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INVESTMENT BANKERS

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Alternative Sources of Capital

With banks tightening credit, higher risk sources of capital may deserve consideration.

by Mark D. Working

As discussed elsewhere in this issue, bankers are both subconsciously and purposefully tightening corporate credit availability in response to their own crises. Greater lender conservatism, coupled with a dwindling field of sources, means that business owners and managers with a need for incremental funding to pursue strategies with more than minimal risk will be obliged to consider alternative sources of capital.

To be sure, these sources of capital tend to be more expensive than traditional senior debt and, for that reason, management would be advised to first look inside their businesses for sources of liquidity. All opportunities should be considered to more efficiently produce, distribute, and/or sell products and services, as well as freeing up working capital by accelerating the collection of receivables and streamlining the supply chain.

When loan proceeds from your banker and internal optimization measures fall short of the capital needs of the business, alternative sources of capital, such as mezzanine lenders, private equity investors, and joint venture partners, deserve consideration.

MEZZANINE CAPITAL

Mezzanine, as described in the Winter 2004 issue of *INSIGHT,* is a flexible, cash-flow predicated, term loan that can extend borrowing capacity beyond the parameters of senior lenders. These loans are contractually subordinate to, and more expensive than, senior debt, even in today's pricey environment. Mezzanine lenders expect to earn between 15%-25% per annum from a combination of upfront fees, current-pay interest, deferred interest (known as payment-in-kind or PIK interest), and no-cost warrants that represent a share of the company's equity. Inclusion of mezzanine in a company's capital structure adds complexity, as it requires close coordination among the lenders and a tri-party negotiation of a variety of issues, including covenants, lender rights and remedies, prepayment terms, and corporate governance.

In a challenging environment, mezzanine offers some distinct advantages. Stabilizing a portion of the capital structure for an extended period, without a rigid amortization requirement, can provide breathing room during periods of slack demand. Although heightened leverage adds financial risk, mezzanine leaves the current owners in control and is far less dilutive than raising equity. Typically, the catalyst for an attractive financing is either a value-creating corporate development opportunity or ownership transition. In most cases, mezzanine is only available to businesses with strong and sustainable cash flows. It is not a source of capital for distressed situations.

Alternative Capital Suppliers with a Northwest Presence

Firm	Fund Size ($ in Millions)
MEZZANINE	
Key Principal Partners	400
Roynat (Royal Bank of Nova Scotia)	N/A
US Bank Mezzanine	N/A
Wells Fargo Mezzanine	N/A
PRIVATE EQUITY	
Blue Point Capital	415
Buerk Dale Victor	100
CopperLion	100
Endeavour Capital	450
Evergreen Pacific Partners	445
Graham Capital	N/A
IntraCorp	N/A
Joshua Green Corp	N/A
Laird Norton	N/A
Northwest Capital Appreciation	N/A
Pender West Capital	N/A
River Lake Capital	150
Sienna Partners	N/A
Stern Partners	N/A
Tricor Pacific	555
Winona Capital Management	150

The traditional providers of mezzanine capital have been insurance companies and dedicated mezzanine limited partnerships funded by institutional investors, such as pension funds and endowments. Over the past ten years, the field of providers has expanded to include publicly traded business development companies and captive mezzanine lending arms of private equity firms, commercial banks and investment banks.

Very few mezzanine providers market directly to prospective borrowers. Most transactions are structured and arranged with an investment banker acting as the intermediary.

In spite of the credit crisis, borrowers approaching the mezzanine market are likely to find renewed enthusiasm among lenders. The risk-and-return tradeoff has greatly improved for this capital segment. Mezzanine providers can now lend at far more attractive returns into situations that, pre-crisis, would have attracted senior debt. As a result, there is an abundance of capital queued up for mezzanine opportunities.

PRIVATE EQUITY CAPITAL

Historically, private equity firms have been "control" investors with a preference to own a majority, if not all, of the voting shares of the businesses in which they invest. That general motivation has not changed, but investments from private equity funds and other pools of private equity will become more inventive as opportunities emerge to help good companies strengthen their franchises in pursuit of further success. Many traditional buyout firms have recently indicated a willingness to make "Warren Buffett" type investments, via minority preferred positions in the capital structure.

Valuation will be a concern as current conditions have put pressure on prices. Intrinsic value has returned to the marketplace. Rather than relying on "market multiples" or on pie-in-the-sky assumptions about how a business might be valued in the future, investors are returning to the fundamentals, where valuations are based on well-justified expectations for future business performance. Expect a critical evaluation of the business plan that challenges all of management's assumptions. Owners must put out of their minds "what might have been" a year ago. Instead, equity investments should be evaluated based on the incremental shareholder value that may be created with the benefit of new capital.

Private equity firms are not all interested in the same opportunities. Different perspectives

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on the stage of evolution, industry, control and governance parameters, dollar amounts, condition of the company, geographic location, and quality of management, make for a highly fragmented private equity market. Steering your way through the jumble of alternatives requires a guide.

The accompanying table lists capital providers with a Pacific Northwest presence. Each targets its own particular segment of the market, with surprisingly little overlap. There are many firms located outside the region that have both experience and interest in providing capital to local companies.

CAPITAL RELEASED FROM BUSINESS COMBINATIONS

As businesses adjust to lower demand, managers will find that excess capacity and duplicate functions can be eliminated in cooperation or combination with other businesses. An outright sale to a competitor can accomplish the cost reduction objectives, but a joint-venture arrangement, in which parties share facilities and consequent cost savings, may also be worth considering.

When rationalization of a business or industry occurs, cost reductions free up capital. Improved performance also makes the resulting business more attractive to senior, mezzanine, and equity capital providers.

Survivors of this economic downturn can expect to find unprecedented opportunities, once the decks are cleared. One thing that has not changed is capital remains the lifeblood of business. Firms that anticipate their needs and adjust their capital structures accordingly, including considering non-traditional alternative funding sources, can strengthen the prospects of building future shareholder value. ❖

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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, please go to ZacharyScott.com.

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