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The Color of Money

Introduction to Capitalizing Your Company

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Next in the series…

- January 21 – Nondilutive Funding (Proof of Concept/Grants)
- February 18 – Angel Funding
- March 18 – Seed Funding
- April 22 – Venture Capital
- May 20 – Debt Financing
- June 17 – Investment Banking

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Greg Feldmann, President Skyline Capital Strategies

As President and co-founder of Skyline Capital Strategies, LLC, a business advisory firm located in Roanoke, VA, Greg brings over forty years of experience in corporate management, banking, corporate finance, and investments, including governance and executive roles within both public and private companies. He is an acknowledged subject matter expert in corporate finance, strategic planning, executive and board leadership, and line of business management in the financial services arena.

Dawn DeHart, Senior Vice President at Carter Bank

Dawn is Senior Vice President and Director of Community Development Lending at Carter Bank. Dawn has expertise in small business government-guaranteed loan programs and in historic, low income, and New Markets tax credit programs as well as various business and entrepreneurial grants. She works with small businesses, government entities, for-profit, and not-for-profit organizations to assist them with their funding needs. Her lending territory includes Virginia and North Carolina.

Objective of Workshop

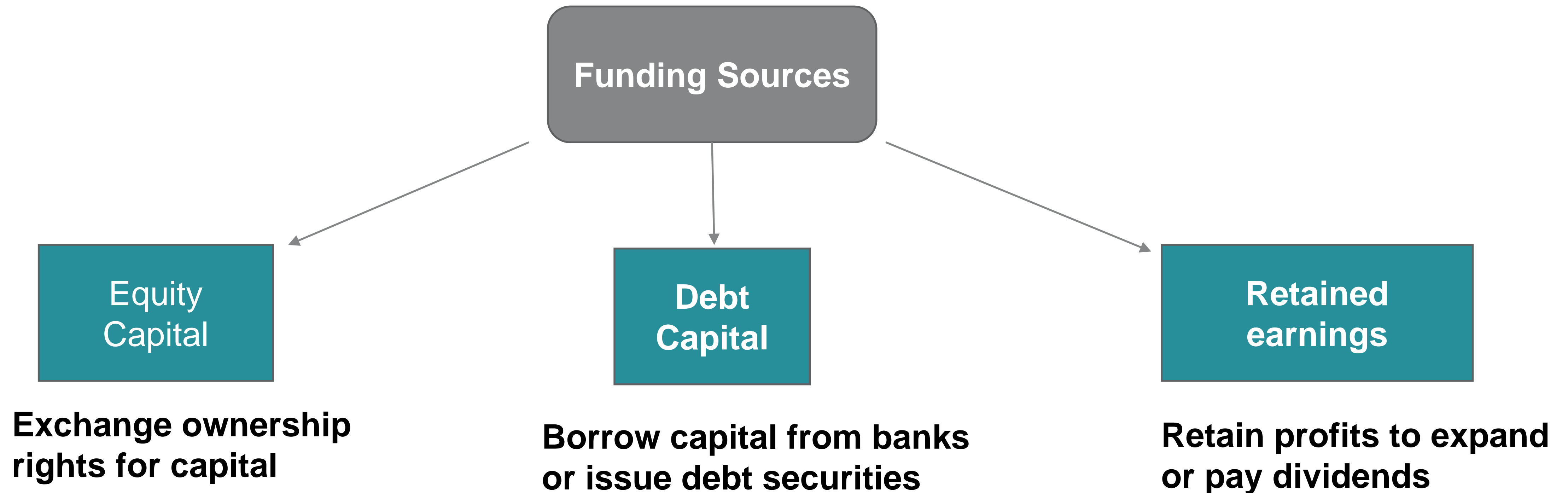
- Understand what “capitalization” means
  - Capitalization Examples
  - Understanding the “capital stack”
- Overview of capital sources
  - Equity
    - F&F, Grants, Angel Investors, VCs, PEGs, Public
  - Debt
    - Bank Lending, Gov’t Programs, Bond Markets

Capitalization & Equity

Greg Feldmann

Business Capitalization Defined

- Capitalization refers to the amount of capital required by the business enterprise.
- Thus, capitalization is the sum total of funds received through shares, bonds, loans and retained earnings.



