KPMG
Private Enterprise

Alternative funding sources for private companies

KPMG Privately Speaking podcast transcript | Episode 15

Erika Whitmore (00:00):
Today we have Mike Rudolph, who's a managing director in our Corporate Finance group here at KPMG. So Mike, if you could give us a little bit of your background. I'm really excited to have you here. And I think our listeners are going to get some good information that's going to help them, excuse me, see what's around the corner of the next six months.

Mike Rudolph (00:20):
Yeah, no, awesome. Absolutely. Happy to be on. Again, Mike Rudolph. I'm a managing director within the KPMG Corporate Finance practice. And effectively what that is, and we always like to say it's our best-kept secret, because obviously, everyone knows about our audit, tax, and advisory. But we are a federal licensed, middle-market investment bank. So unlike maybe some of our larger audits that most people understand with our Fortune 500 businesses, we really, within corporate finance, focus on, call it the 30 to three to 400-million-dollar of enterprise value business. So depending on the sector, that could be EBITDA positive, call it single digit up to 30, 40 EBITDA.

Mike Rudolph (01:07):
Obviously, if it's a tech deal, I mean, sometimes that's not profitable, it could still be in that two, three, 400 million range on the enterprise value. There's about a hundred professionals in the U.S., call it 20-plus managing directors. And the vast majority of what we do is sell-side M&A, but as luck would have it, my background in lending.... Well, my background's in lending and I basically run our Capital Advisory practice. So when companies need to raise capital, they're not looking to sell. And frankly, they don't necessarily know what their debt options are. That's when I come into play.

Mike Rudolph (01:45):
The first part of my career, I was a lender. I was at GE Antares Capital. For many years, I was also at CapitalSource. So really have a good understanding of providing debt loans to privately held businesses of a size range I just mentioned, and now I'm more on the advisory side. So basically helping companies think through all their options. And then fortunately, for me, a lot of times, I'm going to colleagues or prior colleagues, or friends of mine that I've known for 20-plus years, when we're soliciting terms from them.

Erika Whitmore (02:20):
Perfect. Mike, thank you for that background. I think that lays the foundation really well with a couple of topics that we're going to cover today, which includes: Where are private companies getting their money from these days? What is your perspective on the M&A market, and then liquidity, in general? So, we'll kick it off with one of my favorite topics. Anyone who's listened to more than a few podcasts probably knows I get pretty excited about IPOs, although not right now.

Erika Whitmore (02:50):
So, given the slowing IPO market, M&A trends seem to be trending down, excuse me, right now. I've got some venture capital friends that have shared that they've significantly dialed back going to look for deals. And they've asked some of their portfolio companies, depending on what industry they're in, to tighten up spending, et cetera. Heard consistent themes from PE firms. What's your perspective on where private companies are getting their money from these days?

Mike Rudolph (03:22):
Yeah. No, certainly a relevant question. And you're right, I mean, venture capital funds, they effectively put money into speculative businesses, right? So, I think giving all the potential headwinds and just looming and higher pricing and lower leverage, I think venture capital groups are definitely pulling back a little bit. And obviously, I think the flavor of the last couple years were specs and everyone wanted to be a spec. And I think that kept a lot of people very busy. But I think anything in the public markets is a little bit more difficult these days.

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Mike Rudolph (04:01):
But yeah, I mean, I think when you look at who is funding deals these days, I mean, look, it's the same groups that have been funding it since I've been working. It's really private equity firms and capital providers. I think private equity funds are sitting on, or I think it's almost north of a trillion of dry powder, which effectively is funds raised, but money not put to use. So certainly LPs want that money put to use. So private equity funds are still really trying to put money into different privately held deals. And obviously, we saw 2021... coming through the roof on the M&A side. And certainly capital providers have to leverage up and help fund those deals.

Mike Rudolph (04:45):
And you look at the different types of capital providers, I mean, certainly everyone knows banks, the big banks, the big Wall Street banks, and then the local regional banks down the street, but I think really where, frankly, where my group comes into play, there's probably hundreds, if not thousands, of different types of funds out there that are providing senior debt or providing junior debt, or looking at minority equity deals.

