



## WHITE PAPER: 10 STRATEGIES TO RAISE CAPITAL EFFECTIVELY

*Abstract:* Given their job title, private company CFOs are often expected to be able to raise capital for their company, yet many feel unprepared or under qualified. This white paper addresses the steps necessary to effectively manage the capital raising process. By utilizing these guidelines, CFOs from all levels of experience can become decisive leaders that serve the best interests of their company and its owners while potentially creating more wealth for themselves and their management team.

### CHALLENGES OF A PRIVATE COMPANY CFO

Unlike public company CFOs who have to communicate and answer to the capital markets, the role of a private company CFO is almost entirely focused internally on budgeting, cash management and financial reporting. So when the company CEO or business owner asks the CFO to look at raising capital to fund growth, acquisitions or shareholder buyout, many feel unprepared and uneasy. Faced with a variety of options, little experience with the capital markets and a desire to protect the best interests of the owners, CFOs can become defensive and overwhelmed by the prospect of dealing with investment bankers, specialty lenders and professional investors.

### CFO'S OBJECTIVE

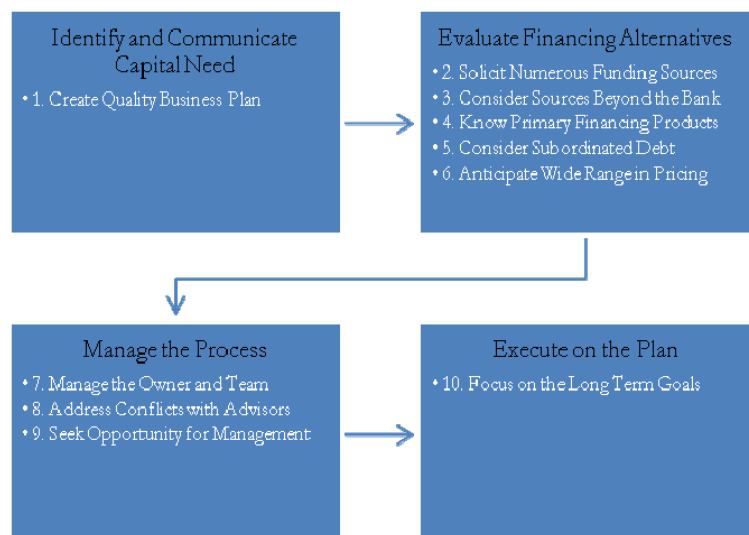
A CFO's objective is to get the best possible financing for their company. What does 'best possible' mean? It usually means the financing proposal the owners like the best. However, business owners are usually moving targets, because they don't know what they want. Once they are presented with some alternatives, they usually begin to pick and choose different financing terms from the various proposals, like an a la carte menu. The goal then for the CFO is to help the owner see a variety terms and proposals. The wider the range of proposals and pricing, the greater the value created for the owners and the greater the negotiating advantage for the company.

The strategies outlined below, many of which are routinely implemented by professional investors such as buyout firms and private equity players is intended to help empower the CFO to lead the capital raising efforts (whether done alone or with an outside advisor) in order to best serve the needs of

the company and contribute the greatest value to the business owner (s) and management team.

### STRATEGY 1: CREATE A QUALITY BUSINESS PLAN

In order to get the best possible financial terms, the capital requirements need to be clearly articulated. That is not likely to happen without some detailed projections of income statements, cash flows and balance sheets. Ideally, projections should be done for a 5 year period with the first two to three years projected on a monthly or quarterly basis. Those projections then outline how much capital the company will need both now and in the future. The goal is to get financing that will work for the company over the next five years. The projections should be optimistic yet achievable. It's also important to provide a concise description of the business, growth strategies, history, industry and management team.



