

## **Raising finance?**

5 critical success factors  
to consider...

Financial advisory



Question: As a business owner, CEO, or CFO how confident are you that your banking facilities are right for your business? ...are they the best that you could have achieved from the market?

From our experience of dealing with small, medium and large corporate clients, the cost of financing, while clearly important, is only one of a number key priorities for stakeholders when evaluating banking facilities. This article is based on the global insights and experiences of the Deloitte Debt & Capital Advisory team, and our experiences in the Irish market, where we've successfully raised more than €1,700m for Irish companies in 2018, year to date.

We've identified **5 Critical Success Factors (CSF)** for borrowers to consider in order to obtain an optimal debt financing package for their companies.



**Being aware of the lending landscape**

Whether considering the financing of capital expenditure in an existing business, acquisitions to enter new markets, or are looking to avail of current favourable credit markets to refinance existing facilities, management are well advised to consider the full range of debt financing options available in the market. This is equally relevant for borrowers that enjoy long-standing relationships with existing banks, or clubs of funders, and who may only seek new debt facilities every 2-3 years.

The spectrum of debt funding options available to SME and corporate borrowers in the Irish market has never been as broad. The three pillar banks, AIB, Bank of Ireland and Ulster Bank continue to dominate the Irish banking sector. Depending on the size of company, and the level of financing required, the likes of Barclays, HSBC and Rabobank are also active players on the Irish corporate banking landscape.

For the purposes of this article, I use the term 'bank' to describe those entities that collectively provide debt financing to companies. Banks are however not the only source of debt financing for corporate borrowers, as the Irish debt market is now complimented by a growing population of 'direct lenders'. These include Bain Capital, Dunport, BMS, Muzinich & Co. and Beechbrook Capital, to name but a few. Depending upon the level of financing required, there are also a number of UK and Continental European based direct lenders actively focusing on the Irish market too, including Proventus AB, Alcentra, Ardian, Cordet and Metric Capital. These direct lenders occupy the gap in the Irish funding market between the commercial banks (i.e. in terms of leverage, flexibility of terms, tenor, structure) and private equity investors, and can often be an attractive financing alternative for corporate borrowers.

With this increasing choice of funders, borrowers have a vastly enhanced range of options to choose from, in order to obtain a structure and commercial terms which best fit the needs and objectives of management and shareholders.

This article outlines 5 Critical Success Factors (CSF) for companies to consider when seeking to raise debt financing. Even those companies not looking to raise financing at this time are well advised to scorecard their current facilities against the CSFs identified – perhaps enhancements can be made.

