Links Capital's Perspectives

Raising Capital During the COVID-19 Crisis

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Living in this unprecedented time, many businesses are experiencing challenges with their capital resources. Whether you are a business with established cash flows or a growth company, it appears that revenues are going to be negatively impacted in the near term. It is important for those companies having capital requirements in the near future, that they react and start preparing for a capital raise. One can't overemphasize, those who don't begin engaging with capital providers for future required capital may likely be left standing in line.

Government Intervention, Crown Corporations, and Chartered Banks

The federal government has stepped in with some programs to support business:

- Flexibility for corporate taxpayers until December
- Business Credit Availability Program, BDC and EDC ($10 billion +)
- Temporary Business Wage Subsidy
- Lowering Domestic Stability Buffer which will allow Canada's large banks to inject $300 billion of addition lending into the economy

Source: https://www.canada.ca (direct link to Support to Businesses)

The big question is, will this government intervention be enough for companies to get comfortably capitalized and how long will this take? There is little doubt that some of these programs will benefit business. The concern lies with the execution by the banks and the crown corporations due to the sheer influx of credit requests they will receive.

Some of the questions around execution include:

- How will lending requests be addressed in a timely fashion so these businesses can survive, and how will the bank prioritize these requests?
- Is the federal government providing guarantees on all or any of the lending?
- Does every client have the same access to capital and how much is available for each company?
- Will bank employees be working at home and if so, are they limited with their resources to conduct business?
- Will the lending be a short or long-term solution?

This lending process will not be expeditious and the longer the shutdown, the more damage individual businesses will endure. Businesses will have to rely on their stakeholders, whether it be their bankers, investors, suppliers or customers in order to recover from this crisis. Patience is going to be required by all.

Available Capital Outside Traditional Sources

Many alternative sources of capital outside of the banks are fully capitalized and once the uncertainty subsides, they will be looking to deploy capital. These capital sources partner with companies, providing them with capital to help meet a company's goals. The capital may be used to repair a balance sheet, provide capital for growth initiatives or acquire other businesses.

Some of these capital sources provide debt financings that will sit behind the security the current financial institution holds and in some situations the banks may even consider this new capital as equity. Other capital providers may provide a hybrid solution where the capital may have the characteristics of both debt and equity. Lastly, there are the equity providers, some who may want to own a majority stake in your business and others that are passive and content to own a minority stake.

Links Capital specializes in the divesting and financing of businesses in the Canadian middle market.

Links Capital's philosophy is to preserve value throughout the entire transaction process. Senior partners handle all aspects of the transaction from inception to close and beyond, maximizing proceeds.

Being experts in private equity markets and corporate finance enhances value to our clients through extensive buy and sell-side experience.

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Raising Capital During the COVID-19 Crisis

Links Capital are specialists working with private equity firms, institutional investors and strategic purchasers in raising capital and divesting of businesses

Subordinated Debt

There are many subordinated debt lenders in Canada and the US that are interested in partnering with good companies in Canada, notwithstanding the current environment. It is important to understand the landscape when dealing with subordinated lenders in structuring and positioning your company to attract the appropriate financing.

Subordinated debt is a loan to the company that is secured by the assets and supported by the forecasted cash flows of the business. Although this debt is secured by assets, the lender does not have a first charge in the security of the company. The chartered bank will hold a prior charge of security on their operating line and any term debt advanced. Typically, the chartered bank and the subordinated debt lenders enter into an inter-lender agreement which sets out the terms and conditions on how the two lenders will act together in the case that the company breaks covenants or goes into default.

The negotiation of the inter-lender agreement is an important process for the subordinated lender and the company. Depending on the structure that is decided upon, the subordinated debt may be viewed by the chartered bank as equity in the calculation of the company's covenants by the bank. With a chartered bank's debt being senior in security, the subordinated debt may be put in a position by the bank where they are unable to receive principal or interest payments due to a breach of covenants or default. If this were to occur, the debt is behaving more like equity and considered by the bank as equity in their calculations.

Typical subordinated debt is usually priced between 10-12% interest per annum and terms are usually around five years. Subordinated debt lenders try to establish a solution for the company, they will customize how the principal and interest payments are paid. They may structure the debt such that a portion of the interest and principal payments are accrued for some period of time and due at maturity.

