Case Study

$2MM Refinancing & Line of Credit

BACKGROUND

A venture capital backed mid-stage communications company needed an equipment loan to finance new equipment acquisitions and to refinance existing debt to allow for more financial flexibility. This case study illustrates the benefits of using a direct lending source as opposed to the possible pitfalls of utilizing a broker for debt financing.

CLIENT PROFILE

Industry	Communications
Stage	Pre-Profit Mid-Stage
Investors	Over $30MM from top tier VCs
Cash Liquidity	$10MM

EVALUATION

Debt Advisors Group (DAG) was engaged by this client halfway through its lender selection process. As earlier noted, the client had in place an equipment loan from a bank, which required them to maintain all their operating and investment accounts with that institution. This requirement, along with the "right to offset" triggered by restrictive covenants, severely limited their future financial flexibility. In essence, they were borrowing their own money. This structure provided no additional runway or leverage on their expensive equity capital. By the time DAG was hired, the company had already obtained several proposals from brokers as well as a new proposal from the bank that provided the first equipment loan. DAG discourages using brokers because of the "bait and switch" tactics that some employ. Brokers may be unable to deliver deals with terms similar to those spelled out in their term sheets.

DEBT NEEDS

The company sought debt financing of $2 million:

- Takeout of existing financing - $180,000
- Tenant improvement (soft costs) - $750,000
- 2004 equipment capital expenditures - $1.07 million
- Total: $2 million

FINANCING GOALS

The chief financial officer's explicit goals for the new round of financing were:

- Maximize future financial flexibility: Complete an equipment-backed structure with no additional collateral requirements and no financial covenants.
- Minimize warrant coverage: Negotiate warrant coverage to limit equity kickers due to the expressed wishes of the client's board of directors.
- Reduce overall cost: Find lowest IRR alternative.

THE PROCESS

DAG decided to bring three direct lenders into the competitive bidding process in addition to the brokers and bank from whom the client had already received proposals. Using a comparative re-bid process, DAG negotiated final terms and conditions with the lenders and recommended one of the direct lenders.

THE BAIT

Despite DAG's recommendation, the client signed a deal with a broker whose terms and conditions appeared to be more attractive. Although, the broker's proposal was attractive, the terms did not represent realistic financial terms for a company at this client's stage. With its extensive current market knowledge, DAG did not feel that the broker would be able to deliver on the terms and conditions promised. DAG expressed these concerns to the client.

The terms promised by the Broker included:

- Commitment amount: $2 million
- Term: 48 month principal and interest payments at a run rate of 5%
- Balloon Payment: 10% of total drawdown
- All-in-Rate (IRR): 9.09% IRR including fees and balloon
- Warrant Coverage: None

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THE SWITCH

Two weeks after committing to delivering the above terms, the broker sent the client documents which indicated an IRR of over 27%. Obviously, this structure did not meet the client's stated objectives.

After being told that these terms were unacceptable, the broker returned with a lease including an all-in-rate of 12.54%. This revised IRR was still approximately 3.5% greater than the rate that the broker had promised to deliver. It should also be noted that this increase in IRR is despite the fact that the interest rate upon which this deal was indexed had decreased 30 basis points since the proposal had been signed and accepted. This effectively made the actual rate 3.8% above the rate that the broker promised to deliver.

In several other attempts the broker delivered final documents that were substantially different from the signed term sheet. In the end, the broker deal fell through.

NET RESULTS

After four months, the client returned to DAG to re-negotiate the deal with the lender that DAG had originally recommended.

The final terms that DAG was able to negotiate included:

- Commitment: $2MM with a drawdown of 10 months
- Lien coverage: Specific equipment only
- Financial covenants: None
- Material Adverse Change Clause: Drawdown period only
- Rate: 36 month fixed principal and interest payments at a run rate of 11% and an IRR of less than 11.35% including fees
- Warrant coverage: 2.5%

In summary, due to drawn-out negotiationg with the broker, the client lost several months of valuable time. In addition, it was necessary for the CFO to re-address the debt situation with the board of directors.

ABOUT DEBT ADVISORS GROUP

Debt Advisors Group's team of professionals brings years of lending expertise to help growing companies evaluate debt and lease terms. Debt Advisors actively monitors lenders, independently assessing their structures, terms, and rates. After rigorous review, DAG's professionals recommend a short list of lenders who will compete for your business. Using a Proprietary Lease Tools™ financial model, Debt Advisors compares financial covenants, warrants, net present value and other terms to achieve an apples-to-apples comparison. Part of the comparative analysis is a succinct but thorough executive summary that helps save time, particularly at board meetings.

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