Enterprise Ireland

Finance 4 Growth

Sourcing External Funding

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- Private Equity Investment
  - Position your business for Funding
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  - Due Diligence & closing the deal
  - Managing Investor expectations
- Case Study Example – Funding

Funding & Raising Finance

Companies often want to raise finance for the wrong reasons or they want to raise the wrong type of finance.

This costs Time and Money.

It is important for a business to understand the different types of finance available - depending on their stage of development.

Companies need to understand what to apply for and from whom.

They need to position themselves and understand the dynamics.

Business Plan

- Irrespective of whether you are raising **Debt or Equity**
- Prepare an informative, clear and concise Business Plan.

- The Plan is the investor's first view of the company and in this situation, first impressions are vital.
- The Plan should include a short executive summary and sections on:
  - Company Background.
  - Product or Service
  - Market & Marketing
  - Management Team
  - Financial Information
  - Risk factors and rewards

- Potential investors will focus on the experience and expertise of the management and the growth potential of the market.

Types of Funding :

- Apart from internally generated funds, there are four broad categories of finance available. Choosing the right finance will : -
- Depend on needs and circumstances.
- A mixture of sources will often be appropriate.
  - Debt Finance
  - Working Capital Finance
  - Equity Finance
  - Other Sources

Debt Finance :

- This covers overdrafts and loans, ranging from short to long term with variable or fixed rates.
- Relies on the quality of the underlying assets of a company and can be inflexible.
- The variety of debt finance is often underestimated and it is important to find a lender who fits the needs of the business.

Working Capital Finance

- Uses the current assets of the business to generate funds - Debtors & Stock
- The popularity of financing book debts and stock has soared
- Traditional stigma attached to factoring has gone.
- Factoring tends to be flexible allowing finance within 24 hours of invoicing a customer.
- A fee is charged as a percentage of the debt advanced.

Invoice Discounting

- Converting trading Debts into Cash on an ongoing basis
- Company can access funds of up to 80% - 85% of approved invoices.
- Customer Invoiced as normal - credit terms.
- Typically discount debts of businesses with min. T.O €1m.
- Drawn facility is secured on the book debts of the Co.
- Used, increasingly, in overall debt structures for MBO’s, Mergers & Acquisitions.

Venture Capital :

- Products and services with a strong competitive edge
- Owners willing to sell their shares, realistic and detailed business Plans
- Clear exit plan within a defined timescale, in the form of a trade sale or repurchase.
- Venture capitalists look for a team with a good management track record
- Competition for deals is tough – for every plan the venture capitalists accept, tens more are rejected.

Venture Capital

- Venture capital - Be it from business angels or from funds, is about generating a high return from a portfolio of investments. The return is to repay them for the risks that they take, but they still want to reduce those risks as far as they can. This leads to further hurdles
  - Terms and Pricing.
- A venture capitalist supplies unsecured financing, usually of sums in excess of €250,000, in return for a proportion of the company’s shares.
- A projected return of 25% within three to five years is the least a venture capitalist will settle for, and targets as high as 30-40 % are common.

Cash Flow/Business Lending

- **Assess Repayment capacity for a business -** starting point for lenders is the Earnings before interest, tax, depreciation and amortization – EBITDA
- EBITDA as a cash-flow proxy is not always appropriate in the context of other draws on cash flow : Essential capital expenditure, taxes, dividends and increases in working capital.

EBITDA & Free Cash Flow

	2012	2011	2010
Xpansion Ltd	€ '000	€ '000	€ '000
Profit Before Tax	2,600	2,500	2,400
Depreciation	250	250	200
Amortisation	- 100	- 200	- 200
Interest	100	120	110
EBITDA	2,850	2,670	2,510
Essential CAPEX	- 300	- 300	- 300
Taxation	- 250	- 240	- 235
Free Cash- Flow	**2,300**	**2,130**	**1,975**

Cash Flow/Business Lending

- **Free Cash Flow** : represents the cash a company is able to generate after accounting for capital expenditures, such as buildings or equipment.
- This cash can be used for debt reduction purposes.
- **Bank establishes the Free Cash Flow and Assess** :
  - Predictability & sustainability of the cash-flow
  - Stress Test : Sensitivity analysis – for example what if revenues fall, margins squeezed, degree of operating leverage, interest rates increase.
  - Diversity – e.g. Is the business reliant on one or two large contracts?

