



INSIGHT

The Junior Secured Tranche B Loan

Banks have significantly curbed lending based on cash flow; now companies are turning to junior secured debt as an alternative.

Over the past several years, unacceptable default rates, substandard returns and regulatory pressure have led banks and other senior lenders to significantly curb

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lending that relies principally upon the cash flow of the business. For growing or restructuring middle market companies, filling the funding gap between senior secured debt and equity without surrendering control is a challenge. In the void created by the virtual disappearance of cash flow loans, a new tier of junior secured debt has emerged as a supplement to senior debt that provides in-

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cremental liquidity and leverage. Although more expensive than senior secured debt, it may supplant the need for even more expensive mezzanine or equity.

SENIOR LENDERS SHIFT FOCUS

To assure capital preservation, senior lenders have shifted their focus toward more

SMOKE, MAYBE FIRE

For the past several years, we have reported about tightening credit, the difficulty of refinancing, and the increased pricing of all forms of capital. It certainly appears to us that this trend has arrested itself and is now headed in the other direction.

A clear indication of the change in direction is the number of requests for meetings by private equity groups, asset based lenders, mezzanine funds, and banks. Two years ago, representatives of these organizations did not seem to be venturing far from their offices. Now they are filling up their calendars with marketing calls in an effort to put out the word about their renewed appetite for new loans or investments.

Many of the private equity firms are from outside the region. They are telling us that deal flow has picked up dramatically and that they are actively working on new investment transactions.

Lenders report that portfolio growth is gaining in priority. We are hearing that they are finding new flexibility with regard to both credit structure and pricing in order to get or keep a good customer.

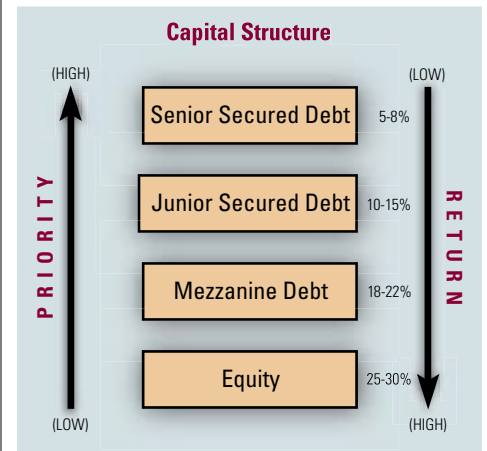
It is not yet clear that the demand for capital is sufficient to satiate this changing appetite, but after a long dry spell, it appears that liquidity is again available to fund new business opportunities. ♦

conservative, asset based credit structures that are underpinned with security interests in assets (collateral). Secured bank financings are purposefully structured to leave a value cushion between the amount of the debt and the realizable or fair market value of the borrower's assets. Many companies have

experienced a double whammy in the search for adequate debt financing to take out maturing financing arrangements. At the same time that senior lenders have steered clear of cash flow deals and sharpened their reliance on collateral, asset values have been severely eroded during the economic downturn. Bankers are willing to lend against hard collateral, but their take on value is pretty miserly. As a result, senior borrowing capacity for many companies has declined, leaving room for another funding source.

HOW THE LOAN IS UNDERWRITTEN

This relatively new tier of capital carries a variety of labels—junior secured loan, tranche B loan, second lien loan, or last out participation. As banks have pulled back, new capital sources, such as hedge funds, specialized finance companies, mezzanine



lenders, and insurance companies, have stepped in to fill the breach in selected situations where the risk can be reasonably quantified and adequately compensated.

These tranche B or junior secured loans meld elements of senior secured term debt, cash flow loans and mezzanine debt. The fundamental credit premise is that there is value in excess of what a senior lender will accept based on the intrinsic value of either the business or its assets. These loans are typically underwritten in one of two ways:

- **Asset Based**—where the credit decision focuses predominately on the liquidation value of the assets, net of the senior advances, as

the ultimate source of repayment; or

- **Enterprise Value**—where repayment is predicated on the value of the business as a going concern.

In the case of an asset based underwriting, the junior lender focuses on the adequacy of the cushion between the senior lender's advance and the realizable value of the assets. The junior lender may also consider the value of assets that are not pledged to the senior lender. Junior secured loans tend to be well suited to situations where the assets are relatively liquid, value is predictable, and the costs associated with liquidation are reasonably quantifiable. Typical situations that may meet these criteria are commodity distributors or retailers where a senior lender is willing to advance 75 to 80-percent of the orderly liquidation value ("OLV") of inventory (net of liquidation costs). A junior lender would, in turn, consider advancing an incremental 10 to 20-percent of the inventory OLV, particularly if other assets, such as

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trademarks, real estate, or leasehold interests, are available as additional support.

