

An Innovation in Loan Covenant Management for Midmarket Companies



White Paper

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Companies large and small employ different strategies to best “dress” or manage their balance sheet. For the past decade, midsize companies, in particular, have turned to accounts receivable (A/R) securitization to help them reduce leverage, improve their credit rating or satisfy loan covenants and ultimately reduce their cost of capital. This solution historically bridged the gap between companies that had access to the commercial paper markets and those that had not entered the world of Wall Street. Unfortunately, in today’s credit environment, many middle market companies have found themselves abruptly unable to access the securitization market and as a result, are being squeezed by their lenders when they fail to meet debt covenant ratios.

Before the current economic crisis, lenders were constructive in working through a minor violation of a covenant ratio. Today, many banks are seizing such scenarios as an opportunity to levy large fees or increase the company’s overall cost of capital. In the worst case, a bank can use a covenant violation to put the company in default and trigger liquidation proceedings, thereby extracting themselves from a lending arrangement.

The Receivables Exchange has introduced an innovative working capital tool that helps middle market companies and their CFOs to surgically convert receivables into cash without taking on any debt or incurring large upfront fees or term commitments. The Exchange allows for the “True Sale” of select on-balance sheet receivables. All purchases and sales of receivables over the Exchange result in “True Sale” of 100% ownership of the receivables and all collection proceeds, with all of the Seller’s rights, title and interest, are transferred fully to the Buyer.

Introduction to the Problem

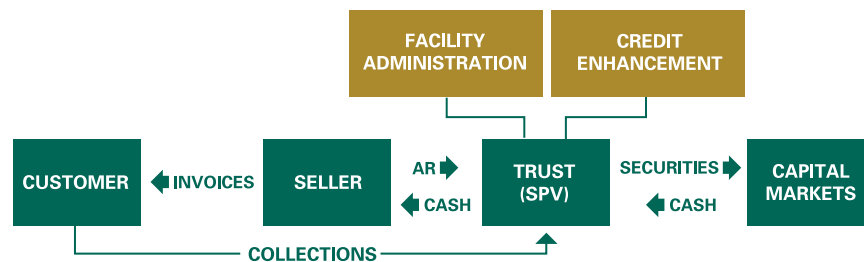
While some parts of the credit market have recovered, the securitization market remains relatively dormant due to decreased appetite of “structured products”, leaving middle market companies to search for new ways to improve short-term cash flow. Typically a tool for balance sheet restructuring, receivables securitization was widely used to help large and mid-market companies manage their balance sheet to help firms improve their credit rating, reduce leverage, satisfy loan covenants and ultimately lower their cost of capital. Figure 1 explains the steps of the A/R securitization process and the key role that a Special Purpose Vehicle plays in the transaction.

The Receivables Exchange provides midsize companies the flexibility and control they need to streamline and optimize their balance sheet without increasing their debt position, incurring large upfront fees or long-term commitments.



Establishment of a Special Purpose Vehicle (SPV) is a key component of the A/R securitization process which issues securities backed by the cash flow of pledged receivables. An effective SPV structure is dependent upon the availability of a continuous flow of new A/R to replace those that have been securitized and sold. The creation of an SPV also represents a significant capital investment, and unless a company has a steady flow of accounts receivable to justify the cost of an SPV for receivables securitization, the cost and time burden will not make sense for many companies. Additionally, the reliability of the product is predicated upon an appetite from the capital markets. This is a function of the institutional demand for SPV-issued securities; however, this demand disappeared abruptly in the wake of the credit crisis. All of these hurdles have now combined to extinguish the active market for receivables securitizations. The following diagram explains the steps of the A/R securitization process and the key role that the SPV plays in the transaction.

FIGURE 1 - Standard Securitization Model



Source - ACG Network

Why pay for an annual or a multi-year contractual arrangement when you can achieve the same goals through a periodic, transaction-based process that eliminates virtually all of the overhead burden and long-term commitments?

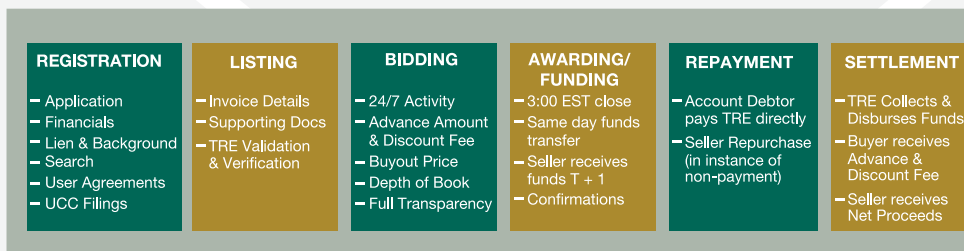
Introducing an Innovative Alternative to A/R Securitization for Midmarket Companies

The Receivables Exchange has developed a financial solution specifically designed to help midsize companies that have been frozen out of the securitization market due to tight credit markets, or for those companies that have never had access to securitization due to size constraints. The Exchange allows for the “True Sale” of select on-balance sheet receivables. All purchases and sales of traded receivables over the Exchange result in True Sales of 100% ownership in each traded receivable and all collection proceeds, with all of the Seller’s rights, title and interest being transferred fully to the Buyer.