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Mezzanine Debt

Mezzanine debt is comprised of subordinated debt and equity, structured in a manner that is less dilutive than an all-equity transaction. The debt component has a coupon rate, which may be less than subordinated debt, that offsets some of the risk allowing for less dilution from a share perspective. The mezzanine lender receives an equity position, typically warrants, at a nominal cost. Some mezzanine lenders will not take an equity position in the company but will choose to take bonus payments and or royalties based on the revenues or profits of the business.

A typical structure for a mezzanine debt financing would be very similar to subordinated debt from a debt perspective but with additional clauses making the investment act more like equity. Expectations over and above subordinated debt conditions may include the following:

- More rigorous due diligence;
- Cash sweeps based on the free cash flow that reduce the amount of the principal quicker;
- Pledge of shares and voting trust agreements;
- Shareholder agreements;
- Board of director's representation; and
- Call and put rights
- Shareholder’s agreement

Having experience as both a mezzanine lender and an equity investor, there are pros and cons to the different types of capital that must be diligently considered.

When deciding to work with any mezzanine lender, one should enter into the relationship as you would with any equity partner. The terms and conditions of the financing can be structured in certain cases that convert to additional equity and will require a skilled advisor and legal counsel to understand all the ramifications of entering into such a relationship.

Some of the chartered banks also have divisions that lend in the subordinated debt and mezzanine markets. There may be a little more latitude given the banking relationship, however, it is important to remember that they are two separate organizations with two different sets of employee metrics that they get compensated on.

Past experience in subordinated and mezzanine lending along with private equity investing, Links Capital is well positioned to help business owners attract capital in a tough environment

Lastly, before entering into any subordinated debt or mezzanine financing, it is important to understand the true cost to your business. Running a cost of capital on the different types of financings is important so you can weigh the risks against the overall cost. As with all debt, interest is tax-deductible which lowers the overall cost of capital to a profitable company while requiring ongoing debt and interest payments that must be taken into consideration in your analysis.

Deferrals on Mezzanine and Subordinated Debt

It is not unusual to see deferrals structured in a manner that allows for all or some of the principal payments being deferred to maturity. Investors may also allow businesses to accrue a portion of the interest costs thus reducing annual payable interest, making it payable at maturity. When principal or interest accrues to maturity, companies often refinance the outstanding amount with lower-cost debt such as a bank term loan. Deferring and paying at a later date may help avoid additional share dilution.

Equity

Equity may be invested by friends, family or institutions such as private equity firms. In the current environment, it is advisable for the business not to enter into any equity investment until more certainty exists in the market and one can properly normalize the costs associated with COVID-19 on the business. On March 2nd, Links' newsletter titled COVID-19's Impact on Private Company Valuations which can be found here, may be helpful in the valuation of companies and normalizing EBITDA when bringing on an equity partner.

Private equity groups want to invest in well-managed companies and typically want the management teams to continue operations. In times of crisis, well-managed companies become very apparent as they have plans in place to manage through difficult times.

It is not unusual for a private equity group to engage a third-party due diligence specialist to help support in their understanding of the business. In some cases, this may be one of the large accounting firms that would be asked to perform a quality of earnings report to help substantiate the earnings of the company as presented by the management team. The entire process is very detailed and often requires the expertise of a group of advisors from corporate finance, tax and legal.

Private equity groups have high expectations for the businesses they invest in and will leverage the business reducing their equity component to earn higher returns. It is not out of the ordinary for private equity funds to lever a transaction to have total debt that is three to four times trailing normalized EBITDA at the close when entering into a majority position. Given it is an equity investment and there are increased debt levels on the company, private equity investors expect more stringent reporting on all aspects of the business from sales/marketing, financial, health/safety and operations.

One should expect in both majority and minority investments that private equity groups will take a position on the board of directors. They will help support the business from the board and often will recruit independent industry experts to join the board.

Raising Capital

As uncertainty subsides in the economy, it is anticipated that businesses may rush to fill capital requirements from capital providers outside of traditional sources. Planning early and getting all of the required information organized as well as creating a dialogue with potential partners is imperative to meeting the business's capital needs in a timely manner. Those businesses that are not proactive in their planning may run the risk of being at the end of the line with alternative capital sources.

Links Capital has been in contact with many lenders and private equity investors who are anticipating a large demand for their capital and have a substantial amount cash available waiting to be deployed. Should your company require the expertise to raise debt or attract equity in this environment, Links Capital would be happy to discuss the opportunities for capital that are available.

Please stay safe during this tough period!

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