With the enterprise value method, which is akin to cash flow and mezzanine lending, lenders consider criteria other than the liquidation value of tangible assets, such as the predictability of cash flow, strength of management, market position and share, and intangible assets (e.g., brand names, proprietary technology, distribution territories, customer base and/or contracts). The junior lender is specifically evaluating the value of the business enterprise as a going concern, based upon most of the factors that an equity investor would weigh. Should the borrower at some point hit a bump in the road, the junior lender needs to have a high degree of confidence that there are readily identifiable and capable prospective buyers for the company, its business units, and/or its strategic assets. Most importantly, buyer interest and value must be sustainable over time, as an unforeseen financial setback that would cause a lender to rely on business value usually does not develop until several years after the original financing is put in place.

HOW THEY ARE STRUCTURED

Junior secured loans are generally structured either as:

- A subordinated lien behind the senior lender[s] on all of the borrower's assets (comparable to a second mortgage on a house); or
- A senior lien on "boot" collateral assets (those assets that the senior lender is unwilling to make a specific advance against). For example, boot collateral might include real property, leasehold interests, or intellectual property such as trademarks.

In terms of the capital structure hierarchy, the junior lien lender has priority over any subordinated debt, unsecured trade debt and contingent claims (by virtue of its security interests), and equity. Following an event of default, these lenders generally have rights and remedies that are comparable to the senior lender other than for their secondary interest in the assets. The relationship between the junior and senior lenders is governed by an intercreditor agreement.

In the effort to arrange a junior loan, size matters. The providers of this tier of capital are looking for borrowers that are not large enough to access the public high yield market, but still have scale within their industries or markets. Ideal candidates tend to be firms with revenues north of \$100 million, although smaller companies can also access this market under the right circumstances. Junior secured loan borrowers are in reasonably mature industries where cash flow can be focused on debt reduction rather than capital expenditures or growth.

GREATER RISK BRINGS HIGHER PRICE

Obviously, a junior secured loan embodies greater risk than senior debt and is priced to reflect that increment of added risk. Lenders typically seek all-in annual returns in the 10

to 15-percent range (in the current low rate environment). Depending on the lender, these financings can be arranged on a fixed or floating (tied to LIBOR or Prime) rate basis. Loan pricing is more attractive than the 18 to 22-percent returns that mezzanine lenders target. In addition, a junior secured loan generally does not require warrants, so shareholders do not suffer equity dilution.

Junior secured debt is commonly viewed as bridge financing that fills the gap until the borrower can reduce its debt and bolster performance. The typical junior secured loan credit structure has a tenor similar to the

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borrower's senior debt, but requires little or no amortization prior to maturity. In most cases, it is refinanced within a couple of years without a prepayment premium. As a consequence, this capital is more flexible than mezzanine debt.

THE EXTRA EFFORT COULD BE REWARDING

The incremental risk of junior secured debt has proven to be of little interest to banks. The field of lenders that is willing to provide what is still a niche product is expanding, but the market is not yet as well developed as the mezzanine market. Although it may take some effort to find the appropriate source for the situation, the potential savings relative to other alternatives can be very meaningful. ❖

Don't Be Fooled By the Numbers

Financial statements are often interpreted differently by prospective buyers than by management.

For most private companies, financial statements are used to keep score, comparing performance from period to period. As long as the records are consistently prepared, that relative measure may be sufficient to manage the business. There are no penalties for imprecise or unclear presentations.

However, when it comes time to sell the business, financial statements take on a whole new meaning. Not only are they used to value the business, but they are also used to measure what the buyer will receive for that value.

Buyers tend to be skeptical. They are undertaking far more due diligence today than was generally conducted during the late

1990's. Part of this is forced by lenders but, make no mistake, before investors write a check, they will make a concerted effort to understand the business and the strategy to create the next increment of value.

The focus of a buyer's due diligence is typically concentrated in two areas: 1) gaining an understanding of how the business generates sales and profits by customer, product, and business segment; and 2) confirmation of the quality of the assets.

Confirming the quality of assets is accomplished by affirming the amount, condition and value as ascribed on the financial statements. Each account is closely evaluated.

Credit vs. Investment Decision

Don't mistake a lender's decision as an endorsement or criticism of an investment decision.

