THE LEAD
https://theleadpc.com/lead-left-interview-stephen-lewis-part-2/

Lead Left Interview – Stephen Lewis (Part 2)

THE LEAD | April 19, 2016

This week we continue our conversation with Stephen Lewis, Managing Director, Headwaters MB. Headwaters is a middle market focused investment bank. Steve's focus is cross border debt capital markets. ***Second of two parts – View part one***

The Lead Left: *You mentioned there are still quirks in the European legal system.*

Stephen Lewis: There's still no central registry for SEC filings in Germany. You can record your security interest, but it's not searchable. You can't find out who or what's in front of you. The whole idea of "security" is different. "Factoring" receivables is a commonplace practice and not just for the apparel and white and brown goods industries. However, the ability to finance against the inventory in many European countries is problematic. There's no registry for "movables." It's the difference between being a "Roman code" country versus being a "civil code" country.

TLL: *Steve, talk to us about some of the problems your clients are facing.*

SL: We worked with a UK international payroll company with a cutting edge platform driven by an innovative team. The problem: a year-over-year flat EBITDA trajectory. We helped by showing investors a true Quality of Earnings report. It highlighted every dollar of earnings was reinvested in R&D and system improvements. The Q of E was instrumental in demonstrating the true earnings power of the business, and allowed us to raise sufficient junior capital, both debt and equity, to achieve their growth objectives.

TLL: *How about helping to solve structural or legal issues?*

SL: In many European jurisdictions it is commonplace and in accordance with accepted business custom and practice to allow companies to legally maintain multiple sets of books – one for taxes and one for GAAP. Our job is to help rationalize different sets of accounts to allow lenders to understand the real earning of a business in order to get to the right capital structure. We spent a ton of time getting to the right numbers.

TLL: *This is always a problem with smaller companies owned by one entrepreneur.*

SL: The owner spends a lot of time trying to minimize tax bills, but investors balk at the lack of transparency. Entrepreneurs are beginning to realize the negative impact on investors the lack of transparency has but there is still a way to go.

TLL: *Do you think we're headed to a less unified Europe for the purposes of secured lenders? Particularly in the face of a possible Brexit.*

SL: It's short-sighted for Britain to exit. So much business has established bases in the UK thanks to its easy access to Europe. They enjoy the benefits afforded all EU members when it comes to free trade, abolishment of tariffs, and unfettered passage country to country. Goldman Sachs estimates that $8.9 billion of its global revenue is generated through London with the EMEA nations, and is therefore at risk if Brexit happens.

TLL: *Any other case studies you'd like to tell us about?*

SL: We worked with a PE firm on the financing of an acquisition of a US based platform business with operating subsidiaries in UK, Italy and Germany. All of the businesses manufactured similar high tech products but sold to very different end markets. The European businesses had been acquired over time never fully integrated. During their due diligence the sponsor learned that the German and Italian managing directors considered themselves competitors and worked to undermine one another. These were the same people who managed the major customer relationships for their respective companies!

With the assistance of our colleagues in Italy and Germany, we advised the sponsor to create new positions for both men at a new UK European head office. That removed them from day to day operations, and gave them significant financial incentives related to customer retention. Finally, in exchange for their new contracts containing non-competes they were required to make full and open disclosure about their past dealings or face the possibility of termination for cause. Ultimately, terms were agreed and our solution worked.

TLL: *Finally, Steve, what's been the biggest surprise you've had since our last conversation?*

SL: Thanks to regulation on both sides of the Atlantic, the rules have dramatically changed. This phenomenon means that the days of benign regulation in the banking sector are over. Also the recent interest in cross border opportunities by middle market companies. Since the Great Recession companies have slowly come out of hiding and are looking for growth abroad. Non-US based middle market companies are seeing the instability in their own countries and welcome the stability and size of US market participants. There's also far less of a cultural gap between the US and most Western cultures, compared to China, for example.

Finally, the very rapid growth of the "alternative lender" class. The banking world has been consolidating for a long time, but banks now are selling leveraged portfolios or business units. Or entire lending teams are leaving to set up shop under the umbrella of an unregulated entity to provide leveraged loans to their PE and corporate clients. The prime example is the sale of GE Capital. That's already spawned a number of new market players on both sides of the Atlantic. Not to mention the large number of hedge funds, PE houses and family offices setting up lending platforms in US and in Europe to take advantage of the dislocation in the middle market lending space resulting from the pullback by the traditional banks.

Contact: Stephen Lewis
slewis@headwatersmb.com