KPMG

Alternatives for commercial debt financing

Alternative debt instruments may enhance investment returns through increased financial leverage—are they right for you?

As global supply and demand rebalances, there is a sense of cautious optimism throughout the oil and gas industry. This optimism has given rise to energy services companies revisiting conversations with partners who are critical to their success, including lenders.

What pops into your mind when you hear the word "banks?" Most people think of either conservative lenders, reluctant to provide the cash one requires to grow, or the "banksters", so aggressive in their investment principles that they lose life savings through mortgaged-backed securities.

The truth is, lenders who serve the energy services industry are rational investors who base their decisions off of risk and return tradeoff considerations.

How do lenders decide creditworthiness?

Understanding the decision-making process of lenders is key to creating and maintaining a strong working relationship with them. Lenders use the "Five Cs of Credit" to determine whether or not to extend credit to you:

1. **Character:** Your reputation in honouring your obligations. Do they trust who you are, personally? Are you known to be a strong player in your sector?
2. **Cash flow:** Your ability to repay the borrowed funds and the debt-servicing costs. Does your historical cash flow and your expected future cash flow suggest you can afford to borrow the requested amount?
3. **Capital:** Your own investment in the business. Are you using other sources of capital, such as equity, beyond the debt being requested to fund the business, to ensure your commitment to succeed (and repay the loan)?
4. **Collateral:** Your assets as a backstop. Assets provide a secondary source of repayment in the case you are unable to repay the loan through normal operations.
5. **Conditions:** Your situation for borrowing and the proposed use of capital. Lenders also look at the economic environment and competitive conditions.

What financing options are available?

Many people are familiar with traditional cash flow lending, including working capital or term loans. However, understanding less well known lending products, such as Asset-based Lending and Mezzanine/Subordinated Debt, is highly advantageous. This is especially true in a time when energy services companies are looking to access capital at all stages of the business cycle.

The following table of financing options demonstrates the tradeoffs between the strength of cash flow versus collateral, and the forms of capital that are accessible:

	Financing options available				
Business conditions	Working capital lending	Asset based lending	Cash flow based lending	Mezzanine/ subordinate debt	Equity
Cash flow strong Collateral value strong	✓	✓	✓	✓	✓
Cash flow strong Collateral value weak	✓	?	✓	✓	✓
Cash flow weak Collateral value strong	✓	✓	?	?	✓
Cash flow weak Collateral value weak	✓	?	?	?	✓
	Collateral focused		Cash flow focused		

Source: KPMG

1. Asset-based Lending (ABL)

ABL is "balance sheet–based lending" with a collateral focus. This financial instrument is well suited to working capital assets, such as accounts receivables and inventory, but can be applied to fixed assets on a case-by-case basis.

In Canada, ABL is most often used when collateral is growing faster, or is more stable, compared to cash flow. Mature companies in Canada with lots of collateral and cash flow tend not to use ABL. However, 50 to 70 percent of all commercial lending in the U.S. is ABL regardless of the business cycle. American companies are more accustomed to using collateral to access debt longer throughout the business cycle.

ABL requires increased reporting, typically through the use of appraisals and field exams. Sometimes, if the amount borrowed is materially less than the borrowing base (available collateral), lenders do not require reporting or covenants – this is called springing covenants. Regardless of the lender's requirements, increased reporting and monitoring provides management with invaluable insights on cash flow cycles.

Generally, the combined costs of ABL including its increased reporting result in a lower cost of capital, as it often displaces higher costs of capital (such as equity) or may be accessed when cash flow lending is less available.

2. Mezzanine/Subordinate Debt (sub-debt)

Sub-debt is "income statement–based lending" with a cash flow focus. Despite a higher interest cost than traditional debt, this financial instrument provides capital cheaper than equity.

In a business cycle, sub-debt is particularly effective when the business is growing. It may also be used in a decline scenario, when borrowings exceed conventional lending covenants.

The sub-debt reporting requirements are less onerous than with ABL.

Collateral is not used to determine a borrowing base limit, but is often relied upon as a secondary source of repayment, and pledged as security. Since sub-debt is based on cash flow, lenders are willing to advance "air balls" (uncollateralized loans). Since "cash flow is king," the primary reporting mechanisms are financial statements and forecasts.

