



Finding sources of capital that won't require control

Many private investors will insist on some measure of equity in your company. But there are alternatives.

A THIRD-GENERATION paint manufacturer in the Southeast was looking to expand its business by acquiring a large competitor that had fallen into financial trouble. The family CEO came to see us with the following dilemma: "I need to raise capital for my expansion, but I'm not interested in giving up control." This is a common refrain among our family business clients.

Indeed, when family companies start talking to outside investors or

tages and disadvantages.

Bank loans are usually the easiest way to obtain capital without relinquishing control. Banks exercise control over assets that serve as loan collateral by including financial covenants in loan documents. Examples of covenants are the requirement to maintain certain revenue or income growth, or to generate a set amount of cash for each dollar of interest. If not met, such covenants would allow the bank to take control of assets.

In today's market, lenders are so

include pension funds, hedge funds, leveraged public funds, limited partnerships and insurance companies. Many private equity investors have raised mezzanine funds, which parallel and sometimes coinvest with the private equity fund. Some banks have also established stand-alone mezzanine efforts.

Midsized companies may use mezzanine capital to finance a growth opportunity, such as acquisitions, shareholder buyouts and expansions. While mezzanine financings often complement bank loans, they are not asset-based and therefore don't require borrowers to pledge their receivables, inventory or plants. Lenders base the terms on the strength of the borrower's cash flow.

The subordinated debt portion of a mezzanine investment typically has a maturity of five to seven years. The interest generally either is accrued over the life of debt or is paid currently at a rate of 8% to 14%, depending on market conditions. The principal is paid as a "balloon" at the end of the maturity period. The equity usually consists of warrants to purchase 5% to 10% of the borrower's common shares, at a price based on the investor's outlook for the company.

Mezzanine investments carry fewer covenants than bank financing does. But mezzanine investors protect their investments by requiring some consent rights over significant capital investments, divestitures or sales.

Small business investment companies (SBICs) are privately owned

Special-purpose investment companies are set up to separate assets from control of the family business.

other capital sources, the issue of control—not the amount of money—is generally the main stumbling block of the negotiations.

Private equity investors may want to take control of the board. At a minimum, they will want control of a liquidity event when it's time to realize a return on their investment, meaning they may force the family to buy their interest back, which might require the family to recapitalize or even sell the company. While outside investors in a family company understandably want to protect their investment, the family may not be ready for a liquidity event.

Alternatives to private equity

Fortunately, in today's market there are plenty of alternatives to private equity funding. Each has its advan-

eager to write commercial loans that they are demanding fewer and fewer covenants. Fitch Ratings, a unit of Fimalac SA of Paris, studied more than 6,600 loan agreements and found that an average loan package in 2005 contained five covenants, compared with six in the preceding three years. Speculative-grade loans also had six covenants, on average, but that was down from eight in previous years. Even with the decrease in covenants, bank loans aren't the best option for high-growth companies, which require more flexibility.

Mezzanine funds, also called cash-flow lending, are a hybrid: subordinated debt with an equity component. The mezzanine segment of the private capital market has increased dramatically as an alternative to bank loans. Mezzanine investors

management investment funds that are licensed and regulated by the Small Business Administration. SBICs invest in small companies with capital raised from private investors plus funds borrowed at favorable rates from the federal government.

not fit SBA's criteria, FOPEFs can be an attractive source of "non-control" capital. They distinguish themselves from traditional institutional private equity funds by offering more flexibility in terms. They are added-value partners and do not require control.

structured as a spin-off of assets of the company in a limited liability company (LLC). Alternatively, the company could recapitalize under an LLC, which would allow investment of private capital on a non-control basis. The common thread of all SPICs is that the assets are separated from control of the family company.

In today's market, banks are so eager to write commercial loans that they are demanding fewer and fewer covenants.

Strategic partnerships with corporations are yet another source of non-control capital. Some family firms find a strategic partner among their competitors or companies in complementary industries.

Typically, SBA will match the SBIC's investment two-to-one.

Because they have access to capital at attractive rates, SBICs can pass on some of that savings to the small companies in which they invest. The SBIC program uses the SBA's definition of a small company: It must have \$18 million or less in net worth and no more than \$6 million in after-tax net income over the past two years.

There are two types of SBICs. *Debenture SBICs*, which provide debt or debt with equity features, are more appropriate for mature companies that can make current interest payments. *Participating security SBICs*, which provide pure equity investments or debt investments with accrued interest, can invest in earlier-stage companies.

There are about 400 active SBICs, many of which specialize in a particular set of industries or geographic areas. Together they invested almost \$3 billion into some 2,300 companies last year, according to the National Association of Small Business Investment Companies (NASBIC).

For companies that fit the SBA's criteria, this is a very attractive source of capital. SBICs invest passively; they are not interested in running the company.

Family office private equity funds (FOPEFs) are the fastest-growing segment of the private equity market. The investors are high-net-worth individuals and family offices. For companies that would

FOPEFs often complement the family's patient capital by investing in a partnership relationship. The duration may be as long as 10 to 15 years. The form of investment may be all equity, a combination of equity and subordinated debt or, in some cases, convertible debt. FOPEFs are very comfortable investing in a minority position, often assuming 10% to 40% ownership.

In addition to the timing of exit, the mechanism of exiting their investment is more flexible than traditional private equity. Some FOPEFs do not even require a fixed exit, just a cash-flow override by allocating a certain amount of cash flow to their investment above a certain threshold. This would allow them to progressively exit their investment and realize their return without forcing the company to recapitalize.

Special-purpose investment companies (SPICs) have recently gained popularity with family firms that are seeking non-control equity capital, that are not interested in raising additional debt and that do not qualify for SBA programs.

A client of ours who wanted to make an investment in the United Kingdom set up an SPIC. He attracted capital from high-net-worth individuals and family offices. Instead of investing in the family company itself, these investors owned a stake in the SPIC.

There are many structures available for SPICs. They can be

Strategic partners become involved with management, which means they may have greater control than other investors. But for family companies that want to develop new markets or new territories, a strategic partnership might be a very attractive alternative.

What do you need?

Before exploring any sources of non-control capital, you must first assess your capital needs. If you're planning a simple generational transition with no strategic implications, bank loans, mezzanine capital or even SBICs may be a very comfortable option. On the other hand, if you're planning to expand your business and position your company for future growth, family office private equity funds, special-purpose investment companies or strategic partnerships may be more appropriate.

Surrendering significant control is not an option for many family firms, particularly as a company passes from one generation to another. Take the time to evaluate all the options to find the combination of terms and costs that will best help your business to grow and thrive. **FB**

François de Visscher is founder and partner at de Visscher & Co., a Greenwich, Conn., financial consulting and investment banking firm for closely held and family companies (francois@devisscher.com).