Capitalization Example #1

$30 million revenue manufacturing company

Industry typically operates on a 60% equity / 40% debt capital structure

$30M Revenue Manufacturing Company		
Assets		
Cash		2,000
Accounts Receivable		2,500
Inventory		5,000
Fixed Assets, net		8,000
Total Assets	$	17,500
Liabilities and Stockholders Equity		
Accrued Expenses		250
Accounts Payable		750
Line of Credit		3,000
Long Term Debt		4,000
Total Liabilities		8,000
Retained Earnings		6,500
Common Stock		3,000
Total Liabilities & Stockholders Equity	$	17,500

Assets world serve as collateral for bank loans, providing a secondary source of repayment with profits/cash flow serving as the primary source of paying back debt.

Funded debt represents 40% of the total capital structure

Retained earnings and common stock issued 60% of the total capital structure

Capitalization Example #2

$5M software early-stage company - $2M preferred stock for growth

Typical industry capital structure 80% equity / 20% debt

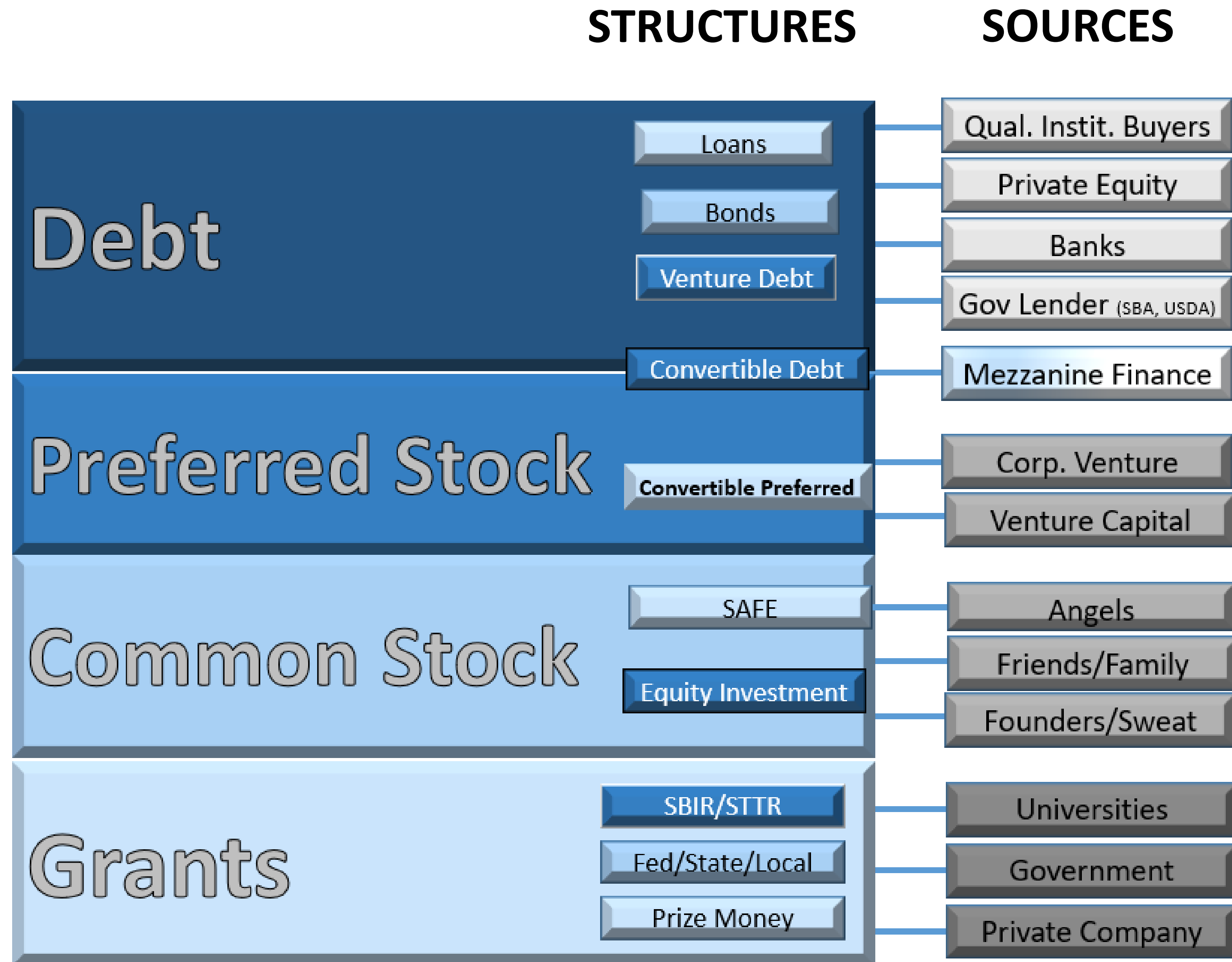
$5M Software Company	
Assets	
Cash	2,500
Accounts Receivable	625
Fixed Assest, net	250
Capitalized Development Costs	1,075
Total Assets	$4,450
Liabilities and Stockholders Equity	
Accrued Expenses	100
Accounts Payable	175
Line of Credit	500
Total Liabilities	775
Preferred Stock	2,000
Retained Earnings	475
Common Stock	1,200
Total Liabilities & Stockholders Equity	$4,450

