

In The Trenches_ The Current State of the Debt Capital Markets

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SPEAKERS

Steve Divitkos, Cory Kaiser, Tim Eaton

C Cory Kaiser 00:00
Tim and Cory, welcome to the show. Great to be here, Steve. Thanks for having us.

T Tim Eaton 00:05
Yeah. Thanks, Steve.

S Steve Divitkos 00:07
So I'm really excited to talk to you guys. Because over the past six months or so, questions about the changes in the credit market have been among the most frequently asked questions. So we're recording this in December of 2022. And it's important for us to put a timestamp here because this episode is more specific to the time period in which it's being recorded than the average episode. So maybe an interesting place for us to start would just be if you guys could give us just your general take on the current state of lower middle market credit. And when I say lower middle market, I'm referring to companies that are some combination of \$30 million in revenue or less, \$5 million in EBITDA or less 100 employees or less somewhere in that ballpark. So can you just give us your take on the current state of lower middle market credit? And importantly, can you contrast it to say, six to 12 months ago, maybe that's a great place for us to start?

C**Cory Kaiser 01:13**

Amazing. Thanks, Steve. It's Cory here, maybe I'll take the first stab at this one. But I think you've done a good job level setting with your listeners here, especially as it relates to the timeline. What I'm going to do here is look maybe in the rearview mirror to get us kick started here, but also talk about where we're at today, and what may be ahead, as short as a month or a few weeks from now, we're really at an inflection point, perhaps. So up until now, the last couple years, if I talked about the pandemic, or what we've lived through in the last two to three years, it's been great for our business, Steve. I'll start with deposit volumes, our customers have been flushed with cash, we've seen a lot of liquidity hit the market with government aid, or funds that may have sat on a balance sheet rather than being deployed in the economy, as we saw at slower levels of activity, especially at the outset of the pandemic. So that's really helped our customers generate some liquidity or some buffer in their balance sheet. So that's been good for our business. Also, on credit volumes, it's been the best of both worlds from our perspective, when you talk about good M&A activity, rising asset values, low interest rates, strong economic growth, strong economic drivers, especially in the last year or two, that has meant very strong credit growth in our book, and it had the added benefit of having we've seen great portfolio quality, we haven't seen our credit quality, our credit portfolio really be compromised. And it should knock on wood when I say that, Steve, but overall, it's been very good times for our business, and very good times for many of our customers. So getting to your question, the current state, and I use the word inflection point, as I think about this, because I get asked this question a lot. We've all sat through economic presentations, we've all read the press about the talk of is a recession coming. Is it around the corner? How mild is it going to be? Can the Bank of Canada facilitate a soft landing? We answer these questions in the day to day. That's all against the backdrop of significant interest rate increases, i.e. 400 basis points or more, just in the last year. So that's going to be a stress if we haven't seen it already, it's going to be a stress for for any borrowers in the near term. But all that said, where are we at today? I haven't seen what I would consider substantive or material changes in the credit market for your listeners, for those lower mid market borrowers. Most of the banks just reported their Q4 numbers. Most of them are reporting really solid strong growth in mid market commercial lending. And apparently, they have an appetite for further growth. I know I've just got my goals for fiscal 23. And there's certainly an incentive for us to continue growing our books. So there is an appetite there for further growth in the bread and butter, mid market commercial lending space. I've started to see some data come out that mid market M&A activity is slowing. It's declined in recent months. I mean, I'm just one individual from one office here in downtown Toronto. But we do still see a solid pipeline of activity and many transactions to close, especially as we enter 2023 here. So I'm reasonably optimistic that the appetite and the growth will be there as we look forward.

S**Steve Divitkos 04:55**

So if you're observation, Cory, is that the lower middle market is kind of more similar than it is different relative to 12 months ago. Is that specific to the lower middle market? Or does that change as you move up market? So for example, are the credit markets materially different for you know what I'll label as mid market companies, let's say \$100 million or more?

C Cory Kaiser 05:20

Good question. And maybe I'll hand the mic to Tim here in a second. But overall, I would say no, we haven't seen it yet. And we deal with companies, say from 5 million in revenue to \$200 million in revenue. So we really haven't seen that pivot yet. But Tim, maybe you want to comment especially?

T Tim Eaton 05:41

Yeah, thanks. Great. No, I would agree. And again, you mentioned just the one data point. And of course, I'm the same bank, same office. But the team I oversee focuses on companies with revenue of 52, generally, about \$150 million, can be a little bit higher. And I haven't seen any slowdown, if anything, you know, it's been a steady as ever. So lots of activity, still lots of opportunities for companies to find buyers that are looking to come in and purchase. And I think there's lots of room to find lenders that are willing to support those purchases.

