Bank of America Higher Standards

CapitalEyes
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Completing The Capital Structure With A Second Lien Loan

The economic downturn has dragged on longer than anticipated. Cash flow and collateral values have plunged. Terms on bank loans and traditional funding sources have gotten much tougher. It's not a pretty picture for the multitude of companies that are overleveraged or have maturing debt. Given these circumstances, one of the biggest fears facing these firms is, "How will I refinance my debt?" Increasingly, for both public and private companies, that fear is being allayed by senior secured second liens.

A senior secured second lien works in tandem with an asset-based loan and provides a company with some liquidity at a time when other capital sources may be less accessible. It has all of the same rights and covenants as a bank loan except that it's second in line in terms of repayment priority. The product itself has been around for several years but until recently has been used only by a small group of borrowers in complex restructurings. However, the market for senior secured seconds is rapidly expanding and it is being used more frequently.

There are a number of reasons that secured second liens have come into vogue, including the depth and length of the economic down cycle and the softness of the cash flow lending market. Cash flow lending all but disappeared from the lending landscape two years ago, and while many expected it would return, so far it hasn't. Consequently, second lien financing in conjunction with an asset-based loan has become the predominant way to refinance when a company's cash flow bank loan expires or its bonds mature.

At the same time that banks have been scrutinizing deal structures, private investors, flush with cash, have been looking for good quality investments. These investors, which include hedge funds, specialized finance companies and mezzanine funds, are non-regulated and not necessarily driven by internal credit risk ratings. They're accustomed to workout scenarios, are looking for true risk/return-oriented structures and can view each potential deal on its individual merits. For these investors, secured second liens can be attractive opportunities.

Typical Structures

Secured second liens generally are structured one of two ways. In the first scenario, the first lien is secured by all the available assets while the second lien relies on incremental dollars against the same collateral pool, not unlike a second mortgage on a home. In the other scenario, the first and second liens are secured by separate pools of collateral. For instance, the first lien might be secured with working capital assets such as receivables and inventory, while the second lien uses fixed assets such as property, plant and equipment. The kind of collateral that is used varies widely depending on what is available: trademarks, trade names, stock of subsidiary companies. Anything that typically is used to secure an asset-based loan can be used to secure a second lien.

In some cases, the hard assets may not support the dollar amount of the second credit facility. Instead, the secured second lien investor takes into account enterprise value and what the company would be worth if someone bought it. In essence, it mixes asset-based and cash flow lending to determine the loan amount. While clearly this is a risk that many banks won't take, second lien investors are willing to take the risk because the potential return is greater. The going rate is anywhere between 10 and 15 percent on an annualized basis. In terms of credit priority, the second lien investor is ahead of any subordinated debt even if the company is over-leveraged. Investors are also in front of contingent liabilities or trade payables through their residual asset claim. From an investor's standpoint, this is considered the "sweet spot" of the capital structure in terms of risk/reward.

Pricing on secured second liens varies from case to case. Some are set on a fixed rate basis while others float with a spread to Libor or the prime rate. Since many seconds are part of a complete recapitalization, they often have the same tenor as the bank facility, which usually includes a three-to four-year revolver. In the event of default, the second lien investor has the same rights and remedies as the banks do in these transactions.

Borrower Benefits

Secured second liens are intended as transitional capital. They give a company time to reduce debt and improve performance before accessing the capital markets. With that in mind, most second liens can be prepaid at par or with a modest premium, a key advantage to the borrower as compared to other forms of debt (Exhibit #1—Second Lien Secured Loan Benefits). Traditional high yield securities generally have 10-year terms that are noncallable for five years, while mezzanine finance is usually noncallable for two to three years.

