Capital raising

Role of the board

The first sources of capital to consider are internal ones (for example, family). Then, external sources of capital may be either debt sources (borrowed money) or equity sources (investors). Alternative sources include franchising, licensing and government grants or finance.

What are internal sources of capital?

An owner-manager investor can inject capital or seek extra capital from family or close associates. However, high levels of investment concentration in a single investment (other than the family home) can place undue pressure on family finances should the investment fail.

The best internal source of capital may be clever ways to find more free cash through working the cash flow smarter by such things as: improvements to accounts payable, factoring, or leasing or lease back.

The biggest advantage with internal funding is the alignment of the current owners to the investment objectives is least impacted. Generally, it has a short time frame and the fewest legal restraints.

What are the most common debt sources?

Debt capital is capital that is borrowed and must be repaid with interest. Borrowing money avoids dilution of equity interests and can be relatively inexpensive capital. However, the interest and principal repayments must be repaid and security may be required. Debt sources can include banks, leasing companies and capital asset lenders.

Provided you have a good relationship with your bank, this is the usual place to start the search for capital.

Questions to ask include:

- Can you borrow or increase your present credit lines?
- Would the bank accept company assets as collateral for a term loan?
- Could the bank factor some receivables or allow you to borrow against them?
- Will the bank accept inventory as collateral to back a loan?
- Senior debt – are you prepared to grant a first ranking charge over assets if required to obtain a loan?
- Direct guarantees – are you prepared to give a personal pledge to repay a debt?

In return for the loan, a bank will very often require a fixed charge (that is, mortgage on a specific asset such as land) or a floating charge (that is, mortgage on an asset that changes in quantity or value such as inventory). This charge is a legal document which must be lodged with the Australian Securities and Investments Commission. Alternatively, a bank may require a mortgage over the proprietor’s real estate.
When assessing the benefits of each debt product, attention needs to be given to:

- cost of debt v cost of equity;
- gearing impact on financials;
- potential movements in interest rates and exchange rates;
- changes in government monetary policies and capital transfer restrictions in those countries where you have dealings.

Business loans are available as

- short-term liquidity to fund seasonal needs (‘working capital’), usually a bank overdraft or a cash advance;
- medium-term loans which typically include (a) loans from 1 to 7 years with the bank requiring security and often quarterly financials (b) leasing for such things as cars or plants with the purchases being made by a finance company and then leased back or (c) commercial hire purchase;
- long-term and used to fund the purchase of large assets; there will be an associated application process and often a business plan will be required.

What are the most common equity sources?

**Venture capital funds**
A venture capital fund is an investment fund that manages money from investors looking for private equity stakes in start-ups and SMEs. They tend to invest sums of $1 – 5 million.

General observations about venture capital funds include:

- They are professional investors and will be tough on terms.
- They tend to be limited to minority positions but can take an active role through the board.
- The investment horizon tends to be patient, usually 5 to 7 years.
- They provide excellent support and understand operational issues.

**Private equity funds**
Some private equity funds focus on niche opportunities (for example, ‘turn arounds’) whilst others specialise in specific industries. They tend to invest sums of $ 5 – 50 million.

General observations about private equity funds include:

- They are tough investors but can provide excellent support.
- They target more mature companies, generally with profits and positive cash flows.
- They frequently want a key manager in the team, often the finance manager.
- The investment horizon is shorter then venture capital but patient, usually 4 to 5 years.

**‘Strategic’ corporate investors**
A company may sometimes decide to ‘strategically’ invest in another company. These companies tend to be complimentary in nature rather than competitive. They tend to invest upstream or downstream in the same industry.
This investor class will differ significantly from venture capital or private equity in the following ways:

- Corporate investors will be more active operationally.
- They invest with their own motive (for example, value add-on to their core business).
- They tend to be more generous in valuation and require less restrictive terms.
- The typical invest time horizon is 4 to 5 years but can change strategic direction.

**Public markets – IPOs**

An initial public offering (‘IPO’) on a market can be time-consuming and expensive. However, when market conditions are suitable, an IPO can be an excellent source of capital for a mature business. IPOs tend to be used to raise amounts greater than $10 million to justify the transaction expenses. A mid-sized capital raising would be $20 million.

There are a number of issues to consider:

- **Advantages**
  - Public market credibility for company
  - Access to raising additional equity and debt
  - Marketability for company shares

- **Disadvantages**
  - Expensive to launch and maintain
  - Requires public company support infrastructure because of continuous disclosure and reporting requirements
  - Limits to management ability to act (for example, related party transactions)
  - ‘Insiders’ generally prevented from selling for 2 years from listing date.

**Are disclosure documents required?**

The Corporations Act 2001 generally requires that a company provide prospective investors with a disclosure document.

However, there are a number of exceptions to this rule, including:

- small-scale offerings: that is, less than 20 offers in a 12-month period, raising less than $2 million;
- offers to professional, sophisticated or experienced investors.
What are some alternative sources of capital?

**Licensing**
A business may choose to license technology or business processes to an out-of-market company. This can provide additional income but will usually involve support and warranties to be extended for a period of time.

**Franchising**
Franchising can be an option for raising capital to expand. However, the *Corporations Act 2001* contains many legal requirements for franchisees. Care must be taken to seek early legal advice and to move cautiously with representations to potential franchisees. The following need to be considered:

- **Advantages**
  - Common branding and marketing across large territories
  - Quality control
  - Common pricing, presentation of premises and packaging materials

- **Disadvantages**
  - Legal compliance issues (for example, franchisees)
  - Establishment expenses and lengthy marketing/recruitment period.

**Government grants and loans**