Mike Rudolph (05:15):
And there's a lot of different funding mechanisms, from just private funds, from CLOs, BDCs. Similar to the private equity world, there's a lot of money that debt providers need to put and to deal. And again, all their investors want a return, but it's just becoming more difficult with not only leverage and pricing issues, but also just the conservative nature of capital providers because of all these perceived headwinds.

Erika Whitmore (05:46):
Yeah, I hear you. And I do see some of our audit clients going through some of those situations. So we'll come back to liquidity. So, in terms of M&A activity, KPMG, specifically Carole Streicher, put out an article or a white paper in June of 2022 called, Appetite for M&A remains strong despite economic headwinds. And in this white paper, it shows the trend in terms of value and deal volume over the last couple of years. And obviously, 2021 was strong. Even second half of '20 was very strong; first half, obviously, was not, but those deals have come down.

Erika Whitmore (06:29):
In terms of looking forward to the second half, just wanted to get your perspective on what you're seeing, in terms of both value as well as number of deals. I think it's just a really interesting topic, right? And we just saw one of the major banks release earnings. They've raised their loss reserves and they've lowered their projected earnings for the rest of the year. So, just a lot happening in here, even in the first couple weeks of July. Would just love to hear your thoughts.

Mike Rudolph (06:59):
Sure. No, absolutely. And yes, as you referenced, I mean, 2021, M&A activity was through the roof and likewise, so was the debt markets supporting those deals. And yeah, I think the last six months, we've definitely seen a slowdown. I mean, we're very much industry driven by our sector bankers. And I think for the most part, everyone's still having a pretty good year, but I know we are starting to see a few deals almost being put on hold, just because maybe they are in more of a discretionary goods environment or residential construction, or more heavily retail.

Mike Rudolph (07:40):
So, certainly, deals have probably "died" because of that sector and some of the headwinds that I think investors are looking at. But we've definitely experienced some of that, but I think one good example is, one of our colleagues, in market, with a, I'd call it, an outdoor recreational spend type business, that was single-digit EBITDA 2019. All of us spending a lot more time at home and with time on our hands, I mean, the company literally thinks it pretty much will quadruple EBITDA over the next coming couple years. And in market right now, versus if the deal was in market six months ago, it probably would've closed relatively smoothly.

Mike Rudolph (08:28):
But right now, both private equity funds and strategic buyers are looking at this and saying, "Okay, I'll still buy this company for eight times," let's say. Plus eight times what? Is it going to be the single-digit EBITDA from 2019? Is it going to be the nearly 30 of EBITDA as of now? Because who knows what's going to happen and what this company's going to look like over the next couple years. So, I think buyers are struggling and putting pencils down. But for that deal, in particular, the owners, they don't want to sell and go to the beach, they wanted to basically sell, obviously take out liquidity in a good market, but they really wanted to put money back into the business and continue to grow.

Mike Rudolph (09:15):
So instead of selling, they're contemplating going to different debt providers that maybe could leverage up. Again, we'd have to decide what that EBITDA looks like, but maybe provide two times leverage on that business, so they could use that money to maybe buy off some of their shareholders that do want to retire, or they could use that money to grow. So I think that's an example where a credit fund could maybe get very reasonable leverage on a really good business, that they maybe wouldn't have gotten a year or two ago, but given the market conditions, it's a really good opportunity for them.

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Mike Rudolph (09:55):
And actually, if you don't mind, I'd like to reference another deal that we closed about a year ago. It was in the DSO dental space. And we are basically helping provide debt capital for a family office that was buying a company in the dental space, sub-EBITDA. The deal was coming north of 10 times overall valuation. So when you look at that 10 times check, we ended up raising close to five times leverage. And almost for all of our capital raises, there's two avenues that we'd approach. So we'd look at credit funds that would do what's known as a unitranche. So that credit fund would fund that full five times. And it's typically price, call it high single-digit pricing.

