



# Matching sources of capital to your needs and strategy

*Before you tap the capital markets, determine how much you really need, and what type of financing is right for you.*

**A**T THE 2005 Family Firm Institute conference in Chicago, keynote speaker Christie Hefner described a conversation she had with Michael Milken in 1988, shortly after she became president of the then-troubled Playboy Enterprises. At a meeting he requested, Milken, then Wall Street's junk-bond king, told her he could easily raise half a billion dollars for Playboy Enterprises.

Hefner—daughter of Playboy founder Hugh Hefner—told Milken she

inspire family-owned and other private companies to stuff their coffers with as much cash as they can raise.

Private equity funds raised record amounts of commitments in 2005. Just consider that as of late last year, according to Thomson Financial, global private equity funds had unused capital in excess of \$482 billion, up 59% from 2002. The global debt market increased at the same rate, resulting in \$5.7 trillion of available funds in 2005. When banks and private-equity funds find a good

only to discover their loan restricts them from taking advantage of that opportunity. Funding an acquisition with bank debt may seem attractive because it's cheaper than private equity. But covenants in a bank loan, such as maintaining debt-equity ratios and profitability, may leave the company no flexibility to raise additional capital down the road.

With financiers so flush with cash, it might be tempting to sign on the dotted line. But it's wise to first look at your strategic opportunities and shareholders' liquidity needs, evaluate all available sources of capital and then determine the right source. The question is not whether capital is available, but whether the right type is available for you.

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didn't know how she could deploy that kind of capital in ventures that would earn enough return to service all the debt. She recalled to the FFI audience that Milken responded, "First you raise the money, then you figure out what to do with it." That didn't sound right to her, so she declined his offer.

Hefner may have been inexperienced in those early days of her leadership role, but she made a wise decision. Strategy should dictate how much capital is right for a company. And the type of capital you raise is equally important. A mismatch can doom your business strategy.

Just as tempting as Milken's offer might have seemed to Hefner, today's flush capital markets may

investment, they want to put as much money in there as possible. If that sounds too good to be true, it is.

A fourth-generation chain of drug stores in the Midwest learned this the hard way. It tapped the private equity market to buy out some shareholders and provide liquidity for family members, as well as to finance business growth. Two years into the investment, the family owners' private equity partners, who owned 40% of the company's stock, spotted an opportunity to sell their shares to a strategic buyer. The family didn't want them to sell, but covenants in the private equity documents clearly allowed them to cash out.

Other companies have used a bank to finance a new growth opportunity,

## First, take these steps

Before searching for outside capital, conduct the following assessments:

- **Draft a strategic plan.** Instead of letting an outsider define your growth strategy, develop your own five-year strategic plan. Identify growth opportunities, determine the cash required and calculate what cash returns they would generate. The strategic plan should drive growth opportunities.

- **Identify shareholders' liquidity needs.** To avoid surprises, be aware of your shareholders' future liquidity needs before an outside source of capital enters the picture. The needs may be as simple as dividends or liquidity flexibility, or as complex as estate settlements and shareholder buyouts. Discussions with shareholders and their advisers

can help you assess the timing of such liquidity needs. To the extent they can be quantified, they should be factored into your strategic plan.

• **Revise or reinforce family governance structures.** Before letting an outside source of capital share in your corporate governance, make sure your governance system satisfies your relatives' control and information requirements. Your governance structures should be strong enough to allow a healthy partnership with the outside capital source.

**Four types of need**

Your strategic and liquidity plans will reveal your need for one of four types of capital. Mismatching sources and needs will result in cash flow shortfalls and strained relationships.

• **Working capital** needs emerge from cash flow cycles. For instance, cash flow needs arise until a company can collect receivables. Typically, working capital needs should be financed by bank lines of a year or less in maturity. The cost of the bank line and the covenants attached to it should match working capital needs.

• **Bridge capital** can finance either a specific project or the acquisition of long-term assets, such as building a new plant or purchasing a

new machine. It's important to match the duration of the financing with the useful life of the asset or project. Bank financing or institutional debt is usually the most appropriate source for bridge capital. The term tends to be fixed-rate, amortized over the life of the project or asset involved. The servicing and repayment of the debt should be matched to the cash flow generated by the project or asset. Debt repayment must be structured to begin only after the venture is likely to generate cash.

• **Transitional capital** needs arise when companies face ownership or strategic transitions. Ownership transitions may involve the buyout of some shareholders. A strategic transition might involve taking the business to the next level of growth, such as developing a new market or new product, or even a long-term acquisition. Such transitions result in shareholder value growth, so the most appropriate sources of capital are private equity funds or subordinated debt lenders. Their investment typically involves equity participation and a relatively short-term exit—typically five years. The key issue is the company's ability to generate sufficient value from such transitions to

provide for the exit of the capital sources and a healthy return to the family.

• **Strategic capital** supports long-term development of a business, such as expansion into a new geographic area that requires taking on a local partner, or a buyout of a whole branch of the family. These initiatives can be financed via strategic, joint-venture partners with deep experience in the industry or expertise in areas such as international distribution. Family business investors who are willing to partner with your family might be another source of capital to consider. Seek out a partner who can bring strategic or ownership value in addition to capital.

Before you accept any offers, define your growth opportunities as well as your shareholders' dreams and expectations. Analyzing your needs and matching them with the sources of capital at hand will pave the way to a healthy relationship with outside capital providers. **FB**

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**Capital sources matched with business needs**

Type of financing	Need	Sources	Time horizon	Terms
Working capital	Cash-flow cycles	Bank lines	Less than one year	Floating rates with asset coverage covenants
Bridge capital	Specific project or long-term assets	Bank financing or institutional debt	Life of the project, typically less than five years	Fixed-rate term debt or institutional debt placement, with covenants regarding cash requirements and asset coverage
Transitional capital	Ownership transition, strategic ownership or growth initiatives	Private equity/mezzanine or subordinated debt lenders	Typically five years, sometimes more	Equity or equity participation, sharing of control, and certain consent rights
Strategic capital	Long-term value growth or shareholder buyout	Strategic partners or family business investors	Ten years or more	Full participation in equity; joint control with existing owners