Investing in Private Debt

3 keys to mitigating your risk

a white paper brought to you by The Knowledge Base at carofin.com
Attractive investment returns are possible through private lending (and they are great to receive!) … but the risk associated with these investments can’t be ignored. Here are the keys to capturing the best possible outcome and mitigating your risk, both before and after investing in private debt. We hope the following recommendations will help you become more successful in this sector of your investment portfolio.

INTRODUCTION & OVERVIEW

Adversity is a great teacher, and we have certainly learned from it … a lot! Over the past 20+ years CFG (Carolina Financial Group), an affiliate of Carofin, has developed a corporate finance practice encompassing a broad range of private financing (debt and equity) that is uniquely suited to helping small- and medium-sized companies grow. Since 2010 over $300,000,000 has been invested into 100+ debt offerings for such companies.

The investors in our privately placed corporate debt offerings have been attracted to the relatively high returns which were possible — often above 12%.

They deserved higher returns because, in private lending:

- The corporate borrowers include higher risk, lower credit quality companies;
- Banks often won’t provide the additional growth capital needed by these businesses;
- These borrowers usually don’t have audited financial statements; and
- The private debt securities invested in are illiquid, “buy and hold” private placements.
Knowing that, it’s helpful to have a guide who remains in the deal from start to finish in case something unexpected happens.

Private lending to middle-market and earlier-stage businesses can result in consistently higher net returns (i.e., net of possible loan losses) only if investors consistently follow a systematic approach that:

- Conducts a thorough level of diligence and avoids risk when red flags are encountered;
- Uses a form of security which best supports the Investor’s return of capital; and
- Involves active, post-investment Investor oversight and responsiveness.

Based upon our experience, we know that taking a thoughtful, risk-averse approach to the due diligence, the use of proper loan structuring and aggressive post-investment engagement with the borrower is essential if Investors are to have the best prospects for a return of (getting their principal back) and return on (receiving the projected interest) their private debt investment.

This goes without saying that the three keys discussed here are not guaranteed to eliminate all the risks associated with private investments. While diligence can be (and often is) a full-time job, structuring a security before any issues arise is worth the time, and ongoing monitoring can help prepare you for the worst-case scenario, the securities offered through private placements are subject to a myriad of unforeseen circumstances that could result in the loss of some or all of your investment. These unforeseen risks include, but are not limited to:

- Changes in government regulations regarding imports, exports, tax laws, permits, etc;
- The loss of key personnel involved with the company;
Management’s ability to manage rapid growth, or ability to manage the Company if it falls short of its forecasts;

Changes in health & safety regulations related to the Company’s products; and

Changes in the Company’s key suppliers and customers’ financial conditions.

In addition to the risks relating to the Company’s operations, it is worth reminding you that securities sold as private placements often have their own set of risks such as the lack of an active market and restrictions on resale, both of which contribute to the increased liquidity risk of these securities.
Despite spending months conducting due diligence with our issuers, occasionally challenges arise that have required us to spend time and, more rarely, legal expenses to protect our investors. Here are some examples to consider:

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<tr>
<th>LENDER CHALLENGES</th>
<th>RISKS &amp; EXPENSES</th>
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<td>Interest and/or principal not paid when due</td>
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<td>Issuer becomes unprofitable due to external challenges</td>
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<td>Issuer becomes unprofitable due to mismanagement</td>
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<td>Collateral reports inaccurate</td>
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<td>Collateral values overstated</td>
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<td>Same collateral fraudulently used to support multiple loans</td>
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<tr>
<td>Collateral fraudulently sold without lender approval</td>
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<td>Loan foreclosure becomes unilaterally necessary</td>
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<td>Other lenders foreclose forcing loan acceleration</td>
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<td>Issuer declares voluntary bankruptcy</td>
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<tr>
<td>Loan collateral sold by lender</td>
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If you are now investing directly in private corporate debt or are considering it, we strongly advise you to follow an investment discipline that incorporates the three elements that follow.
Do your Diligence!

To set the stage for how to approach due diligence, let’s first talk about Red Flags. These are troubling or confusing discoveries made during your research. Trust your common sense! There is almost nothing about corporate analysis that rises to the level of “rocket science.” If there are red flags, walk away. There are plenty of other worthy companies needing your capital to grow.

RED FLAGS - AN EXAMPLE

Carofin was approached by a small company in an import/export consumer goods business looking to raise capital to build inventory.

