Inc.com

Some Assembly Required

Small companies often have to draw financing from several different backers. Here are several questions to answer before entering a layered financing arrangement.

From: Inc. Magazine, April 1998 | **By:** Jill Andresky Fraser

---

Business 101
Looking for financing? Sometimes you have to bring many backers together

Back in 1995, Bob Burnham, the chief executive of Nortec LLC, needed capital to bring his young company's optical-character-reading technology to new markets. But bankers wouldn't give Nortec, a Wilmington, Del., data-processing company that had about $500,000 in revenues, the time of day. "We were hard to collateralize," notes Burnham ruefully.

Like a growing number of entrepreneurs, Burnham found another, more fruitful option: a so-called layered or structured financing arrangement, in which a company raises money from several sources at or near the same time. Though layered financings have always taken place, until recently they've far more often been the domain of large corporations. What's different now is that because of the vibrant state of the U.S. capital markets, financial deal makers are willing to structure often-complex capital arrangements involving small sums and small companies. That's why these deals have become much more accessible to many growth companies.

Layered-financing deals often include some type of private-equity investment, whether from angel investors, small investment pools, or the venture-capital community. In the best of all worlds, the equity capital is supplemented with bank debt. But other types of money can also get added to the mix, whether through factoring, royalty-based financing, or other debtlike arrangements.

Take Nortec's case. "We raised $100,000 by selling equity to an angel investor," explains Burnham. "Meanwhile, we raised six-figure sums, on two different occasions, from the Delaware Innovation Fund, a private venture-capital fund that makes seed-capital investments in companies based in our state. Those two arrangements gave us the growth capital we needed." At the same time, Burnham adds, Nortec improved cash flow by conducting a sale/leaseback of some computers and worked out a factoring arrangement so the company could borrow against its accounts receivable.

The good news about layered financings is clear. By broadening the scope of your capital hunt and offering interested parties the chance to spread risk around, you can vastly increase your company's potential for fund-raising success. The bad news about layered financings? They're anything but simple, so you need careful preparation before you begin.

Money hunters, beware. There are some pitfalls that can trip up even the most promising layered-financing candidate early on. Poor financial preparation is the biggest one. Rather than putting together a slapdash proposal that might satisfy your friends or relatives--but wouldn't get you through the revolving door of your local bank--

you should prepare one well-thought-out package that will meet the toughest standards you'll encounter. If your company's internal financial staff can't handle the work, investigate your outsourcing possibilities, which might include hiring an outside accounting firm or a temporary chief financial officer on a special-project basis.

Rick J. Burrock, the managing partner of Boulay, Heutmaker, Zibell & Co. PLLP, a Minneapolis accounting firm, recommends that your package include audited, up-to-date financial statements, three to five years of business projections, and a solid business plan. "We're working with one now that's about 35 pages long, which is about what you need to be able to give all kinds of potential lenders and investors a comprehensive sense of your business and its prospects," he says.

It's also important that you--or an outside expert--place a realistic valuation on your company's stock. "The key to raising money, especially the part that comes from the private-equity world, is having an accurate valuation for your company," says Ben Boissevain, managing director of E Technologies Associates LLC, a New York City-based investment-banking boutique. "If you're basing your financing efforts and projections on a business valuation that isn't realistic and well documented--or avoiding the valuation issue entirely--the odds are very strong you're going to fail."

Finally, don't expect fast results. "I've been amazed at how long it's taken," confides Brad Galle, the chief executive of Square Earth Inc., a three-year-old New York City-based developer of Web-site applications that had 1997 revenues of $2 million. Galle had hoped to conclude a round of financing relatively quickly--especially once he won an initial commitment from a bank that was willing to be part of a larger package.

Instead, Square Earth spent more than six months pursuing private-equity deals with individual investors. "There's a tremendous amount of back-and-forthing that you've just got to expect when you're trying to bring all these different parties to the table," Galle explains. In fact, Galle ended up selling his company to a larger industry player instead of concluding the smaller private-equity deals.

