



INSIGHT

Second Lien Financing Redux

Once reserved for restructure or rescue financing, second lien notes have quickly grown to replace subordinated debt mezzanine financing.

by Michael Newsome

A little over two years ago, we wrote about the emergence of a new tier of capital for middle-market companies—second lien term notes or “tranche B” debt. In the robust financing market that has prevailed since then, second lien financing has evolved rapidly. Deal volume ballooned from \$3.1 billion in 2003 to \$12 billion in 2004. Through the third quarter of 2005, the market is on an annual pace to grow by an impressive 25%.

Second lien notes were originally employed in restructure or rescue financings for struggling firms in need of an extra shot of liquidity when cash flow was tight. These loans were based upon incremental advances on asset values beyond the normal first lien comfort zone or on other less conventional assets that senior lenders shied away from. Today, second lien financings are no longer reserved

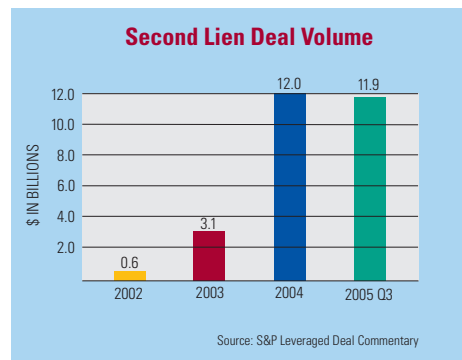
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for turnaround situations. They have become a common component in the capital structure tool kit for leveraged buyouts, recapitalizations, stock buybacks and even growth financings. In each of our last three large sell-side M&A engagements, second lien commitments were prominent features of the financing arrangements supporting some of the most competitive acquisition bids. Interestingly, second lien structures have evolved from asset-based financings into cash flow or enterprise value loans that are more often than not predicated on expected operating

cash flow, business breakup value or the strength of intangible assets. The underlying credit thesis is that the business has significant realizable value in excess of its senior debt, even in a distressed situation.

SECOND LIEN VS. MEZZANINE

The advent of second lien financing has further segmented the middle ground between senior bank debt and equity. It has become an increasingly favored alter-



Second lien financing has evolved rapidly. From \$3.1 billion in 2003 to \$12 billion in 2004.

native to unsecured, subordinated debt mezzanine financing, crowding out the mezzanine providers and pushing them toward smaller companies and higher risk structures. There are a number of differences between the two; but the key distinction boils down to lien subordination (second lien) versus payment or debt subordination (mezzanine). Lien subordination means a duty to turn over to the senior lenders only the proceeds of shared collateral. Payment subordination is an obligation to allow the senior lender to receive all cash flow from the borrower from any source unless specific performance thresholds are being achieved.

In default situations, payments to second lien lenders are typically not blocked and there is only a short standstill period before a

second lien lender can exercise its remedies to collect its principal. In contrast, post-default payments to mezzanine lenders are typically blocked by the senior lender and their

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right to pursue remedies can be deferred via a standstill period for as long as nine months. From a practical point of view, the combination of payment subordination and absence of collateral solidifies the senior lender’s absolute priority over the mezzanine lender. Senior lenders do not have that same right over second lien lenders.

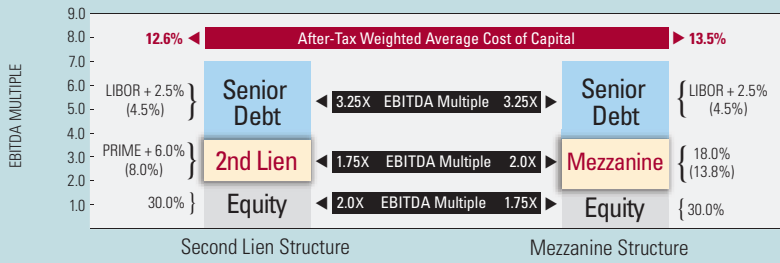
A second lien lender is a secured creditor. Black letter bankruptcy law establishes that secured lenders are entitled to the fair market value of their collateral (provided there is value). The simple fact is that secured (even marginally secured) lenders fare better and have more rights in bankruptcy than unsecured creditors, including:

- Pre-petition rights to foreclose;
- Adequate protection rights;
- Priority over trade and other unsecured creditors;
- Post-petition interest;
- Right to credit bid; and
- More leverage in the negotiations regarding a plan of reorganization.

These rights improve the recovery prospects for a second lien note relative to a mezzanine loan. Typically, most of these rights are the subject of detailed negotiations between the first and second lien lenders and are embodied in an inter-creditor agreement. As the market has grown, the rights and remedies of second lien lenders have been liberalized to improve the strength of their claims relative to first lien lenders.