Business owners and managers are often confused or disappointed with the underwriting decisions made by their lenders. From the manager's perspective, a loan request would not have been made if it had not already been determined that the investment was a good idea. However, management must resist the interpretation that approval of their loan request means that the

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The investment decision must consider the full spectrum of risk and return, from losing everything to generating a handsome return. Alternatively, the credit decision is a subset of the investment analysis that considers only a limited range of risk and return possibilities.

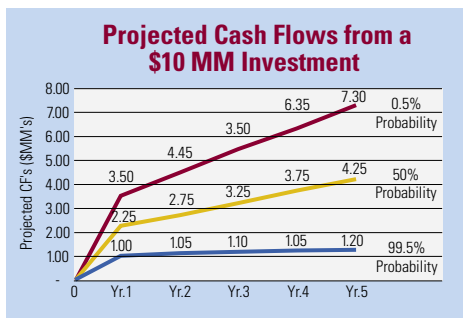
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bank, often a large "sophisticated" financial institution, has agreed with their analysis of the business opportunity. Alternatively, if the bank turns down the loan request, management should not conclude that the investment opportunity should not be pursued. Both lines of thinking are flawed.

Credit and investment decisions are independent thought processes that are only tangentially connected. The investment decision must consider the full spectrum of risk and return, from losing everything to generating a handsome return. Alternatively, the credit decision is a subset of the investment analysis that considers only a limited range of risk and return possibilities.

THE INVESTMENT DECISION

Every asset has a value based on the sum of all future cash flow to be generated, discounted to the present by a rate that reflects the risk of the cash flows. The difficulty in analyzing business opportunities is that the future is not known. That is, there is no



single or certain outcome. The extent to which the possible outcomes vary is a measure of the risk of the opportunity. The graph at the bottom of the first column illustrates the possible cash flows for a hypothetical investment opportunity that would require an initial investment of \$10 million.

The investment analysis requires that the "expected", meaning the weighted average of all potential outcomes, cash flow stream be discounted to the present at a rate that reflects its risk. If the present value of the cash flows is greater than the initial investment, the opportunity will be expected to create value. In this example, the total cash flow expected from the \$10 million investment, discounted at 15%, yields a present value of \$10.43 million or a net present value of \$430,000. Given these expectations, the investment should be pursued as a value creating opportunity.

CREDIT DECISION

A lender considers the same investment opportunity quite differently. The range of possible cash flows available to the lender is considerably different than to the investor. The lender's upside is capped by the potential interest to be earned and the downside is a total loss of the monies lent. Since there is a ceiling on the upside return, only part of the risk can be borne.

Commercial banks for example typically earn only a 1.5% "profit" on a loan. As a result, banks can't afford to lose much and

Example Loan Economics	
Interest Rate (floating)	4.5%
Cost of Funds	2.0
Loan Spread	2.5
Operating Expenses	0.5
Loan Loss Reserve	0.5
Operating Profit	1.5%

remain in business. For example, to make up for a loss of \$1.5 million in principal, the lender must make an additional \$100 million of no risk loans to break-even. It's a small wonder that as banks experience losses, their focus on loan quality is sharpened.

Because of the low return, lenders must conclude that there is a very low probability of incurring a loss of principal. Accordingly, the cash flow stream must have a near certain probability of occurring and must be timed to amortize the loan.

The following table demonstrates the lender's analysis of our example investment.

Lender's Underwriting Analysis						
(\$ 000's)	Beginning	Yr.1	Yr.2	Yr.3	Yr.4	Yr.5
Loan Payment		1,000	1,000	1,000	1,000	1,000
Interest (7%)		287	237	184	127	65
Principal Outstanding	4,100	3,387	2,624	1,808	934	-

Because the range of possible returns is similar to the investor on the downside but much less on the upside, the lender can only justify making a loan equal to 41% of the \$10 million required for the investment. We come to this conclusion by "sizing" the loan to the highest probability cash flow stream. In our example, approximately \$1 million is available for debt service. As shown in the above table, annual payments of \$1 million

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can retire \$4.1 million during the five-year period. In this example, that equates to a loan amount of nearly twice the expected \$2.25 million operating cash flow in the first year.

Of course, investors may induce the bank to increase the amount of the loan by offering collateral that has a value independent from the performance of the investment. In that manner, the downside protection is improved such that a shortfall in the investment's cash flow stream does not mean that the lender will lose the entire loan principal. Long-lived assets are particularly helpful for extending the amortization and maturity of the loan. In this example, to the extent that the value of the collateral exceeds the amount supported by cash flow (\$4.1 million) a larger loan can be justified.

