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A primer on lending's new age

Survey shows tighter standards, high costs from many funding sources

If you want to know something, sometimes you just have to ask. I found myself in this situation earlier this year, wanting to know how the economic downturn was affecting the behavior of private capital providers.



POINT OF VIEW

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So I asked more than 50,000 of them.

More specifically, I worked with Pepperdine University, which did the asking. In April, Pepperdine surveyed bankers, asset-based lenders, mezzanine capital lenders, private equity investors and venture capitalists. Here are some highlights:

Banks: In good times, banks get caught up in the moment and aggressively engage in cash-flow lending. At the peak of the lending cycle, they lend five to six times EBITDA (earnings before interest, taxes, depreciation and amortization). The survey shows banks are now lending only 2.5 times EBITDA and are quickly moving to lending based on asset (not cash-flow) values. Banks are also using the Prime index now much more than LIBOR, making mainly variable-rate loans and using covenants to restrict further capital access when they do lend. But banks remain the cheapest form of private capital, averaging 6% to 8% on an all-in basis for loans of \$1 million to \$5 million.

Asset-based lenders: These senior lenders come in three varieties: Tier 1, for loans of more than \$10 million; tier 2, for loans of \$2 million to \$10 million; and tier 3, for loans of less than \$2 million. Because each targets different classes of borrowers, each tier tends to earn a different all-in rate of return. This ranges from 8% to 10% for tier 1; 10% to 15% for tier 2; and well above

18% for tier 3.

Why would borrowers pay so much for secured loans? Asset-based lenders require few loan covenants and offer limited personal guarantees. Asset-based lending is the next-cheapest source of capital after bank loans.

Mezzanine lenders: These lenders provide loans and get warrants, which enable them to economically participate as the borrowing company gains value. Because mezzanine deals are subordinated debt and usually made without personal guarantees, lenders charge a high coupon (interest) rate. The survey found rates have risen to 12% to 13% for a loan of \$2 million to \$10 million, a point or two higher than a year ago.

When banks pull back, a mezzanine lender is the next available capital provider for most intangible-asset companies such as service providers. Mezzanine providers hope to achieve about half as much return from the warrant as they do from the coupon; therefore, they expect to earn 18% to 20% on an all-in basis. Borrowers in a weaker position may pay a lot more.

Many mezzanine providers only do sponsored deals, so a private-equity group must be part of the capital structure. The most important attribute for a borrower is management strength, with business and financial risk close behind. If you qualify for mezzanine, you can have total debt (including senior and mezzanine) of about 3.5 times EBITDA.

Private equity: About two-thirds of these transactions involve taking control, which is probably an all-time low. Few private-equity groups are looking to exit through an initial public offering at this point. Selling out to another PEG or a public company are the preferred exit alternatives. PEGs want to realize a 25% return on their equity, but they expect to see about 10% on their current funds — an indication of

how hard it is to generate large returns in this environment.

Venture capitalists: Almost 90% of their investments involve taking minority positions, which contrasts sharply with PEGs. Somewhat surprisingly, VCs change chief executives or chief financial officers only 17% and 6% of the time, respectively.

Investment decisions are made mainly by gut feel or market analysis, not through sophisticated financial approaches such as net present value. VCs expect to earn returns of 40% to 45%, with higher returns required for early-stage companies.

This survey matters for two reasons. By better understanding how major capital providers make lending and investing decisions, we can better plan capital access. That will lead to greater market efficiency. Second, business owners and managers will have information to make better investment and financing decisions.

All capital has a cost, and a tenet of finance is that managers don't create value until they achieve returns on invested capital greater than their company's cost of capital. By knowing what the market requires to make loans or investments, owners and managers can measure their cost of capital and determine whether they are increasing the value of their firms. This knowledge is key in any economic environment.

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