How CEOs Can Work with BDCs

Looking for an alternative to banks for your capital needs? Here's why a business development company may be right for your company. By Christian Oberbeck

AT A TIME when more and more small and mid-sized companies need to look beyond banks for sources of financing, it's important to understand the role Business Development Companies (BDCs) can play in meeting capital needs. In 1980, Congress passed an amendment to the Investment Company Act of 1940 in order to create a regulated entity—the BDC—that would serve as a source of capital for smaller, middle-market companies.

Thirty-five years later, there are more than 50 publicly traded BDCs in the U.S. Yet, CEOs are still learning how to work with them.

The advantage BDCs have over banks is that a BDC will make cash-flow loans with higher leverage, fewer covenants and less restricted payment schedules than a bank. Consider a company we will call Vivtxt. It leases office machines to small businesses in two Mid-Atlantic States. Vivtxt is healthy, generating $20 million a year in leasing and servicing revenue.

When its CEO approached a bank for growth capital, the bank agreed to a loan based on two times EBITDA for five years, pending an audit of the number and the value of business machines in place at customer locations. However, the CEO needed four times EBITDA for five years to fund a fully planned expansion. With the bank loan, he would need to find an additional lender or equity investor to provide the remaining funds needed.

However, a BDC was able to take a different approach to valuing the business and its creditworthiness. Ultimately, it lent Vivtxt four times EBITDA with fewer covenants than the bank required.

BANKS VS. BDCS

Both BDCs and banks look for a steady stream of cash flow that will pay interest expense on a five-year loan. However, rather than focus on collateral, a BDC looks at the business itself and its value proposition. In this case, the BDC was looking for a steady income flow and a sustainable business.

What the BDC liked about this business was that it sells to a diversified group of 10,000 customers and it generates $10 million a year just on the recurring service side of the business. This represents a "sticky" revenue

stream because customer lease contracts normally last three to five years.

BDCs also consider the strength of the management team. In Vivtxt's case, a strong team of owners with a vested interest in success had been running the business for 10 years.

Vivtxt's smaller size made it a less attractive customer for banks, which typically require borrowers to have EBITDA of at least $10 million. A BDC, however, digs deeper in due diligence to understand the business itself at a granular level. If a BDC believes a business has a strong value proposition and sees no macro-industry events or regulatory or technology changes looming in the next five or 10 years that would impede its growth, it will generally underwrite a smaller business.

With Vivtxt, the combination of a recurring revenue stream and the quality of the products leased made it stable enough to warrant an investment. Vivtxt leases its machines to churches, municipalities and small business offices, all of which could, in theory, be affected negatively in a downturn. However, Vivtxt had withstood the recession in 2008-2009, demonstrating resiliency and stability.

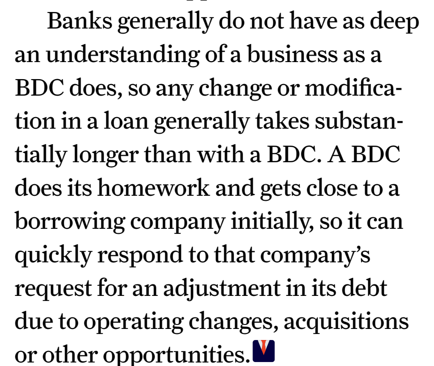
MORE FOR LESS

The bank would have lent capital for two times EBITDA, which meant that Vivtxt would have had to find a second lien or sub debt or equity to get to four times EBITDA. Going with a BDC that covered all four turns gave its CEO "peace of mind." He was able to get a five-year term from a single investor, while not having to worry about defaults from two different lenders, or refinancing a senior or second lien.

The bank's pricing was roughly 5.5 percent for a collateralized loan at two times EBITDA; the BDC's was at 10 percent for a cash flow loan at four times EBITDA. While on the surface the BDC terms are more expensive than the bank's, other factors come into play. For example, bringing in another lender to get the full amount of capital needed would likely have given Vivtxt a blended rate of between 8 percent to 9 percent. Therefore, the additional cost of using a BDC was more than offset by the efficiency of a one-loan transaction.

The bank also required amortization of principal during the term of the loan. A BDC loan can be flexible with scheduled amortization because the BDC has permanent capital. If a company wants to spend more to grow or to invest more on people or capex, a BDC can allow this without having to worry about paying down scheduled amortization. A BDC's sweep can also be flexible, taking into account capex, gross expenses and contingent reductions of the sweep.

When borrowing from a bank, a company must comply with a bank's scheduled amortization, regardless of business circumstances. In Vivtxt's case, the bank offered a one-year grace period, then 10 percent annual amortization with a balloon payment after five years versus the flexibility of a non-amortizing six-year BDC facility. By embracing the BDC approach, Vivtxt's CEO can run his business and pursue opportunities with minimal capital structure constraints. He is able to invest both more dollars and more time withouat being concerned about strict repayment schedules.



One final benefit to Vivtxt was the way a BDC works, which allows portfolio managers to coordinate directly with the chief investment officer. When companies need to make a change, need to refinance or need an amendment, they can get a decision more quickly than from a bank, which would run requests through multiple committees for approval.

Banks generally do not have as deep an understanding of a business as a BDC does, so any change or modification in a loan generally takes substantially longer than with a BDC. A BDC does its homework and gets close to a borrowing company initially, so it can quickly respond to that company's request for an adjustment in its debt due to operating changes, acquisitions or other opportunities.

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