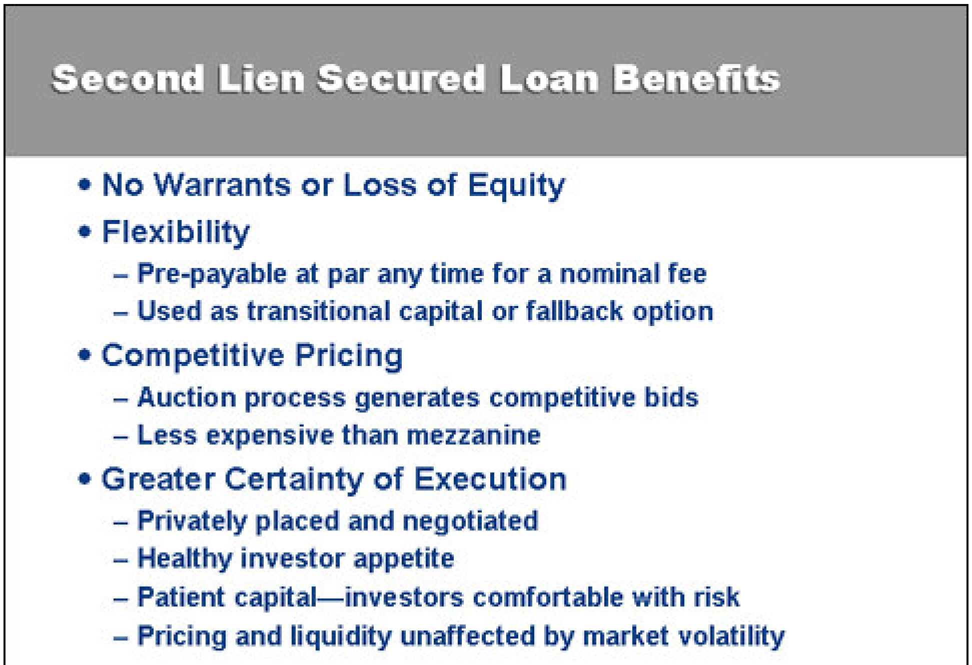


Exhibit 1

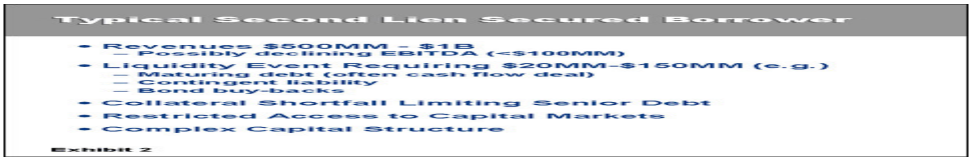
Borrowers also find the pricing attractive compared to mezzanine debt. Rates are significantly less than traditional 18 to 20 percent mezzanine returns. But even more importantly, there are typically no warrants in these financings, so a company doesn't have to relinquish any equity.

Another advantage to secured second liens is that they are privately placed and negotiated. This means they are not subject to huge capital market swings. Investors who invest in second liens typically have money dedicated to these types of transactions regardless of the state of the economy.

Seconds In Action

While not for everyone, senior secured second liens can be the right fix at the right time for certain businesses. Ideal candidates are companies with revenues between $500 million to $1 billion, with defensible market positions and a focus on debt repayment as opposed to capital expenditures or high growth. They generally have complex capital structures that include significant subordinated debt or equity bases, a liquidity event causing a capital need of $20 million to $150 million, and an inability to refinance through traditional sources (Exhibit #2—Typical Second Lien Secured Borrower).

Exhibit 2



One company that recently used the second lien structure is Columbus McKinnon Corporation, a manufacturer of lifting equipment such as hoists, cranes and chains. As a consequence of economic conditions, sales were down and its EBITDA (earnings before interest, taxes, depreciation and amortization) had fallen 18 percent compared to the prior six months. Its $150 million cash flow credit facility was maturing in less than six months, and adequate financing was unavailable through the capital markets.

The company had $200 million of subordinated, high yield bonds as well as $100 million in public equity. Total leverage was more than six times EBITDA, but it was attractive to the second lien investors because other than the asset-based loan, most of the debt would be junior to where they entered the transaction. Since Columbus McKinnon is a dominant player in its industry, the enterprise value would most likely exceed the senior investment if the company were unable to meet its obligations.

After a thorough appraisal of all of the assets, Bank of America Business Capital provided a new $100 million asset-based credit and Fleet Securities placed a $70 million senior secured second term loan through a private transaction. The refinancing effectively stabilized Columbus McKinnon's capital structure and extended the maturity of its senior debt by four years while at the same time funding its working capital needs. When the economy and corporate performance improves, the second lien can be refinanced with no penalty, and the transitional capital will have served its purpose during a difficult point in the company's life cycle.

The Dixie Group also has recently used a second lien, although its needs were somewhat different from Columbus McKinnon. Dixie is a leading U.S. manufacturer of floor covering. It had refinanced its cash flow debt, completed an operational turnaround, and had total debt of approximately 4.8 times EBITDA. It also was facing a $50 million back-end payment on an acquisition made three years earlier and raising the money through the high yield market wasn't an option because of the small size of the issue. The solution was a $37 million senior secured second lien and an amendment and restatement of its existing $128 million credit line with Bank of America Business Capital.

Sourcing Seconds

Companies seeking senior secured second liens will find that suppliers are few and far between. Since it is an emerging product, many lenders are not offering it yet. While there are plenty of investors willing to lend on a senior secured second basis, most of them lack the name recognition needed to generate deals on their own. Bank of America has a network of investors that allows it to match potential borrowers with appropriate investors. Generally, Bank of America provides the first lien and then places and negotiates the second lien transaction through post-closing. This includes assembling the offering memorandum, running a competitive auction, determining the best investor fit and negotiating the loan documentation including inter-creditor issues.

Conducting an auction in an emerging marketplace creates the opportunity for the borrower to get the best possible deal. The process has demonstrated repeatedly that the fee for the service is offset by savings to the borrower. In the case of Columbus McKinnon, when comparing the six bids it received on its $70 million second lien, there was a three percent per annum difference between the cheapest bid and the most expensive one. Without the benefit of the auction, the company may have paid considerably more than necessary for the financing.

It's worth noting that all the senior secured second lien deals Bank of America has done over the last year were with public companies that had access to the public markets in the past. Since public companies are required to disclose the details of all financing, this is raising awareness of the second lien alternative among both public and private companies. As a result, over at least the next 12 to 24 months, the number of senior secured second liens will continue to grow. Until the economy rebounds substantially, the cash flow lending market returns and the equity markets revive, secured second liens are here to stay.

For additional information on second lien secured loans as a borrower or investor, call 866-287-4098 or email capitaleyes@bofabusinesscapital.com.

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