

# Pros, cons of common financing tools for businesses

For the majority of business owners, the last two years have been the most challenging they've ever experienced. Although for most the primary focus has been simply to survive, those who have managed to do so now look to the future.

This market downturn has created new rules for how a business must be run to be successful. Lean, mean and profitable businesses now can start to focus again on growth.

The post-recession definition of growth may look slightly different, but how that growth occurs remains dependent on capital in some form or another. The good news for business owners is that financial buyers who have been reluctant to make a move now have large capital overhangs — private equity capital overhang stands at roughly \$400 billion.

Despite the depth of resources, however, it's much more difficult for a business to prove itself to be a viable candidate to M&A and financing groups.

Not only has the level of scrutiny for all types of financing intensified, but valuations that are acceptable to both the seller and the buyer look much different than they did three years ago.

A business that's serious about growing — and has a solid strategic plan, management team and financial record — can access a variety of capital sources. The first step is to determine what type of financing achieves the business goals and makes the most sense to the owners.

The following is a brief overview of common financing tools:

- Private equity

(1) Investment horizon of three to five years.

## Capital Hunt



Warren Henson

(2) Less capital in exchange for an ownership stake (typically majority control, although there have been some private equity groups interested in minority deals).

(3) Investment is primarily in companies that are somewhat mature, cash-flow positive and relatively stable, yet still have room to grow.

(4) Focus is on internal rates of return and heavily dependent on debt financing.

Private equity pros: Growth capital allows business owners to monetize a portion of their ownership and share in the upside of the business through remaining ownership stake; may provide the business with expertise and industry contacts.

Private equity cons: Dilutive, requires board seats, typically requires majority ownership, loss of autonomy for business owner(s), debt on company.

- Venture capital

(1) Investment horizon of three to seven years.

(2) Typically reserved for early-stage growth companies that aren't necessarily profitable.

(3) Focused on internal rates of return, little to no use of leverage.

(4) Reliant on strong capital markets, because the primary exit strategy is an IPO (initial public offering).

Venture capital pros: Growth capital for companies that may not qualify for

other types of financing; may have expertise and contacts in the industry.

Venture capital cons: Very dilutive, requires board seats, some loss of autonomy for business owner(s).

- Senior debt

(1) Term loans typically amortize in five to seven years, while lines of credit are interest-only and reviewed annually.

(2) Debt secured by the company's assets — working capital lines of credit used to finance receivables and inventory, and term loans used to purchase capital assets.

(3) Loans governed by covenants.

(4) Senior debt providers analyze both past and future ability of the company to repay loans from cash flow.

Senior debt pros: Non-dilutive, no equity ownership given to lender, least costly form of capital.

Senior debt cons: Lenders are very cautious and interested in low-risk credits, covenants may restrict growth, term loans require some form of principal payment, lender is repaid before stockholders in a liquidation event.

- Mezzanine debt

(1) Debt that's subordinated to the senior debt, but senior to equity.

(2) Higher interest rate.

(3) In addition to traditional interest, mezzanine providers charge a separate "paid-in-kind" (PIK) interest rate that accrues during the life of the loan.

(4) Focused on internal rates of return and typically requires warrants to achieve these rates.

Mezzanine debt pros: Interest-only payments allow company to conserve cash, little to no ownership relinquished.

Mezzanine debt cons: Expensive debt, warrants may be high in order to achieve

required rates of return, may require an equity sponsor, may require a board seat.

There are many signs that point to a

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renewed sense of optimism in the M&A market. The credit markets, while still vulnerable, appear to be improving every month.

Buyers and investors are returning to the market after a long hiatus. This renewed interest will provide the influx of financing that many businesses now can use effectively and efficiently.

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