S Steve Divitkos 06:16

So maybe we can dig into some specifics. And if the general sentiment is that things are more similar than they are different relative to six to 12 months ago, maybe you guys can answer this question in the context of I should say, on a more forward looking basis. So obviously, interest rates are rising, obviously, inflation is at, you know, 40 or 50 year highs. There's geopolitical unrest in Europe, obviously, you know, question marks visa vie, whether or not we're in a recession or entering a recession. I want to ask you guys about how lenders think about specific terms and conditions of the loans that they're willing to offer to prospective purchasers of businesses. That's kind of where I want to focus for now. So hopefully, we can go term by term here. So starting out, I'd love to know how you guys think about the quantum of debt, just the absolute number of dollars that you're willing to offer to partly fund bio transactions? And whether that's similar or different to your answer 12 months ago?

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Tim Eaton 07:20

Yeah, that's probably good for me just, I'm a little bit closer on that. So I think I wouldn't really expect much has changed with the quantum that we're looking at, in particular, where we'd be for percentage loan to value. Where I would see it might come into play a bit more is just where a purchaser's view would be on the appropriate multiple, that they're looking at as far as what they're buying, or where we may, if we're looking at a lender's view of that multiple and can we be comfortable that that's a steady state number. In acquisition financing, as you're aware, generally, we're looking at a percentage of the multiple over EBIT, da the EB multiple that people are looking at. So I think, as that moves that can affect the nominal quantum that we're looking to provide, but as a percentage of loan to value. I don't think there's been much. A few specific industries, maybe you've seen a lowering of Purchase Price multiples. But I haven't seen a ton of it change yet. But that's the one spot that I would say, you know, if I'm considering where things could go, could we see a softening in some of the multiples that people are willing to pay, and then that would have a correlation into how much we'd be willing to lend.

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Steve Divitkos 08:29

If you guys were willing to, let's just kind of pick conservative numbers, let's say that you are willing to lend put two times leverage on a deal set another way, the amount of debt that purchaser raises is roughly two times larger than the company's EBITDA, if 12 months ago, you were willing to put, you know, two or three times leverage on a deal and say inflation continues interest rate rises continue, we do enter a recession, are you still willing to put two to three times leverage on a deal, six to 12 months from now?

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Tim Eaton 09:02

Yeah, I think if we're focused specifically on the leverage, yes, I would say that that holds true. And maybe you'll get into it as far as other specific questions, if you're going down there on where debt serviceability might get, but if you're speaking to leverage, we're willing to do 50 to 60% of the purchase price. And maybe it's the right time to delineate between the lower mid market and the upper mid market. On the smaller acquisitions, we may look at more of a nominal level of leverage that we'd apply there. And I don't think anything's really changing there. I think as we look at the larger, it's more of a percentage of that you've done multiple that people are looking to expend. And we're still at the 50 to 60%, I would say in the market. Looking at the larger deals when you're measuring as a percentage of EB.

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Steve Divitkos 09:52

How about covenants, are lenders generally getting a bit more restrictive on covenants as they look forward six to 12 months, or things more similar than different in that respect as well?

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Tim Eaton 10:08

I'd say the latter really meant seen a change in their broad change and how covenants are being looked at. Obviously, it's deal specific which covenants we're thinking about. But if we're looking at what is the overall market considering as far as they're tightening, am I finding when I'm out there competing for a deal? Am I really tightening and still finding a chance to win? No, I'd say it's as competitive as ever amongst banks, and you're always thinking of are these covenants necessary? Are they adding value? And if they're not, then you have to step back and be aware that somebody else might be willing to do it without that covenant. So I think the quick answer is no, not really.

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Steve Divitkos 10:48

How about pricing. I mean, look, I think from a from an absolute interest rate perspective, obviously, debt is more expensive today than it was 12 months ago. And I'll just, I'll just make up a spread here. So apologies if this is completely inaccurate. But let's say that 12 months ago, you were lending at prime plus 3%. Right, 3% is the spread that I'm making up. Well, if you're still lending it prime plus 3% today, obviously, the interest rate has gone up because the base rate has gone up. My question to you is in that spread. So if you were lending at a spread of prime plus 3, 12 months ago, what does that spread look like today? And what might need to happen for that spread to increase six to 12 months from now?

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Tim Eaton 11:29

So maybe I'll start with the last part of the question there as far as what might need to happen, I think, a real softening of liquidity. You think back to the crisis that we had the liquidity crisis, that's where I've seen, I've been lending for 23 years. And the one time where I've really seen a drastic movement was, then. It's really a fundamental shift in the market that's going to drive that change, I don't tend to see big shifts in the spread, when you see the types of movement that we're seeing just in rates right now. Because I do like the way you broke that out, obviously, overall rates, aggregate rates are up, but the spread that the banks charging, I'm not really seeing a ton of movement yet on where that would be. And for some of the larger deals, you're seeing pricing tiers, and we might see the upper or lower bounds of those tiers change from time to time, you know, if competitions really swayed, I'm not seeing a real change in your upper and lower bounds of pricing tiers on the deals that are in market right now.

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Steve Divitkos 12:34

Okay, so the absolute value of pricing, or the absolute interest rate being paid is higher, but that's more a function of the base rate rising as opposed to the spread widening. Is that an accurate summary?