For borrowers, this modest move up the chain of capital priority translates into more favorable pricing, without the dilutive warrants

Second Lien and Mezzanine Structure



or equity kickers and the onerous call provision that accompany mezzanine loans. Although a complete set of data to support our hypothesis is not readily available, it appears that second lien financing is increasingly favored over mezzanine because it yields a lower overall cost of capital. As illustrated in the nearby chart, a capital structure employing second lien debt may require a bit more equity, but that expense is more than offset by the cost differential between second lien and mezzanine funding.

Second lien loans are specifically directed towards middle-market companies that do not have access to the high yield market or borrowers that would rather avoid SEC disclosure requirements. Second lien activity is expanding and moving down market. Target company parameters have widened to include firms with as little as \$10 million of EBITDA.

The ready availability of second lien financing is being carried on a wave of liquidity that has defined the capital markets for the past few years. The primary providers are hedge funds, which control large capital pools and have insatiable appetites for higher yielding debt instruments, and a new breed of specialty finance companies, known as business development corporations or BDC's.

Publicly traded BDC's, such as American Capital Strategies, Gladstone Capital, and Capital Source, are one-stop lenders that offer first and second lien credit, as well as mezzanine loans. Major commercial and

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investment banks are also originating and managing second lien financings, which are either being syndicated to investors (primarily hedge funds) or securitized as collateralized loan obligations known as CLO's. Commercial banks are not typically holding large portfolios of second lien debt. There will be strong demand for second lien transactions among lenders/investors as long as they view the pricing premiums over thinly priced first

lien credit as attractive relative to the perceived risk of loss.

WHERE DOES IT GO FROM HERE?

One of the more interesting questions for second lien borrowers and lenders is what happens next. The market has grown rapidly in a very robust economic environment. At some point, the economy will cycle down and highly leveraged companies will face tougher sledding. In some cases, there will not be sufficient asset value or cash flow to meet the needs of both first and second lien lenders. The claims and rights of this new capital segment have yet to be hashed out in bankruptcy courts. How assets are managed and when they are sold will have a major bearing on the recoveries realized.

The way the market has grown, spurred by hedge funds, has some implications for borrowers in a downturn. Unlike banks or asset-based lenders, these lenders are not set up to closely manage distressed situations. They tend to be traders rather than patient money or relationship lenders. It is reasonable to expect that when challenges arise, hedge fund managers will mark these loans to market and sell them. As a result, it may be difficult for managers of a distressed firm to figure out with whom they can deal to effect a restructure.

Ultimately we will not know whether second lien finance will be a meaningful source of capital over the long haul for middle market firms until the economy has run a full cycle. Nevertheless, in today's leveraged finance market, second lien loans are an attractive alternative to traditional mezzanine capital. Stay tuned; there will be more developments in this market segment as it matures. ♦

Reconciling Purchase Price and Working Capital

Day-to-day and seasonal fluctuations in working capital investment is always the subject of debate when closing the sale of a privately held business.

by Frank Buhler

One of the challenges in buying or selling a business can be reconciling the purchase price to the day-to-day and seasonal fluctuations in working capital investment that are necessary to sustain the operation. The enterprise value of a business is generally predicated on a projection of its expected future after-tax cash flow after accounting for investments in capital assets and working capital. In exchange for paying the enterprise value purchase price, a buyer should reasonably anticipate receiving all of the assets, net of operating liabilities, required to generate the expected future earnings and

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cash flow of the business.

A deal price is often agreed well in advance of determining the actual closing date. For a firm in which working capital needs vary from day to day and over the course of a seasonal operating cycle, a mechanism is needed to link the level of working capital to the agreed purchase price. This issue of "what is received for what is paid" is the subject of debate in virtually every sale of a privately held business.

When a buyer values a business, it is common to think in terms of "Enterprise Value," which means the value of the operation ex-

clusive of both capital structure and seasonal variations in working capital. In other words:

Enterprise Value

- Outstanding Indebtedness (buyer assumes or is paid from proceeds)
- + Excess Cash (seller retains)
- +/- The difference between actual working capital and target working capital
- = Shareholder Value

This article explores the relationship between purchase price and working capital in situations where the working capital level expands and contracts during an annual operating cycle. The objective is to suggest an approach to quantifying the appropriate level of working capital to support the ongoing business and a post closing purchase price adjustment mechanism that assures that what has been bargained for is received by both the buyer and seller.

