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CAPITAL PARTNERS

The Opaque Lending Market

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Synopsis: Conditions in the credit markets are at an all-time high for borrowers. Increasing capital is available for growth, acquisitions, and shareholder liquidity. For companies in the Canadian middle market, information on the type, amount, and terms associated with the capital is nearly impossible to find. Running a competitive financing process and canvassing a deep pool of lenders is the best way to surface the outlier proposal that optimizes your liquidity and flexibility from debt. However, executing a competitive tender can sideline a finance team for 5 months. What is one to do?

Read on for our views…

The Opaque Lending Market

We are in the middle of a historically opportune time to dramatically enhance the valuation of your business by increasing the liquidity and flexibility from your credit facilities. More capital can help:

- Drive growth and productivity;
- Acquire another business; and
- Access capital for personal uses.

Canada's lending market is opaque, and many of our fast-growing clients have experienced frustrations with accessing capital from their existing lenders. This article discusses some alternatives.

The most active lenders in Canada are the domestic banks. They are large, political organizations. If you have complex credit requirements, you are going need the right connections at the bank and very few people have those. Scotiabank, the largest of the "Big 5," has 89,755 employees. The smallest, CIBC, has 44,516 employees. Even if you know which banks would lead in a competitive process, do you have *the right people* in those banks advocating for you?

Most business owners are not aware that there are options for the banks. We maintain contact with more than 300 private lenders who are actively lending to Canadian middle-market businesses. The reason we say the lending market is opaque is that in Canada there is minimal publicly available data regarding key lending metrics for middle-market lending.

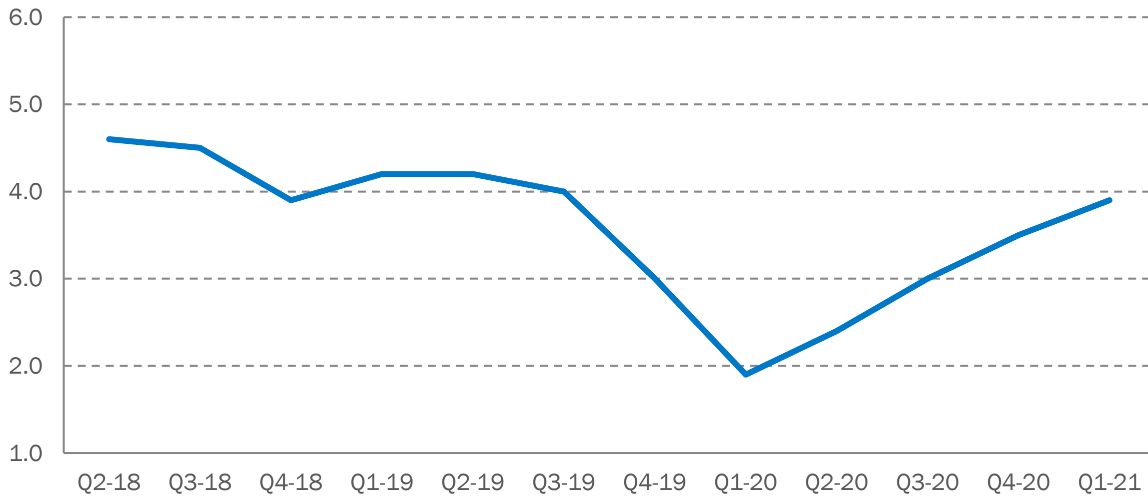
The Canadian Data Dilemma

A wealth of data exists for U.S. based middle-market lending metrics, and this information offers a strategic advantage. A business can understand the pricing and leverage levels that lenders are comfortable with *in advance*. This advance information provides clarity and informs strategy when seeking a new credit facility to refinance an existing loan, or expand credit capacity.

> *"This historically healthy lending market presents a significant strategic borrowing option"*

William Blair (a U.S. investment bank) surveys middle-market lenders to rate the health of the lending market. It is a simple 1 to 5 rating, with five being the most borrower-friendly conceivable. As the general macroeconomic health is currently on the path to gradual, but noticeable recovery, the latest survey in the first quarter of 2021 indicates that the majority of survey respondents would rate the lending environment as borrower-friendly.