In our normal course of conducting due diligence, we discovered that the owner of the company previously had sold a business and, rather than pay federal taxes, he had used the proceeds to improve his operations in another company.

In addition, his accountant, upon learning of the owner’s decision against paying the IRS what was owed, quit the firm, and the owner was currently using a part-time bookkeeper to manage the finances.

Consequently, despite the fact that the business was making money, had great products, was well known in the industry, and the investment structure would have been rewarding to its investors, Carofin declined to pursue the opportunity.

Making management decisions that might affect the success of the investors’ loan (being forced by the IRS to settle its claim and penalties), or the accuracy of the financial reports being generated, was a Red Flag.
The following areas of concern can often give you an early warning of problems to come ….

**MANAGEMENT:** It starts (and ends) with the people … the owners and managers of the business to whom you are lending. No contract or agreement with them will make up for dishonesty or incompetence. What do you know about them, and have you conducted thorough background checks including criminal reviews, a lien and judgement screen and an analysis of their past business performance?

**CREDIT ANALYSIS:** A debt investment is very different from an equity investment. While most companies can issue equity to raise growth capital, most venture-stage companies (i.e., younger businesses that have not yet generated positive operating cash flow), and some more established business with recent troubles should not finance their businesses using debt. A potential borrower must demonstrate to you, the prospective creditor, its ability to “service” the loan, which includes making regular interest and principal payments to you during the term of the loan.

**A FEW FINANCIAL RATIOS YOU SHOULD GET TO KNOW**

- **DEBT/EBITDA:** Total Debt divided by the sum of Earnings before interest, taxes, depreciation and amortization — typically under (ideally, well under) 3.5x;

- **LOAN-TO-VALUE RATIO:** It depends on the collateral involved, but think about what discount to the stated collateral value would be needed for you to sell the underlying collateral in a “fire sale” situation and get your investment back. Your loan amount should be lower than the fire sale value of the collateral supporting it;

- **FIXED CHARGE COVERAGE RATIO:** The ratio of the borrower’s operating cash flow available to meet debt service divided by the amount of principal and interest due — typically at least 1.2x, depending on the predictability of the operating cash flow.

As a lender, you will not be participating in the Issuer’s future profits, so prioritize the sources of loan repayment in your analysis. There should be multiple sources of repayment in case the primary one doesn’t work.
BUSINESS OPERATIONS: It is important to also understand the “how’s” of the business, not just the “what’s” (typical Due Diligence). For example:

- How do the senior managers manage? Weekly staff meetings? Standard Operating Procedures? Strong inter-personal skills? Inviting input from all levels of employees, or is it an insular, tightly controlled process by an inexperienced owner?
- How is information (financial and otherwise) collected and used across the organization? Are business decisions made with good data…or hope?
- Is there a seasonality to the business (particularly in agriculture)?
- How strong is the borrower’s finance staff? Is this financially a well-managed company?
- Is there an adequate information technology infrastructure supporting the business? If not, then financial and other data provided to investors is highly suspect.

There are many other aspects of corporate analysis and of conducting thorough due diligence. We suggest you also read Carofin’s Seven Key Questions for Evaluating a Private Company and use our Due Diligence Guidelines for your next private debt investment.

- [Seven Key Questions for Evaluating a Private Company](#)
- [Due Diligence Guidelines](#)
### Structuring the Loan or Note

The form of loan or other debt investment you make must reflect, at least, the following considerations:

- Other debt the Issuer has already undertaken
- The Issuer’s historical levels and consistency of profitability and cash flow generation
- Company assets which can be used as collateral for the loan
- Whether personal guarantees from the owner of the borrower are available

At the time you are structuring the debt, you should always put into place the most senior security possible. This may include collateral to secure your loan. If so, the collateral must be sufficiently valuable to repay your loan’s principal and the interest due to you if you must sell it in an independent sale. The collateral must be identified specifically in the credit agreements supporting the debt and, separately, liens must be filed which identify your claim to this collateral under the Uniform Commercial Code of the state in which the borrower is located. If there is no collateral or third-party guarantees available, your debt investment is unsecured, and you must, therefore, have confidence that the Company’s cash flow alone is sufficient to repay your loan.

There are many aspects to structuring debt, and we suggest you review Carofin’s Debt Investment Overview and Private Lending to Operating Companies for more background.

