American Capital

RESOURCES

Types of Financing

Use this section to learn more about business loans and specific financial products that might be right for your company.

Revolving Line Of Credit

Revolving lines of credit are the most common and least expensive form of business loan for small- and mid-sized companies. Companies typically enter into revolving facilities to fund their working capital, which is the amount of current assets (cash, inventory and receivables) in excess of current liabilities (items such as payables).

Senior Term Debt

Senior term debt is the second most common form of financing for a small and mid-sized companies. Senior term debt is typically lent against the collateral value of property, plant and equipment. Senior term debt comes in many varieties and there are many sources of this type of financing. It is typically the second most expensive form of financing.

Subordinated Mezzanine Debt

Subordinated debt financing typically includes both debt and equity. There are dramatically fewer sources of subordinated debt than there are of senior debt or equity, so it is often considered to be specialty financing. Subordinated debt is substantially riskier than senior debt since the lender generally has less right over collateral and cash flow than the senior lender. As a result, subordinated debt is more expensive financing than either revolving lines of credit or term debt. Lenders usually require equity, generally in the form of warrants, to augment what they earn in interest income.

Equity Financing

Equity financing incurs the greatest risk of all capital on the part of the investor. Equity investors demand high returns, commensurate with that risk. This sections meant to cover equity financing that is available for management buyouts, growth financings, acquisition financing, employee buyouts, ESOP financing and recapitalizations.

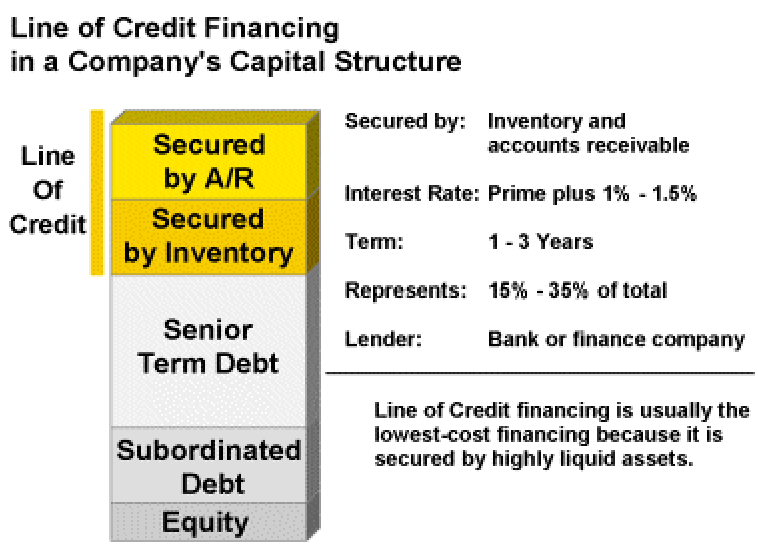
Revolving Line of Credit

One component of senior debt is almost always a revolving line of credit (RLOC). Banks and finance companies are the primary providers of RLOCs. The two most common types of RLOCs are:

- **Accounts Receivable Financing**
- **Inventory Financing**

A RLOC facility is provided to a company based on a certain percentage of the appraised orderly liquidation value of the eligible account receivables and inventory. Typically, a company can borrow between 65 percent and 85 percent of the value of its eligible account receivables and 30 percent to 55 percent of the value of its eligible inventory. These advance rates vary depending on the type, quality and historical performance of the company's current assets.

A lender will typically develop a borrowing base formula to determine how much it can lend to a particular business. The formula will generally be reduced by certain nonqualifying assets, such as receivables that are past due and inventory that has aged beyond a certain specified period of time. The lender also takes into account the predictability of a borrower's cash flow that is used to service senior debt. Thus, the effective advance rates for an RLOC business loan is almost always lower than the reported advance rates.



A RLOC is generally the cheapest type of business loan available to a company because the assets collateralizing it are liquid. Interest rates can range from just under prime to three over prime. RLOCs generally have a term of one to three years with renewal provisions, but it is common for them to have no set schedule for principal repayment.

Senior Term Debt

Typically 50 percent to 70 percent of a firm's capital structure is comprised of senior debt. Senior debt is collateralized by a first lien on the current and long-term assets of the company. It is generally provided by banks and other financial institutions that make business loans, although senior debt can also come from a private placement to institutional investors or via a public bond issuance.

