GE Commercial Finance
Corporate Financial Services

As Borrowers Seek Additional Financing Sources, Second Lien Loan Programs Emerge as a Solution

At a time when interest rates remain low, many companies that are over-leveraged or need transitional capital are reluctant to meet their capital needs with expensive and dilutive mezzanine or equity capital. Increasingly however, companies are discovering that second lien loans may offer a viable alternative. Secondary collateralized institutional loans (SCIL) saw a 580 percent jump in activity, to $3.2 billion, between 2002 and 2003. In fact, 2004 volume has already eclipsed 2003 levels with $3.7 billion completed year to date, with continued growth expected.

"Issuers are increasingly using SCIL for recap—taking out dividends or replacing more expensive mezzanine with less-expensive SCIL financing and buyout financing," notes Iain Douglas, Senior Vice President with GE Commercial Finance, Capital Markets Services Group. "SCIL on a standalone basis or in combination with mezzanine effectively lowers the sponsor's cost of capital, and in the last few months there have been fewer rescue financings and a larger number of dividend recaps or buyout financing. In turn, this has been reflected in the average price of SCIL, which has settled down between LIBOR-plus-500 to LIBOR-plus-800. In contrast, rescue financing typically is priced higher."

A Recovering Economy Helps to Jump-Start SCILs

"A sustained economic recovery, coupled with historically low interest rates and eager investors, has been a lifesaver for companies that want to refinance outstanding, higher priced senior or high-yield loans, fund acquisitions or other expansion efforts," says Douglas. "But a significant number of companies have found it difficult to access traditional debt solutions. GE's answer has been to expand its activity in the second lien loan market and open up opportunities for more businesses. It's an alternative to such structures as mezzanine, high yield and equity."

Second lien loans are typically viewed as a substitution for more expensive private or public mezzanine capital, according to GE's Douglas, who notes that second lien financing can offer more flexibility than mezzanine and other junior capital solutions, while creating additional liquidity for the borrower. It is also less expensive than mezzanine or equity-based capital, and is typically non-dilutive to the borrower.

Competitive Advantages of a SCIL

"A second lien lender will generally be afforded a say in certain voting rights and privileges that the senior lenders enjoy, providing additional protection to the second lien lender," says Douglas. "The major difference is that the second lien lender will stand behind the senior debt for repayment priority with respect to collateral proceeds, but will rank ahead of other unsecured debt such as trade payables. Because of their secured status—

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secured second liens typically rely on either asset values or cash flow of the borrower to support repayment—second lien lenders will generally offer terms and pricing that are more flexible than those of an unsecured mezzanine provider, and are less onerous in terms of prepayment penalties."

"In an asset-based loan (ABL), the senior debt is typically secured by some or all of a company's assets, while the second lien lender looks to incremental dollars against the same collateral pool," reports Douglas. "It's a way for the borrower to tap into or "monetize" the equity in the assets of the company. Other non-traditional collateral classes that second lien lenders have considered have included royalties, or intellectual property like trade marks."

Like their senior counterparts, second lien ABL lenders will rely on appraisal valuations to support their loans. They also rely heavily on the senior lender's monitoring routines of the senior collateral, and trust established ABL lenders like GE to perform this function. Of course, cash flow may also serve as the basis of a loan. In this format, the advance is based on the enterprise, or going concern value, of the borrower.

"Generally, in a cash-flow based second lien loan, a lender will determine the loan amount using a prudent multiple of EBITDA (earnings before interest, taxes, depreciation and amortization) based on an analysis of the borrower's sustainable competitive advantages, including market position, level of industry competition, management strength and financial profile," Douglas details. "The lender will also evaluate valuations of comparable publicly traded companies and recent purchase prices paid for similar companies. The investment thesis is based on the fact that the second lien loan exposure is more than adequately covered by the enterprise value of the company, and there's some safety and an expectation for the lender to recover significant principal even in the event of a distressed sale."

Because of the greater risks associated with cash flow based second lien loans, pricing is generally higher than the ABL second lien loan, though it's still more competitive than other forms of junior capital.

Will SCIL Activity Continue To Rise?

GE's Mary D'Souza, Vice President with GE Commercial Finance, Capital Markets Services notes that as companies have discovered the benefits of second lien loans—including competitive pricing and flexibility—demand for the product is increasing.

"Large (typically $75 million and higher) second lien loans sold into the SCIL market are tracked by Standard & Poors and are rated to provide investor additional comfort," she notes. "In 1998, the SCIL market posted $615 million of activity, which stood as the record until the end of 2002. But that high-water mark was shattered in 2003 with $3.2 billion in volume that will likely more than double by the end of 2004".

