THE ART OF LEVERAGED FINANCE
KEY COMPONENTS TO CONSIDER IN THE SEARCH FUND WORLD

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1. The Purpose of Leveraged Finance

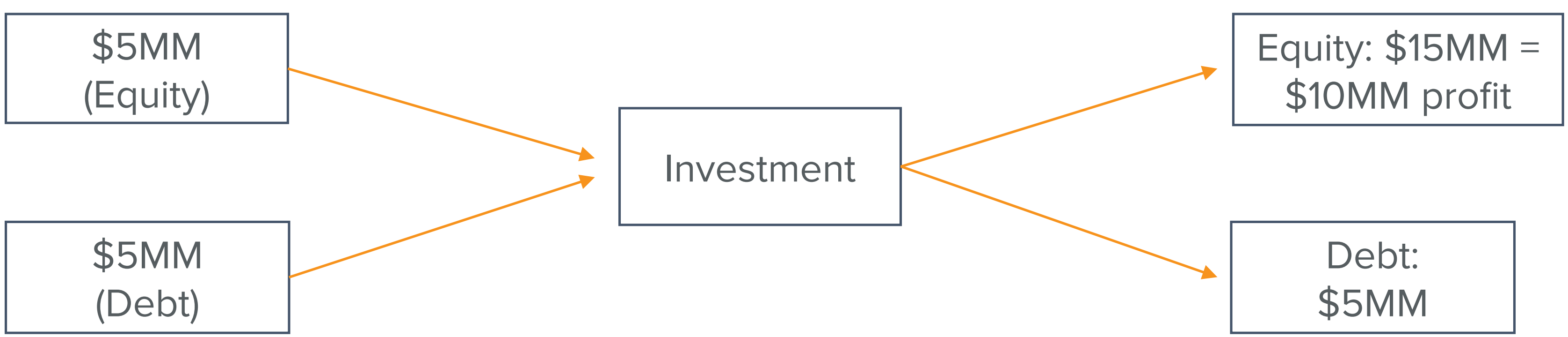
- The purpose of leveraged finance is to purchase a company utilizing both ***debt and equity***, with the primary goal of ***reducing the cash investment*** in an effort to ensure a greater internal rate of return (IRR) for the equity investors
- While the IRR is much higher for ***performing companies***, the risk of leveraged finance must also be considered because there is no guaranteed IRR, meaning that levering up an acquisition contains ***pros and cons/risk and return*** that are far greater than non-leveraged deals
- For those reasons, to truly understand the purpose and profitability of leveraged finance, we must first understand the risks and returns associated with such investments

2. Analyzing Risk and Return

Example: Company purchased for $10 million and later sold for $20 million

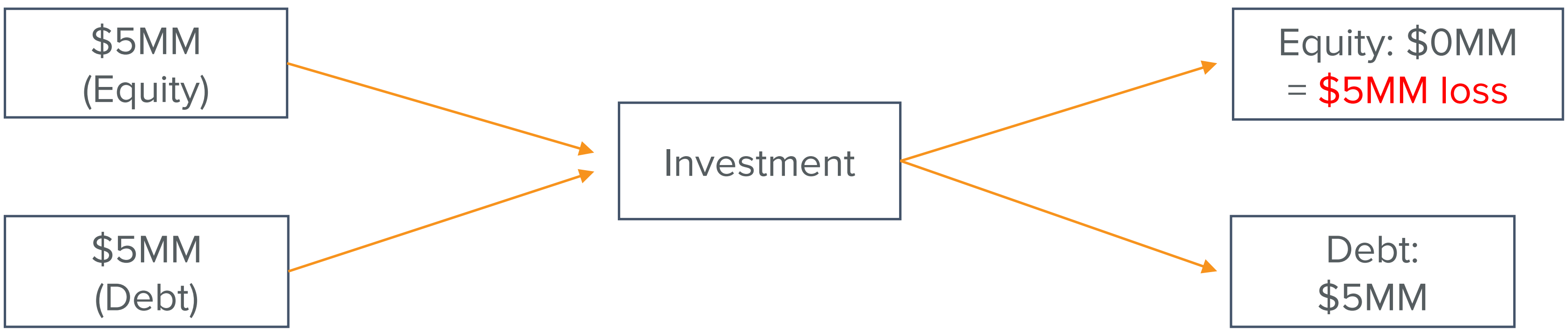
- If we use $10 million solely from equity, the return is 1x (put in $10 million, get $10 million of profit (***100% return on equity investment***))

Leveraged Finance – Pros/Returns: If use $5.0 million from equity and $5.0 million from debt, the return on the equity investment is 2x (put in $5 million, get $10 million of profit *minus* debt servicing costs (***200% return on equity investment***))



2. Analyzing Risk and Return

Leveraged Finance – Cons/Risks: What happens if we utilize leveraged finance for a bad investment? In this situation, let us assume the same as above: $10 million purchase, with $5.0 million equity investment and $5.0 million debt investment. However, let's assume the exit price is $5 million, which means we have a $5 million loss ***plus*** we must pay fees and expenses related to the transaction



