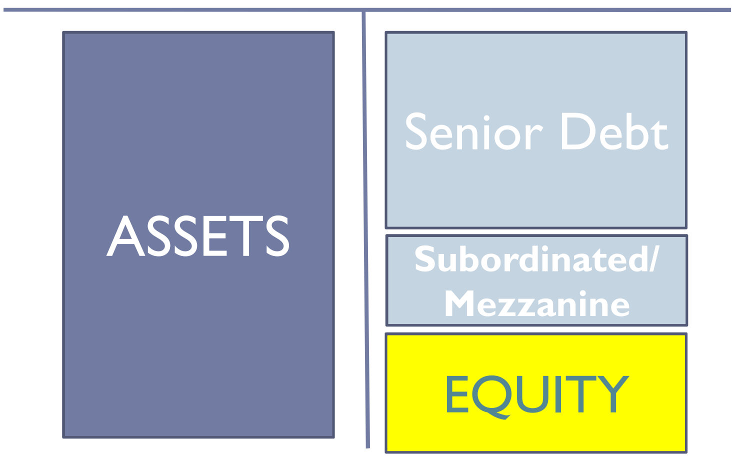
INTERNATIONAL CORPORATE FINANCE

Introduction to debt financing

Anna Chmielewska

Structure of Indebtness



© Anna Chmielewska, SGH 2016

Seniority and subordination

Senior Debt

- Most common form of bank loans and corporate bonds
  - Bonds are usually unsecured and bullet
  - Loans typically secured and amortising
- Typical tenor: up to 5-7 years

- Lowest possible cost of financing
- Closely linked to debt capacity
- Most restrictive covenants

Mezzanine Debt Structures

- Intermediate form between debt and equity
- E.g.: subordinated loans, preffered shares
- Second ranking security or unsecured
- Usually bullet repayment
- Cash interest + PIK interest (+warrants)
- Typical tenor: 5-10 years

- More expensive than senior
- Possibile beyond classic debt capaicty
- No or limited dilution of shareholding

Debt Capacity

Lenders want to ensure the Company has sufficient cash to service its debt obligations

- Where the Company gets money to service its debt?
- Is there anything that the Company needs to pay before the debt?

How to assess debt capacity

- Free Cash Flows – operating cash flow available for all capital structure investors
- Debt Service

- Where the Company gets money to service its debt?
- Is there anything that the Company needs to pay before the debt?

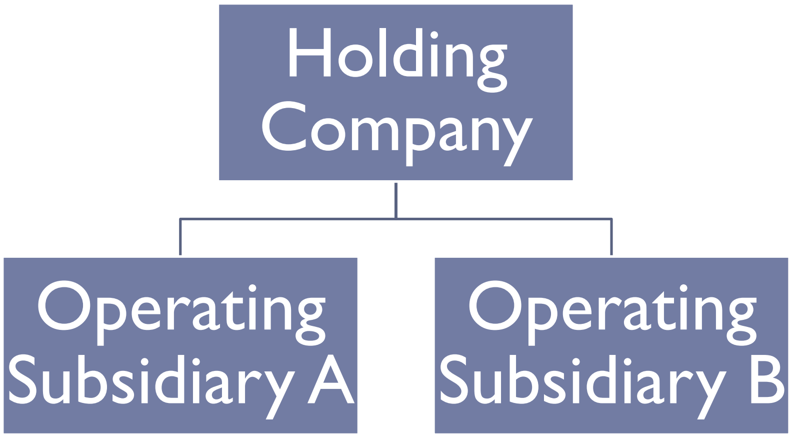
- For general corporate loans: EBITDA multiple, for project loans DSCR

Security/collateral

Collateral is always the second item considered by Lenders. **Debt capacity goes first!!!**

- Aims:
  - Rank senior or pari-passue
  - Achieve full recovery (overcollateralisation)
  - The more liquid, the better
- Types:
  - Financial
  - Physical
  - Intangible

Structural Subordination



Restriction and covenants

- Why the lenders need to secure their rights prior to the disbursement?

Restriction and covenants

- Protect against deteriorating credit
- Agree on how the Company can be run
- Manage conflict between shareholders and creditors
- Limit agency costs

- Covenants typically focus:
  - Cash flows
  - Subordination
  - Event Risk

Afirmantive & negative covenants

- Access to information
- Maintain core business
- Maintain conditions of assets
- Real estate

- Leverage/ limited extra loans
- Securities
- Investments, capex, asset sale
- Dividends

Covenants - examples

- Negative pledge
- Pari-passu
- Cross default
- Change of control
- Material Adverse Clause

Other requirements

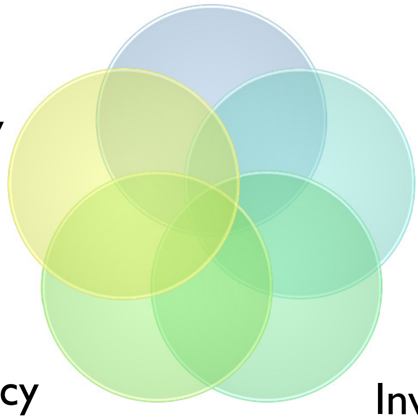
- Debt Service Reserve Account
- Cash Sweep Mechanism

Financial Covenants

- Debt service coverage ratio
- Interest coverage ratio
- Debt to EBITDA
- Current ratio
- Leverage ratio
- Tangible net worth

© Anna Chmielewska, SGH 2016

Ratio Overview



Performance Ratios

- Profit margin
- EBIT Margin
- EBITDA Margin
- Return on Equity
- Return on Assets

LT Solvency (Financial Risk) Ratios

- Debt to Assets
- Debt to Equity
- Debt to EBITDA
- Debt Service Coverage Ratio

Liquidity Ratios

- Current ratio
- Working Capital to Sales
- Interest coverage

Efficiency Ratios

- Inventory Days
- Receivables Days
- Payables Days

Investor Ratios

- Net profit per Share
- Dividend Yield
- Net Profit to Sales
- ROE

Debt Capacity

- After analysing the Company's financials, it is decided how much such Company can borrow.
- What if chosen ratios show different debt capacity?

Corporate Loan

A situation a loan is given to an operating Company and therefore can be serviced with already exisitng cash flows and the proceeds from new investments

Typical considerations:

- Maximum leverage
- Pari passu (no subordination, incl. structural)
- Operating performance is important
- Some form of cash-flow control
- General business
- Security of lower importance

Project Finance

A situation where the debt is given for the purpuse of construction and/or operation of a distinct project and therefore its repayment is solely reliant on the performance of such project

- Typical consideration:
  - Security on everything (incl. assets, shares, key contracts)
  - Assignment of rights and contracts, step in rights
  - Equity Contribution
  - Cash flow ratios
  - Contractual obligations

Leveraged buy out

- Situation where the money is raised with purpuse to acquire another company, and the intention is that debt will be serviced with proceeds comming from such company
- Typical consideration:
  - High leverage
  - Detailed look at subordination
  - Security on shares
  - Managerial Control