Mike Rudolph (10:46):
Or, you could look at a senior mezz structure where you have that traditional bank, who typically would never go much higher than two or two and a half times leverage, especially on a sub-10 EBITDA business. And then the rest of it would be filled by a mezzanine or junior capital provider. But it's interesting, because if you look at that deal, again, let's just say it's five times leverage, banks were a little bit more conservative, so they only wanted to do, call it two times leverage. So that means three times leverage would have to be for a junior capital fund.

Mike Rudolph (11:19):
And if you look at the pricing of those two types of groups, the bank is, call it 5, 6 percent, but that mezz group could be, call it 14, 15 percent. Well, that basically just made the mezz provider, they're not going to win the deal, because it's just going to be way too expensive, since you literally have almost three times or three turns price at 15 percent. Whereas, we were getting credit fund bids in that 7, 8, 9 percent range.

Mike Rudolph (11:47):
But you look at it now, with leverage levels decreasing, and I know we'll talk about pricing in a bit, but pricing's definitely increasing as well. Now that same deal is probably only going to get four times leverage and it really is going to benefit, I think, the junior capital mezzanine provider, because now, they only need to go about a turn deeper, turn and a half deep versus almost three times. So, I think, obviously there's winners and losers in anything that happens in the markets, but I do think junior capital providers should probably get some good opportunities over the next couple years.

Erika Whitmore (12:25):
No, that makes a lot of sense. And that's really helpful to understand your view on how the things work. And I always love stories. I just think they're great. So in terms of liquidity, we mentioned it at the beginning, and there's a lot of different views on where things are at. But how should companies be thinking about liquidity today?

Mike Rudolph (12:46):
I think what I would say is, and reference that there is still strong liquidity, different funds trying to put money to use. I just think it's really knowing where to go to and knowing what type of fund to look at, right? And what I mean by that is, certainly, I think if you look at the ways, and I guess there's a few variables to look at. One is, what are the use of funds and what are the use of that liquidity? I think that's getting really scrutinized lately.

Erika Whitmore (13:18):
Yeah. So, it seems—

Mike Rudolph (13:18):
So what I mean by that... Yeah, I mean, I think lenders, in general, are taking, really, a harder stance on nonaccreted uses of capital. And the main one is a dividend recap, right? Two years ago or a year ago, you probably could leverage up a 10-million-EBITDA business by three times. And that money could, in theory, go straight into the owner's pocket just for liquidity diversification purposes and the lender would've been okay with that. But now, I think the viewpoint is they want to either have that money go into an acquisition, which would be accreted.

Mike Rudolph (13:56):
But we mentioned M&A is obviously slowing, so it's really refinances, buying out maybe older shareholders that want out. But I think lenders really want that capital being used to sustain the business and helping that business grow, right? So I think the use of funds is being scrutinized. I think we referenced a little bit, if you're in a different sector, a more of a volatile sector, again, consumer discretionary spending, residential construction, retail, you can still get deals done, but it's going to be at a much lower leverage and potentially higher pricing.

Mike Rudolph (14:34):
And when we talk about leverage, it's interesting, the types of lenders we talk to and businesses that we work with. I feel like there's a threshold that, if you're north of 10 of EBITDA and the closer you get to 20 of EBITDA, you're going to definitely get higher leverage, in general, and lower pricing. But if you look at the type of leverage that that type of company could've gotten, call it a year ago, it's probably only reduced about maybe a quarter turn or so. So instead of, call it 4.5 to five times leverage, they're probably getting 4.25 to 4.75.

Mike Rudolph (15:14):
Whereas, if you are below 10 of EBITDA, I just think lenders are much more critical, and size matters, I think, with capital providers. So in that case, you could be looking at almost a three-quarter turn decrease in leverage. And then, of course, on the pricing side,

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well, first of all, there's the whole LIBOR to SOFR changeover. So LIBOR's effectively going away and the secured overnight financing rate has really come into play. But that rate, or that spread, I should say, has increased so much over the last even couple months. Probably about a year ago, I mean, LIBOR was effectively 30 basis points. I just looked again, LIBOR's not used that much, but I think LIBOR as of today was almost 2 percent. And SOFR's the same thing, right?

