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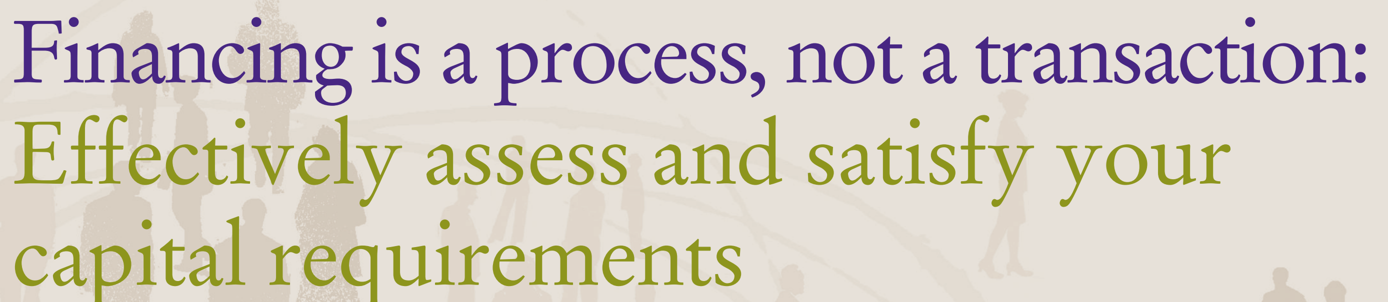
Accessing and securing finance guide

Securing the right financing means asking the right questions:
The why, when and how of managing your capital needs

Effective assessment drives successful financing strategies:
Securing capital in the new economy



Financing is a process, not a transaction:
Effectively assess and satisfy your capital requirements

For fast growing, dynamic mid-market privately held businesses, securing financing in the most efficient and cost-effective way has long been a major business challenge. Determining your precise needs – as well as how and when to execute capital strategies – can be a complex process that many businesses fail to address effectively. To complicate the matter, the recent global economic crisis and the resulting storm of regulatory change and general financial uncertainty have made lenders and investors both more wary and more vigilant.

The fact remains, however, that attracting initial financing and retaining ongoing access to existing financing are necessary for business maintenance and growth. As the global recovery continues, companies seeking to jump-start new growth strategies or meet specific operational needs face a variety of potential capital requirements, including:

- working capital (inventory, receivables)
- fixed assets (plant, machinery)
- IT and research & development (R&D)
- funding operations in a growth or expansion mode (e.g., the lag between hiring sales staff and increased sales)
- acquisitions
- funding shareholder liquidity needs.

Establishing the need is only the beginning of the financing equation. If your company is looking to manage that need to drive corporate strategy and preserve business health, you can take certain key steps to ensure a productive capital raising process: assess where financing needs are greatest, determine the level of capital required to meet varying objectives and how much of that capital must be generated externally, establish your debt management capacity and consider which funding sources best meet your needs. This process should all be framed by a comprehensive business plan that considers the short, mid and long term impacts of various funding scenarios on the company.

Grant Thornton's 2011 International Business Report (IBR)

Executives who cite the cost of finance as a constraint on their ability to grow their business*

24%

Executives who cite the shortage of working capital as a constraint on their ability to grow their business*

24%

Executives who cite the shortage of long term finance as a constraint on their ability to grow their business*

22%

* Grant Thornton's International Business report is a worldwide research study which has been running for 19 years. IBR provides insights into the thoughts and opinions of 11,000 business leaders from 39 economies. The full report is available at www.internationalbusinessreport.com

Using your situation and activities to assess business needs

All businesses need a certain amount of capital to sustain operations and fund growth. Cash is the engine of your business, but with ongoing contraction in the banking sector in many jurisdictions, financing can be expensive and subject to increasing levels of due diligence and ongoing compliance. Purse strings are loosening, but your house must be in order when you are looking for financing, starting with a proper needs assessment. This largely depends on your current business situation and the business activities you are pursuing or planning.

There is a large range of situations that can affect financing needs:

- a company may need specific equipment and machinery to improve operating efficiencies and create cost savings
- businesses that have experienced a dip in performance from historical norms may need to fund operational losses
- seasonal operations can experience great variation in capital needs from month to month or quarter to quarter
- businesses in major growth cycles may need significant working capital to cover tight timelines between receivables and payables.

Capital might also be required to meet shareholder demands – such as dividends or distributions – as opposed to company needs. Debt used to generate liquidity is usually more expensive, and at times problematic, as financiers generally prefer to see capital deployed within operations. Transitioning the business can create challenges as well, if capital is required to finance an owner's exit strategy, for instance.

