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BDO Debt Advisory

Private credit sources & uses

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Private credit debt has become an increasingly popular financing option for businesses, particularly in situations where traditional bank debt is either unavailable or less advantageous from a flexibility perspective. Funding can be sourced through a variety of options such as senior direct lending and/or unitranche focused funds, mezzanine debt, real estate and infrastructure funds, distressed debt and special situations/opportunistic credit funds. It is subsequently becoming imperative for business owners to understand these options to ensure businesses secure financing tailored to their specific risk tolerance, return expectations, and strategic needs.

This article is aimed at providing an understanding of the following:

- Sources of debt funding available to businesses (with a particular focus on the broad range of options offered by private credit)
- Typical uses of debt capital (with a focus on growing mid-market businesses).

By clearly identifying the sources of funds for the proposed deal (i.e. equity, debt, or internal cash flows etc), and the specific uses of these funds (i.e. working capital, expansion projects, or debt refinancing), companies can present a well-defined and coherent financial plan to prospective lenders and investors. This clarity helps in tailoring the debt structure and source of debt capital to match the company's borrowing profile (including cash flow and repayment capabilities), thereby minimising financial risks and enhancing the likelihood of securing favourable terms from lenders.

When is debt preferred over equity?

It is important to note debt will not always be the most appropriate source of capital. The decision between using debt or equity will depend on the existing capital structure of the business and its appetite for risk. Debt can be seen as a favourable option compared to equity, as it is a non-dilutive source of capital and can subsequently allow businesses to improve their valuation prior to an equity event (equity raise, merger, or sale). Since debt obligations are typically fixed in nature, we recommend businesses ensure they understand all obligations (repayment profile and covenants) to ensure the business can service the debt throughout the term of the facility, with consideration applied to downside scenarios (impact of temporary closures, impact of expansion, and accounting for ramp-up timing of growth initiatives).

Sources of debt funding

Senior direct lending

This is the most typical form of financing for mid-market businesses. These loans have a senior position in the capital structure and are subsequently prioritised for repayment in the event of default or insolvency. Senior direct lending offers businesses access to relatively low-cost capital, making it an attractive option for established companies with strong credit profiles.

Mezzanine financing

Blends elements of debt and equity, offering companies a flexible funding option for expansion projects, acquisitions, or leveraged buyouts. It typically comes with higher interest rates and may include equity conversion rights in case of default or at predefined times. This subordinated debt sits between senior debt and equity in terms of risk and priority of repayment in an administration, making it more expensive than senior debt but less dilutive than equity.

Distressed debt

Comes into play when a company is facing difficulties in meeting their debt obligations or required to go through a formal restructuring process. Debt in these situations allows businesses to improve their prospects through operational turnarounds and balance sheet restructuring. This may also involve incumbent lenders willing to trade debts at a discount depending on their security position with the borrower.

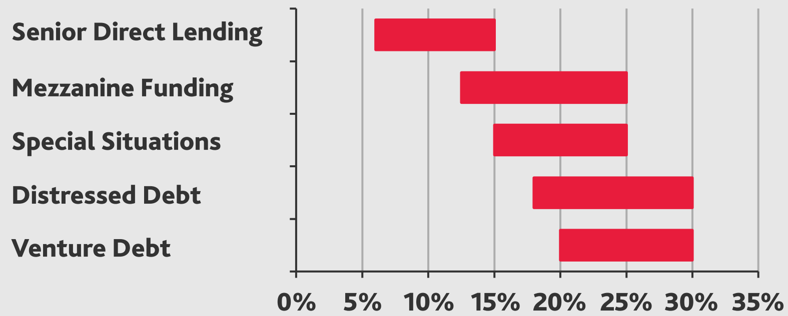
Special situations debt

Relates to investment opportunities arising from unique or extraordinary circumstances that create potential for high returns, often accompanied by high risk. These are often time-sensitive opportunities requiring fast and flexible capital to support corporate restructurings, mergers and acquisitions, or other events that significantly impact a company's financial standing or market position.

