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Elements of Corporate Risk (Fifth of a Series)

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Being in an industry prone to litigation is one of the trickiest corporate risks to manage.

For one thing, lawsuits and class action claims aren't under a borrower's control. For another, judges and juries can be fickle. In dealing with a similar issue, they might hammer one defendant with major damages while letting another off with a slap on the wrist. Finally, for smaller companies, large financial penalties can be devastating.

Given this uncertainty, underwriting for legal risk requires careful due diligence. Lenders (and their private equity partners) use third party consultants to identify outstanding litigation. They also need a clear awareness when a given sector, for example, high-tech or pharma, may be subject to patent or copyright infringements.

Should you lend to a company if a major patent, license, or contract will expire during the tenor of your loan? In the case of a maturing key patent, the borrower may have other patents that ostensibly protect against copy-cat products. But defending against deeper-pocketed competitors is both expensive and time-consuming.

We often see leveraged buyouts in which the business benefits from a significant long-term customer contract. But just as often it seems that contract is up for renewal precisely when the company is to change hands. The buying sponsor typically makes the successful renewal of that contract a condition to close. But if the expiry date is months away, the buyer may have to rely on the relationship. And hope for the best.

Geographic concentration – Not all middle market companies have national scope. But being confined to a narrow geography – one state or one city – involves major risk.

Some years ago we financed a home health provider with a handful of centers in one Midwest state. But the company had been around for a decade, and was a leading regional player with barriers to entry. The company has now been successfully owned by three top-tier private equity sponsors and has 28 locations in seven states.

In another case, we turned down a physician practice management business that was restricted to one Southwest urban area. Economically that city was dependent on a highly cyclical industry. A downturn would negatively impact all service companies there. While the sponsor had plans to expand in adjacent states, we decided to wait until its geographic diversification program was more developed before jumping in.

Second ways out – It's one of the first things you learn in credit training: make sure there's more than one way out of your loan. For many direct lenders who rely on cash flows for debt repayment, the second way out is either the sale of the company or a refinance of the debt. The first option requires confidence that the enterprise value is sufficient to cover your debt with a cushion, and that there will be interested buyers.

Can your debt be refinanced? Experienced lenders analyze whether in a distressed situation the borrower will still be able to attract alternative capital sources.

Next week we wrap up our series with a look at lenders who go up the risk spectrum