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Tim Eaton 12:44

It is, yeah. And I think for I think some of your listeners would be in the sponsor space. And I think they're what I tend to find is, I'm seeing a lot more people putting emphasis on wanting to know that they have appropriate headroom to their financial covenants or looking at amortization. And what can we do versus really trying to hammer down on pricing today?

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Steve Divitkos 13:04

So one thing that I'm seeing, I mean, the next two questions, I will color with my own view as an equity investor. And I'm curious to see how the equity investors view differs from the debt investors view. So with the absolute interest rates increasing as a result of the base rate increasing naturally, with the same level of debt, I'm seeing more and more free cash flow being dedicated solely to debt service. Do you guys have you know, for lack of a better way to put it, acceptable or market percentages of free cash flow dedicated to debt service? And does your view of what that number should be change if you think that we're heading into a recession six to 12 months from now?

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Tim Eaton 13:53

So yeah, so yes, there is a generally accepted range, and it tends to be call it, if you're looking at a fixed charge coverage or debt service, you're somewhere in a 110 to 120 or 125, depending on what you're buying, what industry and some of the terms. That's more on a covenant. And then obviously, you want some some headroom above there. So it's no real change to the thresholds or covenants we're seeing. What I would say though, is I probably as much from your perspective as it would be from a lender's I would say on where your comfort is against that covenant and the headroom that you're okay with. And it really, I think, right now comes down to what's a reasonable sensitivity or shock to your performance that I can handle and in this case, the sensitivity is going to be one of them is going to be interest rates, as you said. So if we've seen the the type of movement that Corey mentioned earlier, and there's the chance that you could foresee that there could be that again, whether or not we believe it's coming or not, we've seen greater movement. I probably need to be sensitizing a little bit more for potential interest rate movement, which means I need to be comfortable that you've got a little bit more headroom on your debt serviceability than I might have 12 months ago.

S**Steve Divitkos 15:05**

How about the the types of analysis or the model cases or assumptions that you want to see from a prospective borrower? So I'll give you an example of what I mean by that. As an equity investor, you know, now more so than 12 months ago, I really want to understand the models recession case, which is, hey, you know, what does this company look like in a prolonged recession? I'm spending a lot more time on that now than I was 12 months ago, maybe that tells you all you need to know about me as an equity investor that notwithstanding, how are you guys thinking about that? Is the type of analysis that you want prospective borrowers to perform, has that changed at all? Are you underlining or highlighting the, you know, downside cases? How has that changed, if at all?

T**Tim Eaton 15:51**

Probably more the latter on that, I don't think we're really asking for a whole lot more from what you would be providing Steve, in your model. As you always would have been looking for in an acquisition, we're going to be looking for a working model that has at least a quarterly breakdown, for the last year and quarterly projected, so that we really understand how those covenants have been in the last year. And going forward. It's great if I think for somebody who's preparing something for a lender, if you can go out of your way to show that you have an understanding of where those covenants might be, particularly if you're updating your model, after you've come to some terms with your lender on what your term sheet might look like. Being able to show that movement and showing your own thoughts on what you would actually be sensitizing for and how you can show in a sensitized scenario. That's really helpful. I think we're obviously going to be doing our own analysis ourselves as well. If anything, I guess the one thing we might be asking for more is just probably going deeper into understanding what the right sensitivities or adjustments would be, and getting that from you. So it's more on the discussion and analysis components, and probably the depth of questions that we'd be asking, looking at your model and your other information, then it would be about providing a different form of model.

S**Steve Divitkos 17:08**

Over the past 12 months or so with respect to the loans that you've issued to fund lower middle market buyout transactions, at the risk of putting you on the spot, what's your best estimate for the what percentage of the total capital structure was represented by debt? So that's more backward looking. And then on a forward looking basis, how do you think that number might change? Let's say 12 months from now, as best as you can tell?

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Tim Eaton 17:34

Yeah, no, I don't think it's too much on the spot. I mean, generally, in this space, you're generally trying to find as much debt as you can. So I think it's been a fairly narrow band from majority deals that we've seen. So you're generally 50 to 60% of your overall cap table. I think what I have seen is more and more for sponsor transactions. This means measuring off what I would say to be your most recent, last 12 month reporting period. And maybe even the highest level of EBITDA that that company has seen ever, I think that's probably been the spot that we've moved the most is just what we're measuring off of. But the 50 to 60%, I think, is fairly consistent. I have seen in the past number of years that there's been a creep with how much of a percentage in that 50 to 60 is covered by senior debt. They notice lots of cases where I would see, you know, that whole amount of 50, 60 is senior debt and not just like a unit trash scenario, but but pure senior. I think what I'm starting to see now is some more discussions creeping in with respect to maybe maintaining that same 50 to 60% cap, but having some more subordinated debt in there, whether it's a half turn or a full turn, making up that structure. And I could very much see that becoming more prevalent now. Because that's where we were before, if I went back kind of three, four years ago, to get to that 60% level, there was generally at least some form of sub debt there. I think I could foresee us getting back there again.