Throughout all conversations with potential backers and investors, open communication is essential. "These days, the key to carrying out a layered financing is informing everyone, up front, that you know you need some kind of private-equity investment and some kind of debt, and this is how you're going about trying to raise all that different money, and this is the stage you're at now," says Douglas A. Fineberg, a banking-industry consultant based in North Hampton, N.H. One benefit of that kind of openness, Fineberg emphasizes, is that business owners can often involve prospective lenders or equity investors in weighing various options. "You can go to a banker and say, 'If I raise this much from investors, how much could I borrow and what kind of covenants would you insist on? How could I improve the terms or size of the loan?'"

If your private-equity investors and lenders (or other financial institutions) know one another through having worked together or by reputation, a preliminary commitment from one may help bring the other aboard. So don't hesitate to drop the names of interested prospects, as long as they haven't absolutely insisted upon confidentiality.

And when that sweet day comes, when you've *finally* gotten all the right players to commit, steel yourself for one last, tedious round of negotiations. "The best way to make sure that all the different agreements mesh together, and to prevent unexpected problems down the road, is to get everyone together in a room," notes Burrock. "Don't open the door and leave until you're certain that everything fits."

Complicated? No doubt about it. Just ask Burnham, whose angel investor received equity, while his seed-capital funder got a royalty-financing deal with a potential equity kicker; on top of that, there are the terms of the factoring arrangement and of the lease. Still, Burnham's not complaining. "I got the money I needed to start to capitalize on my company's fantastic growth opportunities," he says. And recently, the folks at the Delaware Innovation Fund have started setting up lunch meetings with area bankers for Burnham. So the doors keep opening. And that, after all, is what layered financings are all about.

Jill Andresky Fraser is *Inc.*'s finance editor.

Before You Start

You'll increase your prospects for success if you answer these questions *before* approaching prospective investors and lenders:

What type of financing does your company really need?
Participants in a layered financing will want a complete breakdown by specific capital category (growth capital, working capital, project funding, and so on).

Are you aiming to finance only future growth or to clean up past problems, too?
Carrying out a layered financing isn't impossible for, say, a company with cash- flow problems, but the options are more limited. By realistically assessing your situation, you'll save yourself time and the pain of unnecessary rejections.

Have you got the assets to bring a bank into your deal?
One strategy that consultant Douglas Fineberg recommends to boost a weaker candidate's prospects is to try to raise more money than you need. Here's how: Approach private-equity investors first and tell them that you plan to set aside part of their funds to create a tangible cash asset for your company. With that cash as collateral (plus the strength of the company's cash flow and your personal guarantee) you may be able to persuade a banker to lend you the amount frozen in that account plus what you need to meet your overall financing objectives.

Can networking help?
It's always easiest to make one of these deals happen when the parties know and trust one another. So think like a matchmaker. If you sell stock to a key supplier or customer, might he or she be able to bring a banker on board, too? Similarly, selling equity to successful entrepreneurs in related industries could get their bankers interested in you.

And Before You Sign...

If you don't iron out potential problems and conflicts between the various parties involved in a layered financing *before* getting your hot little hands on the cash, you and your company may regret it afterward. John Egan, corporate partner at Boston law firm Goodwin, Procter & Hoar, warns business owners to pay attention to these important and complex issues:

Reporting requirements. "It's very basic but very essential that everyone agree to accept the same financial-reporting documents," Egan says.

Covenants. Generally, whatever your senior lender insists upon goes. But make certain that there isn't some financial or reporting requirement tucked away in someone else's financing agreement that can jeopardize your valuable relationship with your banker.

Consent. Most parties will insist on the right to approve future financings. Your goal is to make sure that everyone's on the same basic track--and that one party doesn't have the ability to sabotage a deal that's in the company's interest.

Registration rights. These agreements govern the way privately held stock will be handled if a company goes public. Egan says he's seen cases in which an owner has given various financing groups different registration rights--and the differences cause problems when the company wants to sell stock to the public.