# LANTERN

## CAPITAL ADVISORS

Creating a quality business plan is usually the most tedious part of the financing process. But a good plan is important for the following key reasons:

*Writing a good plan will leverage management's time later in the financing process. A CFO's intermediate goal is to create competition for financing. To create competition requires a business plan that sells itself. By providing a comprehensive business plan, conference calls and meetings can be shorter and institutions are able to provide proposals faster because many of their questions are addressed in the business plan. The business plan also becomes important to the banker during the proposal process for communicating internally to the credit committee.*

*Detailed, high quality projections reduce 'discounting' by the investor. Financial institutions determine their pricing (i.e. equity, interest rate, warrants etc) based on the financial projections in the business plan. If the business plan has limited information, or erratic numbers, the financial investors will discount those projections, meaning they will reduce the forecasted numbers and then set their pricing. The more detail provided, the greater the credibility – the less discounting takes place.*

*Quality projections enable financial institutions to create financing structures, customized specifically for the company. Financial institutions will look at detailed projections and identify solutions that will help the company in light of expected increases in demand, seasonality, owner distributions or any other situation specific to that company. For instance, many companies qualify for 'accordian features' which means the institution agrees to automatically increase the financing facility assuming the company is performing. Another example is an 'overadvance' feature, where the financing amount is expanded beyond the collateral or normal borrowing capacity in order to provide financing during seasonal periods or to meet future needs. These special features lower the need for additional equity capital, thus greatly reducing the overall cost of capital. These features can be very useful and cost effective for companies but can only be made available if the information is supplied.*

A high quality plan is typically 40-60 pages in length with a concise well written explanation of the business with historical financials and detailed projections including income statements, balance sheets and cash flows.

### **STRATEGY 2: PLAY THE NUMBERS: SOLICIT NUMEROUS FUNDING SOURCES**

Bankers do not like to compete but competition can dramatically reduce the overall cost of capital (see Table 2). Traditional banks tout the value of relationships yet relationships rarely drive pricing or creativity as much as competition. Professional

investors such as buyout firms and equity players know the importance of competition. It is not uncommon for a private equity firm to solicit as many as 50 institutions to find financing partners that will give them the best terms. In fact, some private equity firms are so open about the competitive nature of the financing, that they will invite multiple banks to visit the company at the same time which is a true 'bake-off' mentality.

In addition to getting a wider variety of structures and terms, seeking numerous funding sources has other benefits:

*Talking to multiple groups gives the company a back-up plan. When companies begin due diligence and underwriting issues can arise which cause either the company or the financial institutions to reconsider the proposed financing. By having other interested institutions the company has other alternatives (or the threat of other alternatives) should a problem not be addressed satisfactorily. When private equity firms are lining up financing they will often sign up two institutions to do due diligence at the same time just in case something happens at the last minute.*

*Competition creates confidence in the business plan and management team. Having numerous institutions interested to finance the company, helps the owner and management team gain added confidence in themselves and their business plan.*

*The company learns something new and valuable. Many times companies learn something new and valuable from meeting with different institutions. For example, we had a client that learned of a special election available to S-corporations doing buyouts. That election generated \$1 million a year in tax savings, which the company was able to use to pay down debt faster. The company utilized that good idea but chose a different institution.*

*Competition makes your current lender compete harder to retain your business. At the end of the day, it is not uncommon for a company's existing bank to end up doing the proposed financing. Routinely, those banks will sit and wait until the company has legitimate offers from other institutions then propose something similar in order to retain the business. It is very rare that an existing lender gives a company aggressive financing terms without some competition to challenge that relationship.*

TABLE 1: OVERVIEW OF PRIMARY FINANCING ALTERNATIVES

Financial Product	Annual Cost (Prime %= 6%)	Secured by	Sources
Line of Credit	6.25% - 8.25% (Prime +1-3%)	Accounts Receivable Inventory	Bank or Finance Company
Senior Term Debt	7% to 9% (Prime + 1-3%)	Fixed Assets	Bank or Commercial Finance Company
Subordinated Debt	15%-25% (may include warrants)	Second Lien on Company Assets	Investment, Pension, Insurance and Hedge Funds
Equity	30%-40% Target Annual Return	Not secured (Common or Preferred Stock)	Management, Owners Outside Investors, Sellers