The conversion of receivables into cash and the improvement in covenant test results allow midmarket companies to streamline their balance sheets in a timely and economically accretive method. The Receivables Exchange solution fills the void left by the now defunct receivables securitization market. Additionally, it has simplified the transaction process using standardization and straight through processing, as shown in Figure 2 below.

Midmarket companies are able to optimize their balance sheets and improve covenant ratios by converting A/R into cash.

FIGURE 2 - The Receivables Exchange: Standardization through Automation & STP



Benefits of The Receivables Exchange Standardization Model for Midsize Companies:

- No need to set up an SPV
- Individual transactions can be structured on a recurring or ad-hoc basis
- Little or no legal costs
- No investment banks or related costs
- No rating agency involvement
- No customer notification - Maintain confidentiality
- Dynamic pricing reduces cost of capital with recurring transactions

Sellers generally select customers whom are invoiced consistently to be able to monetize those receivables on a recurring schedule and maintain a healthy level of liquidity. Not only does this repeat activity help them to increase their liquidity, it also helps them develop a transaction history on the Exchange, which, through dynamic pricing, drives down their cost of capital. For companies that do not face consistent challenges managing daily cash flow but are impacted by periodic liquidity challenges, The Receivables Exchange can serve as an effective balance sheet management tool by letting them sell their receivables only when they need to, without any long-term commitment.



These companies may wish to periodically streamline their balance sheet, but don't need a permanent vehicle. Examples would include seasonal "clean-up" requirements on their revolving lines, a need to insure covenant compliance at period-ends, or a desire to reduce their leverage for external financial reporting results. For these midmarket businesses, using The Receivables Exchange, on an as-needed basis, is a fast and effective way to raise capital to better manage their balance sheet.

Increase your Cash Flow and Maintain your Customer Relationship

The Receivables Exchange believes companies should have greater access to working capital and that they should have more control over how to manage that working capital. To deliver on this commitment, the Exchange has developed a real-time auction process for companies to manage these transactions all on their own terms without requiring them to give up the relationship with their customers. The flexibility and control gained by selling receivables on the Exchange, allows companies a quick and easy way to raise capital without having to sell all of their receivables and potentially sacrifice their customer relationships.

Sellers can execute these transactions with a high degree of transparency as they have the ability to set their own pricing and carve out specific receivables in which they intend to sell. More importantly, control over the pricing parameters enables the Seller to easily model the economics of the transaction and its effect on streamlining their balance sheet.

The Receivables Exchange – How it Works

- Select A/R to monetize based on amount of capital need to raise
- Sellers control the timing and terms of each auction by setting the minimum advance amount, maximum discount fee and auction length, 3-10 days
- Sellers watch Buyers, accredited institutional investors, bid on their A/R auction in real-time, 24/7
- Auction remains open for the time period established by the Seller. The Seller is funded the very next day after auction close

The Receivables Exchange transactions allow mid-market companies to gain flexibility and control by selling receivables on their own terms.



- Auction Completion – Once the receivable(s) are paid by the customer, the Exchange remits the amount due to the Buyer (advance plus discount). Any remaining amount is remitted back to the Seller. If the receivable(s) remains unpaid, the Seller is obligated to repurchase the balance of the outstanding receivable(s).

Example of Balance Sheet Streamlining for the Management of Loan Covenants

Financial maintenance covenants are very common in loan agreements. One of the most common tests performed on a company's books is the Net Leverage test. In most cases this test is performed quarterly and measures a company's financial leverage as a function of its trailing EBITDA. Mandatory ratios are customarily written into the loan agreement. The company must maintain this ratio at or below a required level, and many are likely to insulate their ratio at multiples below their maximum level. A company can generally achieve lower interest rates on floating rate loans should they improve the ratio and a pricing grid reflecting these terms is written into the loan agreement. Violating a covenant can be costly, as legal consents can often mean paying percentage points in fees to the lender to gain a waiver or amendment.

Example:

If the loan covenant requires that Net Debt to EBITDA may not exceed 2.5 X on a trailing 12 month basis, Figure three shows that the company would violate its leverage covenant should the financials be reported this way.