Mike Rudolph (16:07):
I mean, SOFR, I think that 30-day SOFR, currently, is about 150 basis points. Whereas, I think earlier in the year, that was probably 50 basis points. And that's real interest expense going out the door, if you're a capital... or, I'm sorry, if you're a business and you almost have to pay another hundred to 150 basis points on that deal that you have in market, or the deal that you have on your balance sheet, because certainly, they're floating rates, they're not fixed rates. So, yeah, so I mean, I think between sectors, use of funds, leverage and pricing, lenders are definitely being a little bit more critical, just in general, in their underwriting.

Erika Whitmore (16:54):
No, I've definitely seen that with the companies that I serve as well. Underwriting is a different story than it was nine months ago. That—

Mike Rudolph (17:06):
Yeah. No, exactly. And actually, Erika, one thing I'd still want to mention, I just, I almost forgot. So just because I remember, and old enough to remember, that back in the '05, '06, '07 timeframe, and I did little research, and middle-market loan volume from '05 to '07, for companies that had 50 of EBITDA or less, I mean, literally, the loan volume in those years ... 35 billion, 34 billion, and 28 billion. In 2021, which we talk about being an amazing debt market, it was not even 8 billion. So, back in that time, again, massively high middle-market loan volume, the prime rate went from 8.25 in '06 and it dropped all the way to 3.25 in 2008.

Mike Rudolph (18:02):
Now, obviously, we all know about the great recession in Bear Stearns subprime auto. So certainly I think the Fed tried to do everything they can by reducing the prime rate during, carrying those tough times. But if you look just in '06 and '07, again when rates were at 8 percent, north of 8 percent, I mean, 34 billion of loan volume is unheard of. So, I guess the point of that is, I think a lot of folks are looking like, and I hear it a lot from clients like, "Oh, my God, rates are going up, rates are going up. Things are going to get really bad because of that."

Mike Rudolph (18:37):
I mean, look, if things do get really bad, pricing will play a very small role in that. It's really the whole inflation and possible recession. Who knows if there's more lockdowns or what have you with the virus, but just based on history, it's not going to get bad just because prices, or I'm sorry, just because pricing's going up as we saw in that '06, '07 timeframe.

Erika Whitmore (19:04):
No, I think that's really, really interesting. Well, Mike, this has been awesome. So thank you again for joining us today. Any final thoughts you would like to leave our listeners with? We touched on a lot of things, right? We touched on the M&A market. We touched on sources of capital, where companies can get money from, liquidity. What are your parting thoughts?

Mike Rudolph (19:28):
Yeah. Well, I guess I'm always optimistic and glasses always half full. And I think you have heard, at least on the restructuring side, that things are going to get really busy. And I know, obviously even within KPMG, we have a lot of folks that are probably busy on the restructuring side, but I guess I would say, and we've looked at a few deals where, I mean, look, maybe you're not set up anymore to be a bank deal and priced at 3, 4 percent. Things have gotten rougher, maybe EBITDA's a little bit less, and asset values went away.

Mike Rudolph (20:05):
But I would say there is a huge universe of capital providers that are, frankly, more aggressive. And yeah, they're going to be more expensive, but I think we will see restructuring pick up, most definitely, but I feel like we've been saying that for four, five, six years, and we haven't necessarily seen it. But I think outside of a restructuring, there's definitely a lot of different types of capital providers that, frankly, could be an avenue of use for companies that maybe they never even really thought that this type of capital even existed.

Erika Whitmore (20:41):
Perfect. Well, Mike, like I said, thank you again for your time this morning. I think it's been really helpful. I know it's been helpful for me. So thank you again, and we hope to have you on again soon.

Mike Rudolph (20:53):
Awesome. No, I appreciate it. Thanks for the time. I enjoy doing it.

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