceed an agreed upon ratio for specified periods of time. Often called a ‘leverage ratio’, this is the most common covenant within the middle market. Leverage covenants vary by the sector and volatility of the business but often have a beginning range of 2.0x – 3.0x.

2. Fixed Charge Coverage - The ratio of EBITDA to the sum of (i) interest expense, (ii) required principal payments, (iii) capital expenditures, (iv) operating lease and rent payments as well as (v) any management fees cannot be less than an agreed upon ratio for specified periods of time. For highly rated credits, a simple EBITDA (or EBIT) to Interest can also be acceptable.

3. Debt to Capitalisation - Also known as ‘gearing’, this is a balance sheet test that measures the ratio of debt to a company’s total capitalisation (i.e. the sum of debt and book equity value).

4. Minimum Net Worth - This covenant sets a minimum absolute equity book value the company must maintain (it can occasionally be expressed as a percentage of closing book value). For highly acquisitive companies, the covenant can be varied to specify Tangible Net Worth, which excludes intangible assets like goodwill.

A corporate borrower can expect to be required to maintain up to three of these financial covenants within any loan agreement (typically a leverage ratio, debt service coverage and balance sheet covenant), that are intended to work in concert and be set at levels appropriate for the borrower’s sector, company-specific needs/risks and transaction circumstances.

Financial Covenants for Specific Types of Companies

Here are several common types of companies and the example covenants each could receive:

	Corporate (Investment Grade)	Corporate (Below Investment Grade)	Asset-Based Financing	Regulated Utility	REIT	Project Finance
Secured vs. Unsecured	Typically Unsecured	Typically Secured	Secured	Either	Either	Secured
Covenants Based on:	Cash flow	Cash flow	Cash flow and assets	Typically assets	Typically assets	Debt services
No. of Financial Covenants	2-3 (BBB- to BBB+) 1 2 (A- or above)	Typically 3+	2-3	Typically 2	Typically 2-3	1-2
Financial Covenant Examples	<ul style="list-style-type: none"> • Leverage: Total Debt to EBITDA Ratio • Interest Coverage (EBITDA/Interest) • Information Requirements (Financial statements, compliance certificates.) 	<ul style="list-style-type: none"> • Similar to Corporate Investment Grade 	<ul style="list-style-type: none"> • Leverage: Total Debt to EBITDA Ratio • Fixed Charge Coverage • Max Loan-to-Value Commensurate with Asset Type 	<ul style="list-style-type: none"> • Gearing (Debt/Cap. or Debt to Regulated Asset Base) • Interest Coverage (EBITDA/Interest) 	<ul style="list-style-type: none"> • Loan-to-Value (Debt/MV of Assets or Debt/Cap.) • Unencumbered Asset Coverage (Unencumbered Assets/Unsecured Debt) • Debt Service Coverage (EBITDA/Interest) 	<ul style="list-style-type: none"> • Fixed Charge Coverage Ratio (CFADS/Scheduled Principal + Interest + Taxes) • Minimum Liquidity Reserve
Threshold Limits	Set at levels that would trigger at below investment grade migration	Set at levels that would trip if material negative credit migration; less headroom than investment grade covenant levels		Set at levels that would trip if material negative credit migration, and/or refinancing risk becomes potent	Set at levels that would trip if material negative credit migration, and/or refinancing risk becomes potent	Set at levels that would trip if project risks manifest materially

Covenants may feel onerous at times. However, they are in place to help frame a conversation between the lender and borrower and potentially provide an early indication that changes need to be made, either within the company or credit agreement, supporting the long-term success of both the lender and borrower.

Pricoa Private Capital



There are important considerations for a company when selecting their senior debt capital provider, some key characteristics to look for are:

- They are **fast-acting, responsive and have access to key decision-makers within their organisation**
- The lender **demonstrates a constant appetite for debt throughout market cycles, the calendar year and stages companies may go through**
- **They follow through on their commitments**
- The lender is **relationship-oriented rather than transaction-oriented or fee driven**

Ultimately, your senior debt lender should be there for you for the operational side of the business but also as a financial partner to help you grow and support you over the long term. If you're interested in senior debt capital, Pricoa Private Capital is here to help.

Please visit pricoaprivatecapital.com for more information.