**STRATEGY 3: CONSIDER FINANCING SOURCES BEYOND THE BANK**

Most CFOs have contacts at local, regional or national banks, but this segment is a small part of the broader capital markets. Beyond the banks there are pension funds, specialty lenders, BDOs and other financial institutions that provide capital. These groups can offer very innovative rates and structures. Often these structures have appealing aspects such as fewer covenants and limited or no personal guarantees from the owners (a big selling point to owners of small private companies).

Given the uniqueness and possible benefits, it's important to include these institutions in the search for capital. On several occasions we have seen companies receive innovative proposals from such institutions only to have a traditional bank or the company's current lender step up and match it (at lower rates). These banks have acknowledged they would not have proposed such terms without the competing offers.

**STRATEGY 4: KNOW THE PRIMARY FINANCING PRODUCTS**

With so many potential funding sources and alternative strategies, CFOs can become overwhelmed by the different financing products. In order to maintain a clear head, realize that most financing products and structures are based on the following four primary financial products identified in Table 1.

Financial institutions, particularly specialty finance companies, will often combine these products to make them appealing to established businesses. As an example there has been a significant increase in "unitranche" or revolving credit facilities where

traditional senior term and subordinated debt products are combined into a single product. The appeal is capital is provided in a single debt instrument typically at a interest rate that is a few percentage points above traditional term debt but significantly less expensive than subordinated debt. In reality that instrument may cost about the same on a weighted average cost basis as combining a senior and subordinated debt products. The terms from the single product need to be compared against comparable financing from two different products. Realizing that financing is based on these four primary products makes that process less daunting.

**STRATEGY 5: CONSIDER SUBORDINATED DEBT AS AN ALTERNATIVE TO EQUITY**

Most CFOs are familiar with the first two products in Table 1. Probably the most exotic of the instruments is subordinated debt. While not a household name, subordinated debt has been around for over 25 years. Entrepreneurs often shy away from these types of instruments because of the high interest rates and increased complexity.

The pros, however, use these financial instruments extensively to finance buyouts, growth or acquisitions. These products are popular with buyout firms because they significantly reduce the amount of equity the buyout firm has to put up in order to buy a company. By buying companies on a predominately debt basis, buyout firms are able to make spectacular returns on their equity. Companies have the same opportunity.

Subordinated debt providers seek a target annual return of around 20%. Most financings are structured as 5 to 7 year term loans with interest only payments for the first 3 to 5 years. Firms typically charge 12-14% interest and then make up the difference with added compensation through detachable warrants. Detachable warrants give the lender the right to acquire a certain percentage of the company’s stock either after the maturity of the note or upon a liquidity event such as a sale of the company or initial public offering. In practice, most warrants are repaid through a ‘put’ option where the lender proactively requests (or “puts”) to be paid out based on their percentage of warrants and the value of the company at the time of the put. Companies can be valued any number of ways, but most are valued based on a multiple of cash flow (often 5 or 6 times) at the time the put is exercised.

The intent of this instrument is to provide a flexible source of financing that is less dilutive to a company’s current shareholders than equity. The loan, while expensive relative to other forms of debt, is expected to be paid off with future cash flows or a refinancing with cheaper sources of capital, such as lines of credit and senior term debt, as the company grows larger.

For a company, the main benefit is it allows the business to borrow substantially more than they can get from a bank without diluting the existing owners (assuming the warrants are paid off – which most are). In addition, *subordinated debt typically has no personal guarantees* making it less risky to the owner than traditional bank debt.

**STRATEGY 6: ANTICIPATE A WIDE RANGE OF PRICING**

The main reason for all this effort is because the differences in the cost of capital and financing terms can be dramatic particularly when institutions bid in a competitive situation. Table 2 (below) shows how pricing and terms can vary.

