WILEY FINANCE

SECOND EDITION

The Handbook of Financing Growth

Strategies, Capital Structure, and M&A Transactions

PREFACE

Over the past two decades, access to capital for emerging growth and middle-market companies has vacillated based on the ebb and flow of the broad stock market and the liquidity and tightness of the credit markets. Even through the boom and bust of the Internet, availability was not constrained as it has been for the past nine months. As we update this second edition of the *Handbook of Financing Growth*, we are experiencing a period of financial challenge not seen since the Great Depression . . . and while there is arguably the greatest amount of capital ever focused on emerging growth and middle-market companies, literally hundreds of billions of dollars,[1] the hurdles to accessing this capital have never been higher.

The difference today is one of gaining access, not just one of getting a better deal or better terms. This applies to both debt and equity from a wide range of sources: from commercial banks to asset-based lenders to specialty finance companies; from growth equity investors to venture capitalists to strategic partners.

In spite of the current economic turbulence, the authors of this handbook continue to share an enthusiasm and positive outlook for the growth and vitality of America's emerging and middle-market companies. And we believe that for those companies that are proactive and well positioned, there is likely capital to be found. For those that need help getting their house in order and need to strengthen their position and focus, we have added a discussion in several sections with tools and ideas in hopes of assisting and guiding you, your team, or your clients in the right direction.

Within these pages, we introduce the full spectrum of funding alternatives available to emerging and middle-market companies, and we present practical strategies and techniques as you consider capitalization and the growth of your or your client's company. In addition, we have bolstered the content on preparing a company for a transaction and introduced new sections to specifically address acquisitions and exits. Given the gyrations in the commercial banking world, we have also added a number of new cases to highlight viable alternatives to traditional bank debt.

Our approach to funding a company, acquiring a business or creating shareholder liquidity is process based—driven by the use of funds, the stage and industry of the company, and the investor objectives, always with an eye towards creating value. We have written this handbook primarily from practical experience and empirical data; and we have included some basic corporate finance theory that is helpful as a foundation in understanding some of the topics discussed within the body of the book.

The focus is on companies with revenues ranging from zero to about $500 million, deemed start-up through middle-market. Representative companies are those in the INC 500 and the Forbes Small Business 100, venture-funded companies, and those many thousands of companies funded with friends' and family money and hard-earned savings and sweat equity.

We find that many competent and successful businesspeople commonly misuse terms and have misconceptions about basic aspects of corporate finance. Many times we hear the leader of a company discussing the alternatives for funding the next stage of growth in the business and mentioning venture capital. The fact is that very few companies are a candidate for venture funding and even fewer actually obtain it. Based on anecdotal data, we estimate the funding rate of business plans submitted to venture capitalists to be in the 0.2 percent to 0.5 percent range, or 1 out of 500 to 1 out of 200 companies.* Even with such a low funding rate, do not give up! We also hear stories from entrepreneurs who just do not understand why their bank will not lend them the money they need to hire the next round of employees required to support their growth. If only these folks understood the role of the bank or the type of companies that venture capitalists actually invest in; if they only understood the full range of financing alternatives and how to obtain the right type of funds for their needs at the right time.

This handbook is meant to address these questions and to provide the basics of corporate finance as well as to provide strategies with which to fund all types of viable operations at the various stages of the company life. In addition, we drill down into the details to illustrate how to execute a financing plan. We desire to provide the reader a solid foundation and perspective from which to address capital structure questions and the financing needs of the company.

You will note a series of recurring themes with regard to financing. These apply both to those who are operating managers reading this handbook and to those advising and supporting the company. These themes are a bit of motherhood and apple pie, but they are central to successful fund-raising:

1. Establish and follow a process.
2. Start raising capital before you need it.
3. It is relatively easy to get an audience with investors compared to getting funding. Be prepared for the tough questions and know your business (get your house in order):
    - Know your market and competition (details).
    - Know your weaknesses and have a solution.
    - Define a clear use of funds (this leads to alternative capital structure and funding sources).
    - Be able to explain your strategy.

*The percentage of business plans funded increases significantly if the basic concept is reasonable and the entrepreneur finds a fundable formula.

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- Identify relationships and levers (this sometimes reveals funding sources and partners).
- Prepare the management team and rehearse your presentations.

4. Select only a few prospects; otherwise you waste time and get a reputation for shopping the deal.
5. Know what kind of money you need and how it plays into the overall capital structure of the company.
6. Sample the market for acceptance and issues; listen to criticism and learn. Go to sources where you have relationships for quick and candid feedback. Look for trends.
7. Be realistic regarding valuation, issues, strengths, weaknesses, and timing.
8. Have alternatives and be creative.
9. Follow the operating principles of "do what you say you are going to do" and "no surprises."

All of this can be summed up into a single word: credibility. There is no substitute for solid operational performance. Given this importance, and new to this second edition, we introduce and describe our approach to business planning and the alignment of strategy with resources, supporting and highlighting the front end of our financing process.

