

MARKET INSIGHTS: Corporate debt products changing rapidly



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When in need of additional capital, a business can either raise equity or incur debt. While either option provides an inflow of cash, they can impact the business in dramatically different ways. So, which should a business choose? For private lower mid-market businesses in Canada, the answer used to be simple: take what is available. That has meant a line of credit and perhaps a secured term loan from their bank, some assistance from the BDC, and for a handful of them, equity from a venture capital or private equity fund.

Recently, though, new lenders have introduced novel debt instruments that are tailored to the opportunities and challenges lower mid-market businesses face. Equity products are also experiencing a significant level of transformation, but in this issue of *Market Insights* we focus specifically on these new debt offerings and what they mean for Canadian businesses looking to raise capital.

Why are new debt products being introduced into the lower mid-market?

The lower mid-market has been underserviced for a long time because traditional lenders find it challenging to operate profitably in this segment, relative to deal size. Their cost structures, institutional culture, governance requirements, and regulatory environment make it prohibitively expensive for them to do any but the most straight forward of transactions.

This gaping void is well known, but it's not until recently that the confluence of three major dynamics enabled new lenders to begin filling it: 1. deal software is more accessible; 2. innovation from the US has been adapted to the Canadian context; and 3. a new generation of credit professionals has come of age, most of them having taken an unorthodox path to lending.

So what's new?

In this paper we only discuss corporate/commercial debt products which today are evolving quickly. These typically start at \$1m in size and thus are suitable for the lower mid-market.

Mezzanine debt lenders have renewed their focus on the lower mid-market, as they tend to do every few years. They come in various flavours:

- **Royalty-based financing** has its roots in the oil & gas and mining sectors. The concept has only very recently been repackaged for high-growth companies: advance cash to fund a project (e.g. building a new software module) in exchange for a portion of future sales. These are covenant-light facilities and the returns sought by these lenders are typically above 15% IRR. Three new funds have launched in Canada in the past 24 months, for the first time addressing transactions as small as \$1m.
- **Venture debt** has reached critical mass—the venture capital ecosystem in Canada is strengthening, and the debt-centric understanding of recurring-revenue business models is sufficient enough such that two new funds were started in the past 24 months. The very technologies that these funds finance has helped them participate in smaller deals. Here again, target returns are high (>12% IRR) and are achieved in a mix of cash interest and return ‘enhancers’ like warrants.

Asset-based lending (ABL) has experienced a tremendous level of interest from a broad range of investors, primarily because it gives them access to yield (typically, non-bank ABL funds target to pay their investors approximately 8-10%). Also, on the surface, it is easy to understand: borrowers have traditional collateral like inventory or machinery—they just happen to be in special situations (distressed, turning around, or experiencing capital-intensive growth), which explains the high cost of this product class for borrowers. The challenge for ABL lenders to grow is managing the quick-changing contexts into which these loans are made: oftentimes, they cause the appraised values of the underlying assets to become vastly different than those when the loan was underwritten originally. Here, innovators have turned to big data and analytics to increase the certainty with which they appraise and underwrite.

Why is this good for borrowers?

More debt financing options for borrowers is undoubtedly a good thing. Because debt is not dilutive to the ownership of shareholders, it is a cheaper source of financing than equity in the long term for successful businesses. In other words, it is a great wealth-building tool for Canadian entrepreneurs.

But is having more debt financing options alone sufficient? No. Quality matters a great deal. Because these new lenders get involved in higher-risk situations, their personnel have to be not only great underwriters, but also have sharp business minds and the ability to speak the entrepreneurs' language. There is tremendous pressure to make the right loans, and consistently do so over a long period of time: these new lenders don't expose their portfolio companies to the risk of loans being called because their other loans did not perform. That risk is real for borrowers of new funds' capital.

How to gain access to this set of lenders?

Most of these new funds haven't done a great job at marketing their offerings broadly. It is understandable, given their stage—they are just getting started and it is costly for them to connect to business owners individually. Investment banks, on the other hand, have gotten to know these funds well, and have opened up their client lists to them.

FirePower Capital has developed a leadership position in the space. Its Capital Advisory practice can quickly assess what may be available for your business in terms of debt financing, and the likely costs and terms associated with it. Contact us to speak with one of our deal-makers and explore how these developments could impact your business.

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ABOUT FIREPOWER CAPITAL

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MAY 2016  TheRedPin. <small>A Different Kind of Brokerage</small> \$2,500,000 VENTURE DEBT <small>FIREPOWER CAPITAL ACTED AS EXCLUSIVE ADVISOR TO THE BORROWER</small>	MAY 2016  CALTECH <small>SURVEYS LTD</small> \$5,500,000 SENIOR TERM LOAN AND OPERATING FACILITIES <small>FIREPOWER CAPITAL ACTED AS EXCLUSIVE ADVISOR TO THE BORROWER</small>	JAN 2016  NEWWAY IRRIGATION \$1,900,000 LEVERAGED LOAN <small>FIREPOWER CAPITAL ACTED AS EXCLUSIVE ADVISOR TO THE BORROWER</small>	NOV 2015  BTLN <small>BROOKDALE TREELAND INSURANCES LIMITED</small> \$7,015,000 LEVERAGED LOAN <small>FIREPOWER CAPITAL ACTED AS EXCLUSIVE ADVISOR TO THE BORROWER</small>
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