As Table 2 suggests, the decision to choose one institution over the other is not solely dependent on the cost (i.e. interest rate). In the case of Example #1, the CFO would need to help the entrepreneur figure out the incremental growth potential of utilizing the additional \$10 million offered by a commercial finance versus the \$20 million credit facility offered by a regional bank. Equally important the CFO would need to discuss with the owners the importance of limiting the owner’s risk with the no personal guarantee covenant. The discussion should also include an analysis of the different costs of capital including any added costs for increased asset monitoring or compliance (i.e. weekly collateral reporting, audits, etc).

While it is true that pricing can vary substantially between the same types of institutions, the structure and covenants differences can be more significant. By shopping all available types and sources of capital, the CFO and entrepreneur are armed with the information necessary to make the best possible decision.

**TABLE 2: COST AND TERMS COMPARISON SENIOR DEBT, SUBORDINATED DEBT AND EQUITY**

Example	Financing Type	Offer	Offer
1	Senior Debt	\$20 Million 7.5% (Prime + 1.5%) Full Personal Guarantee	\$30 Million 9.5% (Prime + 3.5%) No Personal Guarantee
2	Subordinated Debt	\$12 Million 13% Interest Rate 15% Warrants	\$12 Million 13% Interest Rate 35% Warrants
3	Subordinated Debt	\$19 Million 12% Interest 5% Warrants	\$19 Million 13% Interest 15% Warrants
4	Equity	\$22 Million 51% Ownership	\$22 million All Debt (No Warrants)

Ideally, the goal is to source not just the least expensive financing (as many do) but the financing alternative that offers the best opportunity to create the greatest value with the least risk.

#### *Why Competition Improves Pricing*

While some companies may get great financing from the outset, competition consistently creates better pricing for the following reasons:

*Some institutions may be more positive than others about the growth prospects of the company.* This can translate into different opinions about risk or management's ability to hit its projections. Institutions normally reduce or discount projections provided by management in order to ensure they make their targeted return even if the numbers are not met. Logically, firms with more optimistic outlooks will discount projections less.

*Competition helps bankers internally push their own institutional credit committee to give the company better terms.* By telling an institution's representative, the company already has competing proposals, that representative has ammunition to ask the credit committee for better terms or lose that opportunity. On a recent buyout transaction one institution reissued their proposal and reduced their equity participation from 35% to 15% (see Example 3 in Table 2) after learning they were not in the running for selection. The larger and more complicated the financing, the greater the ranges and more value created from the shopping process.

#### **STRATEGY 7: MANAGE THE BUSINESS OWNER AND MANAGEMENT TEAM**

One of the hardest aspects of effectively raising capital is managing the business owner. Business owners often don't know what they really want until they see some different financing alternatives. They also can be initially turned off because terms may be more expensive than a traditional bank. As the CFO it becomes important to manage and educate the owner through the process. Several key steps include:

*Set the expectation that closing on financing can take six months.* Finding financing under duress can be done quickly. However, proactively shopping the market and seeking the best deal and closing on the financing while also running a company, always seems to take more time than expected. Encourage the owner to be thinking six months out. If it's completed sooner, the owner's expectations are exceeded. Conversely, if financing is needed in four months, it's time to start looking!

*Have the owner involved but be careful of fatigue.* Owners can become frustrated and scrap things quickly. Some strategies for keeping them involved but not overburdened is to have them review the business plan (but not write it), set up meetings and share the load for presenting the company story and cluster

meetings and calls within a day or two rather than dragging it out over weeks. By making effective use of their time, the owner is more likely to stay engaged and excited throughout the process.

*Encourage the owner to keep an open mind.* Owners can get discouraged if a meeting doesn't go well but personality fits and financing terms can swing widely from meeting to meeting. Encourage the owner to keep an open mind. The best attitude for any company seeking financing is to project an open (but not desperate) mind and willingness to consider different approaches.

