

Alternative Debt Raising Solutions for Traditional Businesses

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Equity vs. Debt

It is sometimes confusing for business owners when their traditional financiers interchange the terms "debt" and "equity" so casually that it's worth reviewing their meanings. Debt financing refers to financing raised through a loan for a specific purpose over a specified time period. Loans are also usually secured by some sort of collateral on property or other assets of a business. Equity financing is the financing that a business owner invests into his business. This can also come in the form of friends and family money, from private equity funds or even a government-backed fund. Equity financing is given to a business in exchange for a portion of ownership, and therefore a share in any profits. Equity typically becomes a source of long-term, general-use funds.

Striking the right balance between debt and equity financing means weighing the costs and benefits of each, making sure you're not sticking your company with debt you can't afford to repay and minimizing the cost of capital. Choosing debt forces you to manage for cash flow, while, in a perfect world, taking on equity means you're placing a priority on growth.

Equity	Debt
<ul style="list-style-type: none"> ✓ No rigid interest and principle repayment pressure ✓ More flexibility on investment decisions and cash management × Usually takes a significant longer time to raise than debt × Limited or no tax shield for capital provider × More control required by capital provider × Time and transaction expenses × Less protection for capital providers in event of a default 	<ul style="list-style-type: none"> ✓ Tax shield (no double taxation) hence cheaper than equity ✓ Less agency problems ✓ Usually takes a significantly shorter time to raise than equity ✓ Has to be repaid with interest × Collateral required for secured debt × Not available or more expensive during crisis periods

Table 1: Pros and Cons of Equity vs. Debt

Today's Credit Market

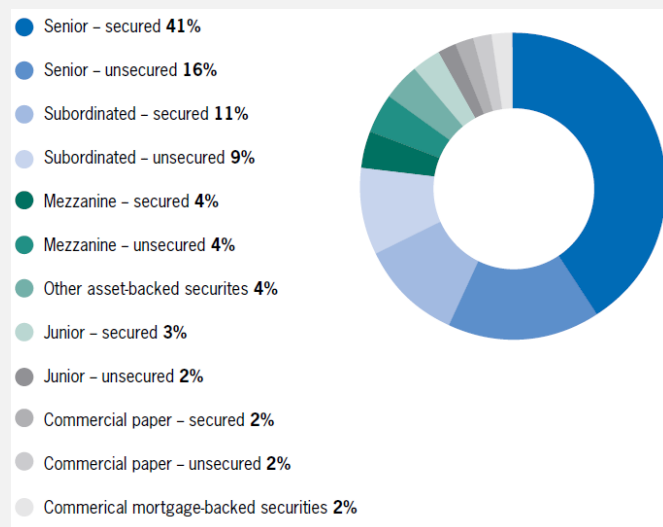
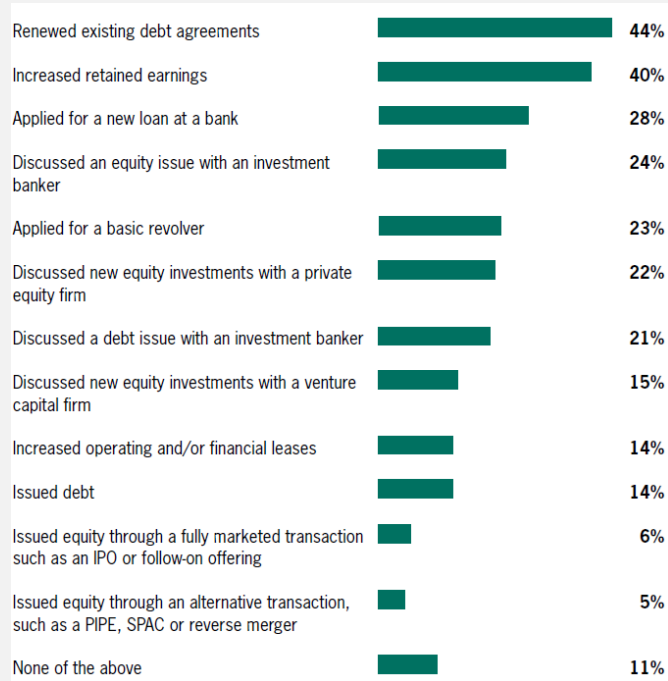
Global

- Some lenders' ability to lend has been impaired
- Companies looking to borrow money are having performance issues due to the economic environment
- Values of fixed assets (e.g., machinery, equipment and real estate) have fallen, making them more difficult to use as collateral
- Valuing of illiquid assets has become more difficult
- Despite the government's best efforts, the credit markets continue to remain tight
- Many of the lenders that businesses have relied on in the past are still focusing on their own balance sheets.
- Credit is still available, but with everything that has occurred in the market over the last three years, the process of obtaining capital through traditional sources has become much more restrictive and cumbersome.

Middle East and North Africa (MENA)

- Debt securities account for a measly 5.6 per cent of the region's \$2.2 trillion (Dh8trn) capital markets, which are currently dominated by stocks and bank assets.
- The regional debt market is severely underdeveloped as corporations and sovereigns are highly dependent on bank borrowings.
- According to the International Monetary Fund (IMF), estimated losses of major global banks will fetch over \$2.8trn from January 2007 to the end of 2010 due to toxic assets and bad loans.
- Because of pressure from the credit crunch, the banking sector in the near future will not have the ability to finance government and private sector projects in the region.

Current Methods of Obtaining Capital



Source: Grant Thornton - Raising capital in the current credit markets 2010

Most businesses are relying on existing debt facilities and banking relationships to obtain debt financing in the current markets. Most are also raising Senior secured debt.

This used to be the most effective and efficient way in the pre-subprime and Lehman era.

