TrueNorth Capital Partners LLC

Chasing "High Performance" Capital

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As owners of middle market business read the headlines these days, whether it concerns domestic debt, unemployment rate or crises of European markets, a question that increasingly is being put forward to those of us raising capital in the middle markets is "how can I source growth capital for my (lower middle market) company". The hesitancy by the commercial banks to provide cash flow funding to smaller businesses has caused many lower middle market business owners to assume that broader markets in general will be equally hesitant if not closed to lower middle market growth strategies. However these markets, if approached with a well-designed and targeted strategy, can provide a valuable source of growth capital or acquisition opportunities to a broad set of industries ranging from automotive aftermarket to retail fixturing. Highlighted below are the current strategies of the investor community, as well as key issues a middle market business must address in raising capital. Additionally we will offer a brief overview as what to expect in raising junior (cash flow) growth capital.

Historical Perspective

The private equity capital market has grown from a total of approximately 125 firms in 1985 to where it now includes 2,650 firms in the US representing investment in 15,680 companies. Within the definition of private equity capital, the investment profiles include firms that invest only equity and firms that invest in hybrid securities: subordinated debt (junior or mezzanine) often with equity and/or warrants attached. In addition, the form of transaction (debt versus equity) and capital requirement enables segmentation of firms by size of transaction they seek to invest in. Over the decades private capital investors have ridden a roller coaster of returns magnified by the use of leverage and the expansion and contraction of purchase multiples. Historically the private capital returns have outperformed the market – as measured as Alpha (performance on a risk adjusted basis). However after the 2008 financial crises and the private capital market requirement to mark to market, firms aggressively wrote down their portfolios. Currently GDP growth, multiple expansion and leverage do not look nearly as favorable in the current recovery as they have in the past. The issues now are how will the private capital markets continue to generate returns –how will they succeed in chasing the performance Alpha?

A Revised Approach

The private capital groups are increasing focus on generating returns by building three mutually reinforcing capabilities. First they are ensuring that they are investing in transactions where the group brings value and experience to the table. Second; that they invest at the right price - one that assumes a reasonable growth projections and market conditions and have an exit planned either through sale or recapitalization. Finally, they are seeking to build a repeatable value creation model—one that builds on core competencies and themes – hence the notion of buy-and –build. Many of these features either preexisted or are shared by the corporate world as well. Underlying this investor creditor strategy will first be the belief that they have identified an opportunity that offers oversized opportunity for investment return including, market opportunity, product acceptance, achieving targets and management experience. A company must consider the characteristics that attract capital, identify those characteristics that form the company's DNA and build a bridge between investor expectation and company opportunity.

Choosing the right partner

Junior debt capital funds (whether mezzanine, unitranche, or simply junior subordinated) provide an active source of growth capital (cash flow lending) for companies seeking to retain control. Typically the fund will seek a return that includes a cash yield and enhance the yield with the inclusion of warrants and/or units of stock. The valuation of these stock units and warrants are derived from the projections company management has offered. It is of critical importance that company management, with the help of its financial advisor, build a thoughtful, detailed, and defendable model of the company's future revenue and income projections. These projections will determine the value the warrants and equity and accordingly the percentages to be negotiated. The source of these junior capital funds include, pension, endowments, insurance, high net worth investors and other forms of institutional/qualified investors and hence mezzanine funds, like private equity funds, maintain a fiduciary responsibility to oversee their investments. In the case of raising growth capital the investment will include a set of terms that put certain restrictions and boundaries on activities such as acquisitions and dividends the company can undertake. At the same time a set of performance parameters will be established that measure the company's pretax, pre-interest earnings (EBITDA) on a 12-month rolling basis to the amount of total debt the company is maintaining – coverage ratios. These are typically measured each quarter and failure to meet these measures can result in default. The great advantage of these funding sources today is their flexibility in structure. They can PIK interest or dividends and weight return to the equity kicker to maximize cash flow today. That said managers are measured on successful outcomes and want to see their investments perform at least as well as projected. Therefore the combination of the right partner, realistic projections and constructive negations will result in success on both side of the table.