## Direct lenders in Ireland and UK



### Critical Success Factor #1: Managing the risks of debt

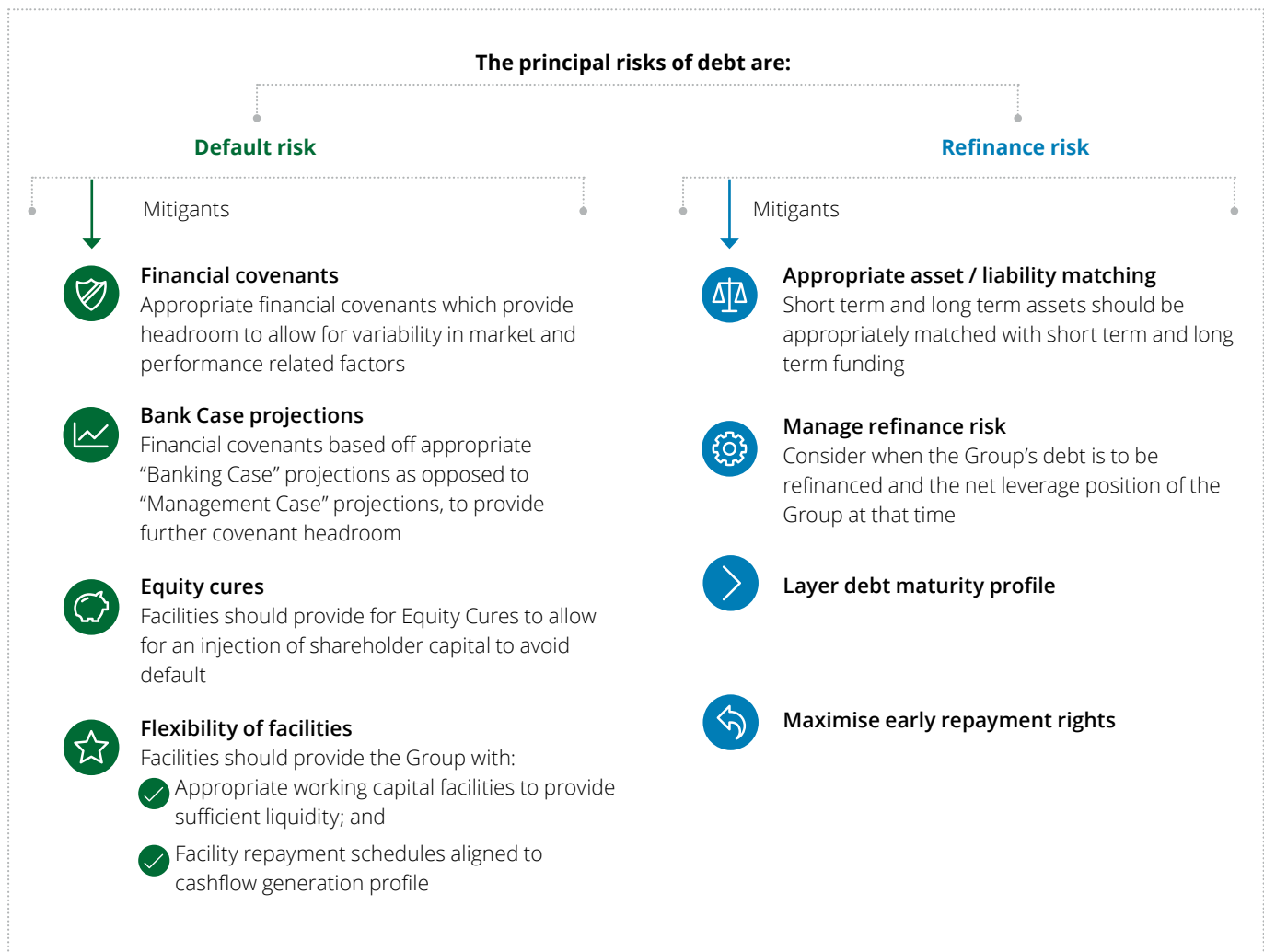
Raising new debt introduces financial risk to a company and can often be daunting for management. This can be particularly true for privately owned businesses, where a substantial part of an owner's net worth is tied up in that business. Accordingly, the protection and preservation of shareholder equity, and the ability to maintain control of the business following a deterioration in performance should be a priority for a borrower.

Management invest significant time planning and preparing financial projections for their businesses. The hope is that performance will be better, or at least be in line with, forecasted budgets.

Sometimes however, performance is worse than anticipated and it is this downside scenario which a borrower, and its advisors, should focus on when evaluating existing, or putting in place new debt facilities. In this regard Default Risk and Refinancing Risk are fundamental risk areas to be addressed when negotiating with your banks.

*"I want to grow my business, but I need to protect the equity value built up in my company!"*

**Appropriate structuring helps manage the risk of debt**  
**Mitigate key risks and protect shareholder equity**



**Managing default risk**

Default Risk is the risk that a borrower could default on its obligations under a financing arrangement, following a deterioration in trading performance, or other event. A default can arise due to a number of factors, but usually as result of a 'failure to pay' an amount due (e.g. a loan repayment amount on a scheduled repayment date), or because of a breach of a financial or non-financial covenant in the loan documentation (a technical default). A default can result in a borrower losing control, to the bank, over its ability to make key strategic decisions, including those which may affect the continued survival of the business. This ceding of control can