Figure 1: William Blair Market Health Survey[1]

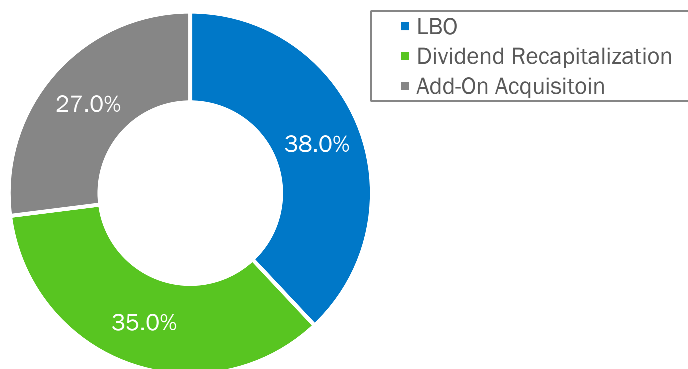


What does a healthy lending market mean for borrowers? Well, for one thing, there is a historic level of money looking for investments and the most obvious place it shows up is in leverage levels.

Research into transaction data from the Bank of Montreal (BMO) shows that currently, when BMO's Sponsor Finance group completes a transaction, on average over 5x EBITDA in debt is placed on the borrower. Many credible U.S. research sources confirm a trend clearly showing a rising tide regarding leverage levels.

Leverage is not the only issue. It is important to know if your type of financing request will be favourably received. The BMO data shows a nearly even split of lending in three transaction types: leveraged buyouts, add-on acquisitions, and dividend recapitalizations.

Figure 2: Popular Transactions



[1] "Leveraged Finance Market Bursts Out of the Gate in 2021 With Record-Setting First Quarter", William Blair, May 2021

If you are in the market to access additional funds for growth, this is good news. Even if you are not in the market to buy another company or fund expansion the dividend recapitalization may be of interest.

A dividend recapitalization (or "recap") refers to when a company borrows money to pay a special dividend to the owners. A dividend recap can be an effective way to de-risk by taking cash off the table and extracting value from your business while the market is hot (which it certainly is these days).

Exploiting Market Inefficiencies

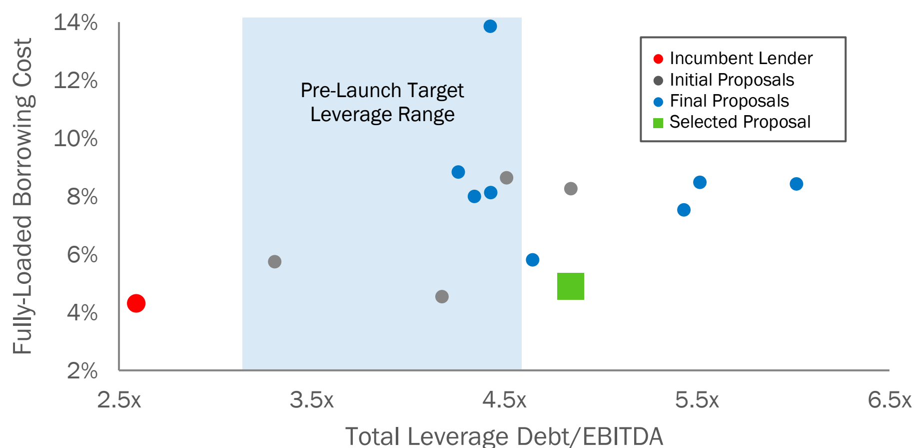
A market is efficient when the players have access to all relevant information. In Canada, there is no equivalent to the U.S. lending market research. The result is that the Canadian lending market is inefficient. Ironically, this market inefficiency presents a strategic borrowing opportunity.