In this situation, we lose ***100%*** of our original investment ($5 million loss), even though the cash investment was merely 50% of the purchase price, ***plus*** any fees and expenses related thereto (consider adding 10-15% on a $10 million purchase). This situation may seem extreme, but it highlights the risks of leveraged financing: If we sell the acquisition at the ***original purchase price or below***, we ***lose money***, because, while we may get 100% of the equity investment back on paper, that amount does not include any fees and expenses, which significantly decreases our investment

2. Analyzing Risk and Return (continued)

- ***The Benefits of Increasing Risk and Return***: In the above analysis, we see three different rates of return, each of which points us to the financial benefits of leveraged finance:
  - Pure Equity Investment: Return is ***100%*** if the sale price is 2x the purchase price
  - Leveraged Finance (Positive): Return is ***200%*** if the sale price is 2x the purchase price
  - Leveraged Finance (Negative): Return is ***0% or a loss of up to 100%*** if sale price is ***at or below*** the equity investment (note again that if we sell the company for $5 million and our investment was $5 million, we do not lose $0, ***we lose all $5 million plus related fees and expenses***)
- The above shows the benefits of leveraged finance because, in both the positive and negative scenario, the original investment is ***cut in half*** at $5 million, meaning our maximum loss is $5 million while our return is unlimited. What is most important about this is that such approach allows us to ***diversify our investments***, meaning that instead of using $10 million to buy one company, we can use $5 million to buy two companies.
- For this reason, diversification is the primary benefit of leveraged finance: We not only decrease our initial investment, but we also allow ourselves to ***further diversity our portfolios, which tends to reduce our global risk and help sustain a higher IRR***

3. Search Fund Financing Structures

- ***Enhancing our Structure in the Search Fund World***: Keeping the risk and return analysis in mind, while we may benefit from the diversification of our investments in the leveraged finance world, we often benefit even more by ***including a portion of our purchase price as seller debt***
- ***Seller Debt***: Seller debt comes in a variety of forms, from a seller note, to an earnout, to a deferred payment obligation. Regardless of the type of seller financing utilized, all are treated very similarly because they are means to defer a portion of the ***equity purchase price*** of the company, which ultimately means we need a smaller equity investment on day one
  - Note the use of "equity purchase price" here because, even though we call this debt, it truly is a deferred equity payment, which is necessary to understand in order for us to properly negotiate the seller debt with both the sellers and the lenders
- ***Example***: With the above in mind, let's assume we are purchasing a company for $20 million with the following financial breakdown:
  - $10 million senior debt
  - $8 million equity
  - $2 million seller debt

  * Note here that the equity purchase price is still half the investment, but only ***$8 million*** needs to be paid up front, which means ***the other $2 million will be paid by the company over time*** (this can be a very beneficial approach because it allows ***the asset we own*** to pay a portion of the equity check, ***instead of the investors making such payment***)

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3. Search Fund Financing Structures (continued)

- ***Senior Debt***: Senior debt can take many forms, including first lien term loans, first lien revolvers, and asset based loans, among other types
  - Primary Considerations: Senior lender has the "first bite at the apple" at all times over the assets of the company, meaning that if the investment goes poorly, the senior lender, ***not the equity investors***, has the first rights at the assets
  - Rate: Because the senior lender has the first right at the assets, its risk is low, meaning the interest rate is relatively low (think 5% - 12%, ideally erring on the lower side). This is the concept of risk/return noted above: The senior lender, by having a first priority lien, ***has a far lower risk than all other parties***, meaning its rate of return is lower
- ***Seller Debt/Deferred Equity Investment***:
  - Primary Considerations: Seller debt has both benefits and detriments, with the benefits generally far outweighing the detriments. Also, keep in mind seller debt is a way to reduce up-front cash investments ***with the hope of paying out the sellers over time***. This is a key component in negotiating, because it allows us to offer the sellers $X on day one and $Y down the road, which $Y amount is based on our belief that the company is worth the investment and will continue to grow over time (shifts the burden on the seller to provide a sustainable business, rather than placing it on us)
  - Rate: The rate on seller debt will be higher than the rate on senior debt (generally 8% - 14%), primarily because the sellers are taking on a higher risk (senior lender gets first bite, seller debt gets second, equity gets last). Note also that if we structure the seller payment via an earnout/deferred payment obligation, there will generally be no interest rate ***unless we cannot make the payment on time***, in which case it will "transform" into a debt investment with a necessary interest rate.
- ***Equity Investment***: The equity investment is the last in line, meaning that we must first pay off the other investments before having a positive IRR

