

ANATOMY
OF A DEAL

Anatomy of a Deal: Entrepreneurial

BY JOSEPH HEIM

Joseph Heim of Culain Capital illustrates a recent deal and how being creative is critical to victory.



Breathless tales of the fearsome warrior Cú Chulainn have been told for centuries. His legendary exploits share similarities with Achilles and Hercules, and even with more modern-day heroes like Iron Man and the Hulk. Known as the “Hound of Culann” in Irish mythology, Cú Chulainn remains Ireland’s best-known folk hero for his unstoppable rage, inhuman strength, iron will and ability of taking on many foes at once. It is from Cú Chulainn that Culain Capital draws our namesake and provides our colleagues with the inspiration and veracity to design and structure specialty finance deals for small and mid-sized businesses nationwide.

The team at Culain Capital promotes factoring as a funding philosophy where the amount of the advance is primarily based on the value of the company’s collateral as opposed to traditional financing that is primarily based on the company and its credit worthiness. In contrast, in a conventional commercial loan, the lender focuses its credit analysis on an assessment of the financial condition of the company – meaning its ability to generate strong cash flow and the strength of the balance sheet.

In factoring, the focus shifts from assessing the borrower’s overall cash flow to assessing the collateral value of the accounts receivable. In factoring, the key credit decisions are effectively based on an evaluation of the collateral. It is not primarily based on traditional cash flow and balance sheet ratios. Not to say that the condition of the company is irrelevant in a factoring relationship, rather the traditional assessment of the financial statements take a back seat in importance to an assessment of the collateral. To a factor, the likelihood of borrower failure is less important than the liquidation value of the collateral.

Factoring is a robust solution for companies that are a start-up, experiencing rapid growth or in distress. Factoring provides short-term funding and benefits a company’s working capital cycle by providing improved cash flow when the company can immediately receive an advance while allowing the account debtor the normal terms of sale. Cash flow increases and allows the company to take advantage of supplier discounts, increase inventory and meet seasonal funding requirements. In addition, the company can experience an increase in sales when the factor extends credit, provides funding and assume the credit risk. This allows the company to provide more services or sell more merchandise to customers than they would otherwise. The company might extend longer terms of sales to customers, enabling them to generate new business or do more business with existing customers.

Like warriors evaluating their options on the battlefield, the professionals involved in a secured finance transaction understand that the anatomy of a finance deal is complicated and challenging because of the many fundamentals to be considered. These fundamentals include the preferred financing means, accounting policies, strength of account debtors, control of cash, daily monitoring, and consistent communication. A proper deal structure will lead to a productive relationship and the successful funding of critical working capital. To illustrate how members of Culain Capital evaluate

these fundamentals, let’s examine the anatomy of a recently closed accounts receivable factoring facility.

The battlefield is a scene of constant chaos. The winner will be the one who controls that chaos, both his own and the enemies. - Napoleon Bonaparte

Culain Capital recently closed a \$3 million accounts receivable factoring facility and a \$1.5 million term loan for a United States-based manufacturer (the “Company” or “Client”) founded in 1948. The Company manufactures custom alloy and stainless-steel bars, precision machined parts, valve components and specialty fasteners for the aerospace, power generation, turbine manufacturing, internal bolting, oil and gas, transportation, marine propulsion, pump and valve manufacturing industries.

The Company’s core products are specialty pins, which are ultimately bought by the Department of Defense (“DoD”) for applications in the tracks of tanks, armored vehicles, and other continuous track vehicles. The DoD procures these pins through a small number of Tier 1 suppliers to which the Company is one of very few suppliers. This leads to a high customer and product concentration. However, the Company maintains long-term relationships with its key customers and has been producing track pins and other core products for many years.

After more than a quarter of century of successful operations, the Company was acquired by a Fortune 500 American manufacturer (“Parent”) and continued to operate, albeit not a core business line of the Parent. In 2022, an ownership group whose members have various experiences in the industry was formed to acquire the Company from the Parent. Like many of the acquisitions financed by members of the Culain Capital team, a critical element of the acquisition was that members of the ownership group previously held key management positions at the Company and led the operations prior to the sale to Parent. During this time, management navigated the Company through several ownership changes and commanded the Company to achieve higher levels of sales and profitability than have since been achieved under the Parent’s ownership period. As a result, the ownership team believed they had a unique opportunity to acquire an asset that is well known to them and that they can restore operations to the levels previously experienced. Equally important, the Parent has confidence in new ownership group as an operator given their experience and views them as the “right buyer” for the Company.

