



Non-Traditional Middle Market Investment Banking

Understanding your Senior Debt Relationship - Part One

By Kurt Loeffler, CFA, Director, Source Capital, LLC

There is often a significant information asymmetry between senior debt lenders and middle-market companies, especially those companies that are considered "lower" middle-market. It is the intention of this newsletter series to provide smaller to mid-sized companies with information and tips on how to deal with senior lenders more effectively. Having come from ten years of corporate banking on both the credit and relationship management sides, I hope to provide some nuggets of wisdom on understanding the banker's mind and processes.

The articles, including this one, will cover several important topics which may prove useful in negotiating a new bank deal, finding the right capital and provider, understanding the credit process, appraisals, financial requirements, etc.

Term Sheet versus Commitment Letter

Let us begin with a typical scenario. Banker Smith approaches Stellar Opportunity Company ("SOC") for a possible banking relationship. Management at SOC needs working capital support for recent growth in its receivables and inventory and a term loan for additional equipment. Smith asks for the typical financial package, including three years of historical statements, maybe tax returns if the statements are company prepared or compiled, personal financial statements, AR agings, etc. Smith examines these back at the office with his underwriter. An initial deal structure, including rates, fees, guaranties, collateral, etc. is developed.

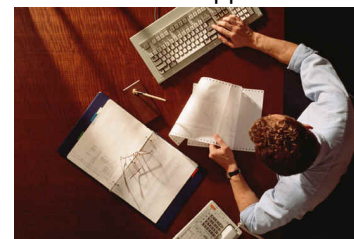
**Beware of the
"Taking the Deal
Off the Street"
Lender.**

At this point, the great philosophical question that plagues the mind of bankers everywhere arises – "Should we issue a

term sheet or go for commitment first?" As potential bank customers, let us consider this point. Smith would like to go back to SOC as quickly as possible, in order to look good in the customer's eyes. This would show a lender, responsive to the management's needs. However, management must pay heed. There is a saying in the banking world – "Taking the deal off the street." The psychological effect of receiving a term sheet from a bank can be comforting, albeit misleading.

I have encountered many companies that have stopped pursuit of financing when they have received a term sheet from a senior lender. Why? The term sheet looks like the deal is done. Also, bank relationship managers are usually fine salespeople, averring that credit approval is forthcoming.

Management teams feel comfortable with the terms, which may be quite aggressive, and then notify other banks that they are going with Banker Smith at Money Bank.



In the worst case, Banker Smith goes for credit approval and the deal gets shot down. SOC management realizes that during the time Smith spent underwriting and waiting for credit approval, they could have received different offers from other banks and these banks could have pursued their own credit approval processes, possibly getting the deal actually completed. Now, SOC is two to three weeks behind in its financing plans. Also, the negative signal that Banker Smith's credit authorities turned the deal down puts the company at a major disadvantage

with other lenders.

Those banks that pursue credit approval before issuing a proposal are more conservative, especially when getting back to the customer. However, when a commitment is issued, management can breathe more easily and negotiating the finer points of the structure can begin.

Communication is key with any potential lending relationship. Talk to other contacts in your industry and find out the usual methods of lenders you are considering. Make it clear with those that offer proposals first if this is what some call a "Swiss

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Cheese Term Sheet” with holes to be filled in later, or a firm commitment. Also remember that when receiving a commitment letter from a bank, there is **always** room for negotiating, especially when banks are “hungry” for assets. Remember, money is a commodity offered by those in oligopolistic competition.

Real Estate Appraisals

Real estate in a commercial lending transaction will almost certainly require an appraisal if the mortgage is for an amount equal to or greater than \$1 million. Be prepared. If your transaction will involve real estate, give yourself an additional 30-45 days for completion of the appraisal. This can also take a significant amount of money, usually in the range of \$4,000 to \$6,000. If the estimate is below that amount, start asking questions.

Each bank will have its own list of approved appraisers. However, most of the larger banks have a vast majority of their certified appraisers in common. Always check to see the credentials of the appraiser. Do your own due diligence on these credentials, such as MAI certification, etc.



If you are a smaller company looking to grow from being financed by a community bank to refinancing with a larger institution, the quality of appraisal may not be important in the short-term, but in the long-term, it could save you some money and time. If you are in

this situation, check around with other banking contacts to see if your appraiser is on their approved lists. If not, and you refinance in a year or two with a major bank, odds are that you will need a completely new appraisal.

As with everything, *caveat emptor* or buyer beware. I have seen acquisitions fall apart in the final hours because the seller had an appraisal used by its existing bank which was *substantially* higher than a new appraisal by a widely-accepted appraiser.

It is best not to cut corners with appraisals.

In my experience, it is best not to cut corners here in the early stages and can save time, energy, and especially money in the long-term.

Need Advice?

If you would like any additional information regarding senior debt relationships or would like to discuss your current situation for recapitalizing, business growth plans, mergers & acquisitions, etc. please feel free to call or e-mail me at the below contact points.

Kurt Loeffler, CFA is Director of Investment Banking at Source Capital in Beachwood, Ohio. He has eleven years of experience in investment and corporate banking, capital markets and debt placements with three of the ten largest financial institutions in the country. Mr. Loeffler has personally completed at least 50 senior debt, mezzanine, and equity placements, leveraged buyouts and acquisition financings in a wide range of industries over his career. He specializes in raising debt capital as a result of his extensive banking and non-traditional funding contacts in Northeast Ohio. He also directs the due diligence and transaction structuring for a majority of the firm's M&A transactions. He can be reached at 216-593-5096 or e-mailed at kloeffler@sourcecapital.ws.

Source Capital specializes in providing investment banking and operational consulting services to the controlling owners of small and middle-market companies, typically with \$3.5 million to \$35 million in annual revenues. Source Capital's team is comprised of entrepreneurs that have either owned or still currently own small businesses. Therefore, we understand the entrepreneur and his or her concerns, goals, and strategies. Our services are designed to help the controlling owners of a business build a more profitable and more valuable company.

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