



Volume 62
2010

Financing the future: Strategies for accessing capital

Companies that want to grow, whether organically or by acquisition, need capital. Sometimes cash flow from operations can fund expansion. In other cases, business owners need to tap outside sources. In a quest for external funding, a private company often starts and ends with traditional bank loans. These days, however, bank credit is not as easy to come by as it once was.

One reason for this is that the number of traditional lenders actively participating in the market has diminished over the past few years, due to banking industry consolidation; and many of those lenders are focused primarily on their existing loan portfolios. Banks that continue to lend have made their loan underwriting standards more rigorous, their covenants for senior debt tighter, and their pricing higher. They've also stepped up their due diligence in assessing potential borrowers, including stress-testing borrowers' projections.

Alternative funding options are often overlooked.

They are worth investigating.

Despite these challenges, there's good news for solidly performing companies: "Many banks and other lenders have money to put to work," says Michael Milani, president of PwC Corporate Finance LLC.¹ "They're willing to lend to businesses that exhibit a strong balance sheet, predictable EBITDA, and a solid business plan. Creditworthy businesses should therefore have a variety of capital sources available to them. The trick is knowing what's out there. It can take a bit of homework."

Some funding sources may be better suited to a company's growth needs than others. With that in mind, businesses seeking funds should research a range of borrowing options, carefully consider which ones make the most sense for their particular growth objectives, and then devise a well-thought-out strategy for accessing the capital.

Know the range of capital sources

A traditional bank loan is just one among a number of potential funding sources. And yet alternative funding options are often overlooked. They are worth investigating, says Milani: "Not only does alternative financing reduce your dependence on your current lenders, but it can also increase your company's ability to invest in long-term

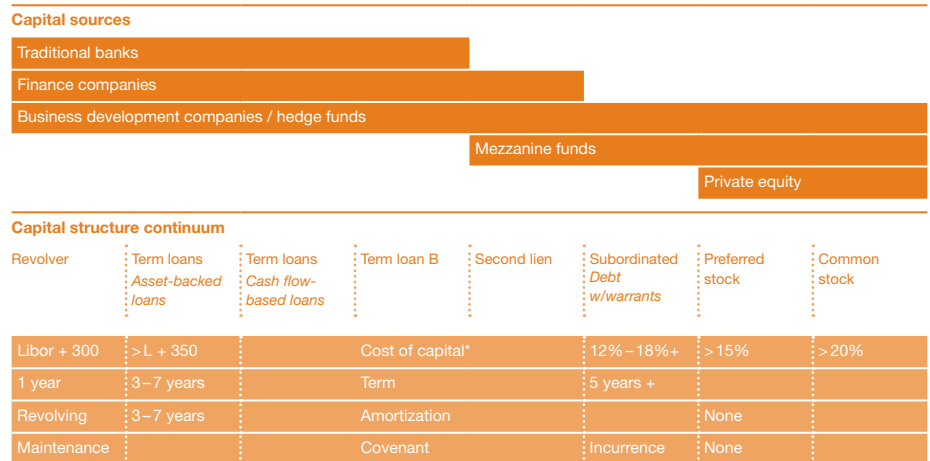
projects. Nontraditional lenders are often more willing to lend for longer periods than banks, or they may provide a tranche of capital that doesn't amortize, with the principal payable upon maturity."

Alternative sources of capital range from asset-based lenders to mezzanine funds. With each funding source, there are specific factors you should bear in mind. Certain capital sources may require you to relinquish some equity, while others may want you to offer them a seat on the board of directors.

"Take private equity firms, for instance," says Avery Tuchman, managing director of the Mergers and Acquisitions group in PwC's Private Company Services practice. "They demand a higher rate of return than commercial banks. But in exchange, private equity firms may offer more underwriting flexibility and provide less-rigid terms. They tend to place more emphasis on a company's cash flow and future prospects than do traditional bank lenders, which focus more on balance sheets and leverage ratios."

The pros and cons to each funding source are something companies will need to consider carefully as they assess their financing options. The chart below shows the types of capital sources available, ranging from traditional banks to private equity firms. It also shows where along the capital structure continuum those institutions provide capital—ranging from revolving lines of credit to common stock.

¹ PwC Corporate Finance LLC is owned by PricewaterhouseCoopers LLP, a member firm of PricewaterhouseCoopers International Limited, and is a member of FINRA and SIPC. PwC Corporate Finance LLC is not engaged in the practice of public accounting.



*Directional guidance based on approximate terms currently available in the marketplace as of July 2010.