Obviously, a company's global situation – where it is located and how wide its corporate net is cast – has a huge influence, not only on availability of capital, but on type of need. In emerging markets, the primary need is often internal growth capital to fund business expansion – new facilities, hiring, R&D, launching new products – and external growth capital to fund acquisitions, products, distribution networks or patents. This has led to significant private equity opportunities in the Middle East, China and Africa, where rapid business expansion drives the need for large influxes of capital.

In 2011, **34%** of respondents to Grant Thornton's IBR survey said they expected finance to become more accessible over the coming 12 months, **45%** anticipated no change and **18%** expected less accessibility. This last number is slightly down from 2010, when **27%** of business leaders said they expected finance to become less accessible.

Determine capital needs: an effective business plan is critical

Financing is essentially based on three questions. How much can I bring in myself? How much can I bring in from the company? And how much should I raise externally? The tendency is to underestimate across the board, creating a cascade of debt issues. However, effective business projections – which include detailed scenario analysis – can help ensure correlation between these critical financing metrics.

Once you know your business uses of capital, you must determine the sources of capital that will effectively answer that need. Whether you are considering debt financing or equity, a comprehensive business plan and a strong financial model can help you assess how much capital you require right now, how you will be able to manage debt in the future and how your capital requirements can be expected to change.

What are your current capital needs?

A business plan is critical as you attempt to place values on how much capital you need. Once you establish strategic goals – grow organically by 10% per year, open up new markets in Asia and Australia or target particular businesses for acquisition, for instance – you can translate the successful achievement of those goals into income, cash flow and balance sheet projections.

"A solid and robust business plan is essential. Before you can secure the capital you require, you need to understand the markets you are entering, the products or services you are offering, the financing spread you will assume and the financial models that apply. Only then can you develop an appropriate funding strategy."

Brendan Foster
Partner, business consulting and advisory services
Grant Thornton Ireland

For instance, to forecast future income, a business could use current production schedules to project future sales, multiply that against the cost of goods sold and subtract related expenses (such as general and administrative costs). To assess cash flows, businesses can use their sales projections to then calculate the rate at which they expect to receive payment from customers (given that booked sales often do not translate into immediate cash on hand). Once you calculate income and cash flow projections, you then have the information you need to develop balance sheet forecasts. Generally, businesses aggregate these projections in pro forma financial statements they can use to forecast their future profits and identify any capital deficiencies. After assigning monetary values to identified company needs areas, you can decide whether those needs are adequately covered by those projections. Typically, they will not be, and some form of capital will be necessary.

Whatever the case, your business plan, business model and pro forma financial statements are crucial to accurately quantifying income projections and correlating them with business needs and capital requirements. And when you go to the bank or to investors to acquire additional capital, you will already have the answers to the hard financial questions they may ask.

"Assessing the amount of capital you need can be a bit of a moving target. Businesses need to map out their cash flow requirements, not just in the next month, but over the next 12, 18 and 24 months. The key is to step back and understand not just revenue requirements, but also your true cash burn rate and the business's true working capital requirements. Gaining this understanding requires a more disciplined approach to cash flow forecasting that provides insight into the business's day-to-day operational needs."

Jack DiFranco
Partner, transaction services
Grant Thornton US

What is your debt capacity?

If you successfully meet your strategic goals and generate the right amount of profit, your business needs may be taken care of. If not and you need to look at external financing, debt – the cheapest form of capital – is generally the logical first choice. This is true whether you plan to seek debt from a traditional lender or arrange for the business owners/shareholders to provide the company with a loan. At this point, debt capacity – basically, your ability to borrow and manage debt – must be considered, and there are several ways to approach it. You can take an asset-based approach to debt capacity, where you pledge assets as loan security (an appealing option for banks since the debt is less than the value of the assets). You can also look at borrowing against working capital, like receivables or inventory. Finally, you might consider how effectively you can service the debt strictly through projected cash flow.

In deciding on the approach to take, it is important to understand the differences between the four major types of debt:

- **secured debt** is backed by specific assets (such as a mortgage or other collateral) which the creditor can seize in the event of default
- **senior debt** is not necessarily secured, but it still ranks above most other forms of debt, which means it must be repaid first if the business experiences financial difficulty
- **mezzanine debt** falls behind, or is subordinate to, senior debt – which is why it is considered a form of subordinated debt. It generally requires borrowers to compensate for this added risk by granting the lender some type of equity interest in the company (such as warrants or options)
- **junior debt** is the lowest-ranking form of debt and is repaid only after senior debt is repaid in full.