DEFINITION OF WORKING CAPITAL

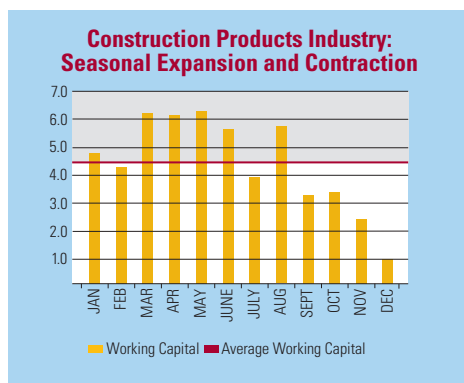
Accountants define working capital as the difference between current assets and current liabilities. Current assets are comprised of assets that will be converted into cash within the span of one year. Typically, these assets include accounts receivable, inventory, and prepaid expenses. Current liabilities are obligations that are due within one year, which generally include trade payables and accrued operating expenses (rent, wages, salaries and benefits, etc.). For the purposes of valuation, working capital excludes cash and interest bearing debt (i.e. current portion of long term debt and the outstanding balance on a line of credit). These items are a reflection of capital structure, rather than the business' normal cash cycle. Both are dealt with in the determination of shareholder proceeds.

The total amount of working capital and its variability over an annual operating cycle are a function of the nature of the firm's business. Companies obliged to extend long payment terms to customers or that have long production cycles require substantial working capital investment. Firms having the ability to demand favorable supplier terms, receive just-in-time inventory deliveries, or enjoy short production cycles require less working capital. In some cases, firms that have strong bargaining leverage with vendors and /or sell to customers on cash terms can actually have negative working capital. Weyerhaeuser and Boeing provide a good illustration of the difference between a working capital intensive business and a firm that can finance its current assets and more with vendor credit.

Weyerhaeuser requires about 11¢ of working capital for each dollar of annual revenue that it generates. This investment must be funded with a combination of debt and equity capital. Boeing, on the other hand, has an extra 13¢ of vendor credit for each dollar of revenue that it produces.

\$ in Millions	WEYERHAEUSER	BOEING
Current Assets	5,424	19,126
Current Liabilities	2,914	26,116
Working Capital	2,510	(6,990)
Total Revenue	22,732	53,955

For many companies, the investment in working capital investment is not static, rather their requirements fluctuate seasonally depending on production cycles and customer demand. The construction products industry is a classic example of seasonal expansion and contraction of working capital. Most companies in this industry follow the construction cycle, which is characterized



by peak working capital requirements in the spring and summer months and excess funds in the winter months. The nearby chart is an illustration of the seasonality of a building products firm, where working capital peaks in May and is followed by a trough in December.

THE PURCHASE PRICE BARGAIN

The average amount of working capital invested over the course of a full operating cycle (typically a year) is the best representation of the amount required to support

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Average annual working capital serves as a reasonable "target working capital." With that agreed, the actual timing of the sale closing has no impact on the value received by the seller or paid by the buyer once the adjustment is made.

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the current level of sales and production. Therefore, when a buyer places a value on a business enterprise, one of the underlying assumptions is that at closing the balance sheet will contain that amount of working capital.

Using the hypothetical construction products business reflected in the chart, it is easy to see that a sale that closed in December would leave the business and the buyer with just \$1.1 million of working capital. Accordingly, the buyer would need to invest an additional \$5 million to fund the business through the annual cycle. Conversely, if the same transaction closed in May, the business would generate \$5.0 million of cash for the buyer's benefit as working capital drops to its seasonal low point. In the absence of an agreement between the buyer and seller to adjust the purchase price of the business as the amount of working capital changes, one party will be disadvantaged relative to the other. To avoid this dilemma, it is common to have a post-closing adjustment mechanism that resets the purchase price, usually on a dollar for dollar basis, to the extent that actual working capital is more or less than the "target working capital" level.

Continuing the construction products business example, the average annual working capital of \$4.4 million would serve as a reasonable "target working capital." With that agreed, the actual timing of the sale closing has no impact on the value received by the seller or paid by the buyer once the adjustment is made. ♦

Purchase Price Adjustment Example

The typical adjustment procedure works as follows:

\$ in Millions	CLOSING DATE	
	MAY	DEC
Enterprise Value	100.0	100.0
Actual Working Capital	6.1	1.0
Target Working Capital	4.4	4.4
Purchase Price Adjustment	1.7	(3.4)
Adjusted Enterprise Value	101.0	96.6
+ Excess Cash	-	3.4
- Debt	(1.7)	-
Proceeds to Shareholders	100.0	100.0

1. Contemporaneous with negotiating a price for the enterprise, a target level of working capital is agreed to by both parties;
2. At closing, the purchase price is determined based on an estimate of the balance of working capital at that time and an adjustment is made to the extent it differs from the target level;
3. After the financial books are closed (60-90 days post-closing), the actual amount of working capital is determined. To the extent that actual working capital differs from estimated working capital, a final adjustment is made to the purchase price.