Shop around

There are a variety of capital sources for private companies to tap.

Here are some of them:

Asset-based lenders

Many companies have significant amounts of capital locked within their organizations in the form of assets that have the potential to be securitized. Often such companies borrow against those assets via asset-based lending (ABL), reinvesting the capital in the business. Asset-based lenders make lending decisions according to the quality of the borrower's assets.

Finance companies

Finance companies are non-bank financial institutions that offer capital to businesses seeking senior debt, mezzanine debt, and equity capital. Finance companies can typically lend on somewhat more aggressive terms (higher leverage/pricing), as well as participate in tranches of capital beyond senior debt.

Mezzanine funds

Mezzanine funds comprise investors that provide companies with subordinated debt for three to seven years. This type of debt typically has no or low payments in the first few years, with either graduated payments in later years or a "bullet" payment upon maturity. Collateral (if required) generally consists of all assets, but claims are subordinated to senior lenders. Many subordinated debt loans have an equity "kicker" in the form of warrants. Usually, a mezzanine lender will want a seat on the company's board or some other method of interacting directly with management.

Private equity

Private equity firms commit equity capital for an extended time, either to purchase a minority/majority position in a company or to fund acquisitions or new technologies. Private equity investors also tend to focus more on long-term growth than on short-term profits.

Institutional investors

Pension funds and insurance companies, collectively known as institutional investors, can also be long-term sources of capital for privately held companies. Institutional investors can provide term debt, mezzanine debt, and equity capital.

Business development companies and hedge funds

Business development companies (BDCs) and hedge funds amass pools of capital (in the case of BDCs, the funds are often raised in the public markets) and then seek opportunities to invest or source capital. BDCs and hedge funds can provide different tranches along the capital structure continuum, depending on a company's needs.

Vendor and customer financing

Potential arrangements include direct loans, accelerated or delayed payment terms, equipment financing, direct equity investment, or financial assistance for new product development. Supplier/customer financing is most appropriate when there are certain synergies between the parties or if the company depends on the innovation of the other company—meaning that, without financing, both parties' businesses could be impacted.

Export-import banks

These government agencies lend money to companies to encourage production of goods for export to other markets. The US agency is the Export-Import Bank of the United States. Many governments outside the United States have similar banks and services.

Divestitures

As a company refines its strategy to adapt to an evolving marketplace, certain business units and subsidiaries can become less relevant to its long-range plans. Best-in-class companies actively monitor their businesses for strategic relevance and consider divesting noncore business units so that the proceeds can be invested more effectively.

Getting started

“Anticipate your funding needs early,” advises Milani. “Quick credit decisions from lenders are a rarity these days, so allow for sufficient lead time as your company searches for capital. Also, understand that the stronger your company and the more prepared you are, the greater your leverage in negotiating terms with capital providers.”

With those thoughts in mind, you should take the following preparatory actions before approaching prospective lenders:

- Assess your company’s creditworthiness.
- Foster strong relationships with current and prospective lenders.
- Make your information package compelling.

Do a self-assessment

“Regardless of whether a company is seeking capital from traditional lenders or from alternative sources, the first step is knowing the key areas that capital providers focus on when evaluating potential credit or investment risk,” says Tuchman. “That analysis will affect the availability of capital to your business, as well as the structure, pricing, covenants, and any other terms associated with the capital.”

In assessing prospective borrowers, lenders typically use the “five Cs of credit” as their main criteria: current capital structure, cash flow, collateral, conditions, and character (see our sidebar for more details). Businesses seeking capital should study these criteria and make sure their company measures up before approaching prospective lenders.

The five Cs of credit

1. Current capital structure

The availability, pricing, and other aspects of capital depend on the nature of the prospective borrower’s existing debt—for instance, the debt’s amount and maturity, the nature of any covenants, and the type of debt (e.g., senior or subordinated/mezzanine, revolving or term, secured or unsecured). In trying to grasp a prospective borrower’s total debt capacity, potential lenders will also assess the company’s ratio of total debt to earnings before interest, taxes, depreciation, and amortization (EBITDA), as well as total debt to equity.

2. Cash flow

In evaluating current and future cash flow, lenders will generally look at three years of past financial performance and five years of projected performance. That includes income statement and balance sheet trends, as well as financial ratio analysis. In scrutinizing projected financial performance, lenders will look at the reasonableness of assumptions and overall believability. They will also analyze debt and lease amortization/payments, interest coverage, capital expenditures, and working-capital needs.

3. Collateral

Lenders consider current and fixed asset collateral, such as receivables and inventory, as well as the appraised asset values of property, plant, and equipment.