If you go through this process and evaluate your senior debt capacity, and it still does not meet your requirements, you may need to look at options like junior debt, mezzanine debt, equity financing or other forms of alternative financing, or simply scale back your plans and expectations. Once again, these determinations will rely heavily on your business plan and how effectively you are able to align your projections with your needs. Before considering equity financing options, remember that equity capital (ie. perpetual claims against the future earnings of your business) is the most expensive form of capital available to you.

When seeking debt financing, businesses must realise that not all debt is created equal. To ensure you attract the most favourable financing terms, you need a strategy for negotiating an attractive interest rate and reasonable repayment terms. Beware the types or amounts of security you offer creditors, especially if it jeopardises your ability to operate effectively. And be sure to gain a full understanding of the financial covenants you will be expected to maintain as part of the loan. Simply repaying your debt as required is often not enough. If you fall offside in maintaining other financial covenants, you may find yourself in breach of the borrowing agreement.

India has always been strongly biased toward debt financing. Not only is equity capital in limited supply, but companies traditionally resist the loss of control and increase in governance that occur when you bring in an external equity player or go public.

How do you account for change that you cannot predict?

In some cases, financing is as straightforward as completing your business plan, making accurate projections and finding the capital solution that works – but that progression is not common and provides no real safeguards. It is a good idea to plan more carefully for the future because you cannot just go to the bank every time you need cash.

There are several ways to try to take the future into account. First, consider the time frames worked into your business plan. An initial needs assessment probably looks six months to one year forward. But how will you fund capital requirements – or service existing debts – beyond that? What refinancing risk have you created? Is there a plan in place? Businesses need to look mid term and long term – two years to five years – and try to have mechanisms in place to help them afford future goals. If you max out your debt capacity early, for example, you put the operation at risk of default. Leave some room to borrow down the road if circumstances require it. This approach requires a more disciplined approach to cash flow forecasting and a deep understanding of day-to-day operational needs.

And what about situations and metrics that simply cannot be precisely predicted from current data: What if you do not grow as fast as you anticipate? What if you grow faster? What if the property costs more than you thought? What if it takes an additional three months to become profitable? What if the cost of debt financing increases? Numerous events, from small to catastrophic, can affect the accuracy of your projections and the effectiveness of your core strategy. Scenario planning with sensitivity analysis – where the predicted results of your model can be changed by altering specific inputs – helps you plan for a variety of possible situations and is the best way to try to account for this type of change.

Sometimes, simply taking on a partner can be a great buffer against an unpredictable future, while providing a great source of long term capital. Although partnership risks exist, the right partner, with the right skill set, can help not only in critical decision making, but in sustaining growth, if their equity capital can counter an unanticipated debt burden.

What do you need, what can you handle and how might it all change down the road? These essential questions will help you develop your business plan and determine the levels of capital that are appropriate for your needs.

Consider which funding sources best meet your needs

When you are confident you understand your business needs and what levels of capital meet them, it is time to determine the types of capital that best suit your situation. The general breakdown is between debt financing and equity financing, with different forms of alternative financing appropriate under particular conditions.

While financing exclusively with debt (if cash flows are high) or exclusively with equity (with the right partner) can sometimes be the right solution, most companies will want to ensure a carefully planned debt/equity mix. Debt is often the correct first choice, but if you are too highly leveraged, you can set yourself up with an unmanageable interest and principal repayment burden. And while some companies fear diluting returns by selling equity, it can be an excellent solution – particularly for profit-vulnerable start-ups – to the dangers of excessive debt.

Each company requires a unique debt/equity solution, but there are a number of key factors and situations to take into account:

- move from least expensive to most expensive and from least dilutive (reductive to shareholder value or distributions) to most dilutive. Start with senior debt, then junior/mezzanine debt, then various forms of equity – preferred then common shares. Remember, even though equity does not require interest payments, it is the most dilutive and therefore the most expensive
- look at your recent history of earnings; this may dictate a preference, or necessity, for one type of capital over another. For example, traditional forms of debt may not be available if you lack the assets for collateral and/or operating history to support it.

While debt is usually the first choice, undertake a more specific matching exercise: working capital is typically funded by a line of credit; capital expenditures are typically funded by some type of term debt or perhaps capital leases; growth or expansion capital can be funded with equity; and shareholder distributions (usually) depend on what is left. Match capital need with the most applicable type of financing while trying to minimise cost.

