The Opaque Lending Market

By Chris Angelatos, Associate

Synopsis: Conditions in the credit markets are at an all time high for borrowers. Increasing amounts of 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 full compliment of lenders is the best way to your optimizing your liquidity and flexibility from debt, however that can sideline a finance team for 5 months. What is one to do? Read on…

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 banks are not the only option. We maintain contact with more than 140 private lenders who are actively lending to Canadian middle-market businesses. The reason we say the *opaque lending market* is that in Canada there is minimal publicly available data regarding key lending metrics for middle-market lending.

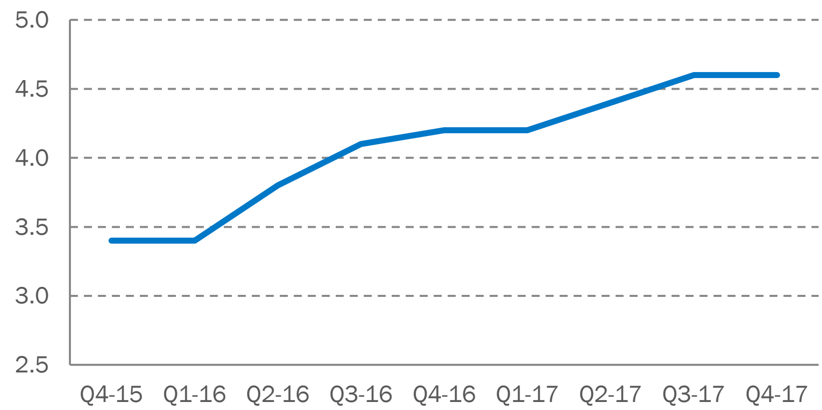
The Canadian Data Dilemma

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. In the latest survey at the end of 2017, the largest proportion *ever* rated the market a five.

Figure 1: William Blair Market Health Survey[1]

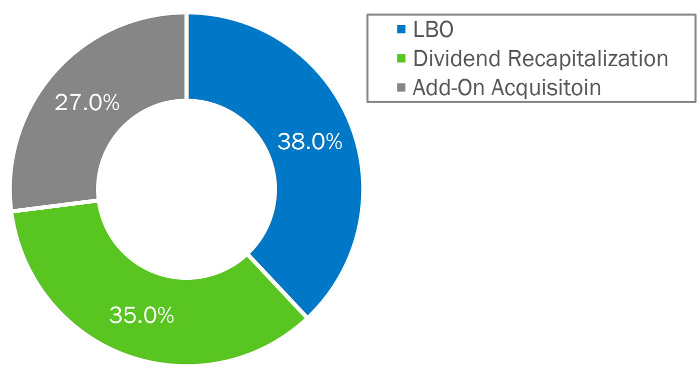


What does a healthy lending market mean for borrowers? Well, for one thing, there is a historic level of money looking for investments and the most obvious place it shows up is in leverage levels.

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



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.

[1] "Leveraged Finance Market Ends 2017 on a High Note, Driving Optimism into 2018", William Blair, January 2018

A dividend recapitalization 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

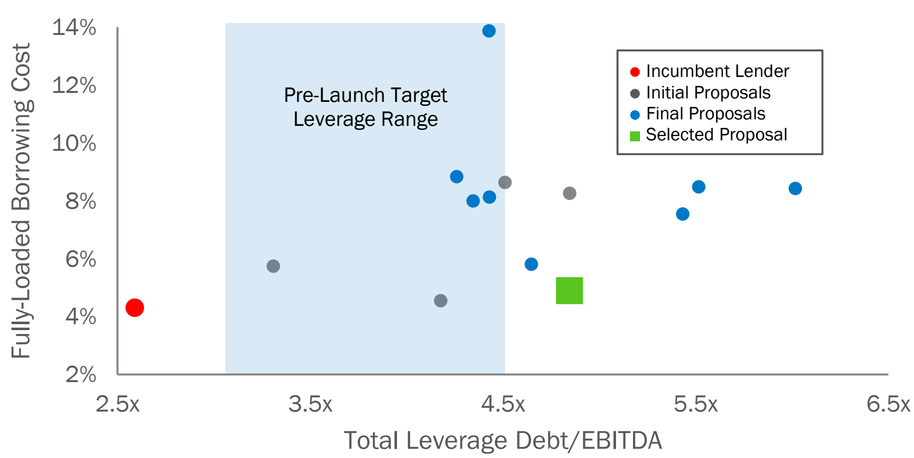
A market is efficient when the players have access to all relevant information. In Canada, there is no equivalent to the U.S. lending market research. The result is that the Canadian lending market is inefficient. Ironically this market inefficiency presents a strategic borrowing opportunity.

