WHITE PAPER

CAPITALIZATION AND FUNDING

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All it Takes is Money.

Supercharged, Scalable Businesses Begin with Proper Capitalization and Funding

The U.S. based system of capitalism sets the environment where almost anyone with a great idea can create a business that will serve the needs of customers. This requires 1) a product or service that customers want or that fills a need (Product), 2) the ability to produce and deliver the product or service at a cost that will allow for a profit margin (Economic Feasibility) 3) the ability to communicate the benefits of the product or service to potential customers (Marketing), and 4) the financial means to get the product or service developed and into the market, communicated to clients and for the ongoing sustainability of operations (Capitalization and Funding).

Today we will be addressing Capitalization and Funding for businesses in various life cycles and situations. Ensuring that your company is properly funded helps insure the viability and scalability of the business. A company that is starved for funding may not be able to take advantage of opportunities that are readily present, while a properly funded company will have many more opportunities for growth and success.

The Home Caddy Company

Let's assume we have a great idea for a product that will bring organization to a garage tool bench or a laundry room, called the Home Caddy. Let's imagine that it's a plastic molded crate, with individual storage compartments, that can be attached to a wall hanger, and moved around on wheels. Our business plan contemplates that our primary sales channel will be through our website, initially but later may include selling through small retailers and eventually through big box retailers.

Two simple questions at this point.

1) What will it cost to produce the product?

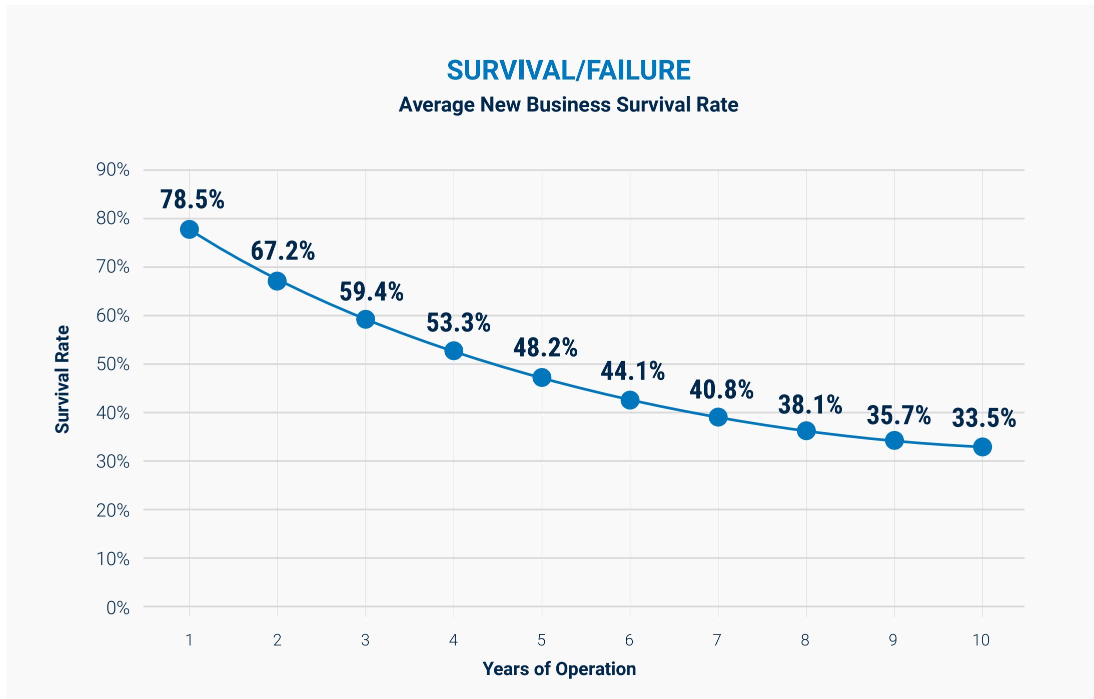
2) What do we think we can sell it for?

