

**OFFICE OF THE CITY MANAGER
DES MOINES, IOWA**

**CITY COUNCIL COMMUNICATION 97-478
SEPTEMBER 22, 1997 AGENDA**

| SUBJECT: | TYPE: | SUBMITTED BY: |
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| DIAMOND ANIMAL HEALTH— SUBORDINATION AGREEMENT WITH NORWEST BUSINESS CREDIT, INC. | ◆ RESOLUTION ORDINANCE RECEIVE/FILE | JAMES GRANT COMMUNITY DEVELOPMENT DIRECTOR |

SYNOPSIS —

In February, 1994, the City Council approved a \$200,000 loan for Diamond Animal Health, 2538 SE 43rd Street. There were a number of additional lenders involved in the financing package, and the various lenders secured their loans with liens on business assets. The company will be financing up to \$1,250,000 of inventory and accounts receivable through a loan from Norwest Business Credit, Inc. The company requests the City subordinate our lien on inventory and accounts receivable. The other lenders in the Inter-Creditor Agreement will also subordinate. Our lien position on other assets is not affected by this request.

While the company's proposed expansion project will increase working capital requirements, this working capital financing is to meet on-going business needs, irrespective of the timing of the proposed expansion project.

The company has performed under the terms of the loan agreement. It has made its loan payments as agreed and is current on the outstanding City loan. In addition, it pledged to increase the plant workforce from 85 to at least 108 people, and present employment is approximately 130 employees.

FISCAL IMPACT —

No additional funding is requested. The City's security on other business assets is not affected. In addition to our lien on business assets, the City loan is also secured by a guarantee from Heska Corporation. Diamond Animal Health is a wholly-owned subsidiary of Heska Corporation.

RECOMMENDATION —

Authorize execution of the subordination agreement.

BACKGROUND —

Diamond Animal Health was created in December, 1993, when the management team of Diamond Scientific, a wholly-owned subsidiary of Miles, Inc. (now Bayer Animal Health), acquired the company from Miles in a management buy-out financed by \$250,000 of equity investments from members of the management team; \$2,350,000 of senior mortgage notes; \$1,500,000 of subordinated notes; and \$450,000 of State and municipal grants and low interest loans. In the buy-out, management negotiated a three-year contract to manufacture Miles' cattle and pig vaccines; acquired ownership to the cattle vaccine line; and acquired or leased all physical assets of the business, including both a USDA and FDA licensed manufacturing facility and a 180-acre research farm.

Since the buy-out, Diamond's management has followed a three-stage strategy:

1. Reorganize manufacturing operations, to improve profitability;
2. Expand the contract manufacturing business to achieve a stable revenue and profit base; and
3. Differentiate the proprietary bovine biological product line to provide future growth and value.

For the first three years since the buy-out, Diamond has operated principally as a contract manufacturing operation. As part of the buy-out, Diamond negotiated a three-year "take or pay" contract to manufacture all of Miles (now Bayer) Animal Health's cattle and pig vaccines, initially representing 90 percent of Diamond's business. Since then, the Bayer contract has been renegotiated and extended by two and one-half years, through June, 1999. Additionally, new customers have been added, increasing Diamond's sales to customers other than Bayer from 10 percent of revenues to 40 percent. Goals for this business include further increasing the customer base to reduce dependence on a single customer, stabilization of revenues at or above \$12,000,000 with steady future growth, and long-term reliance on this and the Heska contract business as a firm base of support for corporate growth.

As the company grows, its need for working capital grows with it. The City and other lenders are occasionally asked to partially release or subordinate lien positions to facilitate growth. The other Inter-Creditor Agreement lenders (such as the State of Iowa, IASD Health Services Corporation, and Iowa Capital Corporation) will also provide the necessary subordinations. In addition to our lien on business assets, the City loan is also secured by guarantee from Heska Corporation.