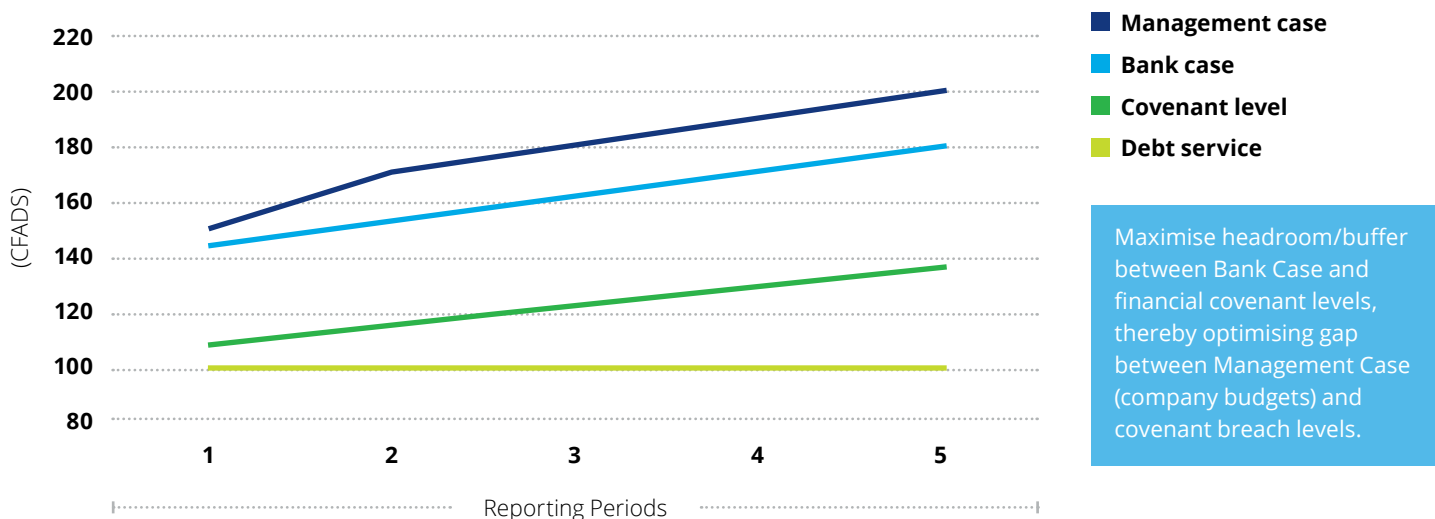
put the value of shareholders' equity at risk, as the bank will prioritise taking steps to ensure it gets repaid its capital, and such steps can often be to the detriment of shareholder equity built up in the company.

The setting of appropriate covenants is therefore key, and in order to protect our clients we therefore negotiate with banks to obtain as much 'headroom' as possible, between management's view of the projected performance of the business, and the trading level below which the company would be said to be in 'default' under its financing arrangements.

An advisor can protect a borrower by:

- structuring loan repayment schedules and financial covenants off appropriately prudent bank case projections;
- restricting the number of covenants to those which are relevant and appropriate;
- optimising the legal definitions of such covenants; and
- running a competitive process amongst select funders to maximise the headroom between projected debt metrics (e.g. leverage, cashflow cover, asset cover etc) and default trigger levels.

### Projections of Cashflow Available for Debt Servicing (CFADS)



Should a borrower default on its financing obligations, it is important that the borrower has the opportunity to cure such a default. This is known as an 'equity cure', in that it gives a borrower's shareholders the right to inject fresh capital into a business to cure a default. By curing a default in this way, shareholders can maintain control over their business. While it may not always be possible for a shareholder to inject new capital into a business, it is important, when negotiating new debt facilities, that the borrower has that option!

#### Managing refinance risk

Refinance risk is the risk that a borrower may not be able to repay its maturing facilities when due, by refinancing or raising new debt in the market. Refinancing risk arises when debt amounts remain outstanding at the final maturity date of a

loan, because unless the borrower retains sufficient cash with which to repay the facilities, it is obliged to source new debt facilities, on or before the maturity date, with which to repay the old. Refinancing risk therefore refers to the risk, or likelihood, that a borrower will be able to access new facilities before the maturity date of the existing loans, as failure to do so would lead to a default of the facilities. In putting in place a funding structure, attention should be paid to ensure that leverage (net debt/EBITDA) is below 2x for most borrowers, while appropriate repayment schedules, maximising term and retaining flexibility of early prepayment rights gives borrowers most flexibility and reduces refinance risk. Depending upon the quantum of debt facilities involved, a borrower can look to layer its debt maturity profile i.e. have loan facilities with a spread of maturity date, e.g. 3yr, 5yr, 6yr.

This helps to ensure that the company always has access to lines of liquidity and that refinancing risk is spread.

Refinancing risk can also arise when the tenor of assets and liabilities are inappropriately aligned. This can happen if long term assets (e.g. capex) are financed by short term (e.g. working capital type) facilities. These risks can also be prevalent when a company is overly reliant on uncommitted, or 'on-demand' facilities, as a main source of liquidity. While short term, uncommitted forms of debt (e.g. overdrafts, invoice discounting) are usually the cheapest, management are advised to use these facilities for working capital financing purposes only, and to consider putting in place some committed lines of credit (e.g. revolving credit facilities) if the industry is volatile or highly cyclical in nature – this is discussed further in CSF #4.



