Principal Alternative Credit

Principal Asset Management℠

Benefits of flexible capital

The private direct lending market is a critical and growing source of capital for independently owned middle market companies (family owned, entrepreneur owned, employee stock ownership plan (ESOP) owned, etc.). However not all business owners are aware of all the accretive ways they can utilize this capital to generate value. There are various strategic uses of proceeds that can increase shareholder wealth if implemented correctly.

These strategies can be amplified when borrowing from a direct lender, Principal Alternative Credit, given the inherent advantages of raising capital from a non-bank lender over borrowing from commercial banks. Typical results may include higher loan amounts, less annual principal amortization, more flexible covenants, the ability to grow through mergers and acquisitions (M&A), and no borrower/personal guarantees. Further, given that direct lenders rely on the going concern enterprise value of the business rather than asset values, service-focused businesses have access to debt capital that once was reserved only for asset-heavy businesses funded through commercial banks.

AT-A-GLANCE:

8 accretive uses for flexible capital

1. Organic expansion capital
2. Acquisitions
3. Create cash flow flexibility
4. Buyout a minority partner
5. Transfer ownership to management team
6. Consolidate existing debt/refinance current maturities
7. Benefit plan optionality
8. Shareholder distribution

Here are eight accretive uses of flexible debt capital:

Organic expansion capital

Organic growth opportunities can require additional capital investment; equity may be too expensive or unappealing to existing shareholders, and commercial bank debt may be too restrictive. Capital provided by direct lenders can provide the right balance of reasonable cost and flexibility.

Examples of growth-oriented financing opportunities include: (i) Capital expenditures to fund business expansion (for example plant expansion, new equipment), (ii) Personnel growth to support new geographies, new product/service lines, expand support services, etc.; and (iii) Working capital associated with organic growth opportunities.

Acquisitions

Acquisition opportunities may arise through in-bound passive requests, through a proactive acquisition strategy, or anything in between. The ability to raise capital when an opportunity arises is a critical step towards being viewed as a legitimate/valid acquirer.

A direct lender can assist in structuring the funding to incorporate the cash generated by the target company. This will help to maximize debt availability, and to stage the funding to match the cadence of the acquisition strategy. And given the often borrower-friendly amortization structures, capital provided by a direct lender can provide the appropriate cash flow flexibility to ensure the post-transaction integration can absorb any unforeseen glitches.

Create cash flow flexibility

Replacing existing commercial bank debt that carries a heavy amortization schedule with debt provided by a direct lender that offers low annual amortization can create cash flow flexibility for any company. This creates opportunities to invest excess cash flow back into the company's growth opportunities or even just create a cash cushion. Other typical benefits of a direct lender loan include higher loan amounts, more flexible covenants and no personal guarantees that further add to the appeal for business owners.

Buyout a minority partner

It is common to have equity partners that have different investment time horizons, whether they know this at the beginning of the business relationship or their desires and liquidity needs evolve over time. In addition, many businesses begin with several minority equity partners to fund operations and growth, and the majority shareholders may want to eventually reward these partners with liquidity prior to the owner/operator's liquidity event or may want to consolidate ownership to streamline the equity structure.

In certain cases, these buyouts can be funded out of the company's cash flows. However, in most cases outside capital is needed. Capital provided by a direct lender can be viewed as an attractive alternative to bringing on another equity partner to fund the buyout(s) and less restrictive than borrowing from a commercial bank.

Transfer ownership to management team

As companies grow and evolve over time, the management team may become critical to the success of the business, particularly if the primary business owner(s) step away from day-to-day management. Rewarding key management team members with increased equity ownership creates alignment, incentives, and key retention attributes.

Restricted share grants and similar awards are a good starting point, but typically do not result in enough meaningful ownership to the management team. Implementing a strategy that involves the company borrowing capital from a direct lender to buy back and retire shares of the majority shareholder(s) can result in increased effective ownership to the management team's share grants, all while also providing a reasonable liquidity event to the majority shareholder(s). The result: majority shareholder(s) receive cash today as part of the buy back, still retains majority ownership and meaningful upside potential; and management is properly aligned, incented and retained to shepherd the next phase of the company's value creation story.

Consolidate existing debt/refinance current maturities

Companies frequently have multiple loans in place for various purposes, each with its own collateral, maturity, amortization, and interest rate. In addition, certain of these loans may have upcoming maturities that need to be paid off. Consolidating and refinancing these loans into one loan provided by a direct lender can result in significant cash flow flexibility. In addition, working with a single lender can alleviate the administrative burden on the company, freeing up both personnel and financial resources.

Benefit plan optionality

Rewarding the company's workforce through the transition to an Employee Stock Ownership Plan (ESOP-owned entity can be an attractive succession plan for company owners. In certain cases, the transition to an ESOP can be funded over time by the company's cash flow. However, to relieve strain on the company's future cash flows and initiate the transaction sooner to benefit the workforce and selling shareholder(s), third-party debt is typically needed. ESOP transactions can also be an attractive alternative to an outright sale to Private Equity or a Strategic Buyer. Given the unique attributes of an ESOP, certain cases can be attractive opportunities to partner with a direct lender, particularly given the flexibility provided by the debt structures.

In addition, for companies looking for alternatives to improve funding levels of existing pension obligations, direct lenders can be an attractive partner. Required funding or optional pension contributions will not only improve funding status, but the improved funded level may significantly reduce Pension Benefit Guaranty Corporation (PBGC) premiums and avoid penalties, if applicable. Ensuring PBGC compliance and the ability to pay the benefits promised to its past workers can alleviate further ongoing issues for the company and its shareholder(s).

Shareholder distribution

Under certain circumstances, a shareholder distribution can be funded by a direct lender, resulting in liquidity to the shareholder(s) without selling all or a portion of the company. This allows the shareholder(s) to retain control and the upside potential of the company while also receiving a cash distribution to fund a variety of things (retirement savings, outside investment, legal settlement, etc.). While shareholder distributions tend to be more common during periods of macroeconomic expansion, they can be factored into a business owner's long-term monetization strategy at any time.

Understanding the strategies available to middle market companies that can be funded by direct lenders can significantly enhance shareholder value and overall financial/operational flexibility. As management teams embark on this process, the investment professionals at Principal Alternative Credit are available to discuss these strategies and answer questions to help improve the likelihood of a smooth and timely outcome.

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