Growing Your Business

Fresh funding alternatives are always handy

Alternative lenders are a welcome addition to the Irish funding landscape, write **John Doddy** and **Daniel Murray**

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Since 2008, the European and Irish banking systems have experienced a period of unprecedented change. Many of the events during this period have been well-documented, and will remain topical for some time to come.

What has emerged is a smaller banking sector containing fewer active players with a reduced capacity to lend and a reduced (and arguably appropriate) appetite for risk. Unlike in the US where companies are predominantly funded through institutional investors, European companies (and particularly Irish SMEs) are strongly dependent on High Street banks for capital.

The changes to the Irish banking sector, coupled with the high level of dependence on banks for funding, has resulted in the emergence of a credit gap which the existing banking system is unable to service. Governments across Europe have been actively encouraging institutional investors to provide funding solutions to fill this credit gap.

In Britain, the government has set up the Business Finance Partnership to invest £1.2 billion in lending to SMEs from sources other than banks. This money is being matched with at least an equal amount from private sector investors, and will be invested on fully commercial terms.

In Ireland, the government has opted for Direct Lending Funds and Private Equity Funds sponsored by the National Pension Reserve Fund, now called the Irish Strategic Investment Fund (ISIF). These Funds include Bluebay Asset Management and Carlyle Cardinal Ireland.

We have also seen increased activity from non-ISIF sponsored Funds such as Broadhaven Capital Partners and MML Growth Capital Partners Ireland (Enterprise Ireland is an investor in MML's Fund), and Private Equity firms such as Lone Star, Cerberus and Apollo.

Minimum deal sizes for most of the Funds is circa €10m, however, in our experience they will support smaller transactions if there is the potential for further investment.

The emergence of alternative lenders has not only introduced additional sources of capital, but has also introduced new products, structures, ideas and ways of thinking in relation to capital structures. Types of funding products provided include:

- senior debt A&B note structures;
- mezzanine finance;
- unitranche debt; and/or
- preferred and ordinary equity.

Unitranche debt is relatively new to the Irish market but is a form of funding that has become increasingly popular. So what is unitranche debt? It is a debt instrument which was created to simplify debt structures by combining different types of debt into one obligatio, eg, combining senior and junior debt to create a single tranche. Its pricing also reflects the blend of senior and junior debt. Since first appearing in the US around 2006, and then in Europe circa 2008, Unitranche has experienced dramatic growth, and a recent study by Deloitte UK has shown it to be the most popular source of alternative lending in Europe.

Alternative lenders should be considered as a source of capital when:

(a) The borrower requires a greater degree of flexibility. Alternative lenders can provide structures with low levels of amortisation, thereby enabling the borrower to retain cash and reinvest in the business. Financial covenants can also be less onerous than those currently required by banks.

b) Speed of execution is a key requirement. Alternative Lenders have flatter approval structures thereby allowing them to turn around proposals in a timely manner.

c) In complex situations which are not suitable for a standard banking product.

d) When higher leverage is required.

However, whilst alternative lenders present an alternative funding source they are not a replacement for banks. Alternative lenders cannot provide working capital lines, hedging and clearing facilities. Also, alternative lenders are less relationship-driven, and have not been tested "through the cycle". Therefore, borrowers should also continue to maintain their relationship with their banking provider. For borrowers who require facilities from both an alternative lender and a bank, the relationship between the bank and the alternative lender is governed by an inter-creditor agreement. As the alternative lenders become more established in the market the terms of the inter-creditor agreement are becoming more standardised.

Although we do not expect Ireland or Europe to adopt the US funding model where bank debt only accounts for circa 10 per cent of corporate funding, we do expect non-bank funding to play a greater role going forward.

This will result in companies having to adopt more complex capital structures as they use a number of sources to fund themselves. However, this should also lead to lower refinance risk in companies, as corporate and commercial Ireland will be less exposed to changes in the banking sector.

When assessing the funding requirements of a business, our advice to management is to have an open mind to these market developments. Through matching the funding instruments and sources to the businesses funding requirements, the level of potential default risk and refinance risk can be significantly reduced.

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