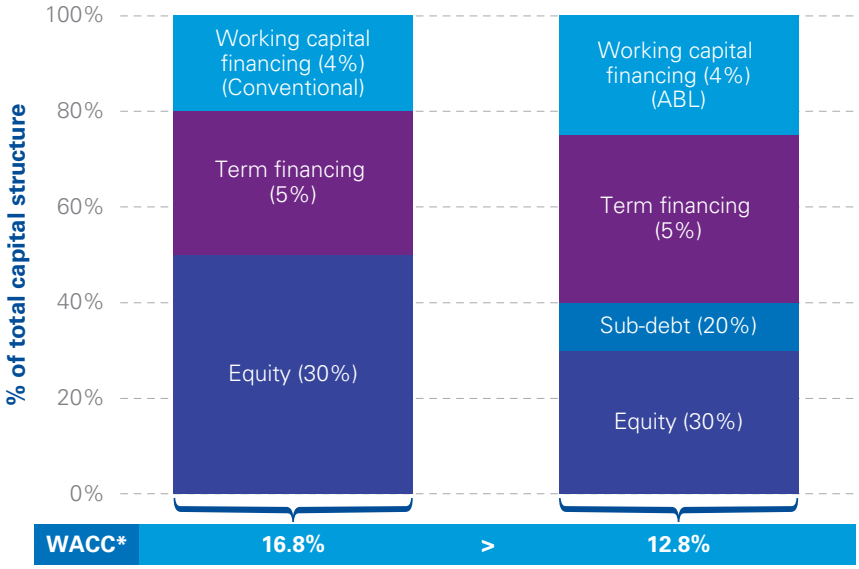
Costs include upfront fees, interest rates and break fees, which are pre-payment penalties applied when borrowers choose to retire debt earlier than the initially established term period. Most sub-debt lenders target an internal rate of return between the teens to low twenties. Given its lower ranking in the capital structure, sometimes lenders will ask for a better line of sight into the strategic decision making, which may include an observer's seat on the Board of Directors. Despite being more expensive credit, sub-debt is less expensive than equity. Interest and fees may be tax deductible, reducing the after tax cost of sub-debt, and more importantly, sub-debt does not have the dilutive effects of issuing common equity.

How do ABL and sub-debt stack up?

Some private company owners have suggested that raising equity is easier, as it has less restrictions and covenants compared to these "alternative lending products." This statement misses on some fundamental concepts in investment and finance.

- While equity has less restrictions compared to debt, it also carries greater risks to "win or lose" it and therefore, has a higher cost of capital compared to debt.
- Effective use of debt lowers the Weighted Average Cost of Capital (WACC), which is the minimum return on assets that must be achieved to satisfy the obligations to the company's creditors and owners. The lower the WACC, the lower the profitability hurdle is for operating activities.
- Debt on a balance sheet creates a disproportionate return, favouring the equity holders. When return on assets exceed the minimum return threshold (WACC), the excess returns benefit the equity holders, because debt instruments are limited to interest as its return, and repayment of principal.

Capital product, with illustrated cost of capital



Source: KPMG

Although there are benefits to using debt, companies need to acknowledge that financial leverage works in both directions. Whether the business is growing and increasing its cash flow, or shrinking and reducing its cash flow, the lender expects payments on principal and interest to continue.

> **An optimal mix of debt and equity takes advantage of the benefits of debt, while acknowledging the earnings volatility of the operations.**
>
> – Othello Tuason, Vice President, KPMG Corporate Finance

What are the tax issues to consider?

Interest expense

Most business people assume interest expense is a fully tax deductible cost of doing business. However, tax courts have concluded that interest is generally a capital item and therefore, it is not deductible for tax purposes. In order to provide a deduction for interest, the Income Tax Act provides that interest must be:

- Paid or payable in the year in which it is sought to be deducted:
  - Simple interest on paid/payable basis
  - Compound interest on paid basis only
- Subject to legal obligation to pay interest on borrowed money:
  - Cannot have contingent interest
- Used for the purpose of earning taxable income from a business or property:
  - Current (direct use)
  - Must establish a link
- A reasonable amount as assessed by reference to the first three criteria

The tax savings that result from the interest deduction have a significant impact on the cash flow costs of paying the interest.

Participating debt

When using sub-debt, it is not unusual to see participation payments as part of the compensation to the lenders. Participating debt often requires additional payments when certain milestones are hit, such as obtaining a certain profit level or cash flow target. These payments are often thought of as interest, but are not based on a fixed percentage of a borrowed sum and may be non-deductible. However, in certain situations participation payments are considered interest deductible.

Energy services companies are often capital intensive and typically rely on sub-debt borrowings to grow. Ensuring that the interest paid on borrowings is fully deductible for tax purposes is very important in meeting growth targets and being a successful business.

What's the bottom line?

Lenders will continue to play a significant role, as energy services companies reposition themselves to not only survive the remainder of the downturn, but to thrive. To do so, it is imperative to understand how lenders decide creditworthiness. Moreover, companies must weigh the advantages and disadvantages of different commercial debt financing options, including the associated tax implications. Effectively utilizing alternative lending vehicles, like ABL and sub-debt, may provide increased financial leverage to help your organization grow.

DealCast

For more in-depth discussion of Commercial Debt Financing listen to KPMG's on-demand Dealcast webinar. kpmg.ca/dealcast

Ready to talk?

KPMG's Deal Advisory team can counsel you through the multiple options available to maintain or grow your business in a cyclical industry. Our forward-looking specialists have business acumen, deep sector knowledge and technical know-how to help you stay ahead of the issues and make the best decisions to meet your goals.

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