SAPIENT
CAPITAL PARTNERS

Capital for Private Companies – Breaking Down the Universe of Possibilities

Okay, your company needs money—for general growth, to enter a new market or develop a new product, or for an acquisition, to gain some breathing room for operations, to get a frustrated and nasty creditor or investor out of your hair, or perhaps to take a chunk of your net worth off the table to estate plan or just reduce your risk and sleep a bit better at night.

What next?

You are now in the world of balance sheet engineering. (Us finance guys LOVE this stuff, but as we find out at cocktail parties, few others do!)

Let's break it down by major categories of financial capital, which will allow us to make some observations about the nature and key terms of each, and how to go about sourcing each type of capital.

We will start with the most conservative (ie. cheapest) sources of capital and work our way up the risk/return spectrum.

Senior (Bank) Debt

Bank debt is generally the most restrictive form of capital, with lots of requirements for companies to maintain certain ratios (e.g. working capital, debt-to-equity, cashflow coverage of interest). There will also be lots of restrictions on what companies can do in and outside the normal course of business, including major capital expenditures, acquisitions and additional financings.

The typical source of this capital has historically been the "Big 5" major banks in Canada, and this remains largely true today, although there are more and more new alternative sources of secured debt capital available.

In certain instances, there are specialized lenders who focus on specific industries and will lend to companies who have few hard assets to secure a loan, but who have appropriately strong cashflow to support interest and principal repayments.

There are also increasing numbers of Asset-Based Lenders (or "ABLs") who lend against the liquidation value of working capital assets such as account receivables and inventory more aggressively than the Big 5 lenders, and are less rattled by unpredictable and somewhat volatile financial performance that is often the hallmark of smaller and high-growth companies.

Other forms of specialized senior debt include factoring of receivables and lease financing, but they are all generally variations on the same theme.

Senior debt is always the cheapest source of capital, usually based on Prime rates set by the Bank of Canada plus some increment for risk. The cost of senior debt is typically in the range of Prime up to Prime plus 3% or 4%.

But senior debt is also the hardest to get for small or growing companies, and the risk of default is a serious one with the potential to upset your growth strategy or even stop the company in its tracks in the event it hits a bit of an air pocket, say losing a major customer or having a new project vastly exceed its original cost estimates.

The process for obtaining senior debt tends to be formula-driven or a "box-ticking" exercise. Banks like to rely on tried and true lending ratios, and not get too creative! You need to fit into their box; they don't generally tinker with the "box" too much. This being said, the process of getting a bank loan is often quite quick, over a matter of a few weeks assuming you have audited financial statements.

There is some truth to the old adage, "if you actually need the money, you are not a good candidate for a bank loan". A good rule of thumb is that it is most often a useful option to reduce your overall cost of capital as your company matures, but not to get there to any large degree!

Subordinated Debt & Equity

Now you are entering the sexy (we like to think) world of "risk capital".

Subordinated debt (or "sub debt") and equity are very, very broad categories which encompass a large number of very different players with very different wants and needs. There are forms of sub debt that function more like equity, and forms of equity that function more like debt—the bottom line is to focus on the details of what they are offering, not what they are calling it.

Not only do the terms of this form of capital vary wildly, but also the cost. The cost is usually the best indication of the type of capital you are really looking at should you get a term sheet from a prospective investor. You should carefully marry the nature of the capital with the needs of your business.

The best place to start when you are considering risk capital is to do a detailed financial forecast of your business (with a full multi-year income statement, cashflow statement and balance sheet) to allow you to run different scenarios in terms of growth and expenditure and see the net effect on your capital requirement.

A proper financial model will also allow you do sensitivity analysis to properly assess the risks of any financing strategy. The biggest thing you want to avoid, is to have your business choked by the company's balance sheet! You have enough to worry about with competition, technology, foreign markets, exchange rates, intellectual property issues, lawsuits etc. etc., you shouldn't be facing a complex business world with one hand tied behind your back.

You need to be well-funded, although not over-funded.

. . . so, back to what risk capital really looks like.

Subordinated debt, or "sub debt", can also be called mezzanine debt and "stretch senior debt", among other things.

This form of capital is generally secured by the assets of the borrower, although second in line to any senior lender or bank. Generally, the loan is not fully secured by asset value, and requires the business to perform up to expectations for the loan to be a successful one for the lender.

As we hinted to earlier, the cost can vary widely depending on the true nature and terms of the debt, but generally ranges from 15% to upwards of 40% or more.