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Steve Divitkos 19:02

Maybe one one quick follow up to that question is, because a lot of folks listening to this have perhaps never raised debt before, maybe their company has never taken on leverage. Maybe they're a first time buyer. How should they think about at a general level, how much debt to put on a deal in today's environment? So on the more aggressive side, just like getting a mortgage for your house, you might just pull five banks and take the highest number, whoever's willing to lend you the most, that's certainly on the more aggressive side. On the more conservative side, maybe you run a model, maybe you run a recession case and a model, and you raise an amount of debt that would still keep you on side from a covenant perspective in a recession. So there's a spectrum of risk and return. I suspect that the right answer is somewhere within those two polar opposites. But if you're speaking to somebody who's never capitalized in acquisition before, they know they want to put some debt on it, but they're questioning how much do I put on this thing. Are there any rules of thumb, best practices, ways that they should think about how much debt to put on any given acquisition?

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Tim Eaton 20:10

Yeah, I think, particularly if you're coming in an acquisition where you, you're trying to get your head around understanding what those risks are, and you may not have, you haven't been running that company for the last five, seven years. So I think starting out with the right type of sensitivities in your model is accurate. But I think a rule of thumb is you generally want at least 20% headroom to your financial covenants to feel comfortable, that a shock to your revenue that can fall into your EBITDA does is going to be something that you can handle without really coming up against your covenants and having some concerns on where your financing might be. You might want that to be a little bit more if this is an industry where you could first see some greater shocks, I think, the smaller the company, the less of a shock to revenue it takes to really hit in at your EBITDA. So those are things I think I would consider.

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Steve Divitkos 21:07

So it sounds to me like I mean, kind of putting a bow on everything that we've discussed thus far, certainly credit, at least in lower middle market remains pretty robust and has been, in a way, kind of insulated from the more turbulent environment that we've seen, let's say in public equity markets. So Cory, maybe I can go to you on this one. Can you talk to us just about how competitive the the typical or average deal is in the lower middle market, from a credit perspective? You know, the number of lenders against which you might be bidding so to speak, has that changed over the past 12 months, if you could just speak to how competitive the market is to lend to companies of this size?

C**Cory Kaiser 21:50**

Yeah, great question, Steve. And, again, you've level set right off the top that the timing is so important here. So my answer is may only be good for today. But we've seen a very robust, very competitive market here for the last few years. It's not uncommon for us if we're pitching on a deal to face to face or stare down three or four term sheets from other banks to be right in the mix with with our competition there. So very healthy appetite for credit growth, as I might have mentioned earlier, all of our competition are seeking growth, they're seeing growth or reinvesting in the business, the the environment has been there in the rearview mirror for really substantial growth in the credit markets. And we're certainly seeing that. But our time is about to change. A case could be made for that. I don't know what's around the corner. But I've been doing this for over 20 years now, just like Tim. I lived through, 08, 09 however, short term that was it was a crisis, it impacted our markets. And what we saw there was a divergence of approaches by the banks on the street as to how they coped with that turbulence. So some banks, if we enter a recession, if we enter greater uncertainty, and you hit it with the geopolitical tension, the upheaval in the equity markets, if we hit a recession here, especially you might see, banks take on different appetites. When they look at lower mid market credit growth, I might take a more glass half full approach that a recession can be a great opportunity for an ambitious lender, provided you understand the risks, you have comfort in the management, you have comfort that this is a sustainable, viable business. This is a great environment, for a good lender willing to do that extra due diligence, it to maybe gain some market share at the expense of a competitor that may have a lesser appetite for growth. So my my advice to your listeners, Steve, if they're looking for debt right now, as you've heard him speak at length. The environment today really hasn't changed visa vie six months or a year ago, but we really don't know what's around the corner. Talk to your lender in advance to gauge their appetite, ask them detailed questions, they should be able to speak to what the appetite for growth is out there. Surround yourself with the right experts, whether it's now or later or 12 months ago, the right accountant, the right lawyer who's on your side, their interests are aligned with yours. That's foundational advice that I can't stress enough and I'm speaking regularly to our clients about and if necessary talk to another lender. Again, lenders are heavily incented to grow their book. My goals haven't changed for this year. So if you're interested in growing your credit with your lender and you're not getting the right comfort there, open up your Rolodex, talk to your advisors talk to other lenders see what else is out there.

S**Steve Divitkos 25:08**

So a very common financing mechanism in the lower middle market when acquiring a business is seller debt, effectively deferred purchase price that is paid for via the operating cash flows of the company. I'm curious how do senior lenders like banks think about the inclusion of seller financing in any given transaction? And for purposes of this question, we can assume that it's always subordinated to the banks loan. Are there any instances in which you might like push back on a prospective purchaser looking to add a seller note into a deal? And if so, what might that situation look like?