"In all instances, it's critical that businesses avoid taking access to capital for granted. Foster relationships with your funders. Keep them well informed. Focus on communication all the time and be as forthright as possible, because when times get tough, these relationships matter. Most of all, never lose sight of your cash flow because cash is king. You can't look at the cash in the bank today and assume it's representative of your future cash flow."

Kevin Fraser
Partner, advisory services
Grant Thornton Canada

Enterprise Ireland is a state institution that provides an alternative financing source for Irish businesses. It offers services, funding and incentives and encourages foreign investment – factors which often encourage Irish companies to seek out equity financing over debt (particularly in light of the personal guarantees generally attached to debt financing in the country).

Alternative financing

Sometimes traditional financing routes are not available or not suited to a company's situation and they must seek alternative sources. Market downturns and resulting bank caution enhance this environment. Alternative sources could include leasing, vendor financing (asking suppliers for finance), customer financing (procuring advance payments to fund capital needs), government-backed financing and non-core asset sales, ie., selling plant, equipment, divisions, etc. to free up and redeploy capital.

There are also financial institutions that provide loans but are not run like banks. They offer debt vehicles that are unsecured, but more expensive due to higher risk. These types of vehicles – mostly structured as junior or mezzanine debt – tend to have longer payment terms and greater flexibility. Despite the increased cost, this flexibility can be valuable if a company is growing fast or transitioning to a new owner.

Private equity

Raising long term capital by selling to a private equity firm can be a solution for some businesses, although there is a big difference in ceding partial ownership to a family member or a hand-picked investor who understands your industry and selling to a large-scale investment firm where control may be highly influenced by shareholder and board decisions, or where substantial restructuring can be part of the deal.

It may be a good decision, however, for owners who need a substantial cash infusion, want to tap the financial expertise and contacts of an established firm or are ready to back away from – or sell – the business. And in global jurisdictions where valuations are lower, it presents an excellent opportunity to raise capital, as private equity investors can be attracted to invest heavily in certain projects.

Going public

IPO (initial public offering) activity slowed considerably in the wake of the financial crisis, as turning to destabilised public markets to fund growth or exit strategies was simply not an appealing financing strategy. With the global economy returning to full recovery in many jurisdictions, this trend should wane, and going public may be a good way to raise capital under the right circumstances. As your company grows, opportunities grow as well, and debt or equity solutions may not be enough to take advantage of them. Once public, it may also be easier to raise future capital as investors may be more confident in the financial statements of businesses operating under current, strict regulatory umbrellas.

Companies must, however, think carefully about this option. An IPO can shore up funds and drive expansion, but you must also deal with issues like higher ongoing compliance, governance and investor relations costs, and loss of privacy and control. Yet if you have the right attributes – good earnings history, asset backing, growth potential and a business plan that supports the IPO concept – it can be an excellent choice and meet capital needs well into the future.

"There's a perception that it's harder to raise equity than it is to raise debt, but the process is fundamentally the same. Either way, you need to position the company in the best possible light. The objective is to get either lenders or investors sufficiently excited about the company's future story and projections that they want to provide capital to the company, whether it's a revolving line of credit or private equity."

Stephen McGee
National practice leader, corporate finance
Grant Thornton US

Take local considerations into account

Respondents who expect finance to be more or less accessible in the coming 12 months
Percentage of businesses

Q2-2011 rolling average	Much more accessible	More accessible	No change	Less accessible	Much less accessible	Don't know/ not applicable
APAC	6	20	46	20	3	5
APAC ex Japan	9	24	42	17	5	4
ASEAN	8	31	48	10	3	1
BRIC	10	23	39	18	6	4
EU	2	23	55	17	2	2
Eurozone	1	24	52	19	2	2
G7	2	35	49	12	1	2
Latin America	15	40	32	10	3	0
Nordic	4	30	54	9	2	1
North America	3	48	42	7	0	0
PIGS	3	15	48	28	5	0
Global	4	30	45	16	2	2

Source: Grant Thornton IBR 2011

While companies can generally use proven methodologies to assess their capital needs and identify optimal funding sources, their ability to secure financing ultimately still hinges on the realities that prevail within their local market. In countries that were particularly hard hit by the global financial crisis, for instance, attracting and securing financing remains extremely challenging.

The Grant Thornton International Business Report 2011 highlights this reality. While 45% of global respondents said they perceived no change in access to finance between 2010 and 2011, significant regional variations exist. In fact, more than a quarter of respondents in Greece, Netherlands, Switzerland, mainland China, Spain, Botswana, Vietnam and Japan indicated that they expected finance to become less accessible over the next 12 months.