> *"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 they were prepared to offer. The borrowing cost includes interest, principal repayment, fees charged by the lender, and fees charged by Valitas. Even when factoring in our fees, the winning proposal was still a comparable price to the incumbent facility, and nearly double the committed amount.

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 it is 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 amount of 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 mezz debt some of the proposals are far superior to others on both borrowing cost and leverage – go figure.

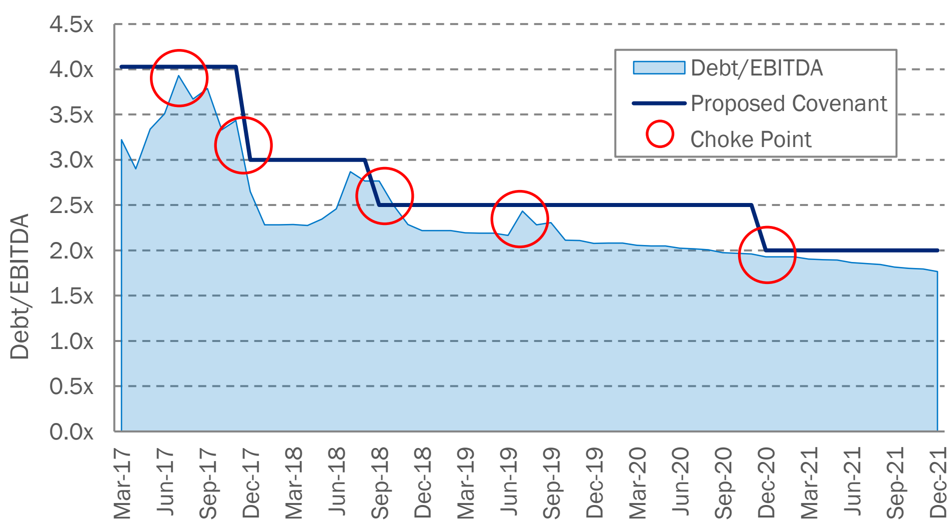
Green-lighting the annual renewal of your credit facility each year assuming it is the best you can get is not a strategy. Exploiting market inefficiencies through competitive tension is crucial to securing a great result.

The Third Dimension: Flexibility

Equally, if not 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 the value in your business.

While a proposal may look good at first glance due to low pricing or a large amount of committed capital, the covenant package is equally important, but less transparent. Breaching covenants will result in problems with your lender that will cost you both money and time to resolve. In order 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 1: 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 know the private lenders and how 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 isn't the finance team's job – this is a specialized transaction, and will see the best results when executed by a specialist.

Figure 2: Time required to create competitive tension

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

If your CFO drops 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 as we head into the next recession, 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 Canadian boutique advisory firm that collaborates with passionate business owners to unleash value over time and realize that value through a well-timed exit. Our work is tailored to our clients' unique priorities and circumstances, recognizing the legacy they have built through years of dedication and sacrifice.

Valitas delivers global firm capability from an agile, entrepreneurial platform. Our value creation excellence is rooted in best practices developed by leading global investment banks and private equity firms. We have completed almost 200 M&A and financing transactions with an aggregate value exceeding $180 billion, including some of the most notable and complex M&A transactions in Canadian history . Clients trust our thought leadership, experience, and privileged access to global networks to identify, evaluate, and execute on their strategic opportunities.

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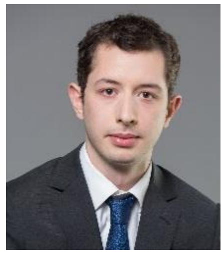

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Chris has prior experience in entrepreneurship, having founded a consumer product company while still in school. He developed and launched the company's product in 8 months to 120 stores, reached the podium at three pitch competitions, and participated in numerous accelerator programs. He was trained by the Next 36, regarded as Canada's top entrepreneurial leadership program, developing strategy, innovation, and finance skills.

Chris holds a B.A.Sc. in Engineering Chemistry from Queen's University, graduating a Dean's Scholar and recipient of the L.A. Munro Award.