We believe we saw an infrequent occurrence with the Internet bubble where companies (dot-coms) could raise capital without regard to business execution; those days have passed! There may be some reading this handbook who think they would be lucky to obtain financing of any type; we would challenge you to look at some of these basic issues to determine the root cause of your struggle. Many times the discipline of an institutional investor (equity or debt) forces management to address the hard issues and to better operate the business. If as an operator or leader of a company you can do this prior to obtaining outside financing, you may be in a stronger position to choose your financial backers and to defend a more aggressive valuation. Once again, we are talking about the credibility of management and leaders.

Our target audience is the leaders, managers, investors, and advisers of and to these companies, and those aspiring to one of the many roles in building these firms. More specifically, and by its title, this work is a *handbook*, written for entrepreneurs, founders, presidents, CEOs, CFOs, members of a board of advisers or board of directors, lenders, investors, attorneys, accountants, consultants, investment bankers, commercial bankers, controllers, and senior management. In addition, we believe this handbook is a useful resource for students in college and professional education courses focused on entrepreneurial and growth companies.

However, unlike either the encyclopedic or the 1-2-3 Home Depot-esque guides that the term *handbook* connotes, this document strives to be far more than that. It's a combination—part reference guide and part repository of practical information and applied research. The contents range from comparative financing vehicle tables charted on the risk-return continuum to detailed capital instrument definitions to a showcase for real case studies. In our collective opinion, the theoretical without the practical would potentially skew the reader's perspective, or worse, offer incomplete information. To further drive key points home, we have continually tried to pepper the text with comprehensive examples from both successful and unsuccessful companies.

The *financing growth* portion of the title reinforces our focus on the growth aspect of a business and which financing alternatives are most appropriate. Not only will capital structure differ by industry and by life cycle of a firm, but also by the risk tolerance of the executive team and investors. Peace of mind and security might be more appropriate in the short run than a perfectly optimized mix of debt and equity, or worse, a strategy that leverages assets to their greatest extent possible in order to maximize value. Of course, these same executives must concurrently balance their psychological needs with investors' requirements, internal rates of return, and actual shareholder returns.

Part One of this handbook, "The Financing Process," provides a detailed description of the steps followed in an ideal scenario. We start with an overview of strategy and the importance of defining the objectives of the company and the various stakeholders. Then we transition to a discussion of the use of funds and addressing risk issues. To support this section, we provide a refresher or summary overview of corporate finance in Appendix A. Much of this content is derived from work by Aswath Damodaran in his text *Applied Corporate Finance*.[2]

Aswath Damodaran is a professor of finance and the David Margolis Teaching Fellow at the Stern School of Business at New York University. He has received several awards, including the NYU Distinguished Teaching Award in 1990, Stern's Outstanding Teacher Award in 1988, and the Professor of the Year Award in 1988, 1991, and 1992. He also offers training programs in corporate finance and valuation at Deutsche Bank, Swiss Bank, Credit Suisse, JPMorgan, and Smith Barney. A former instructor at the University of California at Berkeley, he has written several articles for many of the nation's leading financial journals.

We chose not to reinvent the wheel when it comes to the basics, but to use Damodaran's extensive research in this area. We provide a theoretical and practical discussion surrounding capital structure (the design of the balance sheet—i.e., the mix of debt and equity used to fund shareholders' objectives). We place emphasis on the spectrum of funding instruments, sources, and expected rates of return, followed by suggestions on the use of third-party experts. Lastly we address closing the deal, managing the relationship with the investors/lenders, and exiting or repaying the funds.

Part Two, “Case Studies,” provides real examples of transactions with companies in varied stages and industries; this provides the backdrop for a meaningful discussion. Part Three, “Financing Source Directory,” is an extensive list of actual funding sources. It’s accompanied by access to our online database.

In Appendix B, we provide a short tutorial regarding financial statements and reporting. Appendix C contains a note about calculating the discount rate used in valuing emerging growth and middle-market privately held companies. Appendix D is a reprint of an article titled “How Fast Can Your Company Afford to Grow?” illustrating how to determine the maximum rate of growth for a particular company based on internally generated cash flow. In Appendix E we present some observations and thoughts about financing start-up companies. We added Appendix F to provide an overview of generally accepted accounting principles (GAAP) and some insight into the planned transition to international standards.

Finally, an extensive Glossary provides a guide to the most common terms used in corporate finance and a practical definition for each.

We want this handbook to be a reference and guide for you as you develop and execute the financing strategy and plan for a company. Further, upon completion of reading this handbook, we intend that you will have the basic tools to structure a company’s balance sheet to meet its objectives, and the direction to find the required funding.

It is worth noting that where applicable we have adapted content from select writings of specialists in various fields. Though we are knowledgeable in every aspect of the financing process, we want to ensure the reader is receiving information from the most qualified sources with a contemporary perspective. In addition, we have reached out to the investment and lending communities as part of our primary research to capture current data, actual examples, and an industry-based perspective to counter our own experiences and biases.

We are always receptive to questions and comments, so do not hesitate to write us at: khmarks@HighRockPartners.com, lrobbins@Wyrick.com, gfernandez@HighRockPartners.com, jfunk@HighRockPartners.com, or swilliams@HighRockPartners.com.

Kenneth H. Marks

Larry E. Robbins

Gonzalo Fernández

John P. Funkhouser

Delbert "Sonny" Williams

Raleigh, North Carolina

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