*Help the owner understand the risk and returns of different proposals.* Many proposals, particularly from specialty lenders have higher costs and rates but may offer less personal risk (ie. no personal guarantees) and fewer covenants. CFOs can help their owners look objectively at their situation and company.

#### **STRATEGY 8: ADDRESS ANY CONFLICTS WITH ADVISORS**

The benefits of using an advisor or consultant can often far outweigh the costs. However several common conflicts which buyers should be aware of include:

- ◆ Investment bankers and advisors are often paid a *variable* amount based on the amount and type of capital raised. The most common approach to investment banking is for an advisor to be paid more to raise equity than debt (typically twice as much). This compensation structure can encourage advisors to lead clients toward equity rather than debt and needlessly giving away too much ownership because the advisor wanted to maximize his fee.
- ◆ Advisors often take *additional* compensation in the form of stock or warrants. For those that do, the amount of stock or warrant received is based on the valuation of the company at the time of the investment. This means the *lower* the valuation the more stock or warrant is paid to the advisor. This obviously works directly against the owners.

When working with an advisor use common sense and make sure that advisor is willing to help the company seek a variety of financing alternatives and ensure that their compensation is not in conflict with the best interests of the company. A way to address this is to work (as our firm does) on a fixed fee-only basis so that the company can feel confident the advice, timeline and approach is not compromised for a higher fee.

## STRATEGY 9: PROACTIVELY SEEK OWNERSHIP OPPORTUNITIES FOR MANAGEMENT

Management team members and CFOs are often promised ownership in their company when they join but the owner never formalizes it. For companies where the owner has set such an expectation, a major financing event provides the opportunity for management to seek a stake in the business either through options or a small management buy-in. For companies with strong growth prospects, an option plan can be good for the owner because it can motivate management, increase retention while minimizing equity dilution. For a company where the owner may sell the company in the next five years, a partial management buy-in may be attractive. In the case of a buy-in, management invests personal capital that is combined with outside capital to allow management to purchase a small stake in the business (say 5% to 20%). For the owner this can provide some real liquidity and personal financial diversification while locking in management to stay committed to the business.

### *Management Buyout Illustration*

A more dramatic event is when management teams finance a significant buy-in through a leveraged buyout using the same financing vehicles the pros use, but without an equity firm involved.

As an example a recent client team comprised of the CFO and three managers borrowed \$23.5 million of debt financing based solely on the cash flows of their company to purchase 80% of their company's stock from the owner. The transaction created a great opportunity for both management and the owner. By using leverage, management created an opportunity to attain significant personal wealth as the debt was paid down and the business continued to grow. The owner, on the other hand, was able to sell 80% of his business at 6 times cash flow, a price that exceeded an offer two years earlier at 5X cash flow. For the four key players in management this transaction became a life changing event. For the owner it is an opportunity to help key management build wealth while getting significant personal liquidity that is no longer tied to the business. The owner is also able to stay involved and can decide later whether to sell his remaining 20%, retain it personally or move it to a family trust.

## STRATEGY 10: FOCUS ON THE LONG TERM GOALS

Financing can be time consuming and everyone should celebrate when one is complete. However, long term success is driven by ensuring management stays focused on the ultimate goal of trying to hit their five year projections. Unfortunately, companies will often work hard to make a great financing happen only go shelve the business plan and miss their numbers. Often problems with execution can be traced to the following:

*Financial reporting is not timely enough.* Lots of companies do not receive information fast enough to track their financing performance. Closing the books quickly, creating a digital financial dashboard and other real time reporting measures help management understand information quickly and assess the company's performance on a regular basis.

*Daily operations are not integrated with business plan objectives.* Once it appears funding is likely, it's important to take the business plan to another level of detail by translating the financing assumptions and growth strategies into important management objectives for sales people and operating personnel. Many companies that do not succeed have not built that bridge between the daily objectives and the business plan.