> *"We exploit market inefficiencies by creating competitive tension"*

The graph below contains the results from one financing we arranged and shows the differences between lending proposals. The vertical axis plots the fully-loaded borrowing cost vs. the horizontal axis which plots the leverage the lenders were prepared to offer. The borrowing cost includes interest, speed of principal repayment, fees charged by the lender, and fees charged by Valitas. Even when factoring in our fees, the winning proposal cost of funds was still a comparable to the incumbent facility, and nearly double the committed funding.

This graph reveals astonishing differences even though each lender received identical information. You would think that the lenders would be assessing the same risk through the same parameters, but the outcomes are not even close.

Figure 3: Fully Loaded Borrowing Cost versus Leverage



Another odd difference is that the graph shows a very low correlation between:

- Borrowing cost – for the risk assumed; and,
- Leverage – a rough proxy for the risk assumed.

You would assume that as leverage increases the price would increase accordingly, but not so. The old saying *you get what you pay for* clearly does not apply in this market.

If you were the borrower above looking for senior debt: you would have a poor result if you only contacted lenders to the left of the chart, because the proposal that was ultimately selected offered nearly double the leverage. For a combination of both senior and mezzanine debt some of the proposals are far superior to others on both borrowing cost and leverage – go figure.

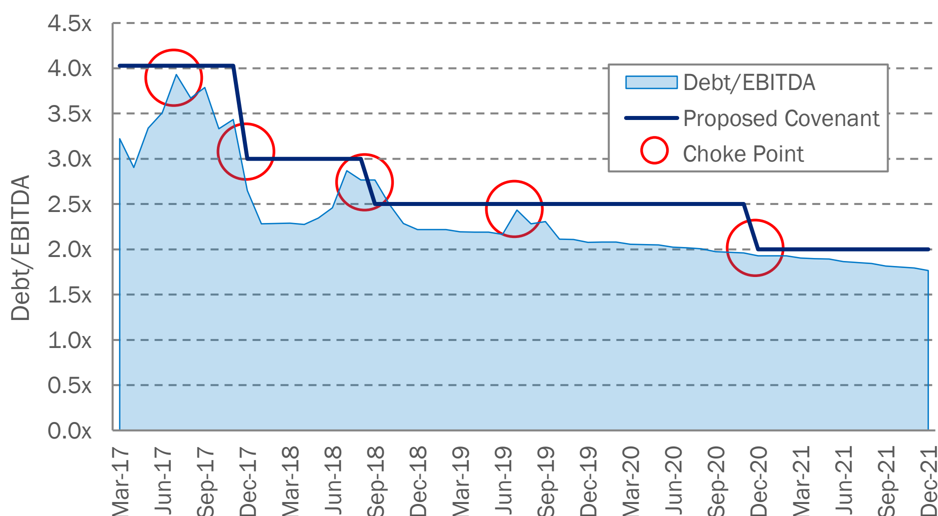
Green-lighting the annual renewal of your credit facility each year assuming it is the best you can get is not a strategy. Exploiting market inefficiencies through competitive tension is crucial to securing a great result.

The Third Dimension: Flexibility

More important than borrowing cost and the amount of financing is ensuring that the covenants on the credit facility are flexible enough that you will not breach covenants as a result of normal variability in your operating results. The last thing you want to be doing is managing your business to meet your covenants instead of unleashing its value.

While a proposal may look good at first glance due to low pricing or a large amount of committed capital, the covenant package is especially important. The challenge is that it is also less transparent. Breaching covenants will result in problems with your lender that will cost you both money and time to resolve. To identify potential choke points or breaches, a credit model must be developed for the life of the credit facility. The below example reflects an acquisition financing we closed recently. We developed a five-year forecast for the client including debt schedules and covenant tracking. By adjusting the model to reflect the terms of each proposal, we were able identify points over the course of the loan where breaches were likely to occur. From there, we negotiated changes to the covenant package to increase the flexibility of the proposal. In this case, we pushed the step-downs out by a quarter.