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Tim Eaton 25:49

Yeah, maybe I'll take that one, Steve. And I think you caveat it quite well, actually on the subordinated so that way, as a lender, I don't have to worry about all my my takes on how it needs to look. So in that scenario, where it is subordinated and let's assume it's subordinated under terms that makes sense for a lender, I'd say generally, it's looked at in a positive light. You know, in this space, successful companies often tied to more of individuals who would be departing, at least in some part. And I think, while you're likely having them on through some form of an employment contract, if that makes sense. But having vendor continuing to be tied to the company post closing financially, is a great way to ensure that, that original individual is vested in continuing to see the success of that business through this transitional period. So I view that as a plus. As far as where where might be, I would say, to what degree, might it make sense. So I think the biggest point of advice I'd give to prospective purchaser is just to ensure that your structure does have enough actual cash equity coming into a deal. From a lender perspective, if I'm looking to see 40 to 50%, of equity in a leveraged buyout, then I'd want to see likely 20 to 25% of that to be cash equity coming from the purchaser. And then that's assuming, of course, that the remainder that that VTB is structured very much equity like, and your lender would be able to explain to you what types of terms would be required to make it equity like. And then I think, just as I'm sure you're aware, just is the vendor, take back the right avenue, obviously, each scenario is unique. So it doesn't make sense to be a VTB a whole back and earn out, maybe even a revenue out. Maybe it's just a matter of continuing to do what you've done before. And you just want to see that that continues. I think any of those would make sense and be viewed as positives for a lender.

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Steve Divitkos 27:41

How about fixed versus floating rate debt. I mean, this is kind of the proverbial question in a way, but I want to talk about that decision specific to this market. So those who are raising debt to finance, an acquisition, you know, CEOs who are running companies who are looking to raise debt to grow their business or refinance, or whatever the case may be, how should they think about the question of fixed versus floating rate debt? And what like, what variables might they consider in navigating this decision?

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Tim Eaton 27:49

Yeah, I think that's right, because it's not something that we've discussed a ton of prior to this timing. So the timing, of course, makes a lot of sense. I think the best way to understand this or two, because it really comes down to that risk tolerance of the individual who's buying it and what that business itself can handle. Unless your company's you know, a financing intermediary, I don't really think that interest rates are something that you're in the business of wanting to deal with. So some degree of hedging likely does make sense. To what degree I think that's your comfort, as well as just does this company have a whole lot of other external shocks, or outside variables that might affect its cashflow? So I think if there are a number of them, then maybe locking in more of your debt might make sense so that you can control that debt burden. And then I guess just does it make sense? Maybe Steve, just to mention the difference between a fixed rate loan or an interest rate swap, or leave that for further ado

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Steve Divitkos 28:13

No. Let's do it.

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Tim Eaton 28:13

Okay, so yeah, I think um, the the main thing, and that that I think of is in the upper mid market, you'll often see that lenders are willing to give you tiered pricing. And if you're buying a company in a in a leveraged manner, obviously, obviously, that's the spot in time where you're going to have some of the highest debt load that you would have, you're probably higher levered, which means you're at a higher pricing tier. If you lock in a fixed rate today, at the time that you're doing this, you might find that you're locking in with the highest spreads that you would have had. So great, you're locking in and you're protecting yourself but if you consider an interest rate swap, that swap gets it's a floating swap for fixed prior to the spread coming on. So there's a way to control some of your comfort against the the underlying, however, it allows you to then benefit from the tiered pricing that you would have had, if you bring your leverage down, your overall amount that you're gonna be paying can come down. Now, obviously, there's some open risk to that too, because you have another 2008. And that can be impacted. But if you're, if you're fixing things in, you're likely, as long as you're on side of all your covenants, you're going to have the spreads locked in as well for for your commitment period.

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Steve Divitkos 30:35

I want to ask you guys a few questions about your credit committee. And before I do that, Cory, maybe I can go to you on this one. For those listeners who might not be aware, can you explain what is a credit committee? What do they do? And how does you know their work interface with let's say, the work that you and your teams do every day? Let's start there. And then I'll ask you a few questions about them.

C

Cory Kaiser 30:59

Yeah, great question, Steve. So chances are your listeners when they interact with the bank, they're dealing with an account manager or relationship manager, and the infrastructure that may exist, quote, unquote, out in the field. These are the people responsible for developing business, for relationship management or existing portfolio. Oftentimes, there will be credit limits, residing on the front lines, i.e. that relationship manager or their boss would work closely with a credit manager side by side that may have the ability to sign off on a certain level of transactions. For anything more material, I'm talking, say three to \$5 million and above, my guess is that those credit limits only reside centrally in a credit risk management or a group risk management. So their job at group risk management is to be arm's length is to be independent from the field, or more independent from the field than your relationship manager or account manager. So they have higher limits, but they also have accountability to the shareholders. So the best risk managers, somebody once told me, risk management isn't about saying no, it's about working with the company, understanding the risks to get to the right place and make the right decision for the bank. So hopefully that answers your question. But the best relationships with the best risk managers involve constant dialogue between the front lines and group risk management.

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Steve Divitkos 32:42

So specific to that credit committee. I'm curious, when you guys approached them with any given opportunity, are there any questions that maybe they're asking you now that they weren't asking you 12 months ago? Or maybe are there any questions that they're asking more frequently today than they were 12 months ago?