Venture debt

Is a type of debt financing provided to early-stage, high-growth companies. It is typically used by startups that have already received equity investment from venture capital (VC) firms but need additional capital to fund their growth without diluting their equity further. Venture debt is often used as a complement to equity financing and can help extend the cash runway between equity funding rounds.

Indicative Target Returns (%)



The above indicative interest rates are indicative only and may vary significantly depending on specific attributes of the borrower (i.e. capital structure, collateral available and industry).

Uses of debt funding

Companies utilise debt for a myriad of different reasons including new locations, entering new markets, or increasing production capacity. By leveraging debt, businesses can accelerate growth without awaiting accumulated profits. Here are some typical uses of debt financing:

01 Growth opportunities

Private credit can offer more flexible and tailored financing solutions compared to traditional financiers, enabling rapid scaling and investment in new markets. Flexibility can be provided through additional leverage or a back-ended amortisation profile to ensure it is tailored to the growth profile of the borrower or opportunity at hand.

02 Working capital

Debt can be used to finance daily operations by securing funds against receivables, inventory, and trade credit, ensuring the business has sufficient liquidity. This helps maintain smooth operations and meet short-term financial obligations.

03 Mergers and Acquisitions (M&A)

Debt can be utilised to finance mergers and acquisitions, enabling businesses to acquire other companies, assets, or intellectual property that can drive growth, increase market share and achieve strategic synergies.

04 Capital Expenditure ("Capex")

Borrowing can support significant capital expenditures such as purchasing new equipment, upgrading facilities, or expanding infrastructure. This investment can drive long-term growth and operational efficiency.

05 Diversifying product or sales expansion

Debt can fund initiatives to diversify product lines or expand sales channels, mitigating risk by spreading revenue sources. This strategic investment can enhance market reach and competitiveness.

06 Managing cyclical business needs

For businesses affected by seasonal or cyclical variations, private credit provides a financial cushion to manage fluctuations in revenue and ensure stability during lean trading periods.

07 Research and development

Debt financing can support research and development efforts, allowing businesses to innovate and stay ahead of competitors through investment in new products, improved processes, and long-term growth.

Typical uses of debt raising

Growth opportunities

Working capital management

Acquisitions and Mergers (including MBO)

Capital Expenditure Program

Diversifying product or sales expansion

Research & Development

Managing cyclical business needs (manage seasonal fluctuations)

How can we help?

The large number of alternative capital providers in private credit can make it difficult for businesses raising capital to navigate without a trusted advisor. BDO offers comprehensive Debt Advisory services, and an experienced team with a deep understanding of the private credit market and extensive relationships across Australia and New Zealand, particularly in the mid-market.

These long-standing lender relationships ensure we partner our clients with the best lender to suit their needs from a strategic partnership perspective, supported by a proven track record in the respective industry and the relevant experience to deliver through to completion.

Preparation for finance

Assisting borrowers prepare for finance is the key to a successful debt procurement process. We assist borrowers in assessing their business to understand the key risks from a lenders perspective and ensure they are mitigated prior to approaching the market. If required, we can also assist in preparation of three-way forecast modelling (a key requirement in raising debt).

Debt advisory

Refinancing or obtaining new debt in the current environment can be challenging, as financiers seek to reduce risk and improve margins. Through BDO's strong relationships with major banks, alternate and non-bank lenders, credit funds and private equity, we assist clients to source the right finance option for their current circumstances.

Growth capital

Growth capital is essential for businesses looking to expand, innovate, or enter new markets. Our team provides strategic advice and tailored financing solutions to help you achieve your growth objectives. Whether you need funding for product development, market expansion, or scaling operations, we ensure that you have access to the capital required to take your business to the next level.

Special situations & distressed debt

Borrowers facing underperformance or distress may result in covenant breaches with their existing financiers, insufficient working capital or failure to meet financial obligations. We assist clients in developing complex debt solutions, stakeholder management and negotiations in distressed or special situations, refinancing of existing lenders and advice on strategic financial restructuring options.

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