

HANDOUT 1-1: THE IMPORTANCE OF CAPITAL STRUCTURE

Why Is Capital Structure Important to the Bank Lender?

The four most important questions the lender asks when developing a cash flow statement:

- Does the company have sufficient net cash from operations to service debt interest?
- Does the company have sufficient net cash income to repay scheduled term debt payments?
- What is the company's financing need?
- How has the company financed itself?

Capital structure is critical to the lender in the context of these questions. The bank's management of a relationship with all the other providers of capital to the company is critical for the preservation of the cash flows for the servicing or repayment of bank debt.

What Sources of Capital Are Available to a Borrower?

In developing the liabilities and equity side of the balance sheet, we will find:

- **Accounts Payable/Trade Credit.** Recall that whenever accounts payable increases, this represents a source of cash and, therefore, a reduction in the need to borrow bank debt. Trade credit should be "ridden," or taken advantage of (but never abused so that suppliers decide to reduce or eliminate such credit), as part of the effective working capital management of the firm. By maximizing trade credit, the maximum amount of cash is preserved for servicing and repaying bank debt. This is particularly important for a growing company, for a company emerging from Chapter 11 bankruptcy, or a company whose growth has now stabilized and the lender is looking for cash, which otherwise would have been invested in additional working capital, to be used for repayment of debt.
- **Accrued Expenses.** These are not normally a source of financing on which the lender focuses. However, as a result, if a lender is relying on some of the firm's growth to be financed by a type of "seller paper," the lender will want to ensure that its redemption or repayment is subordinated to or comes after the repayment of bank debt.
- **Senior Revolving Debt.** This can be in the form of either a seasonal working capital or a permanent working capital loan secured by a first lien on current assets (accounts receivable and inventory) and a first or second lien on fixed assets (PP&E), as well as a pledge of stock of the acquired company and/or its subsidiaries.

- **Senior Term Debt.** This can usually be secured by a first lien on fixed assets or a first or second lien on current assets, as well as a pledge of the stock of the acquired company and/or its subsidiaries. In both these cases, the usual entity providing the debt will be commercial banks or similar institutional lenders.

Note: In some cases, senior term debt, while not technically subordinated through subordination provisions in an intercreditor agreement, may still be effectively subordinated if the principal repayments occur after expiry of the bank debt. This may occur in those circumstances where a borrower has raised capital in the private placement market, for example, for periods of seven to ten years with delayed, balloon, or bullet maturities which occur after the bank debt has been repaid. Again, the effect is to ensure that the cash flows of the company are directed first to servicing and second to repaying the senior bank lender's debt. These principles apply to the borrower as a going concern. They would not apply, however, if the borrower was to go into bankruptcy.

- **Subordinated Debt.** Sometimes (particularly if there are warrants or convertible features to the subordinated debt) referred to as "mezzanine" debt or "junk" bonds. This debt is usually unsecured or is secured by second liens on the assets. (Be a little careful with this feature, since rights of junior lienholders, while technically subordinated, may provide those holders with potential leverage in restricting the senior lienholder's ability to sell or otherwise dispose of the assets at its discretion.) It is usually placed for longer than the commercial debt, at a fixed rate, and the usual providers are insurance companies, pension and investment funds, or other long-term investors. Principal provisions in subordinated debt include:

- In insolvency or bankruptcy the senior lender will be paid out before the junior lender receives any payment.
- Payments of the subordinated debt are prohibited if the senior debt is in default. Sometimes the rights of the senior lenders to block junior debt payments can be enforced only for a limited period (90-270 days) but usually around 180 days.
- No principal payments are scheduled on the subordinated debt until after final maturity on the senior debt.
- The senior lender will often seek the right to have all penalties, fees, and expenses of collection paid before the subordinated lender gets any payment.
- The subordinated debt will remain subordinated to allow for refinancings or senior debt.
- Subordinated debt may be expressly subordinated to trade debt, particularly if the senior lender feels that the trade debt is an important part of the liability structure of the balance sheet.

- Suspension of enforcement rights by the subordinated lender upon an event of default may restrict the subordinated lender from taking action against the company upon the earlier of a fixed period of time, acceleration of the loan by the senior lender, or the full payment of the senior lender.

Again, the principal objective of these provisions is to protect and preserve the rights of the senior lender to the cash flows of the company for the purposes of servicing and repaying its senior debt.

- **Sellers' Subordinated Debt.** This can be in the form of seller paper in which the seller of the company takes back a note that is subordinated to the senior acquisition bank debt, as part of the purchase price consideration. In such circumstances, the seller paper is sometimes convertible into stock in the company at a later point in time.
- **Sellers' Preferred Stock.** This represents an equity equivalent of sellers' subordinated debt. It has the advantage of being regarded as equity for regulatory reasons (particularly for highly leveraged transaction definitions) and is also regarded as more a part of the company's permanent capital than subordinated debt. Its only disadvantage in the longer term is that dividends are not tax-deductible when the company is profitable, which is obviously the reverse of the interest payments on subordinated debt.
- **Common or Preferred Stock.** This represents the equity owned by the shareholders. For a public company, shareholders range from private individuals to public institutions. In the case of a private company, particularly one where there has been a buyout by management of the public shareholders, the equityholders will be a combination of management and selective institutional investors.

Conclusion

The most important lesson to draw from this discussion is to understand that the primary purpose of loan structuring is to preserve the cash flows of the company for the purposes of servicing and repaying the bank debt. As a result, it is extremely important that the relationship of the bank to each of the other sets of creditors is closely managed so that their credit availability can be maximized and the servicing of this availability protected to ensure the preservation of the cash flows for the benefit of the lender.