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Cory Kaiser 33:04

Yeah, great for you to highlight this for your listeners, Steve. We've always done, say interest rate sensitivity, foreign exchange sensitivity, depending on the business, we ask foundational questions around financial risk, business risk. None of that has really changed. But given this environment, we've really keyed in on some of these key risk factors that are especially present in today's market. And the most obvious example then is interest rates. While we did interest rates sensitivity two years ago, I don't think any of us could have seen a 400 basis points rise in interest rates coming. So some of that sensitivity that we did is probably not current. So our committee is asking us to really double down and understanding on what our customer's exposures to rising interest rates are, how have they protected themselves, how they hedged themselves. I'd also say the same for supply chain, the last two years has made us aware of something that maybe wasn't tops on the agenda when doing our risk assessment. Previously, it's the supply chain of our customers and how the disruption that we've seen in the last couple years can impact their ability to do business. So we really keyed in on that. Lastly, the third point I'd make here Steve, is labor shortages, really, really tight labor market here, in Canada, in North America. So we're asking those questions regularly of our customers to make sure that they've got a plan, that that they're protected from what is an exceptionally tight labor market, even to this day?

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Steve Divitkos 34:49

That's really interesting. So are there any industries or business models that your credit committee would have funded 12 months ago, but are no longer willing to fund today? Like, I'm just trying to think of an example. So for example, inflation brings to mind the question of pricing power, right? Can any given company pass through price increases to their customer base, you know, in a reasonably low friction way? If the answer is yes, great, they can at least maintain margins. If the answer is no, then you know, you can make a reasonable case that margins are likely to erode. Anything like that any businesses or industries or pricing models or anything like that, that they would have happily funded 12 months ago that are, you know, being met with a lot more skepticism today?

C

Cory Kaiser 35:37

Yeah, good question, Steve. I thought about this one. And the most obvious example, I'm not a real estate lender per se. But the most obvious example, we've all read the headlines, we've all seen the data, what's happening in the real estate market, anything related to real estate might get an extra degree of scrutiny. But for operating businesses, even for the riskiest of industries, we always took the position that we'll bank the best companies in the riskiest of industries, right? If we're comfortable with management, if they've set their company up, right, then they should be able to withstand these downturns. And hopefully, they've been getting the right reception from their lenders, even as we enter in, or we could potentially head into a recession here. But outside of real estate, we haven't seen it yet. Steve, that would, I don't think would be worth commenting on.

S

Steve Divitkos 36:33

One thing that first time borrowers might not appreciate is that the first term sheet that they get from a bank, let's say from a relationship manager is, of course, the bank's best estimate in good faith with respect to what can get funded on closing date. But what first time borrowers don't necessarily appreciate is that sometimes those term sheets change. And sometimes that changes the result of the credit committee. So I guess, in your experience, just to calibrate expectations for first time borrowers who have never done this before, like what percentage of deals get final approval from the credit committee on the exact same terms, as were reflected in the term sheet? And I guess Part B to that question is, how can borrowers get as certain as they can possibly get that the term sheet that they quote, sign off on will not materially change after getting final sign off from any given banks credit committee?

C**Cory Kaiser 37:30**

Yeah, yeah. Great for you to bring this insight to your listeners. I know this one, if I was an entrepreneur, this one would keep me up at night in it. And I'd also say that this is something we as lenders sweat, to a great degree, nobody wants a reputation of say, baiting and switching or showing something on paper that we ultimately can't deliver on at the last minute, Steve, so you're right to raise this. What percentage, I mean, I hate to take the easy way out here. But it would depend, if it's a really complex deal. And by that, I mean, multiple lenders, multiple shareholders, bigger dollar amount, less asset, cover less security for the bank, you could always expect some degree of what I would call tweaks around the edges with your final approval. Keep in mind a term sheet, even the most detailed of term sheets would only be five pages long. Whereas your credit agreement, if this is a really big deal, it could be up to, I don't know, 40 or 50 pages, right. So there's going to be some tweaks around the edges that might not have been previewed with a term sheet. Having said that, if there are substantial changes between the final credit agreement and the term sheet, that is something that everybody's looking to avoid. And really, it's only in an exceptional circumstance that an experienced lender is having to deliver a nightmare scenario like that to the customer at closing. So I would say, especially with the backdrop of the strong economy that we've had that that hopefully is a very exceptional circumstance. The latter part of your question, what can an entrepreneur do to avoid that? I'd say the upfront and early due diligence of your lender is so key. If you sit across the table from your banker, you will know in your gut if they're asking the right questions, if they're understanding your business, if they've got experience in your industry. Are you confident that they understand enough to convey the story, to convey your quest, and to convey the risks of your business through to their credit committee? If you're getting a little bit uneasy about the tone of the conversation or how they may have gapped in some of their more foundational due diligence, that I'd want to escalate that. Ask to meet the senior management of the branch, ask to meet a credit manager, ask to understand the reporting structure of your lender. Again, I have the pleasure of leading an office of 58 people, it is my job to understand and onboard new customers to the bank, there's no deal, no new piece of business that's too small for my involvement really. So if you're getting that uneasy feeling, make sure you're escalating and getting in front of the right senior people that really hold the pen on these ultimate decisions, to make sure you get that sense of comfort from your bank.