These institutional SCIL loans are issued with lower pricing than smaller second lien loans, due to their secondary market liquidity.

The growth of the second lien loan market—which was once dominated by a few players like Ableco, Hilco,

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BackBay, and Gladstone, has expanded to hedge funds, high yield funds, and Collateralized Loan Obligations in search of yield and security interest, but now has dozens of active participants—is being driven by a number of trends. Among others, senior lenders are becoming more comfortable with the inter-creditor arrangements; and additional sources of junior capital, principally hedge funds, are emerging.

Pricing Is Important—But It's Not The Only Determinant

Douglas notes that although second lien loan economics can be attractive, companies should carefully look into the lender's track record before signing an agreement.

"It's important not to commoditize the borrowing process," he cautions. "While pricing is important, it's not the only issue. Speed and certainty of execution are also key components of a deal. "

At GE, for example, a borrower will receive a "turnkey" package backed by GE's direct execution experience with the second lien product. Second lien loans are almost always completed along with a new senior loan facility.

"Because GE has a successful track record and unparalleled second lien investor relationships, a borrower can be confident that a proposed deal will actually get done," D'Souza adds. "Moreover, because GE has the ability to not only arrange, but to take a significant hold position in the second lien financing, we can send a strong, positive message about the deal to the market and to potential investors."

Turning her focus to the details of second lien lending, D'Souza points out that while the 26 SCIL transactions completed in 2003 were priced at an average of LIBOR-plus 738 basis points, 2004 pricing has featured lower spreads, averaging LIBOR plus 595 basis points. Meanwhile, the smaller middle-market cash flow based second lien loans typically come in at LIBOR-plus 10 percent to 15 percent, while middle market sponsored transactions pricing ranges from L+600 - 900."

D'Souza goes on to clarify those observations, noting that sponsored transactions are "typically priced tighter than non-sponsored." Also, pricing on both sponsored and non-sponsored transactions is one factor among several that include leverage, industry, and free cash flow. While second lien ABL loans are typically priced inside that of the smaller cash flow loan product, based on their collateral coverage, she notes that rates on all second lien products are being priced more aggressively as a result of increased competition and market acceptance.

"Compared to say, mezzanine capital, second lien debt generally has a shorter term of three to five years, versus seven to ten years for mezzanine, although SCIL loans can be structured with a longer tenor," Douglas points out. "A second lien product also offers more flexibility on prepayments, allowing a borrower to prepay the debt in good times—less than five years for rescue or transitional financing, and up to seven years for sponsored buyout or dividend recap institutional rated (minimum B3/B-) SCIL."

In contrast, he adds, mezzanine loans typically have no call features and expensive prepayment or "make

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whole" premiums. Because of its secured nature, second lien lenders can tolerate higher overall total leverage, the second lien debt may offer flexibility in amortization schedules and overall, a company's debt service may be tailored to its unique circumstances.

Looking ahead, both GE's Douglas and D'Souza see continued growth in the second lien market, particularly as senior lenders continue to develop strategic relationships with second lien lenders in order to offer "one-stop shopping" for debt products.

"These second lien lenders will continue to bridge the gap between available senior debt financing and companies' debt financing needs," they say. "Further, the flexibility of second lien debt and the reluctance of many senior lenders to finance stretch pieces of capital will help to drive even more demand. As we see it, companies that are seeking additional financing at competitive rates, with financing flexibility and without equity dilution may find SCILs best meet their needs."

Secondary Loans at a Glance

Secondary Lien Loans	**Asset Based**	**Cash Flow**
Priority	Secondary credit behind senior lenders	Secondary credit behind senior lenders
Structure	Assets serve as collateral — such as AR, inventory, machinery, equipment, real estate, and intellectual property.	Financing is based on company's going concern value, instead of asset liquidation values.
Term	3 — 5 years	3 — 7 years
Pricing	LIBOR plus 5% — 12% Pricing is typically a function of asset quality and supportability of advance rates.	LIBOR plus 5% — 15% Pricing is typically a function of size, availability of credit ratings, and financial sponsor support. Secondary market liquidity afforded to larger tranches ($50 million +) with acceptable risk ratings; minimum B3 (Moody's) B- (S&P), and equity sponsor support will drive more competitive pricing. Increased leverage or weaker enterprise valuation will typically increase spreads.
Benefits	Additional source of financing, with no equity dilution or additional covenants. Also offers flexibility in loan amortization schedule.	Additional source of financing, with no equity dilution or additional covenants. Also offers flexibility in loan amortization schedule.

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