Cash Flow Lending

Measures used to assess the company's ability to service debt include :

- **Debt Service Cover Ratio** (FCF/ Debt Service)
  - Less than 1x signals that the company cannot repay the debt.
  - Minimum guidelines of 1.2x to 1.4x.
- **Interest Cover Ratio** (EBITDA/ Interest)

Interest Cover Ratio

- The interest cover ratio is a measure of the number of times a company could make the interest payments on its debt with its earnings before interest and taxes, also known as EBITDA.
- The lower the interest coverage ratio - the higher the company's debt burden
- An interest coverage ratio below 1.0 indicates the business is having difficulties generating the cash necessary to pay its interest obligations.
- Banks looking for consistency on the cover Ratio’s

Cash Flow Lending

- The difference between the debt service cover ratio and measures of financial strength such as gearing and interest cover is that DSCR takes into account the actual financing arrangements.
- By taking repayments of principal into account, it tells you the ability of a company to stick to its commitments to avoid default

Cash Flow Lending - security

- Typically, security will encompass a debenture incorporating a **fixed and floating** charge over the assets and undertakings of the company
- Guarantees may be applicable / key man cover
- Bank may also seek to subordinate shareholders / Directors loans and further debt may require consent from the lender.
- In some cases the bank may seek personal guarantees from shareholders

Cash Flow Lending

- The bank will incorporate ratio’s as financial covenants into the Offer Letter to be tested :
  - Annually & Directors will have to sign off on a compliance certificate.
  - Management will be key and inevitably the most critical factor – track record
  - The Ability to deliver on Business Plan.

Trade Finance – Import Letters Of Credit

- Exporters may not provide goods unless they receive payment in advance.
- A letter of credit is a conditional payment guarantee by the importers bank to the exporter.
- The payment guarantee is conditional upon the exporter providing documentary evidence and is payable upon receipt of the correct documents at some future date.
- A credit line is required - Tangible security such as cash may be required or could form part of an overall debt structure.

- **Standby letters of credit :**

  A form of back up guarantee to cover default by the borrower. The buyer pays directly for the goods and only in the event of non payment is the bank liable.

- Export letters of guarantees, inward guarantees, documentary/clean collections,discounting of letters of credit, bills of exchange, promissory notes etc – no credit line is required.

Overdraft Facilities

- Short term facilities, repayable on demand.
- Purpose is to fund the day to day operating requirements of the business such as working capital funding
- Seasonal fluctuations in cash flow or late payment of debtors.
- Not a permanent source of funding or to be utilised to fund capital expenditure.
- The bank will expect the facility to revert to credit for a minimum 30 days per annum.

Sample - Funding Transaction :

- New customer approached bank to finance the acquisition of a distribution business.

- Total funds required to fund purchase and working capital was circa €12.5m

FUNDED By :

- Cash input of €3m
- Business loan of €4.0m (over 4 years)
- Invoice finance of €5.5m.

Sample - Funding Transaction :

- Rationale was to purchase an established business, in a similar industry - synergies and economies of scale
- High turnover levels & Extensive product offering.
- The business loan was secured by a group debenture (floating) over the assets and undertakings of the new group of companies.

- Cross guarantees.
- Assignment of key man cover for €2m – merging two businesses has its risks – the buyer was held in high regard by the bank
- Key to making the transaction work and had excellent track record with existing business.
- Invoice finance is secured on the book debts.
- Director’s signed indemnities.
- Excellent information (due diligence, audited accounts, management accounts and projections). Customer and advisors willing to meet bank regularly.
- Tight deadlines because there were other interested parties from start to finish transaction closed within 3 weeks.

Information Requirements

- Information quality is key and Credit committees will not sanction a facility without understanding all the risks.

- Provide Quality Information :

  - Minimum 3 years audited accounts with detailed income statement schedules (and breakdown of overheads).
  - Management accounts – Gross & Net Margin %
  - Key Performance Indicators Analysis
  - Cash Flow Projections - QTR on QTR 2yrs
  - Debtor and creditor listing – commentary

Feedback - Credit Watchdog :

- Currently Banks not showing evidence of ‘’ enterprise risk taking ‘’ in their current lending policies - Credit Review Office
- Banks must respond within 15 days under the lending code set out by the Central Bank
- Disappointed with the ‘’ Slow No ‘’ - drip feed information

Raising Capital :

- A company's ability to raise capital is integral to its growth potential and financial well-being.
- This is true in good times and in bad.
- Planning is critical to the process

Seek potential Investors

- Potential investors - be they debt or equity investors.
- Initially a **business executive summary** is sent to potential investors and if they are interested the full **Business Plan** is forwarded for their consideration.
- If interested, they will then proceed to meeting the company.