S**Steve Divitkos 40:48**

Does any given lender approach their credit committee at a very specific time? So for example, let's say that we have a transaction, we think that it's going to close on December 31. Does the average lender say okay, we always go to our credit committee for final approval, X weeks before the contemplated closing date. The reason why I asked that question is because I'm trying to figure out, is it fair for a prospective borrower who might be losing sleep about a Retrade, so to speak? Is it reasonable for them to go to their lender and say, hey, I want you to bring this to your credit committee X weeks before you ordinarily would? Just because I want that peace of mind. Is that a fair request?

C

Cory Kaiser 41:30

It is, it is a fair request, Steve. But keep in mind, a credit committee at that term sheet stage may not have all the information required to make that final decision, right. So this is where you really need to lean on the experience and the expertise of that relationship manager of that account manager that's on that other side of the table. If they're nervous about ultimately delivering what's on paper there, then hopefully, they recognize that and have brought the appropriate parties to the table. I've had prospective customers ask me not only for an introduction to my boss, or a credit manager, but also asked me for references from other customers in similar industries or in similar types of transactions. So no question is unfair of you to your lender. The ultimate goal here is to get you that satisfaction or that confidence that that lender can deliver on the term chain.

S

Steve Divitkos 42:36

You know, it's funny, I pulled some of our listeners before this conversation, and ask them, you know, what do you want me to ask an experienced lower mid market lender? And it was very interesting to note, the answer that I got back most frequently had to do with tripping covenants. So let's talk about that. When a borrower trips a covenant, or they suspect, you know, they might trip a covenant at some point in the near future. First of all, like what happens? What actually happens when a borrower trips a covenant? Let's talk about that. And then what should they do? If they suspect that in X weeks or months, you know, they, they might trip the covenant? So maybe we can just kind of take those in order?

C

Cory Kaiser 43:25

Sure, sure. So I'll take this one step. What happens So chances are, when you trip a covenant, it will be flagged by us when you submit your annual reporting, your quarterly reporting, or whatever the reporting package is. We will do the work internally here and it ultimately ended up on a credit managers desk as being in breach of your contract with the bank. What happens from there again, will depend on the severity of the breach, your track record with the lender, our relationship with you. So all those things really matter. So what advice would I give to a customer of mine or a listener of your Steve, open lines of communication are so key when when you think about financial reporting, it's a snapshot in time. Most often, well in the rearview mirror, so it's 90 days old, it's 180 days old, in some cases. A lender never likes to be surprised. And that's a tough position for you as an entrepreneur, to walk back from if you're hitting your banker with a surprise to the downside. Especially in a material respect, right? So my number one piece of advice is open lines of communication are so key. If you're in danger of gapping on a covenant, let me know. Let me know as soon as possible. Even if you're not sure, like just just that even that messaging that you send to your lender that I received back my bank deal, you can have confidence in me that I'm aware of the terms and conditions of my bank deal. That goes a long way with a lender and the credit committee. Here's somebody that really respects the contract I've got with them. The more notice I have the better. Everybody raises to the doomsday scenario, well, if I breached this covenant, is the bank gonna call my loan? Are they going to kick me out? Keep in mind, I'm incented to retain you as a customer, I want your business I chances are I fought hard for your business, I had to compete against other lenders, I want to retain you as a customer. So it's really easy for you to keep a good relationship with me if those open lines of communication are there. It also really helps if you have a contingency plan, depending on the severity of the breach, I'm going to want to sit down and work with you on how to get you back on site. So okay, you've missed your leverage covenant today. What is the next quarter look like? What does the next six months look like? What is your plan to get back on track? Let's understand what the risks are to that plan. And let's work together on it. Because the more I can articulate with some efficiency to our credit committee, your plan to get back on track, again, that signals to your lender, your bank, that you're all over this, you're a capable operator, and you're again, taking your bank's wishes into consideration. I think that pretty much covers it Steve, but feel free to dive deeper there.

S**Steve Divitkos 46:36**

Well, you know, what's really interesting is in your answer, you kind of highlighted in a way, what makes a good borrower, right. And certainly communication, you know, like anything, good communication, a clear action plan, a clear indication that you're on top of things. Those are intuitive, I think, for all the best reasons. So those are maybe some of the things that make a good borrower, so to speak. And if I've missed anything, certainly feel free to fill that in. Maybe the inverse of that question is what makes a good lender? And I'm specifically asking that question in the context of the competitive environment that you highlighted a couple minutes ago, where the average borrower, financing a lower middle market transaction, or maybe just financing their business, on an ongoing basis is choosing between two to three to four lenders. So if you haven't actually worked with these people, you don't have the benefit of knowing them at an intimate level, you know, beyond the interest rate that they offer, like how should a borrower think about what makes a good lending partner? And how should they choose between the two to three to four term sheets that are presumably more similar than they are different?