*Failing to adapt to change.* Real life always presents unanticipated problems, challenges and opportunities. Assuming managers have the information to assess the current performance of the business, it's important to consider whether changes need to be implemented. Unfortunately, many companies that run into challenges and fail, do so either because they made no adjustments or made too big of change to their direction or core growth strategies. Usually the best course of action is to apply different techniques to the same growth strategies. A relevant example from a fast food chain can illustrate the point. The company launched a new fast food concept with a great menu and fast delivery but sales at the first locations were lagging. Rather than change the menu or the direction of the new chain, management retooled its store opening process and spent more on upfront marketing. As a result of that change in tactic, revenues and sales began to grow rapidly.

### SUMMARY

Despite some inherent challenges for private company CFOs, most are in an ideal position to make a strong positive impact on the success and value of their company. By implementing these **10 STRATEGIES TO RAISE CAPITAL EFFECTIVELY**, CFOs will have the opportunity to grow their skill set and serve the best interests of their company.

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Chris Risey is the founder and President of Lantern Capital Advisors, an Atlanta-based financial consulting firm that specializes in helping successful entrepreneurial companies finance growth, acquisitions and buyouts. Since its formation in 2006, Lantern Capital Advisors has helped clients develop strategies and fund their Company in a way that best suits their unique needs and growth potential.

Prior to founding Lantern Capital Advisors, Mr. Risey served as a Managing Director for niche consulting firm that provided corporate financial consulting and helped companies raise capital from a variety of institutions including banks, specialty and mezzanine lenders, venture capital firms and underwriters. After nine years, Mr. Risey left to launch his own financial consulting firm to provide cost effective services, guaranteed results and high client satisfaction. Chris started his professional career as a CPA in the audit and advisory services group for Arthur Andersen in New Orleans, Louisiana.

Active within the business and civic community, Mr. Risey has served for many years in a variety of leadership roles within Rotary International, Financial Executives International and The Association for Corporate Growth. Mr. Risey is also a frequent writer and speaker to financial executives and entrepreneurs throughout the country interested to learn more about today's financing and planning strategies that have created significant value for a variety of companies.

Mr. Risey is a magna cum laude graduate of the University of South Florida with a degree in Finance. He was twice named Academic All-American (Men's Basketball) and is a former Rotary International Ambassadorial Scholar and studied at the Australian Graduate School of Management at the University of New South Wales in Sydney, Australia.

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MANY CLIENTS HAVE LIMITED PRIOR EXPERIENCE IN THE CAPITAL MARKETS AND WANT TO GAIN THE BENEFIT OF AN EXPERIENCED ADVISOR TO SOURCE FUNDING ALTERNATIVES AND GIVE ADVICE THAT IS IN THEIR BEST INTEREST. LANTERN CAPITAL ADVISORS HOURLY BASED APPROACH UNIQUELY POSITIONS US TO DO JUST THAT. OUR PROFESSIONALS HAVE BEEN ENGAGED IN A BROAD ARRAY OF LARGE AND SMALL ASSIGNMENTS ACROSS VARIOUS INDUSTRIES ACROSS THE UNITED STATES. COMMON CLIENT ENGAGEMENTS AND ACTIVITIES INCLUDE ONE OR MORE OF THE FOLLOWING:

- ✦ EVALUATE GROWTH AND VALUATION ALTERNATIVES
- ✦ SECURE CAPITAL FOR GROWTH OR LIQUIDITY
- ✦ COORDINATE MERGERS/ACQUISITIONS
- ✦ COORDINATE MANAGEMENT BUYOUTS
- ✦ PREPARE QUALITY BUSINESS PLANS
- ✦ REPLACE CURRENT LENDERS OR INVESTORS
- ✦ REMOVE PERSONAL DEBT GUARANTEES
- ✦ SOLICIT UNDERWRITERS FOR SECURITIES OFFERINGS