Information and Insight for the ARM Industry September 2010

ARM Intel

Greenberg Advisors
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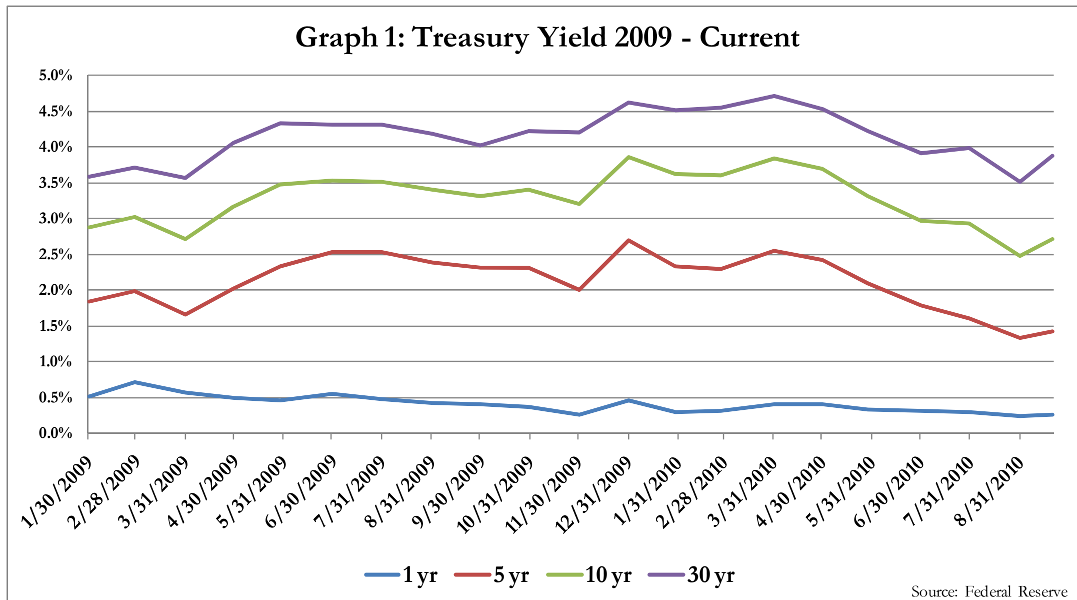
Debt… Is It Flowing?

We're often asked about today's market and whether or not debt financing is available for purchasing pools of receivables, for M&A deals and/or for other business needs. While we've seen a significant uptick in M&A activity within the Accounts Receivable Management (ARM) industry and elsewhere, we wanted to approach the question from a quantitative standpoint and also address the ground level, practical implications for business owners and investors. Since the recession and its aftermath saw a significant curtailing of available debt to consumers and businesses, the question must be asked... What is the current state of the credit market, and is it finally loosening up?



One high level indicator, U.S. Treasury yields, steadily rose through 2009 until approximately the end of 1Q 2010 (see graph 1). As yields and prices move inversely, this indicated that Treasury prices were dropping as investors were optimistic about the economic outlook and therefore willing to take on more risk. They did this by making other investments including corporate loans, which are obviously more risky than U.S. Treasuries. From April through August 2010, there was a "flight to quality" as economic reports came out showing weakness in areas like employment and credit card charge-offs (see graph 2). Treasury yields steadily went down in that period, however there has been a turnaround in the last few weeks (see graph 1), as recent economic reports in September have been more upbeat.

Our activities and discussions confirm that the credit market for M&A and for non-M&A financing remains tight. However , *it is loosening*, and as always, the availability of credit is primarily dependent upon the opportunity. We've witnessed the creation of a number of new debt funds and financing sources over the past 12 months, further proof that for the right opportunities, credit is most certainly available. In fact, according to S&P LCD, loans issued in 2010 for M&A and leveraged buyouts recently made up 47% of all loans issued, up from 29% earlier this year. That being said, where lenders are still lending, they often demand higher returns than they did in prior years. What remains to be seen is whether the higher cost of capital is a new plateau or whether it will ease over time. We believe that the increased number of debt providers, along with improving economic conditions, will ultimately force a downward pricing trend.