Let's assume that our research tells us that we can have the product manufactured by a third party for $2.00 each (minimum order of 10,000), and that we can retail through our website for $5.00. So, it appears we may have a viable idea. Now we need to spend the following to get the operation up and running:

START UP COSTS

Item	Cost
Product design and development	$50,000
Website Design and optimization for ecommerce	$50,000
Initial Inventory Purchase	$20,000
Rent for small warehouse and shipping center (x 6 months)	$12,000
Employees (marketing, shipping, accounting) (x 6 months)	$45,000
TOTAL	**$177,000**

OK Now what? We will refer back the Home Caddy Company example as we work through this topic on Capitalization and Funding.



Every year in the U.S., somewhere around 500,000 new businesses are started. Its not hard to imagine the enthusiasm, determination and optimism that each founder poured into the creation of their business. Unfortunately, only about 1/3 of these companies will survive through 10 years. More than 1/2 will be gone in 5 years.

Business failures can be caused by a variety of factors including but not limited to a poorly developed business plan, improper pricing or margins, competition, hiring the wrong team and client concentrations. However, approximately 29% of business failures happen because the company simply runs out of cash. Why is that? It could be because the business was under-capitalized and relied too heavily on debt. It could be because of poor cash flow and working capital management. Or, it could be that the company had so much opportunity, that the sales growth outstripped the ability of the company's resources to buy inventory, manage receivables, and personnel.

Planning ahead for funding, whether for initial startup capital,
working capital growth or acquisitions,
is one of the key responsibilities for a business owner.

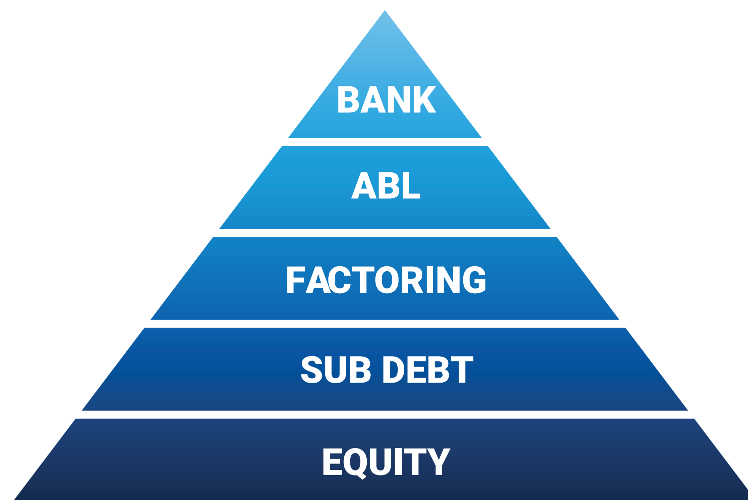
Plan Ahead – Before Funding Request

When raising capital or applying for debt, there are several very important points of preparation that must be made, prior to approaching a capital or debt source. It's necessary to be able to clearly explain what the company does and how, and to anticipate questions that will be on the minds of the debt/equity sources.

- **Sound, achievable business plan** – easily understandable explanation of what the business does and how it operates – differentiators – advantages - opportunities
- **Management Team** – depth/expertise/succession
- **Good, accurate, timely financial statements** – understand and show how you use them
- **Projections** – 1 year and a 3 to 5 year long term horizon. Where is the business going and what's needed to get there?
- **Cash Forecasts** – weekly/monthly
- **One-page management report** – show the key metrics that you watch in driving the business
- **Personal Credit Score and Online Reputation** – protect both – these will be an important part of due diligence for debt/capital sources – expect background searches and questions on credit report blemishes – full disclosure early is important

Business Funding

Now we will turn our attention to the characteristics of several different types of business funding. As we go through these, we will begin to match up funding sources to the causes of funding needs along with the costs.



Equity: First In - Last Out

Equity typically forms the foundation of funding for most businesses. It is usually provided first and can come from the business owner or other investors. The money invested is at risk and meant to absorb any losses generated by the business first, before lenders and debt holders. Equity is considered the primary and permanent capital for the business.