Business Valuation :

- Do you know what your business is worth ?
- Do you understand what drives the value of your business ?
- Do you know how value is determined ?

Fair market price for business i.e. amount that a willing buyer pays to a willing seller in an arms length transaction

Business Valuation

The appraisal and subsequent valuation estimate is not an exact science and requires considerable judgment of many factors :

- The history and nature of the business the Company
- Outlook for the overall economy and the industry the Company is in.
- The latest financial condition of the Company.
- The future earning capability & Growth of the Company and the Risks
- The capability of the Company to continue to generate the necessary cash flow to support the business .

Assess business' current position…

Strategic Value

- Leadership in marketplace
- Brand or company reputation
- Distribution network
- Management depth & experience
- Customer base and loyalty
- Employee knowledge
- Minimal reliance on single product or customer
- Perceived synergy to acquirer or Investor

Industry trends include ….

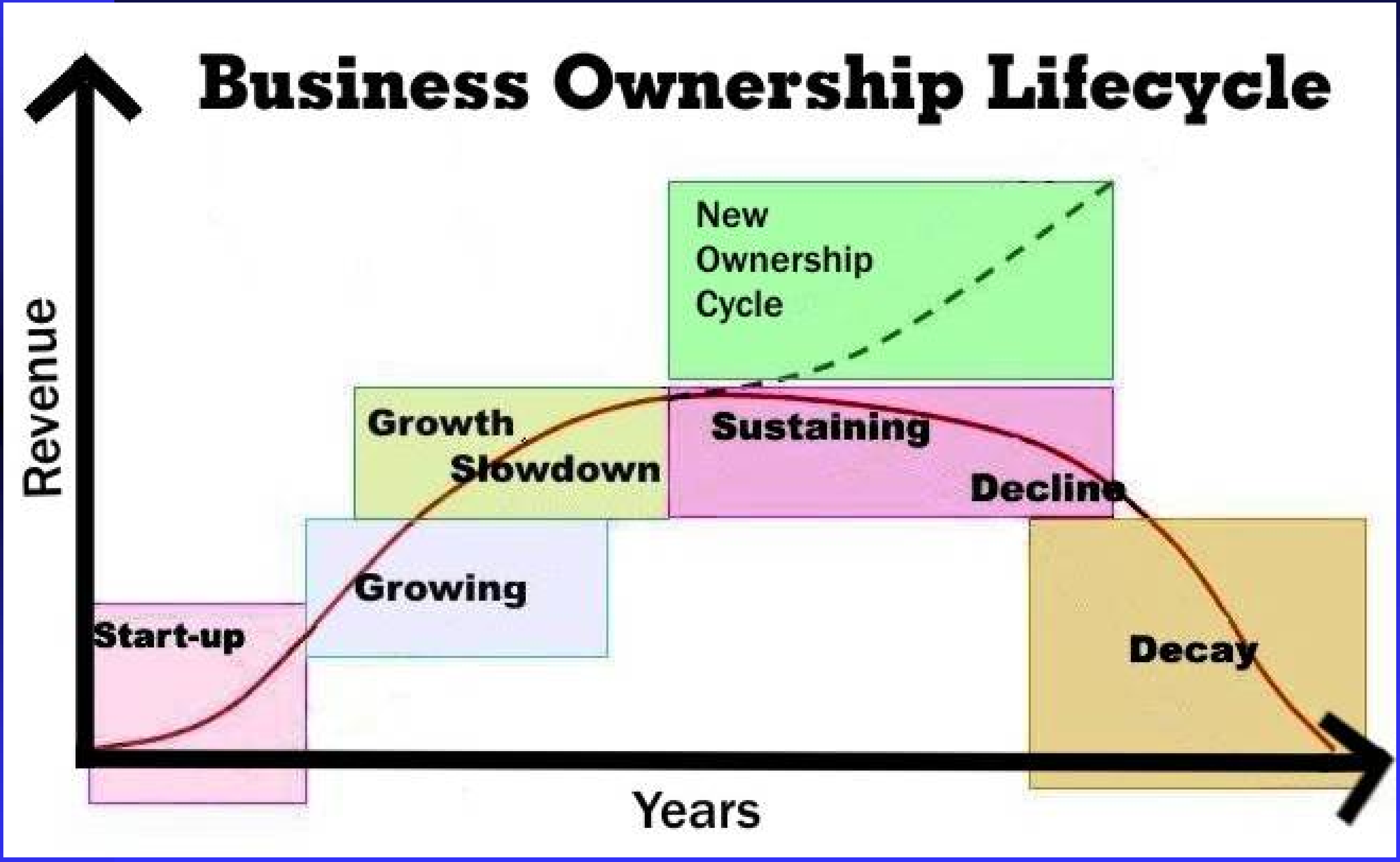
- Competitive landscape
- Industry attractiveness
- Growth prospects for industry
- Economic or regulatory threats