## Critical Success Factor #2: Maximising operational & strategic flexibility

A common challenge reported by borrowers is that the terms of their financing arrangements are too restrictive, and unduly impinge on management's ability to run their businesses. While banks need controls (financial and non-financial covenants, undertakings, negative pledges, conditions precedent) to be in place to protect their position and to ensure they get repaid, the terms of the financing arrangements cannot disproportionately dictate the running of a trading business. Every business is different, and the flexibilities desired by borrowers can differ from company to company, and from sector to sector. Outlined below are just some of the areas where we support borrowers to obtain greater flexibility in their financing structures:

- Restrict number of financial covenants to those which are appropriate and relevant, thereby minimising management distraction and aligning the focus of company and bank on key performance metrics;
- Minimise frequency of covenant compliance reporting and agreement of appropriate on-going information undertakings so as to reduce administrative burden for management;
- Negotiate optimal loan facility headroom (i.e. available lines of credit), be it for capital expenditure, acquisitions, or working capital, to give the borrower flexibility and confidence that it has liquidity available when it needs it (e.g. for growth, or to fund challenging trading periods);
- Structure appropriate loan amortisation schedules to better align loan repayment obligations to cashflow generation profile of the business;
- Negotiation of short non-call periods and allow for voluntary prepayment rights to enable borrowers repay facilities at their option, and a minimal cost, to enable them to avail of favourable market opportunities which may exist;
- Provide for accordion facilities and extension options in financing agreements to facilitate borrower options to call for increased funding, or an extension of the maturity date; and
- Together with legal advisors, negotiation of security packages, to minimise costs, time and structure complexity from a borrower perspective.

“My day to day business cannot be dictated by my banking facilities.”





### Critical Success Factor #3: Having confidence in access to funding lines

The three most common reasons why our clients seek to raise debt financing include:

01. to finance new capital expenditure;
02. to finance bolt on or transformational acquisitions; and/or
03. to provide for the working capital needs of a business.

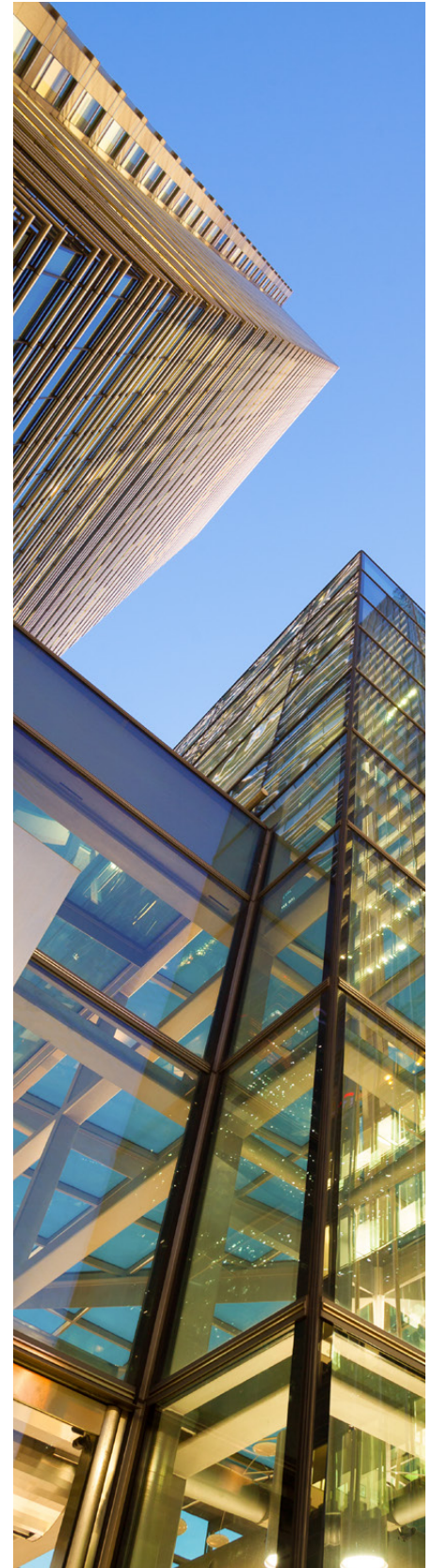
In each instance, a borrower can seek to raise committed or uncommitted financing lines with a bank. Uncommitted financing is cheaper, from a borrower perspective, than committed financing facilities, as a bank is required to hold less risk capital and liquidity against those facilities. The quid pro-quo, and resultant risk from a borrower perspective, is that the bank retains the right to cancel such facilities, often on demand, or with a very short notice period. Accordingly, if a company is overly reliant on uncommitted facilities, has a relatively short relationship with its bank, or is subject to cyclical or turbulent business trading, there is a risk that a company will not have access to funding when it most needs it.