4. Conditions

These comprise the company’s industry environment (including cyclicity and seasonality); competition and barriers to entry; pricing power; gross profit margins and operating profit margins; product and technology risk; product life cycle; the company’s position in its industry; and comparable companies and transactions.

5. Character of borrower

This reflects the nature of the business itself, management’s strength, the company’s customer base (existing and potential, turnover, backlog), and the company’s suppliers (concentration and alternatives). In assessing a prospective borrower’s character, lenders may consider a variety of other factors as well, including contingent liabilities; legal and environmental issues; “intangible” assets such as goodwill and trademarks; and labor relations.

Cultivate lender relationships

To make itself attractive to lenders, your company will want to develop relationships with multiple potential funding sources. Your current team of advisors—attorneys, consultants, investment bankers, and accountants—can be instrumental in making introductions to new lenders, by leveraging their networks to identify appropriate funding sources for your particular needs. They can also help you cultivate and manage relationships with both your current providers of capital and prospective lenders, developing requests for proposals and negotiating terms, among other things.

Although you might end up tapping only one or two of the lending sources you cultivate, maintaining relationships with a good number of them is a sound strategy. Keep as many eggs in your basket as you reasonably can. It could end up being well worth the effort.

Make your package compelling

Once you have assessed your company via the “five Cs of credit,” as well as considered what a particular lender might be looking for, the next step is to create a comprehensive, well-organized package that’s tailored to each of your targeted funding sources.

The package should not only include your request for capital and what you intend to do with the funding, but also present a solid business plan—one mapping out a clear strategy and financial projections. Make sure your plan demonstrates that you have a good handle on your business, your cash flow, and your capital needs. All data should be presented accurately and clearly, and the package as a whole should have no significant information gaps. Be transparent about any concerns, past or present, and about your plans for the future.

Case study

How does a company find growth capital in a tight credit market?

Here’s the way one company did it.

Looking to finance construction of a large new production facility, Company ABC² came up empty-handed after seeking funds from its usual lending sources. With guidance from PwC Corporate Finance LLC (PwC CF), the company tried again.

First, the company assessed its creditworthiness, based on the “five Cs of credit” criteria. Next, it sized up its financing alternatives—the potential transaction structures and the types of lenders that might work with the company. The company then considered the strategy it would use to negotiate lending terms with each prospective source of capital.

Having done the necessary homework, the company proceeded to prepare a solid information package for potential

capital providers. The financing memorandum package included financial projections and other forward-looking statements, as well as a description of the envisioned transaction.

The company was then ready to go back into the market to seek capital. PwC CF introduced prospective lenders to the company, helped it assess their level of interest, assisted the company in preparing for due diligence visits, and advised the company as it negotiated the terms of the financing agreements.

The result? A failed attempt to access capital was revived as a successful \$45 million financing—one that included a construction loan, a revolving line of credit, and an equipment term loan.

² To protect the privacy of the company, we have used a fictional name in this example.

Conclusion

Regardless of whether your company wants to make an acquisition, launch a capital-intensive project, refinance, or find a way to bridge a lean period, it will benefit from looking at a range of capital sources beyond traditional bank loans. By studying those sources and maintaining your company's creditworthiness, your business can work more effectively with current and prospective capital sources and, as a result, better position itself for growth—in any type of economic environment.

More information

Want to learn more about strategies for accessing capital? Please contact someone on the PwC team, including:

Michael L. Milani
President
PwC Corporate Finance, LLC
312-298-2755
michael.milani@us.pwc.com

Avery Tuchman
Managing Director
Private Company Services
Mergers and Acquisitions
973-236-7652
avery.tuchman@us.pwc.com

© 2010 PricewaterhouseCoopers LLP. All rights reserved. In this document, "PwC" refers to PricewaterhouseCoopers LLP, which is a member firm of PricewaterhouseCoopers International Limited, each member firm of which is a separate legal entity.

This document is provided by PricewaterhouseCoopers LLP for general guidance only, and does not constitute the provision of legal advice, accounting services, investment advice, written tax advice under Circular 230 or professional advice of any kind. The information provided herein should not be used as a substitute for consultation with professional tax, accounting, legal, or other competent advisors. Before making any decision or taking any action, you should consult with a professional advisor who has been provided with all pertinent facts relevant to your particular situation. The information is provided 'as is' with no assurance or guarantee of completeness, accuracy, or timeliness of the information, and without warranty of any kind, express or implied, including but not limited to warranties of performance, merchantability and fitness for a particular purpose.