Financing Growth

In the last article in this series we discussed when to grow. We concluded that in general, it is always a good time to grow. However, we asked three questions which drive smart strategic growth:

- First, is the company prepared internally to grow? Does the company have the operating processes, procedures, financial systems and a people process that will support growth?
- Second, what is the market opportunity offered? How are the company's customers changing? Where are competitors disappointing customers? Is there an opportunity to create value for a supplier and create an opening in the market?
- Third, what growth offers the best opportunity for value enhancement? Should the company add new locations? Should the company open window and door plants? Should the company open an installed sales division?

If the answers to the above questions support a decision to grow the business, the next question is how do you finance new growth? Four critical questions must be answered:

- Are you buying an existing business or building one from scratch?
- What are the financing requirements of the new business and what does the company's current balance sheet and cash flows support?
- What are the alternative sources of capital?
- How is growth structured so it will minimize taxation, limit risk, and support the wider objectives of the company's shareholders?

With these questions in mind, a comprehensive plan to finance growth can be developed.

Are you buying an existing business or building one from scratch?

After you have decided to grow the business, you must consider whether to start a new business unit from scratch or to look for an existing business in the area to buy. There are pros and cons to either alternative. However, the financing strategy can be quite different.

There are several advantages to buying an existing business. An acquisition has the benefit of speed to market. An existing business will bring a built-in customer base which will expand your business in general and may enhance your goodwill in the market. There is an existing employee base with sales, delivery and operations staff. In addition, there is a significant financing advantage. As we will discuss below, starting a business from scratch can be very expensive. There will be a significant need for working capital to cover the location's overhead and depending upon the services offered, it could take more than 36 months to break even.

Financing an acquisition is often less expensive than a start up. With the right purchase price and purchase structure, the acquisition should be cash flow positive very soon after it is acquired. In addition, the risk is reduced since the acquired business is an operating company presumably breaking even at worse, giving your bankers assets and cash flow to lend against – and no 36 month period of losses before breaking even.

Sources of capital will be discussed below, but it should be noted that buying an existing business offers one additional source of financing: the selling shareholders.

What are the financing requirements of the new business and what will our current balance sheet and cash flows support?

Where do you get the money to grow? Before looking for sources of capital, it is important to understand what the capital requirements are to buy or build a business. The financing requirements for an acquisition are easier to project because there is an existing business with cash flow, assets, a customer base and a management team. This greatly reduces risk and uncertainty. In addition, the seller is frequently required to finance part of the purchase price through a note. Since the seller knows the business intimately, he is more comfortable with the risks and will require less due diligence than an outside source of capital.

It is much more challenging to forecast the financing requirements of a start up location. The costs of starting a new business unit, such as installed sales or a door shop, fall into two categories: hard and soft costs. The hard costs are easier to identify although still difficult to forecast. The hard costs include capital expenses or investments, such as real estate and building acquisition, equipment, vehicles and inventory. Hard costs also include working capital requirements until the business breaks even, and the interest expense of this working capital. A forecast is developed to estimate when the business will break even and then become cash flow positive. This forecast, or proforma, is subject to many variables that are inherently difficult to estimate.

The soft costs of beginning a new business draw upon resources, which are frequently more scarce. Management time and attention is the easiest start up cost to underestimate in planning. Is there an individual in the organization with the knowledge, time, energy and emotional balance to work through the challenges proactively and devote significant time to bring along employees new to your organization? Will removing this key employee from his current position create a hole in your organizational chart and is there a successor?

What are the Sources of Capital?

You now have financial forecasts for your growth plan. Where do you access the required capital? What is the cost of that capital? Who will provide this capital, thus becoming your new partners? There are two types of capital: debt and equity. New businesses are frequently funded by two different sources: professional institutions or

friends and family. This article will limit its focus to professional institutions. Friends and family capital is too situation-specific to address in broad terms.

The easiest, least expensive, and "friendliest" source of capital is secured debt from your existing bank. Many dealers & distributors have significant equity in real estate and buildings, and many companies are over capitalized with respect to working capital. Your bank will help determine the company's borrowing base, frequently making additional debt financing available through a secured loan. A secured loan from your bank will be the cheapest source of capital for your company. Your existing bank knows that you may be out talking to other banks who will want all of your business, so it should be competitive and responsive to your needs. This source of capital is also available regardless of the size of your business, which is not the case with the other sources of capital as we will see below.