The bottom line is that the buyer and seller both get the value for which they bargained.

Private Equity Bridges the Gap

A private equity partner is one avenue to address your business and personal objectives.

by Mark Working

Contrary to financial theory, private business owners do not make corporate capital allocation decisions independent of their personal circumstances. The theory doesn't translate into practice because the life cycle of a business and the investment horizon and risk tolerance of the private owners are rarely in sync. A more holistic perspective of a privately held business suggests that the business and the owner(s) be thought of as one, and the needs of both are intertwined.

The traditional solution to diverging needs of business and ownership has been to sell the company to a new owner. But, this may be a less than ideal solution for the owner or family that wishes to be involved in running or being associated with the business. Fortunately, products have evolved in today's capital markets to bridge the gap between the needs of both business and owners. Two examples where former clients of ours have grappled with quite different businesses and personal situations illustrate how external capital can enable both personal and business objectives to be achieved simultaneously.

Tom Campion left the corporate world to start a young men's apparel store, Above the Belt. From humble beginnings, Above the Belt evolved into a sophisticated distribution channel for teen apparel and outdoor gear, targeting the "alternative" segment of the market. As the evolution continued to a fast growing mall based retailer, the name changed to Zumiez and the need for more depth in the management team was recognized. Rick Brooks joined the company as an owner and, over a period of time, became the company's President. This change left Tom with time to direct the creative merchandising side of the business. Business boomed and the growth in new stores and territories rocketed up.

At the same time as the business was evolving and growing, so was Tom, a man with a wide variety of interests. One of his keenest passions is environmental protection. Tom's desire was to establish and fund a foundation that could support the issues he felt so strongly about. Unfortunately, the demands of the business for capital in its growth phase meant that either the business would have to be slowed or his personal goals put on hold.

Jim Coles has the reputation in the world of Class 7 and 8 heavy-duty trucks as operating the most successful dealer in the Peterbilt Motors network. After earning a degree in engineering and spending the early years of his career working on equipment distribution for Caterpillar, Jim decided he needed to find

out what he could accomplish on his own and bought a small dealership in Casper, Wyoming. Later, he merged that dealership with a failing Peterbilt dealership in Seattle, Western Peterbilt. Twenty years later, the reach of his dealership organization extends from Alaska, south into Northern California. At Paccar, owner of Peterbilt Motors, Jim is recognized as having developed the model for dealerships of the future. Western Peterbilt is a multi-dimensional firm that sells new and used equipment, rents and leases equipment, sells parts, provides a complete slate of maintenance services, and handles customer financing needs. At the same time that opportunities to transfer his industry leading business model to a broader network were being presented, several other personal goals tugged at him. Mounting concerns about personal risk for him and his family, together with discomfort with ceding control to a burgeoning management team, placed a constraint on the growth of the business.

A private equity partner was the solution to bridge the gap between the needs of the business and the personal objectives of the owners in both cases. After careful consideration of a variety of alternatives, both Tom and Jim took on private equity partners. In the case of Zumiez, a deal was negotiated with Brentwood Associates, a Southern California based private equity firm that focuses on consumer products investments with an emphasis on lifestyle marketing. Brentwood purchased a position in the company from the current owners. Tom took a few chips off the table, providing him the opportunity to direct funds towards achieving other personal

goals outside of Zumiez and devote its cash flow to the accelerating growth of the business. Tom and Rick took on a partner with specialty retail experience and contacts to help guide the business forward. In the spring of 2005, Zumiez issued public stock (NASDAQ symbol, "ZUMZ"), providing its many employees a market for their options and raising capital for further expansion. Recently, a secondary offering occurred to increase the breadth of public ownership and allowed Tom and Brentwood some further liquidity.

Jim Coles also took on a partner, Greenbriar Equity Group, a transportation specialty investment firm, led by Gerald Greenwald, the former Vice Chairman of Chrysler and Chairman of United Airlines. As part of a recapitalization, Jim was able to monetize a significant share of his holdings, while remaining as CEO and maintaining a meaningful investment. By bringing on a new partner with extensive transportation industry contacts and experience, the new ownership group plans to jointly develop a succession plan for executive management of the business and build the bench strength to allow the Western Peterbilt business model to be exported to other dealership entities.

Private equity is not the answer for every business problem; but it can be an effective tool for bridging the gap between private business owners' business and personal objectives. In today's market, there are a wide variety of capital alternatives available to address these issues creatively. ♦

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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