On the M&A front in the ARM sector, the challenging credit market has been a boon to strategic **(Continued on Page 2)**

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Greenberg Advisors, LLC is among the most experienced advisors to owners, executives, and investors in the Accounts Receivable Management (ARM) industry worldwide. With nearly 15 years of experience dedicated to the ARM sector, the firm's staff has completed over 65 M&A and strategic advisory transactions in ARM, including recent transactions with TRAKAmerica and NARS, among others. The firm's advisory services focus on M&A, capital raising and valuation, as well as operational advice to assist clients in resolving critical operational challenges to enhance the value of their business.

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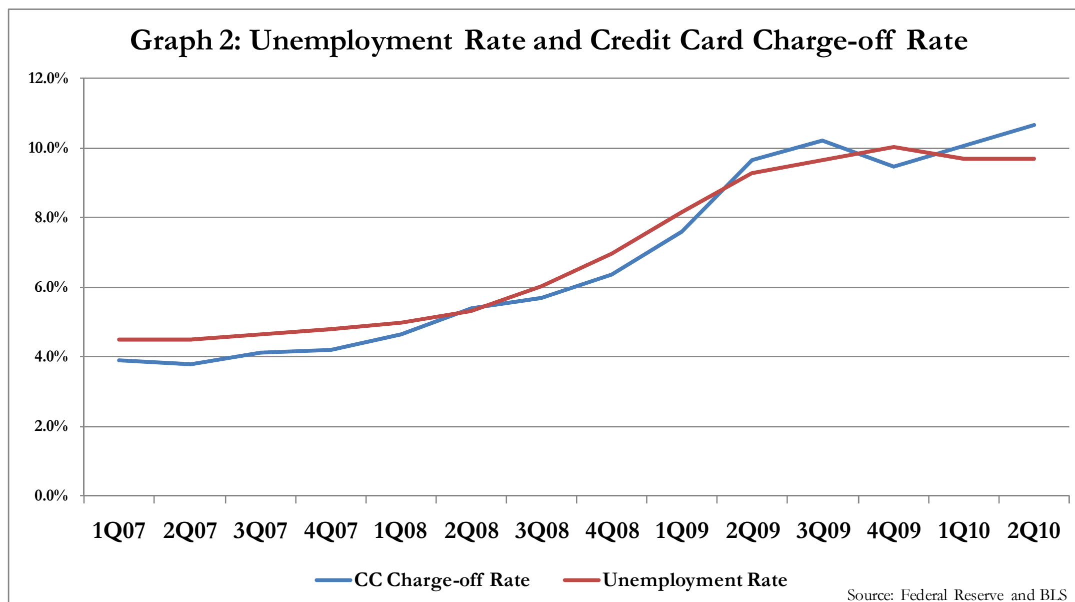
buyers, often giving them the upper hand. On a quarterly basis, with the exception of 4Q 2009, financial buyers have generally been outbid recently by strategic buyers, as strategics are more likely to finance acquisitions through internally generated cash flows coupled with solid banking relationships, rather than strictly through outside financing. We believe that the recent trend toward earnouts, deferred payments, and other forms of deal structure will continue until more debt, and more reasonably priced debt, is available for M&A activity. Even still, it is encouraging to note that deal activity has picked up in recent quarters in spite of the credit environment. After all, the 2nd quarter of 2010 brought 15 transactions in ARM, a level not reached since the 2nd quarter of 2007.



The financing landscape is also changing rapidly for purchasers of receivables. New debt providers, returning executives that bring operating expertise and relationships, and the search for new funding structures appear to be creating interesting alternatives for debt buyers in this asset class. As an example, lenders to this sector are more frequently utilizing structures where funding is underwritten on a case-by-case basis and provided at the time of purchase, rather than a more typical senior or subordinated credit facility utilized at the borrower's discretion. In some cases, the cost of capital for this type of funding can be relatively high, especially when provided by institutional groups such as hedge funds. We like how this new supply dynamic is shaping up, however, as this market has been hit hard by the lack of capital availability over the past 24 months. The inflow of new capital will be an important boost to this segment of the ARM sector, and as with the market in general, we expect that the competition among capital providers in this segment should result in better pricing and more equitable deal structures.

