Subordinate Financing

A strategic alternative for your growth capital requirement

Business Development Bank of Canada Overview

- Financial institution owned by the Government of Canada
- Report to Minister of Industry
- 1,800 employees located in 100 offices across Canada
- Three divisions:
  - Financial Services (Term Loans)
  - Consulting
  - Investments
    - Venture Capital (Early Stage)
    - **Subordinate Financing (Later Stage)**
      - → Subordinate Financing Portfolio: AUM = $500 million
      - → GTA team: 1 Managing Director + 5 Managers

BDC Subordinate Financing Overview

- Focus on Small Medium Enterprise (SME) market; investments from $250,000 to $12 million
- Leveraged finance product (debt-equity hybrid); similar to debt because you need cash flow for repayment; the level of BDC investment is based on the enterprise value of the company
- Financing can be obtained without any tangible asset coverage
- Security is subordinated to secured lenders
- BDC offers flexible repayment options which can help to preserve your client's working capital
- Subordinate financing limits the dilution of the ownership

Financing Alternatives Comparison

	Senior Debt	Subordinated Debt	Equity
Investment Level Criteria	Asset and cash flow coverage	**Valuation, cash flow risk, management**	Technology, market size, management
Security	1st ranking	**Subordinated**	N/A
Return	Interest	**Interest and upside**	Upside
Risk	Low-medium	**High**	Highest
Management Involvement	No involvement	**Minimal / Passive**	Active
Due Diligence / monitoring	Low-medium	**High**	Very high
Uses	Multiple	**Working capital, acquisitions, shareholder buyouts**	R&D, sales and marketing etc.

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BDC Subordinate Financing
Typical Terms and Conditions

- Term: 3 to 7 years
- Balloon and/or cash flow sweeps and/or regular monthly payments as per client's needs
- Subordinated rank (after secured creditors)
- Internal Rate of Return = 12% - 18% for most transactions, based on risk and payment structure
- Return calculated as a combination of:
  - Fixed Interest Rate
  - Variable return:
    - Royalties on sales or EBITDA
    - Bonus interest based on enhanced value
    - Warrants

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Investment Criteria

- Strong management team with vision
- Clearly defined market position
- Proven historical earnings (positive EBITDA)
  - Will consider early-stage businesses (pre-cash flow), but not greenfield start-ups
- Equity commitment from principals/management
- Supportive financial institution with operating line of credit in place
- Review engagement (investments of up to $2,000,000) or audited financial statements
- Sector agnostic – will consider investments in most industries

Typical use of proceeds

When you are:

- Expanding into a new market or with a new product which demonstrates realistic market and sales potential
- Interested in making a strategic acquisition
- Looking to key member(s) of the management team to buy into the business (succession planning)
- Have reached the limit of your line of credit due to fast growth and/or efforts to innovate
- Looking for financing with no assets for security
- In need of financial ratio improvement

Subordinate Financing Benefits

- Offer a range of customized financing structures, designed to afford sufficient residual cash flow for growth during the term of the investment
    - Subordinated Debt
    - Mezzanine
    - Quasi-Equity
    - Equity (minority positions)
- Flexible investors in intangible assets
- Less costly than equity financing: Leveraged Buy-Out Model
    - Interest expense is tax-deductible
    - Does not dilute ownership
    - Maximizes ROE
- Treated as equity by chartered banks

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A Note on Early-Stage Businesses

- Criteria:
  - Existing revenue generation
  - Business plan fully funded (not dependent on further cash injection)
  - No technology/product risk
  - Viable cost structure
  - Visibility of cash flow
- Management/shareholders need to have some equity in the business
- The target is <u>not</u> venture-stage disruptive technologies
- We will take equity stakes, but not control positions

Subordinate Financing Case Study

Company: Internet and network solutions provider

Project: Working capital (to replenish working capital impacted by unfunded capital expenditures)

Revenue: $4.4 million

EBITDA: $0.8 million

Project	$000	Financing	$000	%
Working capital	750	**BDC – Subordinate Financing**	**750**	**100**
	750		**750**	

Benefits: Financing corrected working capital shortfall and misuse of operating credit borrowings

Subordinate Financing Case Study

Company: Specialized manufacturer and distributor of foam gaskets

Project: Management buy-out (100% acquisition)

Revenue: $24 million EBITDA: $3.1 million

Project	$000	Financing	$000	%
100% acquisition of shares	12,500	**BDC – Subordinate Financing**	**2,000**	**30**
Closing costs	185	Refinance term loan	3,900	46
		Operating line of credit	2,585	24
		Preferred shares	3,000	
		Common Equity	1,200	
	12,685		**12,685**	

Benefit: BDC provided the higher risk financing to facilitate the MBO

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Subordinate Financing Case Study

Company: Customer management software

Project: Management buy-out (100% acquisition)

Revenue: $6 million EBITDA: $2 million

Project	$000	Financing	$000	%
Acquire shares, repay loans	7,250	**BDC – Sub-Debt**	**2,500**	**32**
Working capital, closing costs	500	**BDC – Quasi-Equity**	**500**	7
		Vendor note	4,750	61
	7,750		**7,750**	

Subordinate Financing Case Study

Company: Risk management software

Project: Working capital (create internal sales force)

Revenue: $2.4 million

EBITDA: $250 thousand

Project	$000	Financing	$000	%
Growth capital	1,500	**BDC – Sub-Debt**	**1,500**	**100**
	1,500		**1,500**	

What Investors want to know in your business plan?

- How much can I make? (ROI expected)
  - We all want to make money; don't be shy to talk about the upside potential for the investors.
- How much can I lose? (Loan guarantees or other contingent liabilities)
  - Be very transparent. Identify the challenges and refer to the risk mitigation strategies where available.
- Who says this thing will work? (Third party verification of assumptions and markets)
  - Do it before you are ready.
  - Pick your reference customer first and lock the relationship.
  - Build credibility.
  - Build from the heart.

What Investors want to know?

- Who else is in the deal? (The management/investment team and their qualifications)
  - Create your dream team from day one and build on it as you grow.
  - Find someone who can make a warm introduction to the investor.
- How big is the market? (Is it growing? Is it hot?)
  - Educate your investor.
  - Talk about COMPETITION. Never pretend as if they don't exist.
- How will the company reach its clients? (Verification of marketability and scaleability)
- How do I get my money out and when? (Exit strategy for IPO, Acquisition or Merger)
  - Don't aim for the exit; it has nothing to do with you. Aim for beyond the exit…

Conclusion

Work hard, play hard and be the *PURPLE COW* ...

*Cows, after you've seen them for a while, are boring. They may be well-bred cows, Six Sigma cows, cows lit by a beautiful light, but they are still boring. A Purple Cow, though: Now, that would really stand out. The essence of the Purple Cow -- the reason it would shine among a crowd of perfectly competent, even undeniably excellent cows -- is that it would be remarkable. Something remarkable is worth talking about, worth paying attention to. Boring stuff quickly becomes invisible. (***Seth Godin***, Purple Cow: Transform your Business by Being Remarkable)