Committed capex, acquisition or working capital financing lines mitigate against many of the liquidity risks associated with a reliance on uncommitted financing lines. Borrowers should take care however to ensure that they get full benefit for the higher cost associated with committed facilities (particularly for capex programmes or acquisitions), and ensure that such facilities are really committed.

Committed capex or acquisition facilities are generally subject to so-called 'Drawdown Conditions', which are conditions which must be met before a bank will allow for funds to be disbursed. While it is normal and reasonable that a bank will require some controls around drawing of funds, a borrower should seek to minimise the number of such drawdown conditions, and negotiate for as much flexibility as possible in such conditions. The likely controls will vary from transaction to transaction, but at the very least will include compliance with financial and non-financial covenants, and typically maximum leverage conditions.

In seeking to put in place the cheapest possible form of debt financing for their growth plans, borrowers often end up with committed facilities which are subject to drawdown conditions which are so numerous, subjective and restrictive that the committed facility is rendered effectively 'uncommitted' as the bank retains so much ability to refuse or challenge the advancement of funds.

“I need to be confident that my financing will be there when I need it.”





#### **Critical Success Factor #4: Reap the benefits of finding the right banking partner**

Depending upon a borrower's main strategic requirements, certain debt providers may be more appropriate partners for your business than others. As outlined in the opening paragraphs, the lending landscape in Ireland has never before offered as much choice to borrowers. In addition to the provision of debt financing, the following are just some of the factors companies consider when selecting a funding partner for their business:

- Breadth of ancillary services (e.g. general banking, payments platforms, FX risk management services, private banking, trade finance, investment banking and overall product range);
- Geographic footprint of the bank – particularly relevant for borrowers trading in international markets, or seeking to enter new jurisdictions;
- Sector specialisms and industry knowledge of the bank;
- Cashflow lending versus asset based lending focus of lender - depending upon the nature of a borrower's business and balance sheet, certain lenders may have more lending appetite than others;
- Desire for a club or group of banks, versus desire for a one stop shop for all banking services.

Some lenders will also have a record of being more relationship focussed, than purely transactional driven. While it's not a universal comment, relationship driven lenders, and most typically banks, are likely to have more patience to work with borrowers through challenging periods, than direct lenders. Bank lenders will also be focussed on cross selling, and will have an expectation that a borrower will buy from their other services (e.g. general banking, leasing, investment banking, treasury risk management, wealth management), as a means of enhancing returns on the borrower relationship.

“My bank is ok, but aren't they all the same?”



#### **Critical Success Factor #5: Using competitive tension to optimise commercial terms and overall cost of capital**

The answer to this question is certainly not one size fits all. Indeed, two neighbouring borrowers of equivalent size and from the same sector could have different loan pricing and commercial terms depending upon what's strategically most important to them, and how they rank the Critical Success Factors outlined in this article. By assessing a company's strategic requirements and priorities, certain lenders and funding structures may be more appropriate than others.

Having determined the ideal funding structure, a borrower's advisor will also have insights into pricing benchmarks, areas for commercial negotiation and target commercial terms. Given the array of debt financing options in the market, it is important for borrowers to consider the cost of debt in the context of, and as only one component of, the overall cost

of capital for the business (i.e. debt plus equity). For companies considering growth, a financing package including higher leverage, and higher cost debt financing (such as unitranche, mezzanine debt and other hybrid structures) may provide a lower overall cost of capital for a company, than a financing structure including low cost senior bank debt, but which requires a greater level of equity capital.

Company stakeholders ultimately want the peace of mind that they've obtained the best terms that could have been achieved from the market. In this regard, the key final step in the journey is to run a competitive debt raise process amongst prospective funders.

A competitive debt raise process, supported by an advisor, will typically involve an Information Memorandum (IM) being shared with relevant target funders. The IM helps ensure that prospective lenders have access to the necessary information required, to enable them provide financing terms. By availing of favourable credit market conditions, the breadth of funding options available and their intimate knowledge of the market, an advisor can then create the competitive tension required between prospective banks to give management and the board comfort that, having followed the 5 Critical Success Factors in this article, the company will obtain its optimal financing package.

“Now we've determined the best debt structure – what should it cost?”



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