On the opposite end of the spectrum is equity capital. This is where an institution, such as a private equity firm, partners with the company to either provide growth capital and/or capital to buy out shareholders. The private equity firm usually becomes a majority shareholder in the business and requires seats on the board of directors. A private equity firm requires strong management, which is staying active on a full time basis. Private equity firms frequently target returns of 18% to 25% per year on their investment, so the growth story must be compelling. Private Equity firms intend to invest large sums of capital at one time, so the value of the company must usually be $15 million or higher. These firms will fund acquisitions and prefer to invest in companies which, if all goes well, will lead to additional investments in the company.

There is a hybrid source of capital, which has attributes of both equity and debt, called mezzanine financing. Mezzanine financing is usually structured as debt, a loan to the company, which is subordinate to senior secured lenders of the company. Being a junior creditor with more risk, a mezzanine lender requires a higher interest rate. In addition, the mezzanine lender requires equity in the company in the form of stock, options or warrants (the right to buy stock at a predetermined price in the future). Mezzanine lenders are looking for stable cash flow to cover interest payments. Mezzanine lenders will require board seats and most choose to invest in companies with at least $2.5 million in cash flows.

How do I coordinate growth with tax planning and shareholder objectives?

Business growth financing has additional dimensions to consider. Structuring the investment of new capital, the associated risks, and the creation of taxable income and equity value requires careful and coordinated planning. There are significant questions to ask, consider and answer in the course of structuring and financing new business growth.

- What is the ultimate business succession strategy at the retirement or death of a shareholder? Are there gifting and estate planning opportunities to consider in financing and structuring growth?

- Which corporate structures will meet the needs of new lenders or investors while minimizing business risk and taxes in the future?
- What new business structure lends itself to the existing corporate structure, and should the current corporate structure be changed?

The personal objectives of company shareholders are too varied and complex to address comprehensively in this article. However, it is important to recognize that different shareholders frequently have different objectives, and that shareholder objectives may differ from business objectives. This is especially true when there are active and non active shareholders, family and non family shareholders. Starting a new business unit and/or acquiring a company create opportunities to address conflicting objectives. Inactive shareholders may not want to share the risks of a new business unit or divert current dividends or distributions into new business growth. Now might be the time to separate an operating company from the real estate within the company, and transfer the real estate to inactive shareholders.

Decisions regarding corporate structure need to be thought out as well. New corporate structures have evolved in the past 20 years that may not have existed when your company was incorporated. These structures, such as limited partnerships, S-Corporations and LLCs, may offer more flexibility to shareholders, minimize taxes and reduce risk. Should the new company be a subsidiary of the parent, a division of the parent, or a stand alone entity? If an acquisition is being contemplated, structuring issues will affect how much tax is paid by the seller, what risks you will assume going forward, and what your tax basis will be in the acquired business.

Acquiring a business or starting one from scratch entails new risks. Should those risks be absorbed by the parent? Frequently, building supply dealers and distributors have land and buildings with significant equity value inside their corporations. This exposes the value you have created over the years to unnecessary risk. Should the operating company and the non operating assets such as land and buildings be separated to limit risk? If so, then how will that impact corporate credit facilities? These are issues that you will have to work with your bank to resolve, but the benefits could be well worth the effort.

Finally, estate planning objectives should be considered in conjunction with growth strategies, since the value created will ultimately be subject to estate taxes. If you have gifted stock to children and grandchildren through a partnership or trust, perhaps the partnership or trust should be the owner and investor in the new business. If your children are ultimately going to own and run the business, perhaps the new business should be owned by them outside your estate. There are many questions and alternatives when you consider estate planning objectives in conjunction with growth strategies.

Summary

Growth is necessary in today’s market in order to remain competitive and protect your position in the supply chain. Those companies that are not committed to growing their

business will watch other companies capture market share and drive more efficiencies to their bottom line. A carefully considered, well executed plan can lead to growth, or growth can result from temporary market forces that benefit all companies in your area, "a rising tide lifts all boats." Growth presents challenges and stress in your organization no matter how well conceived or executed. Laying the foundation for financing growth before it arrives on your doorstep is critical to being able to support the financial requirements growth brings. How much will it cost to grow your business? And what are your alternative sources of capital? Answering these questions is critical in helping your organization plan for growth. In addition, growth presents many opportunities to advance other personal and business planning objectives. When a strategic plan to grow your business is formulated with these criteria in mind, you increase the possibility of executing on your plan – and doing so successfully.

Greg McCarthy is an Advisor with Kellick & Associates - A building supply industry advisory firm serving clients across the US and internationally. Mr. McCarthy provides investment banking and Merger and Acquisition advisory services. He has worked with public and private companies and private equity groups in executing merger and acquisition programs and financing growth strategies. www.KellickandAssociates.com

This article appeared in the September/October 2006 issue of *The Lumber Co-Operator*.