Not anymore.

Current debt environment

- Bank balance sheets still contain bad assets, consumers and businesses remain stretched, and credit recovery is some time off
- Banks still will face funding difficulties in the next few years, as their bonds mature and the special government assistance programs are withdrawn
- Credit recovery will be "slow, shallow and uneven," as heavy government borrowing soaks up available funds and banks continue their reluctance to lend to repair their balance sheets
- Authorities are likely to strengthen bank capital and liquidity requirements to increase the safety of the financial system. And banks must refinance nearly \$5 trillion in debt that will mature in the next three years
- There are problem pockets in regional banks with heavy real estate exposure in the United States; among Spanish banks, which are heavily exposed to real estate development loans; and in some regional banks in Germany

Debt financing options

Senior debt financing

Cash-flow

- Based on the borrower's projected cash flow, without directly considering the borrower's underlying assets, such as inventory or receivables
- For companies that generate less than \$10 million EBITDA, cash-flow lending is almost non-existent

Asset-based

- Asset-based loans are collateralized with specific assets, such as inventory or receivables
- Asset-based lending is more active in this current business cycle as loans are made against assets, not against free cash flow
- Asset-based loans are senior loans and are a first lien against a company's assets. Facilities average about three years, and rates will float above the prime rate or LIBOR



- Not all assets in asset-based lending are treated equally, and there is a continuum from liquid to illiquid assets

Mezzanine financing

- Mezzanine lenders provide junior lending — which is subordinate to bank loans — between secured loans and equity stakes
- Mezzanine financing typically has both debt- and equity-like features
- Accordingly, the rate of return that mezzanine lenders require is between debt and equity, and is therefore higher than that required for secured debt in order to compensate the lenders for their increased credit risk
- In today's market, the lender expects an internal rate of return of approximately 18%
- However, current market environment, equity valuations for private companies are generally lower. As a result, management's view of the implicit cost of financing will likely be higher than 18% when factoring in the cost of equity warrants.

How to raise debt capital successfully

- Success in obtaining financing in today's market requires that companies better understand what lenders and investors are looking for.
- The rules have changed regarding pricing, valuations, covenants and collateral.
- The more versed a company is in what is available and what is required, the better a company's negotiating position will be to secure financing.
- Think outside the bank. Just because you have an existing relationship with a lender, do not assume that relationship will survive in its current form.
- Consider other forms of financing, such as subordinated debt, private equity or venture capital. These options may take time to arrange and be longer in duration, they are still available.
- Be aware of what is happening in the credit and equity markets, even if your company is not distressed or seeking immediate capital.
- Enhance the information your company communicates to lenders.
- Be prepared and ensure that your company's financials are in order.

Factors to consider when negotiating

- The capital provider's viability – will it still be in business 5 years from now?
- Size of the loan – different capital providers have different "sweet spots"
- Facility terms – the Capital Provider may be willing to commit only to a one-year facility and then want to renegotiate. The borrower may then be forced to renegotiate with a different provider, resulting in significant refinancing risk
- Interest rates - Interest rates have increased for middle-market companies, and some capital providers have added floors to prevent future rates from going below a certain level
- Relationships – capital providers want ongoing relationships, and the borrower may have to "sell" the bank on the value of the relationship in order to get a loan
- The "forward financing calendar" - For example, there will be a refinancing "bubble" in 2013 and 2014, when highly leveraged transactions that were funded during the "covenant lite" years immediately preceding the credit crisis come due

Why not raise debt financing from Banks?

- Banks are NOT INDEPENDENT
- Banks goals are NOT ALIGNED with borrower’s goals
- There are ALTERNATIVES to raising capital from banks

Bank’s Goals	Your Requirements
<ul style="list-style-type: none"> • Maximise returns through high fees and interest rates • Minimise risks through strict requirements • Cross sell ancillary products • Fulfil the interests of the Bank’s shareholders through high profits 	<ul style="list-style-type: none"> • Optimise debt structure to ensure profitable project outcomes • Minimise fees and interest rates • Maximise tenor • Flexible requirements from lender • No obligation to purchase ancillary products • Fulfil the interests of Borrower’s shareholders

Table 2: Banks Goals vs. Your Requirements

Private Equity Landscape

- 26% of private equity firms did not make any investments in 2009
- 71% expected to see an increase in the volume of new investments over the coming 12 months
- 80% of respondents to the Private Equity Barometer said they still needed to invest 25% or more of their latest fund. A total of 27% still needed to invest more than three quarters (75%) of their latest fund.



How Apache Advisors Can Help

Apache Advisors is a private and independent business that specialises in the finance and investment industry. We offer bespoke consulting services to governments, investment managers, banks and private offices. We advise on business strategy, relationship building, product development, distribution & marketing strategy globally, with a particular emphasis on the Middle East and Asia. Headquartered in Dubai, we are uniquely positioned to take advantage of opportunities for our clients.

Originality is the touchstone of our approach. Our aim is simple – to provide objective counselling to structure solutions most pertinent to the needs of our clients. We recognise that no two assignments are the same and our clients can expect creative and original thinking coupled with professional advice of the highest quality.

Focus and selectivity

We pursue selected assignments in which Apache can add value by bringing strategic and financial expertise from senior professionals to provide solutions to our clients

Solution-Oriented

Apache's innovative thinking provides strategic solutions to complex problems

Objectivity

Our goal is to be a long-term strategic financial advisor to our clients. That means providing objective, unbiased advice and the readiness to advise against a transaction if it does not meet the needs of the client

Relationships with capital providers globally

Our investor relationships cover the full spectrum of the private capital markets, including venture capital funds, hedge funds, mutual funds, strategic investors, sovereign wealth funds and private offices

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