Strength of earnings include ….

- Revenue history and growth
- Earnings performance
- Strong free cash flow
- Licenses and permits
- Intellectual property
- Company assets
- Obligations such as leases and employment contracts

Operational Efficiency ….

- Cost structure
- Capital allocation levels
- Profitable business lines
- Appropriate level of debtors
- Debt to Equity capital mix


Business Ownership Lifecycle
Revenue
New Ownership Cycle
Growth Slowdown
Sustaining
Decline
Growing
Start-up
Decay
Years

EBITDA & Free Cash Flow

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Calculating the PE Multiple

- Having established the adjusted net profit EBITDA it has to be decided what the appropriate multiple for the company's sector is. Indicative Guides :
  - The multiples for SME non-listed companies and businesses usually range from 1 - 10.
  - Owner Managed businesses are normally valued at between one and eight times adjusted net pre-tax profit.
  - Managed companies or businesses in Ireland with profits up to €600,000 will attract a factor of between - 2 -7 Indicative guide
  - Companies in Ireland with profits > €600,000 usually attract factors of three to 10. (Guide only).

What are Private-Equity Firms looking for ?

- Strong growth prospects top the list.
- But the Private-Equity executives surveyed said they are also focusing intensely on the quality of the senior management team as a whole
- Perhaps the most surprising result was that the quality of the CEO/ MD was the *least* important factor.
- Private-Equity executives are looking for **deep** management talent, rather than simply betting on the vision of a single person.
- Other factors, such as profitability and barriers to entry are important, but clearly are secondary

Private Equity : Key Findings UK Survey

With the competition for investment in attractive mid-sized

- A company's **growth outlook** was considered the most important factor in the investment

- Decision, rated much higher than current **Profitability.**

Private Equity – Survey

- The quality of the senior management team was one of the most important factors Private-Equity firms consider before making an investment in mid-sized private co's

- In contrast, the ability of the individual CEO was one of the least important factors.

Private Equity firms - Most Important Attributes when considering Investment in mid-sized companies – Ranking

Private Equity Key Considerations

Growth Prospects	1
Quality of Senior Mgt.	2
Profitability	3
Competition	4
Quality of MD	5

Fund Raising Process

a) **Valuation :** price/value dynamic /optimise biz value
b) Choose Biz broker : roles/responsibilities / sector exp
c) **Sales Memorandum** : most important doc /create the contest /aimed at
d) **Negotiation the sale** : bidders identified /no exclusivity
e) **Tax planning** : structure / exit strategy
f) **Heads of Agreement** : fundamental deal points
g) Disclosure & legal due diligence : Documentation Due Diligence – tightly scoped / timing
h) Closing the Deal – Purchase & sale agreement
i) Post transaction Planning

Investment memorandum

- The Investment memorandum is likely to be the most important piece of advertising in the funding process.
- It will often be the first information on the company to be reviewed by potential purchasers.
- Aim to convince the acquirer to assess its full value.
- Tailored to meet the circumstances of the transaction – who is it aimed at – industry (strategic fit)

Contents of Investment memorandum

- Executive summary: guidance notes
- Company overview
- Business environment - vision & strategy
- Business operations & product overview
- Marketing plan & sales strategy
- Management & key employees
- Business systems and processes overview
- Financials - historical trading performance and cash flow
- Historical cash flow generation
- Historical balance sheet performance
- Conclusion