Note company lacks the same type of asset base as the manufacturing example, which means there are less assets available to serve as collateral for bank loans.

Use of debt in this case is limited to an assumed line of credit, which represents about 11% of capitalization.

Equity sources, including the preferred stock issued, constitute 83% of balance sheet capitalization.

Capital Stack



Sources of Funding by Stage

Pre-revenue ⟷ Profits & cash flow

Seed/Startup | Early stage to Expansion | Mature | Various | Mature

	Family & Friends	Angels	Venture Funds	SBICs	Banks	Corporate & Strategic Investors	Public Markets
$ Availability	Low	Low	Medium	Low	Medium	Low	High
Cost	High	High	High	Medium	Medium	High	Med/High
# Quantity	Low	Low	High	Medium	High	Low	Low
Level of Co. Maturity	Low	Low	Med/High	Medium	High	Medium	Med/High
Risks	• Typically, no value beyond $s • Hard to manage • Relationship risks	• Herding cats • Time consuming with little visibility on $ amount • Generally limited strategic value	• High return expectations • Loss of control • Down rounds can be punitive	• Subject to high reporting • Long application process • Typically, follower • May require current coupon	• Company must be CF + • Debt terms can be restrictive • Regulated	• Slow investment process • Trojan horse problem • Change of guard	• Regulatory & reporting • Dilutive to existing owners • Markets can be cyclical tied to economy and capital supply & demand factors

Debt

Dawn DeHart

Bank Financing

- Geared to Low to Medium Risk business ventures
- Opposite end of the Venture Capital spectrum
- (VC’s look to the upside potential; banks look at downside protection)

5 C's of Credit:

1. Collateral
   - Banks look for security on a loan to mitigate risk & to have a backup source of repayment if the business fails. Short term Lines of Credit may be secured by accts receivable and inventory. Longer term amortizing loans will be secured by real estate and/or equipment.

2. Capacity
   - The ability to repay the loan.
   - Banks seek 3 sources of repayment:
     - Primary: Business cash flow
     - Secondary: Collateral
     - Tertiary : Personal guarantees

5 C's of Credit continued

3. Capital
   - Borrower has "skin in the game" and has contributed his/her own equity; vested interest.
   - Banks to share the risk and will not take on 100% of the risk
     - Rule of thumb: 20% equity, 80% debt.
4. Character
   - Banks want to know that the borrower will honor his/her commitment.
   - General trustworthiness of the principal is usually judged by credit history, local reputation
5. Conditions
   - Consider state of the economy, industry trends, bank concentration limits in a particular industry segment

General Comments

- Banks are regulated by state/federal agencies and must demonstrate prudent & safe lending guidelines to prevent losses.
- Banks prefer to lent to stable, established business with a favorable track record and demonstrated repayment ability. Startup entities and technology companies are high risk with no track record, sometimes long ramp up periods before profitability occurs and often no hard collateral to provide.
- Banks can provide cheaper interest rates than other sources because they are focused on safe collateralized loans, but they do use risk/reward pricing. The greater the risk, the higher the interest rate depending on the type of business venture…up to a point.
- Banks frequently use loan covenants such as maximum debt to worth, debt service coverage ratios, liquidity requirements.

Credit Enhancement Loan Programs

Small Business Administration and USDA Business & Industry

- Banks get a guarantee from the federal government to help offset risk on higher risk business with no history.
- Not all banks participate in these programs. Programs require expertise and greater monitoring to maintain the government's guarantee protection in a loss situation.

Credit Enhancement Loan Programs cont'd

Pros

1. Can be used for more "traditional" startup ventures (with hard collateral).
2. Business gets a longer repayment term to allow business to stabilize
3. Programs discourage banks from using covenants; balloon maturities not permitted.

Cons

1. Technology businesses are not likely to qualify due to lack of collateral, long ramp up periods.
2. Personal guarantees required of owners with 20% or more ownership interest.

Questions?

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