Lets' go back to our Home Caddy Company. We had calculated start up costs of roughly $177,000 to get through the first six months of start up and operations. Typically, this would be funded by equity from the business owner and/or other investors, who believe in the product and business plan enough to put the money at risk. If the idea works the investors could reap huge returns, if the business fails, the investors could experience a total loss.

Equity is usually the first money in to fund start up or early stage operations. Where a lender would want to see a proven repayment capacity first, equity funds the idea with little to no certainty of repayment based on past performance. Below are some of the typical lifecycle type events that would usually require equity as their primary funding source:

- **Start up or Early Stage Funding – before a proven track record has been established**
- **Unproven concept of business model**
- **No historical track records**
- **New product development**
- **Acquisition (can sometimes be coupled with debt)**
- **Funding anticipated operating losses**
- **Transitional/Distressed situations**

Because of the risk involved with being an equity investor, its is the type of funding that is the most expensive. Investors taking risks where their entire investment could be lost may require returns of 20% to 40%.

Sources of Equity

The sources available to provide Equity for a business can fall in to two general classifications; those where the business owner maintains control of all decision-making, and those where decision-making control is ceded or shared with an investor.

Within Owner Control

- Owner's investment in the business
- Earnings generated and retained by the company
- Friends and Family

Outside Owner Control

- Angel Investors
- Small Business Investment
- Private Equity Fund
- Venture Capital Fund

The amount of initial investment and retention of profits by the company is a very important part of fueling the ongoing growth and scalability of the company. However, if the owner's resources are limited and/or the retention of profits is not providing enough funding for the growth opportunities available to the business, the owner may need to seek outside sources for equity. Many times, there is a conflict with business owners weighing the benefits of reducing taxable income (by aggressive expensing and bonusing) versus making and retaining profits in the business. For a growth company, the retention of profits provides a measure of stable growth capital and may postpose the need to raise outside capital.

Angel Investors

Angel Investors are usually high net worth individuals or groups of high net worth individuals who are interested in making equity investments with their own funds into operating companies. Sometimes they can also bring industry or operational knowledge in addition to funding, as they tend to be current or former business owner/operators themselves.

Small Business Investment Companies

Small Business Investment Companies (SBIC's) are private equity funds that are leveraged with money borrowed from the SBA. They are set up for the purpose of making investments in small businesses to facilitate growth, expansion or acquisitions. The investments can take the form of Equity or Subordinated Debt or sometimes both. Once an investment is made, representatives of the SBIC will typically take a seat on the company's board and will begin to help hone the company's strategies. An SBIC will want to see an increase in the value of the company, and hence its investment and will want to realize that gain in 5 to 7 years through sale of the company or a buyout of its position by the other owner or another investor.

Private Equity and Venture Capital

Private Equity and Venture Capital funds come in many shapes and sizes. Capital to be invested in portfolio companies can be raised from institutional firms (pensions, insurance companies etc.), private investors or family offices. Venture Capital is most often seen in startup or early stage companies, while Private Equity more often plays a role in more established companies. However, there are varying niches of each depending on the charter and direction of the fund.

When a company ‘brings in equity” from an outside source, it is selling an ownership interest in the company and its future profits. This should be weighed very carefully by the business owner. This selling of equity to bring in funds to the company has advantages and disadvantages.

Some of the advantages include:

- Longer term capital without scheduled payments
- Underwriting based more on projections than historical performance
- Investors may bring expertise, support and governance
- Investors may bring a wider strategic view of industry and opportunities

Some of the disadvantages of bringing in equity partners may include:

- Accountability to others, shared decision making (you now have a boss)
- Higher return expectations (18% to 30% or more)
- Share a larger portion of the company’s profits
- Investor legal rights

While selling a portion of equity may have many immediate and long-term benefits, the process should be entered into carefully. One of the most important steps would be to agree on a fair valuation of the stock being sold. With closely held companies this can be a challenge. Agreeing on a fair process for valuation early in the process may help the two sides to come to a better agreement on value.

