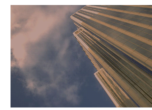
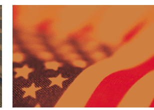



Tools for Growth and Liquidity in the Middle Market

Tools for Growth

Seed Financing Seed rounds tend to be relatively small amounts of capital provided by "friends and family", by angel investors and by certain very early stage venture capital investors. These funds are frequently in the form of convertible debt and are generally earmarked for use during the initial stages of the establishment of a business, including product development, proof of concept and testing. This round does not typically cover launch expenses, commercial production or marketing. Round sizes tend to range between $100,000 to $5 million, with venture capitalists focusing on $1 million and upwards.

First Round Financing First round capital is typically provided to enter commercial launch, expand marketing, and meet growing working capital needs of an enterprise that has commenced pilot or even actual production. Round size is generally determined on the basis of detailed cash flow analysis and can range from $2 million to more than $20 million, depending on need and timing requirements.

Second Round Financing (and beyond) Capital provided to an enterprise that has established commercial production, established basic marketing and sales capabilities, typically focused on market expansion, acquisitions, additional product development and refinement, etc. Round size once again is determined on the basis of cash flow requirements and can range from $5 million to $50 million.

Mezzanine Financing and Convertible Debt Mezzanine financing is a flexible financing methodology used to fund later stage corporate expansions as well as buyouts. Mezzanine financing generally has both senior bank debt coupled with certain equity characteristics. It commonly ranks as subordinated debt below senior bank debt for repayment calculations and its debt terms typically have a shorter payout schedule and a higher interest rate than traditional senior bank debt. Mezzanine financing can enhance the long-term capital base of a company by providing increased borrowing capacity beyond traditional bank debt. This increased borrowing capacity comes at the cost of an increased interest rate and the additional requirements of equity warrants. These warrants may have exercise rights set to both negative and positive performance metrics. As a general rule, the equity "kicker" of mezzanine financing does not result in significant shareholder dilution, and the outcome of using mezzanine financing frequently is the
enhancement of equity returns for investors.

Line of Credit (Working Capital Line) Financing of the cash conversion cycle of a growing business. Usually bank debt is used to finance the conversion of raw materials into products, products into sales, and accounts receivable into cash. Formula-based as a percentage of certain types of physical and financial assets such as receivables, inventory or property. Can be any size.

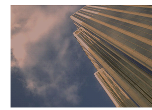
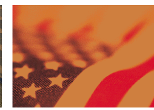
Tools for Liquidity

Stock Sale The sale of all of the assets, liabilities, and equity of a company. This is a wholesale transfer of ownership, and the new owner assumes any past and any potential future liabilities that the company may face. A stock sale is generally preferred by exiting sellers since they are free of future obligations to the buyer, with the exception of any contractual obligations. Stock sale in which the consideration is stock of the buyer will generally postpone tax liabilities for the seller until the buyer's stock is sold by the seller.

Asset Sale The sale of certain assets and liabilities of a company, but not the actual equity in the company. Structuring an acquisition in this manner serves to protect the buyer from potential hidden liabilities, like lawsuits or warranty claims. Has potential negative tax implications for the seller, and leaves liabilities and potential liabilities behind for the seller to deal with after a liquidity transaction has occurred.

Divestiture The sale of a segment of a larger business. Divestitures are done for a number of reasons: to focus the parent company on its core business, to raise cash, or to get rid of an unprofitable or less profitable division. A divestiture often solves a management 'problem', but it can be tricky to separate out the business segment from the parent company. Issues for both buyer and seller of a divested company involve accounting issues, including corporate allocations and the ability to account for the entity as a freestanding enterprise.

ESOP An Employee Stock Ownership Plan (ESOP) is an employee benefit plan that can be used either as a financing strategy to raise new growth capital, or as an exit strategy for a retiring owner. It is also used as a management tool, giving employees an equity stake in the company's future. ESOPs generally provide a level of liquidity to the current owners of a company, while giving employees an increasing future equity stake in the company. In an ESOP, employees typically borrow the money required to buy the company, secured by company assets as collateral. This can put additional cash flow strain on the business given the addition of significant interest payments. Another potential pitfall involves corporate governance in which certain types of decisions (merger, sales, liquidations, etc.) now require the assent of the new corporate owners, including employees.

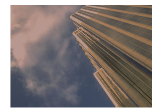
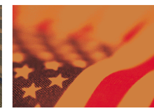
Tools for Liquidity & Growth

Recapitalization A method of selling a portion of a company which can take various forms to accomplish a number of potential goals. As a general rule, recapitalizations have the following characteristics: they involve the immediate sale of less than one hundred percent of the business for cash or securities; the equity owner gets to "take some chips off the table" but remains involved in the running of the company; and, there is a new "partner" with an equity stake in the business. Private equity firms provide a broad spectrum of recapitalization options and investment philosophies which can be matched to the goals of the owner, his/her time frame for ultimate exit, and the needs of the company. Some firms want a controlling interest, while others are willing to invest in a minority stake. Additionally, there may be provisions for additional investments in working capital or specific provisions for the future buyout of the remainder of the company. In the context of a public company, the transaction is commonly structured as the sale or repurchase of 90% of the common stock rather than an outright purchase in order to avoid traditional purchase accounting treatment and resulting goodwill amortization.

MBO/LBO A Leveraged Buyout (LBO) involves securing private equity and debt financing to purchase the outstanding shares of a company. An LBO may be led by either the current management team, or an outside investor. A Management Buyout (MBO) results when a company's current management team secures private equity financing to purchase the outstanding shares of the company that they run. MBOs and LBOs are not restricted by size of the company or ownership structure (public/private). The debt is typically secured by the assets and cash flow of the company. Either transaction provides the original owner with a means of divesting of the business, while providing the management team with equity and ensuring continuity in the management team.

IPO An Initial Public Offering is the first offering of a company's stock on a public exchange. The proceeds from an IPO can fund business development and growth, reduce debt, or simply provide liquidity for the current owners. IPOs are typically available only to companies with a demonstrated revenue record, a history of profitability, and strong future prospects. An IPO may eventually provide liquidity for the original shareholders of the company but generally require the holding of the newly issued public stock for an extended period of time (a "lockup"). Such lockups can be both statutory or contractual and generally exceed twelve months. IPOs can be risky, however, as the process is highly influenced by numerous factors external to the business, such as current market conditions or economic or political dislocations. Initial underwriting fees are hefty. Public companies generally face additional scrutiny and expense with legally-mandated audit and reporting obligations. Frequently follow-on discretionary coverage by stock analysts is critical to the long-term success of the IPO.

Reverse Merger Provides some of the benefits of public ownership without all of the immediate costs associated with an IPO. In a reverse merger, a public shell company, with no or limited assets or liabilities, purchases a private company for stock in the public company. The shareholders of the private company thus become the shareholders of the public company, and are able to change the name of the previous public entity to the name of the purchased company. The formerly public company then trades, generally over-the-counter, with its shares under the name of the purchased company. The shareholders may benefit from increased liquidity, as well as an increased ability to utilize their stock as a viable currency for future acquisitions. Although compelling in theory, more than not, reverse mergers do not deliver the desired level of liquidity for shareholders because of lack of institutional investment and analyst coverage. Small companies utilizing a reverse merger must adhere to all audit and reporting requirements required of public companies.

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