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MID-STATES ADVISORS
A Private Placement and Business Brokerage Firm
Newsletter

# Mid-States Advisors, Inc.
# Monthly Article & Updates

Good Morning,

As we continue into the latter half of the year we continue to see active markets. M&A multiples remain strong, lenders remain active and companies appear to be ready to commit to growing their labor force and in some cases spend on CapEx needed for growth.

Chip shortages, metal prices and logistics continue to be an issue but the ever changing landscape continues to provide new opportunity to those able to adjust. Many companies are reporting that their sales have increased beyond pre-covid levels. It will be interesting to see in the coming years if the issues related to the reliance on offshore suppliers leads to a major trend of onshoring.

We continue the focus on commercial loans in this volume. These are the funding tools available to companies to sufficiently capitalize operations and to fund the growth.

As always, if you are interested in learning more about this volume's content or if we can help you or a client in any way please feel free to reach out to one of our team members.

Best Regards,
The Mid-States Team

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## JUST WHAT THE HECK IS A COMMERCIAL LOAN AND WHERE DOES A LOWER MIDDLE MARKET COMPANY GO TO GET THEM?
## Part II

When pushed for a response from a close friend and much respected consultant, business coach, and author as to how best to describe what we at Mid-States Advisors, Inc. ("MSA") do, our team struggled for months for an answer that would satisfy him. Repeatedly, he rejected our responses as being overly detailed, too deep into the how of what we do. Finally, we came up with a remarkably simple answer.

## Mid-States Advisors, Inc. provides liquidity solutions for lower middle market companies and their owners.

We either refinance or "recap" the balance sheet, thus providing liquidity to the company, or we locate a buyer, thus providing liquidity to the owner. This article will continue to deal with the balance sheet "recap".

We begin the conversation with potential clients by asking, "What do you need or want in a lending relationship"?

Where do we find the lenders, and how do we and our clients, find the proper fit?  It is a matter of our ever-expanding network of borrowers, and deep knowledge of underwriting practices. MSA has ignored the conventional wisdom of expanding our product offerings, and instead intensified our efforts to add to our database of lenders and funding sources. Additionally, we keep abreast of changes in the various programs offered by the SBA, the Department of Agriculture, the CARE programs, and the Federal Reserve Bank. These programs keep changing largely to the benefit of the borrowers.

In Part I of this series of articles we discussed the major sources of outside funding for the lower middle market, Commercial Banks, Asset Based Lenders (ABLs), Government Guaranteed loans, and Factors.

In this article, we will cover the role of Subordinated Debt Lenders, Small Business Investment Companies (SBICs) and Mezzanine Funds, providers of Purchase Order Finance, and Trade Finance.

In Part III we will cover Commercial Real Estate Loans, Loan Syndications, the recently enacted and temporary CARE loans, Hard Money Lenders, and SBA Direct loans.

Additional points:  It is also important to understand how to negotiate loan guarantees, and to understand the importance of finding the proper person within the lender's organization.

Before proceeding: It is important to recognize that "risk and rate are different sides of the same coin". These lenders take more risk and thus their funds cost more.

**Subordinated Debt Lenders**, sometimes known as mezzanine lenders, serving the lower middle market are becoming increasingly difficult to find. None-the-less, if you know where to look, they are out there. Loans of over $10 Million are readily available to qualified borrowers, between $5 Million and $10 Million is difficult, and under $5 Million is uniquely difficult.

There are two types of sub-debt lenders; stretch lenders and cash flow lenders. Stretch lenders fill the gap between what is available from the senior debt lender and 100% of the orderly liquidation value of the available collateral, usually accounts receivable, inventory, and machinery and equipment. Cash flow lenders, the second class of sub-debt providers, on the other hand are interested in the consistency and trend of cash flow and earnings. Like an equity investor, they are relying on the quality of management. As you might expect rates are high and usually there is some type of enhancement often in the form of warrants to purchase or earn common shares which can be "put" back to the owners upon repayment of the loan. For borrowers reluctant to give up equity, we have been able to negotiate enhancements in another form that allow the lender to achieve the rates of return they are targeting. These lenders can be very flexible, often providing interest only terms for from 1 to 5 years, with increasingly larger payments in the later years. We most often see subordinated debt used in acquisition financing or in Balance Sheet recapitalizations of an already successful business, perhaps to allow the owners to achieve personal liquidity for themselves and their families without the immediate need to sell the business.

**Small Business Investment Companies (SBICs)** have proliferated and until recently were often the providers of mezzanine or subordinated debt loans to lower middle market borrowers. These are regulated businesses although the regulation is not as stringent as those for commercial banks. Several years ago, the heavy hand of Wall Street influenced the Small Business Administration to allow Private Equity Funds and Family Offices to access these monies to purchase lower middle market acquisition targets. SBICs have also been a significant source of venture capital funding. But that too is changing or has already changed. The primary use of subordinated debt in the lower middle market is as part of the "Capital Stack" for funding acquisitions, and more rarely as part of a Balance Sheet recapitalization. There are dedicated, **Non-SBIC Mezzanine Funds** formed to provide loans for the purposes described above. Additionally, some Private Equity Funds will consider mezzanine funding. Not surprisingly, it is all about returns.

**Merchant Finance** is not a loan but a contract, a sale of future revenues. It is short term money, generally due in under a year. We urge troubled clients to avoid the temptation to access these monies, because all too often, its use is a prelude to business failure. If subordinated debt is unavailable, there is a possible role for Merchant Finance as a temporary bridge in completing a transaction, but we would only recommend such financing as a bridge when profitability is assured.

**Purchase Order Financing** is available and beneficial to businesses who are either undercapitalized or early stage, or both. Companies with a lending limit and unable to continue rapid growth due to lack of funding should consider this funding alternative. There are not a lot of lenders offering this kind of funding, but MSA knows who they are, and how to work through the complications arising from the senior debt lender that usually has a lien on all the borrower's assets.

**Trade Finance** is available for companies wishing to buy or sell product in the international market but lacking the expertise or financial strength to provide letters of credit or other enhancements.

**Commercial Real Estate Loans, Loan Syndications, and Loans available**

**under the CARE program**, will be covered in Part III of this series.

We welcome discussion and comment on this or any of our Newsletter articles. If you would like to discuss our services in more detail or to discuss the content in today's newsletter, please contact us to learn more about how we can assist your company or client. Below are the direct phone numbers and emails for a Mid-States team member who can answer your questions (yes, we answer our own phones):

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See our team at Midstates Advisors' website