Perhaps the greatest challenge of the current credit environment has been for small to mid-sized businesses. When debt markets are tight, these businesses, including many ARM firms, are often the first to be denied traditional bank financing. As evidence, in 2010, the number of corporate debt issues has been trending around 60,000 per month, lower than in 2009 and 2008, and only 32% of the 185,000 per month level of 2007 (see graph 3). For firms that need financing, it makes sense to investigate non-traditional sources. Examples of this include factoring, alternative lenders, or even high net worth individuals. Of course, the avenues available to a firm depend upon its operating profile. For example, for firms without significant receivables, factoring wouldn't be an option.

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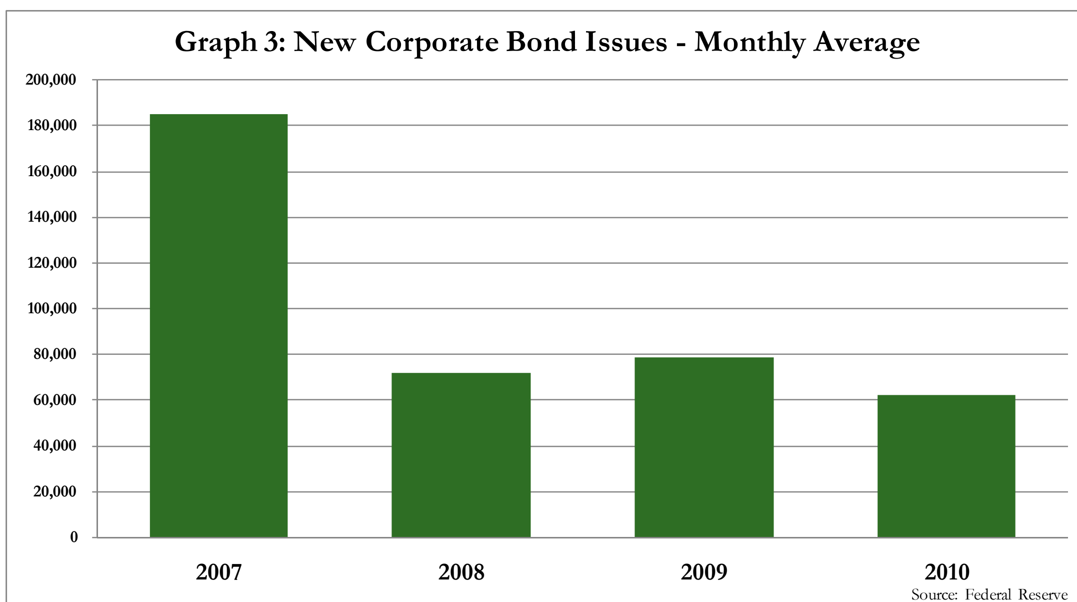
In this environment, companies will need to make sure their leverage ratios and liquidity ratios are more conservative than they have been in the past, as lenders demand stronger interest coverage and liquidity to reduce their risk. Small and mid-market ARM firms that are operating successfully and generating cash will probably be best served to internally fund growth and operations, and to postpone projects that would require significant up front outlays. Alternatively, they may want to take on a strategic and/or equity partner. Joint ventures and strategic partnerships have become more common in recent years to fund specific projects, enter new service lines, or simply to create a stronger, more balanced entity that can withstand economic cycles. In general, small firms (and larger firms, too) may need to utilize higher percentages of equity financing in their capital structure than they might have done in an easier credit environment, by for instance, retaining more earnings, issuing equity, or curtailing issuance of debt.



Although credit markets have been challenging, we believe that the recent improvements will continue assuming favorable employment trends and further economic growth. Nonetheless, adopting a conservative capital structure would be wise. It is more critical than ever for business owners to understand how their business will be viewed by potential lenders, and how their credit-worthiness compares to that of other firms. After all, these other firms will be competing for the same dollars when seeking to fund operations and/or engage in M&A-related activities. Without this awareness, and without proper lead-time to make improvements, executives may be damaging their long-term chances of securing capital and meeting their growth objectives.

For more information about optimizing your alternatives and successfully navigating the current economic environment, please call us at 301-576-4000, or email us.

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