FIGURE 3 (A)

ACME CO. - PRE TRE TRANSACTION			
Trailing 12 Month P&L			
Sales			1,000
EBITDA			300
Net Interest Expense			39
Tax Rate			40%
Net Income			156.6
BALANCE SHEET	AMOUNT	SPREAD OVER PRIME	INT. RATE
Cash	20		
Accounts Recievable	125		
Revolver Outstanding	200	50	3.75%
Term Loan Outstanding	600	200	5.25%
Total Debt	800		
Net Debt	780		
Net Debt/EBITDA	2.6x		
Prime Rate	3.25%		



Below is what the Seller's financials would look like if we assume the following:

- Seller sells \$37.5 of A/R
- Seller receives an 80% Advance (\$30)
- Seller agrees to a 1.5% 30-day Discount Fee (example)
- All invoices pay in 30 Days

Upon completion of the TRE transaction, the Seller's profile will now look like this:

FIGURE 3 (B)

ACME CO. - POST TRE TRANSACTION	
Trailing 12 Month P&L	
Sales	1,000
EBITDA	300
Net Interest Expense	39
Loss on Sale of Assets	0.5625
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Tax Rate	40%
Net Income	156.2625
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BALANCE SHEET	AMOUNT
Cash	50
Accounts Receivable	87.5
Retained Amount	7.5
Revolver Outstanding	200
Term Loan Outstanding	600
Total Debt	800
Net Debt	750
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Net Debt/EBITDA	2.5x
<hr/>	
Prime Rate	3.25%

This example assumes that the Seller can expect to pay a .50% (50 basis points) waiver or consent fee to the lender for a waiver of this covenant should they be in violation at the time of measurement. If we assume that the fee is charged on the outstanding amount under the loan, we can calculate a breakeven analysis. In other words, what is the maximum cost the Seller would be willing to incur for a sale of receivables before the economic benefit is nil?

FIGURE 4

Prospective Consent/Waiver Fee	0.50%
Outstanding Term Loan	600
Consent/Waiver Fee	3
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Receivables Sold Thru TRE	37.5
30-Day Discount Fee %	1.5%
Total TRE Transaction Cost \$	0.56
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Variance Between Consent and TRE	2.44
Breakeven 30-Day Discount Fee	6.50%



Even with a 30-day discount fee as high as 6.5% ($2.44/37.5 = \sim 6.5\%$), Figure 4 shows that the Seller would be better off financing a receivables sale through The Receivables Exchange because the cost of violating the covenant is generally much steeper and applied to the entire outstanding amount. Selling the receivables would be a much more cost-effective transaction. This example also highlights a key advantage of the Exchange over an A/R securitization or similar financial tools. While a securitization must use an SPV to achieve True Sale status, transactions on the Exchange are structured specifically to achieve True Sale status without the use of an off balance sheet vehicle (SPV).

Another common use for tools like a securitization would be to take advantage of interest rate reductions available to the company, typically dictated by a pricing grid stipulated in their credit agreement. A pricing structure for many credit facilities includes a pricing grid which allows for a step-down of the interest rate upon achieving certain covenant tests. Frequently, the covenant tested is an operating leverage ratio.

The same process explained above can be performed in relation to achieving such interest step-down covenants. The Seller would simply calculate the amount of cash they would need to raise to meet the Net Leverage ratio that will give them an interest step down. The interest savings would replace the waiver or consent fee from the previous example and the economics will calculate using the same method.

The Receivables Exchange transaction has a few key variances that differentiate it from an A/R securitization.

THE RECEIVABLES EXCHANGE	A/R SECURITIZATION
Open Competitive Auction	Fixed Cost
Weeks to Set up	Months to set up
No commitment	Long-term Commitment
Flexibility	Rigid

First, A/R securitizations are financed at a fixed annual cost, while The Receivables Exchange provides an open competitive transaction-based auction platform. In other words, why pay for an annual or a multi-year contractual arrangement when you can achieve the same goals through a periodic, transaction-based process that eliminates virtually all of the overhead burden and long-term commitments?

While a securitization must use an SPV to achieve True Sale status transactions on the Exchange are structured specifically to achieve True Sale status without the use of an off balance sheet vehicle (SPV).



Additionally, securitization conduits can take months to set up and often require long term commitments. TRE transactions can be executed in as little as 3 days, excluding the one-time registration process (approximately 1-2 weeks). Finally and perhaps most importantly, is the flexibility that the Exchange provides midsize companies: the ability to streamline their balance sheet. These features have made The Receivables Exchange an attractive option for many mid-market businesses looking to effectively manage and optimize their balance sheet for sustainable growth.

Every day more businesses across more industries are turning to The Receivables Exchange to better manage their balance sheet or increase liquidity. The Exchange provides a flexible and efficient capital marketplace for both small and mid-market businesses to turn their receivables into cash without increasing their debt position, incurring large upfront fees or long-term commitments.