The analysis and examples provided herein are for the purpose of explaining the primary differences in the investment and lending decisions. Obviously, many other details could bear on the result. Nevertheless, by better understanding the context of lenders' underwriting decisions, borrowers won't mistake the lender's conclusion as either confirmation or criticism of their investment decision. ❖

Don't Be Fooled *continued from p.2*

Balance Sheet Accounts

ACCOUNTS RECEIVABLE

INVENTORY

PREPAID EXPENSES

FIXED ASSETS

ACCRUED LIABILITIES

CONTINGENT LIABILITIES

Among the most common issues are:

1. ACCOUNTS RECEIVABLE

An evaluation of accounts receivable typically begins with confirming that each of the obligations arose from a legitimate sale transaction. The investigation then turns to an evaluation of whether all of the accounts are collectable within customary terms. To the extent that they are not, the buyer will demand a discount, will carve out a portion of the purchase price, or will require an escrow or seller guarantee.

2. INVENTORY

The value of inventory is often a subject of significant controversy. A buyer's evaluation of inventory focuses on cost, quantity, condition and salability. Other than to confirm consistency, buyers have little interest in the costing methodology used for accounting purposes. Rather, they want to know that inventory is valued at the lowest possible cost at which the same items can currently be purchased. They want to know that all of the inventory that is currently on hand is salable in the ordinary course, and whether any is obsolete or stale dated. They will typically require a complete physical count at closing and will determine whether the quantities on hand are in excess of that required by current customer demand. Negative conclusions to these tests will give rise to a claim for a reduction in the purchase price.

3. FIXED ASSETS

Accounting standards require that fixed assets are recorded at their historical cost. That may or may not be a relevant measure today. In all but distressed situations, buyers are typically paying some premium over the value of the assets. However, buyers are always on the lookout for deferred maintenance or assets which are not used or useful in the conduct of the business. Buyers are always keen to assess the cost to maintain and replace the assets at the end of their use-

ful lives. Excessive repair and maintenance expenses or significant capital investment required in the near term to maintain the productive capacity will be grounds for a price reduction.

4. PREPAID EXPENSES / ACCRUED LIABILITIES

If prepaid expenses are to be included in a sale, buyers will evaluate each to confirm that the goods or services subject to the accrual have not already benefited the seller. Any deferred revenue will be evaluated to ensure that the amounts are sufficient to fully cover the cost of providing the goods or services at the anticipated gross margin. Mismatches in these accounts may give rise to a claim for adjustments to the purchase price.

5. CONTINGENT LIABILITIES

Although most businesses do not explicitly recognize or record them, nearly all have some type of contingent liabilities. The most common would include product warranties

the purchase price.

The uninitiated may expect that an impairment of asset values would reduce the purchase price dollar for dollar. We have, on many occasions, worked with buyers that have demanded price reductions in multiples of the adjustment amount. How is that result possible? It is justified on the fact that the

Businesses that adopt procedures to closely monitor balance sheet accounts will not only improve the result if there ever is a sale but, as important, they will not be fooling themselves as to the true financial performance of the business.

When it comes time to sell the business, financial statements take on a whole new meaning. Not only are they used to value the business but they are also used to measure what the buyer will receive for that value.

or service guarantees. Buyers will expect a reserve that reflects actual experience. Often business contracts can give rise to contingent liabilities such as employment agreements, supply or purchase contracts. While businesses often deal with such matters as an ongoing cost of business, buyers expect to assign value to these liabilities and deduct it from

asset impairment resulted from a systematic overstatement of earnings, which should be grossed up by the multiple implicit in the valuation of the business. The implication is that the profitability may not be as represented by historical financial statements and, therefore, that future expectations may also be lower. As one might imagine, this can come as a rude shock to the seller who thinks the price has already been negotiated.

So, while a private company that is not for sale may choose not to concern itself with these realities, we would advocate that business managers always treat financial reporting as if they were a buyer of the business. Businesses that adopt procedures to closely monitor balance sheet accounts will not only improve the result if there ever is a sale but, as important, they will not be fooling themselves as to the true financial performance of the business. ♦

ABOUT ZACHARY SCOTT

Zachary Scott is an investment banking and financial advisory firm founded in 1991 to serve the needs of privately held, middle-market companies. The firm offers a unique combination of in-depth knowledge of the capital markets and industry competitive dynamics, sophisticated analytical capabilities, and proven expertise in structuring and negotiating complex transactions. For more information on Zachary Scott, go to ZacharyScott.com.

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