Subordinated Debt

Subordinated Debt, sometimes referred to as Mezzanine Debt is a loan to the company that fills a gap between what a senior lender, like a bank, can provide and the funding provided by equity. Referred to as Junior Capital, this is a loan that usually requires interest to be paid periodically, with the principal balance due in full within 3 to 7 years. It is referred to as subordinated or junior, because its rights to repayment are inferior or subordinated to a senior lender and it usually has no claim to collateral. It is however in line for payment before equity repayment.

Because this is typically unsecured and subordinate to a senior lender, the underwriting by Subordinated Debt providers focuses almost exclusively on the cash flow history of the company. They are looking for consistent historical performance in cash flows, sufficient to ultimately provide repayment of this instrument.

Subordinated debt is most often used to fill the gap of financing when the financing need goes beyond collateral values, sometime referred to as “Airball” financing. It is often used to assist in acquisition financing where there is a significant about of goodwill or intangible assets.

Subordinated debt typically carries an interest rate that can range between 12-18%. Sometimes the interest may be separated into a current pay amount and a portion that is accrued for payment in the future or at maturity. It may also carry warrants, which give the holder of the debt the right to a future purchase of the company’s stock at a designated strike price, within a certain time frame. Assuming the value of the company rises during the term of the debt, the value of the warrants may add a significant amount of additional return to the debt holder, as well as create additional cost or equity dilution (more shares issued) to the company.

As with understanding equity valuations when contemplating an equity investment, it is very important, to understand a warrant component of a subordinated debt issuance.

Providers of subordinated debt include funds formed exclusively for this type of lending, angel investors, equity or SBIC funds. Also, many times with a sale of a company, the seller of the company will finance a portion of the sale by taking back a note for a portion of the sale price. If there is a senior lender, like a bank or the SBA, it is required that the seller note be subordinated to the senior lender.

Accounts Receivable Factoring

Accounts Receivable Factoring is a form of working capital financing in which a company sells its Accounts Receivable at a discount for cash now. It is a way for a company to significantly accelerate its cash cycle, rather than waiting 30-90 days for collection of its A/R.

Back to our Home Caddy Company. As the company begins its transition from online sales to selling to big box retailers, its cash cycle will change significantly. With online sales, the company is receiving payment at the time of sale, before the product is even shipped. That cash can then be immediately deployed for additional inventory purchases, payroll and the like. Once the company begins making sales to retailers, it will take much longer to return its investment in inventory back to cash. With the retailers, the company will sell in larger shipments (increased inventory investment) and then will have to provide payment terms to the retailer anywhere from 30 days to 90 days. This means the company may have cash invested in the inventory shipment for up to 120 days overall before converting back to cash. Strong growth in revenues, but significant strains on cash flow.

Since the company still does not yet have a track record of 1–2 years, it will be hard to borrow working capital from a bank. However, this could be very suitable for A/R factoring. Here is how it works.

Once the sale to the retailer is shipped and invoiced, Home Caddy can sell that invoice to a factoring company for 98 or 99 cents on the dollar, meaning the invoice is purchased at a discount of 1–2% for each 30 days the invoice is outstanding. This creates an immediate collection of most of the cash owed to Home Caddy which can then be redeployed into additional inventory for the next shipment. Otherwise the company would have to wait 60 days for collection before it could pay for the next order.

Because factoring companies place most of their credit underwriting emphasis on the account debtor (the retailer that owes the invoice), the operating history and condition of the selling company (Home Caddy) is not as important. The factor will ensure it gets paid for the invoice by notifying the account debtor of the sale of the invoice, directing payment directly to the factoring company, verifying documentation such as purchase order, proof of shipment/delivery and by calling on collection status.

Even though it seems that 1–2% discount is nominal compared to the cash immediacy it creates, the company needs to understand when this is converted to a comparable interest rate, a 2% discount equals a 24% to 28% interest rate, depending on the amount of reserve that may be held back.

