Finding the Right Capital Match

BY JOHN HAMILTON

You've survived the recession, but now your business needs capital to keep up with demand. Raising those funds will require developing a careful strategy so you'll be properly equipped before approaching a bank or alternative source of financing.

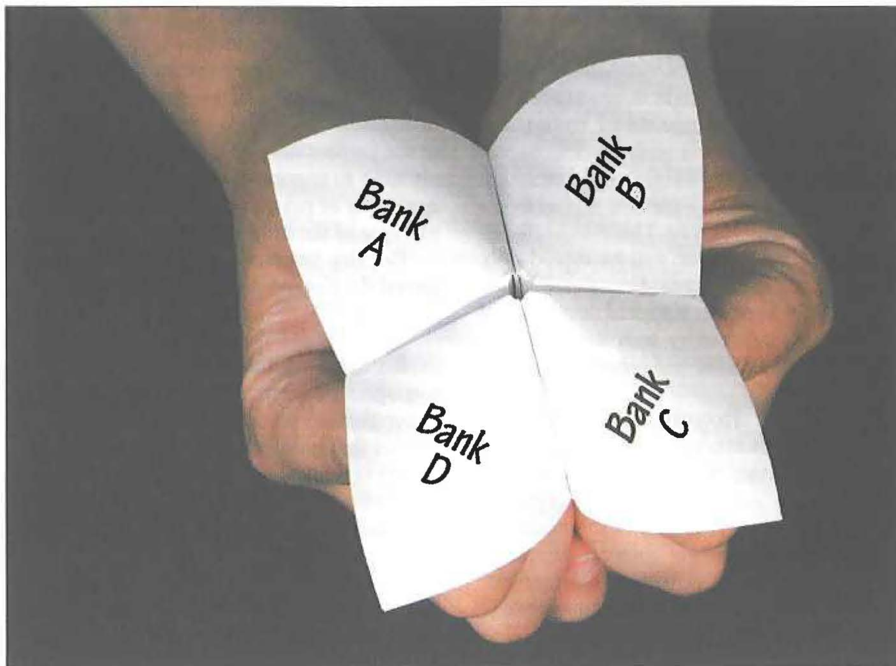
Before starting, ensure that you do the following:

1. Begin with the end in mind. Be clear on what you need the money to accomplish and when. Are you looking to even out the seasonality in your business cycle, or to introduce a new product to the market? Be sure the terms of repayment match the purpose and cash flow. For example, if you are buying equipment with a 10-year life span, you want to repay the loan over seven years. Ideally, the need for financing is supported by a business plan. Also, by focusing on the underlying business goal, you will not be lulled into thinking that raising capital is the goal. That mindset can result in a short-lived victory dance and a mismatch that threatens the business when, down the road, the financing structure doesn't meet your business's true needs.

2. Enlist outside advisors with financial expertise. Unless finance is a particular strength of yours, recognize that you "don't know what you don't know." Tap into retired business people who take pleasure in helping other businesses. The best are those who are committed to your success, but who are not afraid to tell you how they truly feel. Even better, form an advisory board that meets regularly so each advisor gets the benefit of hearing the others' questions and concerns and is better able to support you and hold you accountable.

3. Share bad news as if it were good. As you meet financing sources, don't sugarcoat your answers. Instead, provide expansive answers that include the bad news, just as you would if the news was good. It is better to get down to brass tacks and "problem solve" the tough issues than to try to skirt them or hope they never arise. Being up front builds trust. Even if that financier doesn't invest in your venture, he or she will likely provide a strong referral to another source. Those referrals make you stand out and get you closer to your goal.

4. Turn the tables: Interview the investor. Due diligence ought to be a two-way street, because investors are not all created equal.



The value of a good investor or lender goes well beyond the money. It includes taking time to understand your business, making referrals to new customers and sharing insights that help resolve your business challenges. It is also important to role play with the investor various potential downside scenarios to discover how helpful and patient they will be. No matter how uncomfortable those conversations are, it is far more difficult when the problems are real and you don't have the hypothetical conversations as a guide.

Approaching Banks

Once you are ready to meet with financing sources, the first goal is to try to find a banker you can bank on. Banks are designed to be the source of least-cost debt, so you will want to discover what portion of your capital needs are bankable.