There are a multitude of structures for this kind of debt, from those requiring on-going cash interest payments and some scheduled principal repayments, to those with little in cash service requirements until maturity or at least nearer to maturity. The latter act more like equity and tend to cost as much as equity.

Sub debt lenders, as with all risk capital providers, tend to do a lot of due diligence on the company, its management, and its industry and competitive prospects. The process can be a lengthy one, carrying over months.

You may also need to provide a sub debt lender with an equity "kicker", or some form of upside based on the value of the company. It can be in the form of common shares or a security structured to perform like shares.

Sub debt lenders will generally not micro-manage your business and will generally trust management to run the show, but they will be watching closely and tend to be in regular contact with you, either in formal board meetings or just over the phone, checking in. They can be an excellent sounding board for managers and offer significant contacts and industry connections or knowledge to your business if you choose them carefully with your eyes wide open.

Types of sub debt bleed into the next category, Equity.

Equity, like sub debt, can take many forms and vary widely in nature. (We won't get into the distinction between Common and Preferred Equity, and also Convertible Debt, except to say that they are different flavours of the same food, rather than different foods!)

Bottom line, equity is generally the most flexible form of capital, with few if any real restrictions on how you run your business day-to-day--but with the right to step in if things aren't going well with the business. Again, it is critical to choose your equity or sub debt partner carefully, as they really are your partner in the truest sense of the word--if the investment is structured correctly with the appropriate investor. Easier said than done, unfortunately, but not impossible with the right help!

Unlike senior debt, risk capital providers generally focus on the future of your business, and not just historical performance. They will invest with an eye to exiting the investment in 5-7 years and try to grow the value of the company as high as possible over their investment horizon. Some risk capital providers have a much shorter timeframe, looking to get in and out in 1-3 years. This is a key element of choosing the right risk capital partner—matching their horizon with yours as closely as possible. Big problems occur when investors and companies split apart in this realm.

The cost of risk capital is mostly in the form of giving up a chunk of the value of your company, rather than in cash payments. This is why risk capital providers are so focused on "exit strategies" while they are considering making investments in companies—ie. whether you sell your company, or “go public”, or refinance with new investors.

The returns on equity tend to be in the 25% - 50% or higher range. 50% or higher is generally in the realm of early stage, proprietary technology companies. More traditional companies are generally at the lower end of the range.

Each industry will have its own methodologies for determining value, and the risk capital provider will tend to use these in structuring their investments. The key is to be prepared and to do this analysis ahead of the negotiations, to best position yourself for the negotiation!

Compared to senior debt providers, there are a much greater number of risk capital providers across Canada and particularly the U.S. Some are private companies (e.g. venture capital firms, private equity firms, merchant banks, and hedge funds), some are government-related (e.g. pension funds or Labour-Sponsored Investment Funds).

Risk capital can also be provided by individuals called “angels”, who tend to be experienced operators or investors who are profit-oriented but also looking to impart their knowledge and experience to earlier stage companies.

The risk capital industry is still pretty young in Canada as compared to the U.S. We have a long way to go to see the same depth and breadth of risk capital as is available in the U.S.

But this is not to say that you cannot access the U.S. risk capital market as a Canadian company. Your position north or south of the border will not be the key factor in whether you will be of interest to U.S. investors—your industry, your technology, and your customer base are some of the keys.

Bottom line, there is a HUGE amount of risk capital sloshing around in the North American markets these days. You can’t open a newspaper without hearing of yet another multi-billion deal. Things are good at the smaller end of the market as well, but not anywhere near as plentiful as in the mega-deal world. Smaller, private companies have a much more complex and sometimes arduous task to find and obtain risk capital, but that money is out there today!

To get the right deal done for your company, you may use combinations of some or all of the types of capital we have discussed. The right combinations allow you to structure your balance sheet to most closely fit yours and your company’s needs.

To conclude, we leave you with two general guiding rules:

First, we always tell our clients to try to keep their balance sheets as simple as possible. Over-structuring or getting too clever tends to just complicate your life and increase the fees you pay your advisors and lawyers.

Second, in your discussions with capital providers or advisors, if you hear something that is just too easy or good to be true, chances are it is! Financing your business is all about blocking and tackling—good, solid analysis, and staying true to the facts of the situation.

We would be very pleased to discuss any of this further with you as you figure out your plans for the future.

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We hope this paper is helpful, but stress that it is for your general information only. We urge you to obtain proper professional advice, be it legal, tax or corporate finance, before making any decisions regarding your business.