Factoring can be an expensive form of financing and also intrusive into Home Caddy's relationship with its client. If used for a short period of time until bank financing is available, however, it can be very helpful to early stage companies that find themselves in distressed situations when bank financing is unavailable.

Asset Based Lenders

Asset Based Lending (ABL) is a specialized form of business financing that leans to higher risk companies. This type of financing begins with a strong focus on collateral values and a smaller focus on earnings and cash flow, although that is not ignored. This approach assumes that its primary repayment source may ultimately be a liquidation of collateral. For this reason, the ABL is very thorough in its valuation of collateral assets, whether A/R and Inventory or equipment and sometimes may include real estate. On and ongoing basis the ABL will require consistent and frequent reporting from the company on collateral assets, so that they stay within their acceptable margins on collateral assets. ABL can supply both working capital financing as well as other asset financing such as equipment purchases. An ABL can tolerate higher leverage and weaker earnings from the company as long as they are secure in the collateral values. This type of financing can be suitable to a company in high growth or expansion mode, deteriorating earnings or distressed situations. Borrowing rates will be higher that bank financing but typically lower than equity, subordinated debt or factoring.

After Home Caddy establishes a track record of operations but before it is bankable, it may consider moving to an ABL in order to get additional funding on its inventory investment. Where a factoring company will only advance on A/R, an ABL will usually advance funds on both A/R and inventory. The ABL would require an analysis of the Home Caddy inventory to determine its liquidation value and would set its advance rate on inventory accordingly. By moving to an ABL from factoring, Home Caddy would most likely achieve a lower borrowing cost and additional funding for growth. Its reporting requirements to the ABL would likely increase as well.

Commercial Banks

Of all the forms of financing discussed so far, most will be far more expensive than bank financing if it is available to a company. Because banks lend money at very thin spreads over its cost of funds (equity and deposits), they just cannot afford losses and so must be assured of repayment of its loans. Bank's lending decisions will focus on multiple paths to repayment, demonstrated below:

Primary Repayment Source – the business must show a history of operations and cash flow sufficient to repay its loan. Could the company repay this loan from the cash flow it has historically generated?

Secondary Repayment Source – usually collateral – if the primary repayment source deteriorates or fails, can the collateral be liquidated at a value sufficient to repay the loan?

Tertiary Repayment Source – guarantor liquidity or income from other sources – Do the owners of the company have other assets or income that could help repay the loan if the primary and secondary sources are not sufficient for full repayment?

The bank will take an in depth look at the management of the company and look at past economic cycles to gauge the team's ability to manage through a down cycle. The bank may also try to determine if there are other lenders such as Factoring Companies or Asset Based Lenders that could move the relationship in the case of deterioration of the company's repayment capacity.

Because of the repayment certainty required by banks, the borrowing needs best suited to bank financing are:

- Funding for incremental operating growth
- Funding for A/R and inventory growth to support sales
- Equipment and Building acquisition
- Company acquisition
- Must have proven historical cash flow and collateral

Every bank has its particular areas of interest and focus. Some banks focus on real estate investments and development, some focus on consumer lending for homes and cars, and other have a more commercial and business focus. It is important for a business owner to know and understand the area of focus and comfort for the banks they are working with. A real estate development focused bank will not be a good resource for working capital or business acquisition financing.

After Home Caddy establishes a two-year history of profitable operations, it would be well suited to move its lending relationship to a bank in order to significantly lower its borrowing costs as well as to create the most flexibility in funding for future growth. The company may be on a similar borrowing formula as with the ABL but lower costs, fewer reporting requirements and audits will make it worthwhile. The bank can also help with other aspects of Home Caddy's business such as cash management, credit card processing, corporate purchasing cards and many other services that help the company's operation.

Conclusion

Businesses are fortunate to have access to so many varied capital and funding sources to assist with starting, growing, and operating. Having an awareness of the various sources and how they match up to certain causes and needs, will help the business owner make decisions on the best fit for funding based on their unique circumstances.

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