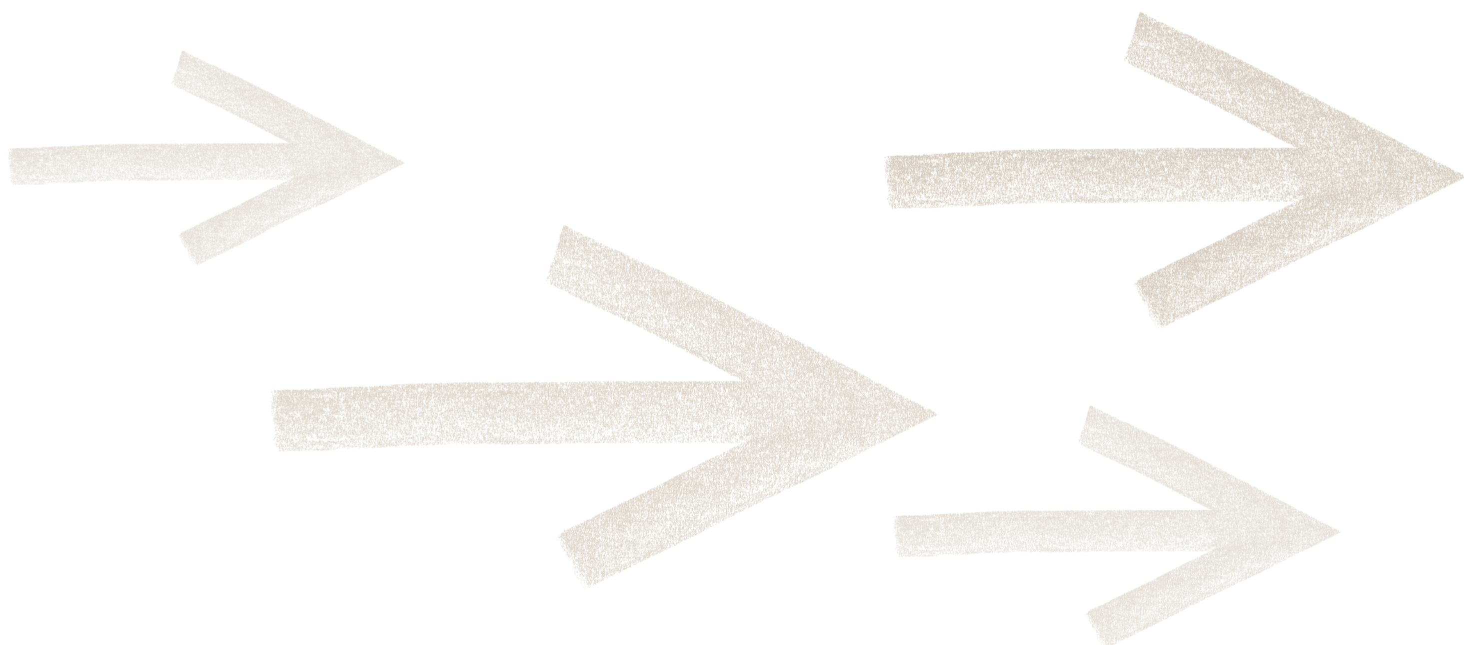
Conversely, at least 50% of respondents in Georgia, India, Mexico, Chile, Thailand, South Africa, Botswana, Turkey, United States of America, Brazil, Philippines and United Arab Emirates indicated that financing was likely to become more accessible over the same period.

To leverage improving financing opportunities, your plan must be in order

Generally speaking, it is becoming easier to secure financing, and the improvement is global. This view is reflected in the opinions of businesses around the world. According to the Grant Thornton International Business Report 2011, the aggregate global opinion is that constraints to business growth like "cost of finance", "shortage of working capital" and "shortage of long term finance" are less than they were in 2010.

These are positive signs for companies currently looking for financing, but bear in mind that this trend is partly due to the simple loosening of purse strings that accompanies economic recovery. Companies cannot assume banks are handing out money – in fact, they are more vigilant than ever and will want to see clear evidence of business viability and careful planning. Competition from other borrowers will be rising as well, so companies must get their house in order before they go to the bank or seek out investors.

No matter what type of financing you are seeking, it is all about positioning your business in the right light and not taking financing for granted. Ensure the quality of your business plan and strategy; do robust short, mid and long term projections; use scenario planning and sensitivity analysis; make sure your financial situation is in order. In short, your business story must be compelling before you present it to the bank, other lenders or potential investors.



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