Amount

The amount of senior term debt typically provided to a company depends on the type and quality of its collateral and the stability of its cash flows. A senior lender's first priority is to analyze the value of the assets. Generally the company's current assets are already claimed by a revolving line of credit; senior term debt will usually be collateralized by a company's fixed assets. The amount of the term loan will be based on a formula that applies an advance rate to the assets in order to determine the amount that may be borrowed. Advance rates depend on the type, age and quality of the assets. Typical advance rates are 60 percent to 85 percent of the appraised fair market value of the land and buildings and 40 percent to 90 percent of the orderly liquidation value of the machinery and equipment.

The amount of senior term debt advanced at closing is further limited by the predictability of the company's cash flow to service that debt. If the company has stable cash flows, the lender may provide additional funds above the collateral coverage. Lenders consider earnings before interest, taxes, depreciation and amortization (EBITDA) as a proxy for the company's cash flow, and will lend up to a certain multiple of EBITDA. This multiple will vary greatly between industries and is dependent on the company's health and competitive position. For purposes of performing a preliminary analysis, three times EBITDA is a median multiple for senior term debt.

Term and Amortization

Senior term debt typically amortizes over four to seven years. Payments are generally made monthly or quarterly, but the amortization schedule can vary to conform to the company's stream of cash flows. Some lenders are willing to forego amortization payments for a number of years and allow the loan to be repaid in one or a few large payments. Typically, the longer the time to repayment, the higher the interest rate.

A lender may also impose a prepayment penalty, if a borrower repays the business loan ahead of schedule. These penalties are often a percentage of the amount prepaid.

Price

Interest rates on senior debt range from 0.25 percent under prime to 5 percent over. Depending on the perceived risk of the company's cash flow and the quality and quantity of the collateral, interest rates for senior term debt may be either fixed or floating. A lender will occasionally tie the interest rate to a grid, so that as a company becomes less leveraged and less risky, the interest rate on the debt decreases.

Security

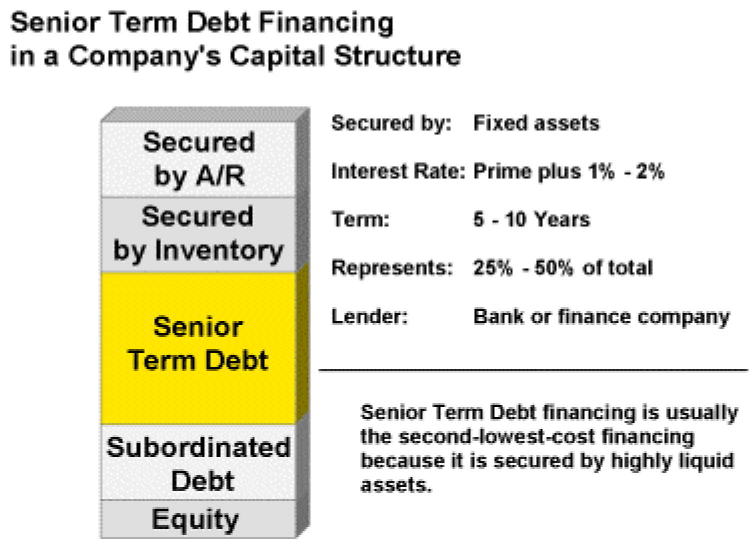
Senior debt has a prior claim over subordinated debt with respect to collateral value and cash flows. The senior lender applies advance rates to ensure that the loan amount is less than the quick sale value of the assets. In order to maintain this level of security, most lenders require monthly or quarterly asset audits to ensure that the value of the collateral is not deteriorating.

Financial Covenants

A lender uses covenants to exert control over the borrower in order to protect a business loan. Senior debt that is repaid from cash flow will often require financial covenants. Covenants are designed to keep the company within certain financial parameters. For example, the lender may want the company to stay below a certain ratio of debt to cash flow and to stay above a certain ratio of cash flow to interest. Breaking a covenant may put the company in default.

Typical financial covenants associated with a term loan may include:

- Senior Debt / EBITDA
- EBITDA / Senior Interest
- (EBITDA - CapEx - cash taxes) / (cash interest + debt amortization) known as "fixed charge coverage."



Subordinated Mezzanine Debt

Between 15 percent and 30 percent of buyout financing is typically comprised of subordinated debt. This debt is subordinate to senior debt, giving it a second claim on a company's assets. Subordinated debt financing is generally provided from insurance companies, finance companies and subordinated debt funds. Alternatively, it is raised with public offerings of high-yield - or "junk" - bonds sold to insurance companies, pension funds, and other institutional investors. Governments or other public entities may also be a source of subordinated debt, usually on much better terms than capital market sources. Subordinated debt terms are typically six to ten years, and principal payments are commonly deferred until after senior debt is retired.