Rules of Engagement Defined

The transaction was structured so that financing was used to support the acquisition of 100% of the stock of the Company. The Parent established a purchase price based on the enterprise value of



■ **JOE HEIM**
Culain Capital

\$9.25MM for the Company. The Parent would finance \$6.25MM of the purchase price via a Seller Note and Culain Capital would provide financing for the balance of the \$3.0MM cash due at closing. Culain Capital sources of funding consisted of a \$3 million factoring facility secured by a first position in accounts receivable with advances limited to 85% of eligible receivables and a \$1.5 million term loan based on a maximum advance of 50% of the Net Forced Liquidation Value of machinery and equipment.

When a team takes ownership of its problems, the problem gets solved. It is true on the battlefield, it is true in business, and it is true in life. – Jocko Willink

As is common in acquisition financing, the prospective owners were faced with the problem of persuading potential finance partners to provide capital to a business that was experiencing deteriorating financial results including a decline in sales and gross margin, coupled with a heavy allocation of overhead costs from the Parent. All financial indicators pointed out the possibility that the company would not be able to service the existing debt. For these reasons, the deal became non-bankable and would need to rely on the expertise of a specialty finance company.

In December 2022, Culain Capital president, Jamie Franz, traveled to the company's headquarters to meet with the prospective owners and determine the preliminary sources and uses of capital needed to finance the acquisition. "Meeting the stakeholders face to face, understanding their goals and objectives, touring the facility, and seeing the production lines was an important step in evaluating the risks and the mitigants of the proposed transaction," said Franz. "I discussed with management how the demand for critical parts for tanks and armored vehicles is driven by the need for modernization as well as ongoing geopolitical tensions and conflicts worldwide." The need for more advanced tanks and armored vehicles with superior capabilities like enhanced mobility, firepower and protection may rise as conflicts escalate. Since the start of the current Russia-Ukraine conflict, hundreds of Ukrainian army tanks and armored fighting vehicles have been either destroyed, damaged or captured by Russian forces. In this situation, both NATO countries and Ukraine will have increased needs the longer the conflict continues.

A term sheet was signed on December 28, 2022, and the transaction subsequently closed and funded within five weeks on January 31, 2023. In between those dates, the Culain Capital team

and their advisors outlined a timeline to perform their respective due diligence to design and execute an efficient and effective closing.

The most important 6 inches on the battlefield is between your ears. – Jim Mattis

The troops received their marching orders and commenced the field examination and the machinery and equipment appraisal. The internal field examiner provided assessments of the credit quality of the account debtors, identified concentrations, and calculated the historical accounts receivable activity. All these elements were critical in defining the advance rate and eligible receivable criteria. Equally important was the appraisal of the machinery and equipment supporting the advances on the term loan.

Armed with the information, the underwriting team presented the deal to the credit committee and upon approval marshalled outside counsel to

draft the factoring agreement and related legal documentation. Simultaneously, the operations team parachuted into the battlefield to perform invoice verifications, fire out Notices of Assignment to all account debtors and direct payment of invoices to Culain's lockbox.

Know thy self, know thy enemy. A thousand battles, a thousand victories. - Sun Tzu

From an early age, Cú Chulainn trained in Ireland and Scotland to become the deadliest warrior of his era. His skill was unmatched, and he was more than capable of taking on many foes at once. In that same spirit, the Culain Capital team brings the education, experience, tenacity, speed and creativity to design a working capital solution that results in victory on the battlefield! 🏆

Joe Heim is the chief credit officer of Culain Capital responsible for the firm's credit analysis, risk and secured financing and oversees the underwriting and servicing of factoring facilities and other related transactions. He is a Certified Public Accountant and Certified Fraud Examiner. In 2022, he co-founded Culain Capital to provide working capital facilities ranging from \$250,000 to \$5 million to businesses nationwide.



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