Begin with a "road show" to solicit proposals from a few banks that meet your criteria. Choose whom to visit based on a decision matrix. Consider if the bank is in good economic health by researching its financial condition. One option is TheStreet.com, that offers a consolidated graph using FDIC factors including liquidity and profitability, among others. Do compare ratings—but don't panic—many banks' ratings are depressed in today's market.

Also consider if the bank is in your "sweet spot" in terms of its focus in the commercial market. You should aim for the middle of its loan size and the industries that it knows well, not the edge of its market. You don't want to fall off your bank's radar based on too much, or not enough, growth. Banks that lose interest in serving your market segment tend to be the most inflexible.

Treat the bank as a relationship, not a commodity to be priced. If you are shopping simply because the bank down the street is offering a rate a half-point better, don't! Relationships matter, and your loyalty will count for something when you most need it. Also, don't think that all banks are the same. As an investor, we see great variability in bank terms and levels of support that go beyond the pricing on the loans they offer.

Understand who will make the decisions on loans. Some banks separate the credit analyst from the front-line lender, while others integrate these functions. Some banks make credit decisions at the regional level; others locally. Which is best for your business?

Look at the banker, not just the bank. Qualities to look for in a banker include someone with whom you can make a personal connection, who is a trained professional, who will take the time to understand your business and advocate for you within the bank, and who has credibility with the bank's decision makers. Call a retired banker: They know whom was hardest to steal customers from. Or call an investor: They see a high volume of deals and can suggest how to start your search.

Given the recent hard times, your business may get turned down by banks for all or a portion of its capital needs. If that happens, reflect

on recent conversations and incorporate any "lessons learned." Here is one way to guide your next steps, organized by the investor's risk tolerance and cost of capital, from low to high:

Sub Debt

Business Characteristics: Healthy cash flow, experienced management team and serving established customers. Due diligence focuses on management team and a sensitivity analysis of the projected cash flow.

Reasons Not Bankable: Insufficient collateral, recent losses, sales concentration, business relocation, poor credit or new owner.

Goals: Not a turnaround or restart, but most any other business goal.

Deal Structure: Straight debt, just like a bank, but priced 4 to 7 percent higher to reflect that it is subordinate. This means that in liquidation, the investor will be repaid only after the bank is fully repaid.

Sub Debt Sources: Regional development corporations, community loan funds, Vested for Growth, mezzanine and private investors.

Royalty

Business Characteristics: Gross profit margins of better than 25 percent with a strong management team and growth proposition. This could involve a new acquisition or merger, or an existing company introducing new products or pursuing new markets. Due diligence focus is on the management team and sales pipeline.

Reasons Not Bankable: Same as sub debt, but constitutes a higher risk, requiring returns greater than 11 percent.

Goals: Same as sub debt, plus a desire for long-term, sustainable growth and an openness to having advisors who share ideas as partners, but who do not make decisions. Can be a turnaround or restart.

Deal Structure: A royalty is paid as a percentage of future gross revenues for a negotiated period of time or level of sales. This can be used in conjunction with sub debt to increase the investor's return due to higher risk. Royalty can also be structured without debt so the monthly payment entirely adapts to the performance of the business. You simply have to negotiate when it ends (when the aggregate of payments equals the negotiated multiple of the original investment).

Royalty Sources: Vested for Growth, regional development corporations, angels.

Equity

Business Characteristics: Seasoned management team, gross profit margins of better than 45 percent and a new product or service that is defensible and has a large market opportunity. Due diligence focus is on the management team and the feasibility of the investors getting paid out in an exit event in three to five years.

Reasons Not Bankable: Insufficient cash flow or strategic decision to reinvest revenue rather than to pay investors from cash flow.

Goals: Sale of company is desired in the next three to five years and management is comfortable with having investors as decision-making partners.

Deal Structure: Equity investors own a percentage of the company and realize their return when the company is sold, as a percentage of the net sale proceeds.

Equity Sources: Angels, venture capital, private equity.

Individual sources may differ in how they apply these tools. Also, the capital market is dynamic and ever-shifting. For example, while an investor may never have done equity before, it doesn't mean you can't raise the option of their using royalty financing. Of course, there also may be the option of raising funds from family and friends at more favorable terms. But they too will likely look to these same deal structures for guidance. ■

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