3. Search Fund Financing Structures (continued)

- ***Appeasing Both the Senior Lender and Seller via a Subordination Agreement***: One of the more interesting components of having seller debt is negotiating both the payment and seniority levels with the seller, which are generally set forth in the subordination agreement (a document that governs the rights and priorities of the senior and seller/subordinate lenders)
  - Senior Lender's Desire: Senior Lender's desire is very simple: Ensure the senior debt is paid in full before a penny goes to pay down the seller debt
    - Senior lender seeks to achieve this goal by ensuring the seller debt is subordinated to the senior loans and that such subordination is "deep and dark," which simply ensures payments on the seller debt are not made if such payments ***(i) are being made by a struggling company that is in default under the senior credit agreement or (ii) would bring the company down/create a senior default***
    - For this reason, the senior lender wants to block ***all payments to the seller debt***, primarily to retain control of the company's assets/cash flow
  - Seller's Desire: The seller's desire is also very simple, and opposite: Receive payment when due with no restrictions whatsoever
    - Seller Note: All interest payments made on time as well as principal amount payable when due, in each situation, without any restrictions
    - Deferred Payment/Earnout: If the payment is structured as an earnout, then, once the threshold is met (whether via time or performance) the payment is made without any restrictions

  * Note that in both situations, the seller wants ***all payments to be made*** regardless of whether the company has the cash to do so OR whether such payment would bankrupt the company or cause a senior default while the senior lender wants ***to block all payments made at such time***

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3. Search Fund Financing Structures (continued)

- ***Creating the Happy Medium***: Considering both the needs of the senior lender and the sellers, creating a happy medium between the two is where our Search Fund finance team creates significant value. While we do need to keep the subordination provisions in place, we can negotiate them in a manner that appeases both the senior lender and the seller and, most importantly, is beneficial to you, the investor.
  - Seller Debt Interests Payments: As a general rule, the senior lender will allow ***no*** payments on the seller debt; however, to appease the sellers, we are often able to allow for general ***interest payments*** so long as no event of default exists under the senior credit agreement
  - Principal Payments: Principal payments are the paydown of all or a portion of the seller note/earnout/etc. This payment is generally made inside of the maturity date of the senior debt, which is why such payments are subject to restrictions. Below are the reasonable approaches to such payments:
    - No Existing Event of Default: Such payments cannot be made during an Event of Default under the senior debt; this is a very fair ask by the senior lender, which we fight hard to ensure is accepted by the seller
    - Payment Would not Cause an Event of Default: This is another request by the senior lender that is fair; if the payment would cause an event of default, we are not forced to make it

3. Search Fund Financing Structures (continued)

- ***Creating a Happy Medium (con't)***:
  - Dealing with Blocked Payments: Payments that are blocked because of an event of default is the issue sellers are primarily concerned about because, without guidance, they assume that if such payment is not made on time, then it ***will never be made***. Highlighting this because we always want to alleviate this concern using the two approaches below, each of which tends to back the seller off negotiating more beneficial provisions in the subordination agreement:
    - Payment is Paused: Most sellers assume that if a payment is not paid, it will never be paid, which is generally inaccurate. Rather, if such payment is not made because of an event of default, that payment is merely put on hold, meaning that once the default is cured or waived, the company is able to make such payment
    - Penalty Interest Rates: To get sellers comfortable with the above, we allow any unpaid amount to be subject to a rate:
      - Seller Debt: Because seller debt already has an interest rate, we consider this a "penalty" rate, meaning that the interest rate will go up a certain amount (usually 2-4%) while the payment is not made. This approach is fair because the sellers should get some benefit from the deferred payment, which allows them to back off other negotiation points
      - Earnouts/Deferred Payments: These generally do not have interest rates, but, if ***not made on time***, "transform" into seller debt with an interest rate that accrues over time (usually 8-12%). Another fair middle-ground that allows the seller to drop their subordination points because they are protected if a payment is not made on time

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4. Beyond Structure

- ***Beyond Structure***: Negotiating and finalizing the structure with the senior lender and seller is the most complex portion of the financing piece of any search fund deal, but there are numerous other components to communicate with Goodwin's Search Fund team, including:
  - Financial Covenants: Nearly all lenders require financial covenants with each loan, including debt/equity ratio, debt service coverage ratio, fixed charge coverage ratio, etc. These are all fair/consistent covenants we work with on a daily basis and can assist you with in each transaction. Prior to engaging our team, one of the most important points with financial covenants is that you provide potential lenders with ***conservative*** financial models, meaning you ***are not*** showing them the best case scenario. Rather, show them the middle of the road, because the bank will then use those numbers for your financial covenants (in short, ***do not*** try to oversell your investment to lenders, because the lender will then assume your company is more valuable than you are paying and automatically create more difficult financial covenants based on such enhanced/inaccurate financials)
  - Reporting Requirements: Lenders require various reporting requirements, including yearly, monthly, and quarterly financials, along with compliance certificates. We can work with your team to create the proper forms and work through these deliverables.
  - Equity Investment: Certain Search Fund lenders request equity investments. This is generally fine, but let us know before signing any commitment letters with them, only because, as investors, they will receive far more rights to the company's financials than a lender, meaning we often need to carve them out from receiving certain deliverables (any discussion about potential bankruptcy, for instance)

Questions?

Contact Us: To discuss the above or receive additional information on any debt finance issues, feel free to contact Will Pearce or Melissa Wright.

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