C**Cory Kaiser 47:42**

Yeah, yeah. Great, Steve. Let's be clear. So much of what Tim and I do in the day to day is commodity like, no matter the color of the bank that you deal with, chances are they have roughly the same risk appetite, roughly the same policies, products, etc. Like these, especially in Canada, there's really not a whole bunch that separates us when it comes down to credit policy and products. So in my mind, if I'm talking to a junior lender, we're talking about our value proposition, like what can differentiate you from the lender across the street working for the other bank. And for your listeners, Steve, I'd say it comes down to personal relationship, right? So again, do they understand your business? Does your lender understand your industry? What experience do they have in your industry? How is the office setup? How is it structured? How is that team set up that's going to work with you in the day to day? And by that I mean, like who's who's in charge of the day to day admin that will surely come with that relationship? So I'm talking about opening a bank accounts, statements, any inquiries related to your accounts? How about cash management too, how is that departments set up? How do they work hand in hand with the lender because credit, while you may? Well, credit is, is the most likely door opener for a new customer to come and bank with me. They all need some level of cash management and electronic banking. They also, Tim highlighted interest rate hedges earlier, like these are all they might be considered ancillary or secondary to the initial reason why you're looking or approaching a new bank. But they're all very important. So how does that team work together? I'd also take it one step further to say, how are they set up to do your personal banking? Like, have they introduced you to their wealth or their private banking department that can look after your family's personal banking needs too. And this is how we set ourselves up, Steve, to tackle this exact question that you asked me. How can we be the face of our bank to the customer and provide them everything they need, not only business but personal, their family needs as well?

S**Steve Divitkos 50:05**

You mentioned some industry specific considerations. And that's where I want to go next. And I specifically want to ask you guys about lending to software or technology businesses more broadly. I mean, that's close to my heart, because I purchased and ran a software business myself. But I'm curious to know, like, has your view on lending to these types of companies, whether it's on an ongoing basis, or to finance the acquisition of one of these businesses, has it changed over the past, you know, one, three or five years? Because when I was raising money for my deal, this was 10 years ago, it was asset light, it, you know, maybe high revenue growth rate, but not a lot of EBITDA. And as a result of the combination of not a lot of EBITDA, and not a lot of assets, bankers, you know, sometimes shied away from those types of businesses. But you know, every year, every month, frankly, every day that passes, these types of businesses are representing a larger and larger percentage of our economy. And by extension, I suspect a larger percentage of any given lenders book. So I mean, how do you guys think about lending to these types of businesses? How do you think about their asset like nature, and as a result, their lack of collateral relative to more like industrial business? And has your risk appetite changed with respect to lending to these companies relative to a handful years ago?

T**Tim Eaton 51:26**

Yeah, obviously, you've experienced their shows, because I think you're right to delineate between the ongoing acquisition nature of this deed, we're definitely continuing to learn to them ourselves. This is something I think, like my view on that. We've seen this as an area, as you said, a tremendous growth. We're trying to build up an advisory team that can cover knowledge based industries or tech deals. I know, a lot of our competition has that as well. So you're really trying to get soe good minds, some good industry, individuals, people who have had experience in this that can help us understand why that revenue might be recurring. So if I think of this, from the operational side of things, we had a lot of help just to make sure that we can understand exactly what's going on with that recurring revenue. I know that the industry really does look to more of a monthly recurring revenue, that's something we do as well. So you're lending on a revolving basis against a multiple of the monthly recurring revenue. We've set guidelines for this in the past couple of years that I don't think have really been changing other than just trying to do more of it. So I don't think there's been a lot of change in how we look at that, again, it comes back to something I said earlier, it's more about understanding how the company is doing in that respect the background behind it more of the qualitative than the quantitative structure. And then on the acquisition side, it's not all that different from what we were talking about before. A lot of acquisition financing really is against goodwill. So it's less about what are the hard assets behind this company? And it really does come down to why am I comfortable that this company can continue to generate that revenue or generate that EBITDA? And I don't think there's been a lot of change there. I mean, potentially, there's been some changes in the multiple that people are willing to pay for tech companies right now. And so that can play into it. But no, I don't think there's a lot of concern. I think it's what you said, as far as we know that there is a big market out there. And I think all lenders are looking to chase these deals.

S

Steve Divitkos 53:36

Guys, as we conclude here, are there any requests of the audience, things that you would scream from the proverbial mountain top if given the opportunity to communicate to every lower mid market acquisition entrepreneur, any thoughts or perspectives or anything else that you'd like to leave them with as we conclude our discussion today?

C

Cory Kaiser 53:58

I don't think so. Steve, I think we've hit on all the right notes, your questions here were were very appropriate. I guess, if I leave them with one thing is just open up those lines of communication, right, especially as we enter a period of uncertainty in 23. Talk to your banker, make them aware of what you're up to, just to avoid those surprises.

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Tim Eaton 54:28

I would agree. Yeah.

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Steve Divitkos 54:30

Cory, and, Tim, thank you so much for joining us today. We appreciate your insights, and we appreciate you being generous with your time.

C

Cory Kaiser 54:38

Thanks, Steve. This was fun.

T

Tim Eaton 54:40

Yeah, great. Thanks for having us.