Figure 4: Covenant Forecasting to Prevent Future Breaches



Your Finance Team Cannot Do This Alone

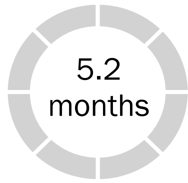
A big reason that you have not heard of these private lenders is that they work with a relatively small number of businesses. You cannot access them without conducting significant market research.

Even if you have access to the right decision makers at the right lenders, you don't necessarily have the time and resources required to execute a competitive process.

The time commitment required to exploit market inefficiencies through a competitive process is significant. We maintain a database of private lenders and have proven systems to execute these processes, and they take us up to 900 hours to complete. How much extra time would your team need to efficiently access these lenders and create competitive tension between them? This is not the finance team's job – this is a specialized transaction and will see the best results when executed by a specialist.

Figure 5: Time required to create competitive tension

A competitive credit process takes a dedicated team of specialists 900 hours to complete.



If your CFO dropped all of their regular duties and dedicates 40 hours per week to the process, it would take 5.2 months to complete. Of course, that's not practical.

If your CFO continues to spend 40 hours per week at their "day job," they would have to work every evening and weekend for ten months to complete this process

Conclusion

It is a good time to take a careful look at your credit facilities. If you could use capital to:

- Drive growth and productivity;
- Acquire another business,
- Access capital for personal uses,

...Or you want to ensure maximum liquidity and flexibility to maximize your resilience, then now is a historically opportune time to maximize your flexibility by taking advantage of the very robust and inefficient credit market. If you are interested in a no-obligation expert assessment of your current credit facilities, we would be pleased to provide insights into your situation.

About Valitas

Valitas Capital Partners is a relationship-focused merger & acquisition (M&A), corporate finance, and strategic advisory firm. We collaborate with ambitious owners of high-performing businesses with a potential value of at least $100 million, to discover, unleash, and realize their full business value potential.

Owners and their leadership teams rely on Valitas when they:

- Want to triple the value of their business in five years or less, but realize they lack the expertise and experience to achieve this alone.
- Want to sell their company now, assured they will look back after the transaction knowing they got the best possible outcome.
- Seek the peace of mind of taking some chips off the table now, to secure their family's financial future without giving up control or the future increased value in their business.
- Are anguished they had to say no to growth opportunities they worked so hard to create because their bank cannot keep up with the needs of their fast-growing business.
- Are frustrated at the lack of traction they are getting with their acquisition efforts, whether it is not seeing enough quality acquisition opportunities, or by wasting time and money coming up empty-handed in auctions.
- Are dispirited by the significant investments in expensive specialists, technology, systems, and financial modeling capabilities required to execute their audacious strategic goals.
- Are intrigued by the idea of selling their business to their management team over time but want to recognize the full value now, while getting their cash payments as quickly as possible.

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About the Author

Paris Aden, Partner

Paris Aden is the founding Partner of Valitas Capital Partners. Since 1994, he has been involved with more than 100 M&A transactions with an aggregate value exceeding $80 billion. He has advised clients at Morgan Stanley, Credit Suisse First Boston and RBC Capital Markets and has acted as a private equity investor at Clairvest Group where he served on portfolio company boards. Paris was also a co-founder of Alluence Capital Advisors, a mid-market M&A advisory boutique that focuses on cross-border transactions.

Paris is recognized as an expert in business strategy, M&A and corporate finance. Previous roles and speaking engagements include:

- Lecturer at the Stephen J.R. Smith School of Business at Queen's University in their Master of Finance (MFIN) program
- M&A subject matter expert for Moody's Analytics' Advanced Capital Markets Program for capital markets professionals
- Three-time expert panel moderator for the Toronto Business Transitions Forum
- TEC Canada "2018 Speaker of the Year" recipient
- Guest speaker for various industry and business leadership organizations

Paris formed Valitas to meet the unanswered needs of ambitious business owners seeking to:

- At least triple their business value in five years or less; or
- Are seeking an elite advisory boutique as their trusted advisor for their complex, mission-critical transactions.