Subordinated debt is lent based on the amount and predictability of cash flow required to service senior debt. Interest costs can be anywhere from two to eight percentage points more than senior debt. Because subordinated debt usually has little collateral protection, the lender may request warrants convertible into the company's equity. The warrants typically represent an amount of between 1 percent and 10 percent of the company's outstanding stock.

American Capital's providers typically make subordinated loans ranging in size from $1 million to $10 million, with terms ranging from five to ten years. These loans are secured by a second lien on property, plant and equipment. Principal amortization can be deferred during the first four to five years to conform to a business' cash flow constraints. Interest on these facilities can be fixed or variable, with rates depending upon the company's credit situation and the structural features of the loan.

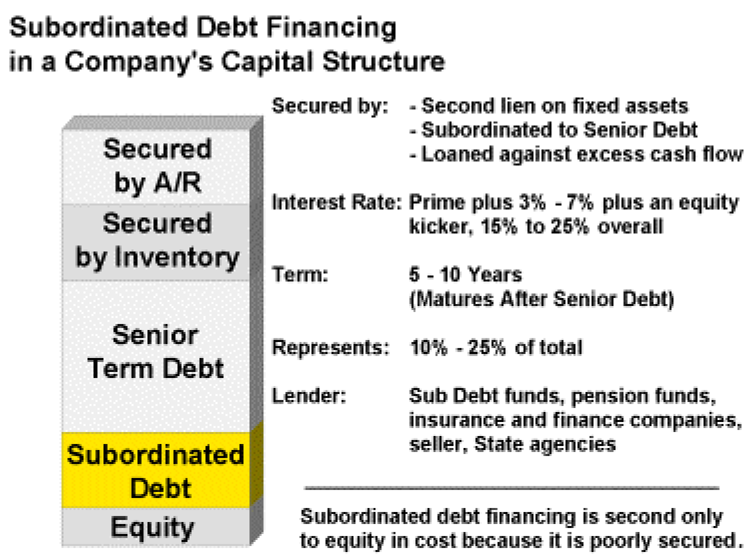
Subordinated loans are provided to meet a number of corporate objectives, such as:

- **Refinance Existing Debt**

  A subordinated loan can be used to increase the available balance secured by a second security position on the firm's assets, to meet balloon payment obligations or to secure lower current interest rates.

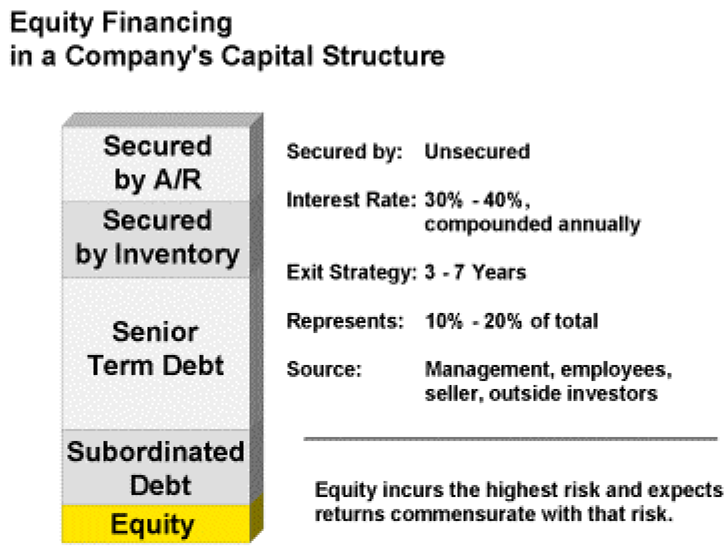
- **Support of a Broader Financing Package**

  A subordinated loan can be used as part of a broader financing package of debt and equity to complete a management or employee buyout or finance a turnaround.



Equity

The structure of a typical private equity transaction contains between 10 percent and 50 percent equity. Private equity capital makes up the difference between a transaction's total value and the amount provided by senior and subordinate debt.



American Capital can provide your company with equity financing ranging from $250,000 to $10 million. While private equity providers typically prefer to exit an investment in five to seven years, American Capital has no fixed time horizon to exit from its equity investments. This gives you more flexibility to build your company without the constraint of a private equity investor's exit strategy.

Equity investments may be used to meet a number of corporate objectives:

- **Replacing an existing investor**

  Equity financing provided by American Capital can be used to buy out an existing shareholder.

- **Support of a broader financing package**

  Equity can be used as part of a broader debt and equity package to finance a management or employee buyout, or to undertake an acquisition, growth, rollup or turnaround transaction.