- Debt Investment Overview
- Private Lending to Operating Companies

We also strongly recommend that you engage a lawyer specializing in corporate finance to help evaluate the Issuer’s corporate structure and existing indebtedness (including contingent liabilities) and, then, to structure your debt investment in a way that reflects the Issuer’s circumstances. There are many, many legal nuances that will become critical to the recovery of your investment if they are not identified and reflected in the loan structure you invest through … in anticipation of a potential Issuer default.
What to do After the Loan is Made

Following the debt investments we offer, Carofin typically acts as Administrative Agent for our investors who participated as part of a syndicate, or group of individual investors. All Carofin investors are both “High Net Worth” (meaning that, at a minimum, they meet the Accredited Investor standard), and we have determined them to be “suitable” for such higher risk investments, i.e., they have an appropriate risk/return outlook, and the investment matches their other investment selection criteria. However, many of these investors may not have the time or experience needed to administer adequately all the elements of their loan investment.

We remain engaged because we have learned, over time and through challenged transactions, that it is critically important to:

- Continually monitor the Issuer’s performance;
- Coordinate communication among the participating investors; and
- where necessary, to respond quickly and aggressively to defaults by enforcing the investor protections built into a given security’s credit structure.

Carofin’s investor support includes actions identified below. You should be prepared to take the same steps yourself if you are lending independently.

- Processing interest and principal payments to investors, looking for patterns of pushing the limits of “grace periods” after the time in which payment is otherwise due to the lender/investor;
- Conducting regular business update conference calls and meeting with Issuer management, including on-site inspections;
Monitoring collateral and other loan covenant compliance, receiving ongoing third-party verification whenever possible;

Quickly engaging legal counsel qualified in litigation and the local bankruptcy courts when there is the first sign of trouble.

We try to protect our investors throughout the life of the investment (the investment’s “Full Cycle”). When defaults occur ... and they will from time to time ... we have found that an immediate and aggressive response consistently leads to the best ultimate outcome for the Investor.

A “SCRAPPY” CASE STUDY

**BACKGROUND:** Carofin financed a scrap metal dealer that needed additional working capital to purchase scrap because it had high cost overruns in building a large scale shredding operation.

Numerous lenders already were providing equipment financing with broad claims on the company’s assets (potential collateral). Consequently, we created an off-balance sheet structure, a single purpose vehicle (“SPV”). This new company would purchase scrap, the dealer would process and sell it for the SPV, and the SPV would repay the investors their principal and interest, with the remainder delivered to the dealer as a processing fee.

The value of the collateral was required to be high enough at all times to be able to support payments to the investor lenders.

**THE CHALLENGE:** The dealer began to assess higher values to the collateral than had been originally agreed. He requested more new scrap than the outstanding loan could support. The real problem was that the dealer was not sufficiently profitable.

**ACTIONS TAKEN:** Carofin denied the dealer’s request and required a return to the original collateral levels. When the dealer refused to comply, Carofin began to pay off investors using the free cash flow retained by the SPV.

**RESULT:** Carofin investors received a 98.7% return of their investment (i.e., they lost 1.3% of their principal). However, the others, the on-balance sheet lenders, reportedly received only 33% of their loan principal when the dealer declared bankruptcy.
Conclusion

Generating returns in private debt which are substantially higher than the broader money markets and public bond markets required a consistent approach, follow-through, and perhaps a bit of luck - these are still speculative investments. As they said in economics class, ... there is no “free lunch.” You have to work for it.

Private lending to middle-market and earlier-stage businesses can only result in consistently higher net returns, i.e., net of losses, if a program is in place that:

» Conducts a thorough level of diligence and respects red flags when they are encountered;

» Uses a form of security which best supports the Investors; and

» Involves active, post-investment Investor oversight and responsiveness.

As a result, Carofin does not limit its activity just to acting as an agent in a traditional private placement — merely raising the financing needed by the Issuer and moving on to the next transaction. Following each security’s issuance, we stay involved by formally representing our investors throughout the Full Cycle of their investment. We know from a significant amount of real world experience how critical this has been to our investors.

We are committed to improving investment standards for the broader Alternative Investment community and hope that you find this information helpful. Please tell us your experiences so we can share them with our community.

As always, please reach out to schedule a call if you have questions. (828.393.5401)

And, if you are ready to consider investing in our alternative investments, please click here.
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