Investment memorandum

- Strategic positioning
- Pre cursor to the valuation

Negotiating the Investment

- Developing a negotiating strategy
  - Restrict bidders and no exclusivity
  - Assess the business fit with bidders
  - Introduce competition / tactics - contest
  - Justifications for an increased offer
  - Identify allies on the purchaser's team and supply relevant information
- Who is best to undertake the negotiations ?
- Key principles to remember
  - Identify the bigger picture before making any compromise
  - Deal breakers
  - Timing
- Expression of interest / letter of Intent / Offer letter

Heads of Agreement

- Based on the business plan and presentations, the company should endeavor to receive offers of funding from more than one potential investor.
- Gives greater strength and flexibility for negotiation.
- Prior to selecting one offer over another, the company should evaluate the financial and non-financial issues of each offer of finance. It may often be the case that the long-term benefit that can be gained from the expertise of the investor may out weigh some short-term financial benefits.
- All of the contentious terms of the potential agreement should be agreed prior to signing the Heads of Agreement. The heads of agreement will include:

Heads Of Agreement

- Pro-forma heads of agreement subject to contract

Fundamental deal points on which the parties have agreed Basis to proceed to complete the deal subject to contract and without legal obligations.

Heads Of Agreement

- The Offer detailing the equity/debt financing that the Investor is offering and return to that Investor be it by way of security, shares…etc.
- The Proposed Finance Structure.
- The Due-diligence required by the Investor – timing
- The main terms of the proposed Shareholders Agreement or the Lending Agreement.
- Negative pledges – commitments not to perform certain tasks without the consent of the minority shareholder
- Exclusivity for an agreed period.
- Exit mechanism – if the process does not conclude

Disclosure & Due Diligence

When Heads of Agreement are in Place - Due Diligence process begins.

This will be on behalf of the investor and normally include:

Due Diligence

- **Financial due-diligence** : Investor will look at the current state of affairs of the company
  - past performance of the company
  - detailed look at the financial projections

- **Commercial due-diligence** :
  - Review include the markets
  - the production process
  - selling and the distribution process
  - key suppliers….

Due Diligence

- **Technical due-diligence** – where the product or service is of a high technical nature the Investor may appoint an independent assessment of the product or service.
- **Legal due-diligence** is to include a full legal review of the title deeds, patents, etc.
- This process can be the most time consuming part of the financing process taking 4 to 6 weeks for equity investors, but shorter for debt investors,
- Process needs to be managed correctly to ensure that no undue delays occur

Projections & Assumptions :

- **Business Case** : Commentary on the proposed funding amount, purpose, term, proposed security and equity input.

- **Business background :** Management structure, performance (historic and current), the market, competitors, future and strategy.

- **Capital Expenditure** requirements year on year.

- Detailed statement of affairs for Personal/Investor borrowers

Expansion through Acquisition

- Acquisitions - One may ask how relevant this is with the doom and gloom of the “credit crises”
- Recently published survey carried out on privately owned business shows that over 70% of participants forecasted growth in their business over the next 12 months.
- Growth will be delivered through organic growth and through acquisitions

Expansion through Acquisition

- The key place to start is to identify the **type of company** you wish to target and so you need to set out target selection criteria, addressing questions such as:

- What **sector are you targeting** – are you looking for expansion of own business sector or diversifying into a new sector?

- Do you want to **expand your existing market** or do you want to move up or down the supply chain?

- Do you want to expand into a **new geographical area?** In recent years, many Irish companies have acquired in the UK and in Central/Eastern Europe.

Investors and lenders expectations

- Forecasting lies at the heart of persuading both investors and lenders to finance company development.
- They will want to see a clearly worked **cash flow forecast** which shows the reasonable future performance of the business based on sensible assumptions.
- The investor will be looking to see the market potential in the **company's products or services**, current and future, which justifies the proposed investment

Summary

- Finance will be required at every stage of the business cycle usually used to fund growth –
  - either organically or through acquisition.
- Raising finance must be planned.
- Enough Finance should be raised to see the business through at least the next two years.
- Funding Mix should be forecasted in the plan depending on the business and structure.

Summary :

- Confidence in the business & team that has delivered on its business plan in the period up to finance will attract lenders.