Paradigm5 Partners

How Successful Founders, CEOs and CFOs Fund Business Growth

Are you thinking about your next phase of growth/expansion? Do you require capital to fund your growth? Do you know what funding option is right for you? This e-book will help you navigate through the key considerations of debt and equity funding.

"Growth capital enables leaders to raise enough capital from investors to fund their expansion plans without losing majority shareholding or control of the business."

01 Funding Growth

Leaders who are seeking growth capital know they have a scalable business model and need to make further investments to get to the next level of growth or expansion.

While their business might be generating revenue and operating profits, the business is unable to generate enough cashflow to fund their next major step-up.

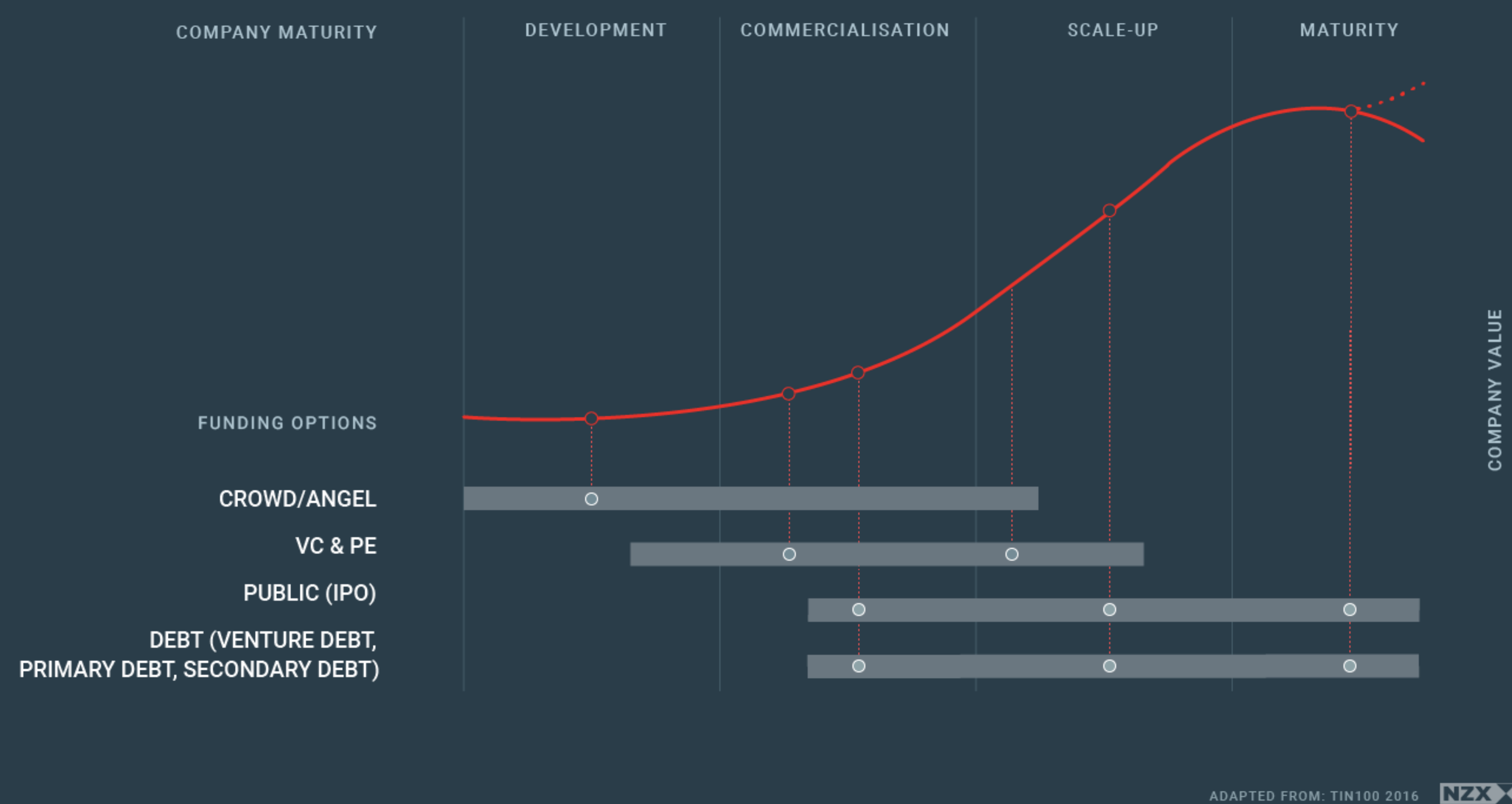
These businesses are likely to be carrying a level of bank debt but are unable to extend this facility to raise sufficient capital to fund their next phase of growth.

In the next section, we will explore the various ways successful business leaders can access capital to fund facility expansion, new offices, sales and marketing initiatives, equipment purchases and new product development.

02

Typical Funding Sources for Growth Businesses

The diagram below illustrates the sources of funding that typically suit each growth stage of a business.



03 Debt as a Source of Growth Capital

Debt can be a desirable source of capital as it allows business leaders to retain their shareholding and control. But debt needs to be paid back with interest, and servicing the loan places a burden on cashflow.

For leaders of growth companies, sourcing sufficient capital via commercial loans can be challenging, as funders tend to focus on a business's historical performance to calculate the serviceability of the debt.

Leaders who are confident that they can deliver on their growth plans may choose to seek additional debt, on top of any existing bank loans.

Choosing additional debt over bringing in equity capital enables shareholders to reap the full benefit of any increase in the value of the business resulting from investment initiatives. We will now look at the options for raising additional debt.

04 Subordinated or Junior Debt

Businesses can raise loans called subordinated (or junior) debt, in addition to their bank debt.

Junior debt is generally unsecured, and therefore is much more expensive than a bank or commercial loan. But it can be useful in situations where capital is needed to grow a business, refinance debt, or complete a transaction. Also, providers of junior debt offer custom and flexible repayment structures.

The cost of the debt may be reduced by providing equity upside to the debt providers via stock warrants or convertibility of debt.

“Growth capital allowed Manuka Health to grow sales almost fivefold over a period of five years, taking their sales from $17M in 2012 to $80M in 2017.”

05

Venture Debt

Venture debt is another option business leaders can access through specialist providers, provided their business has a minimum revenue of approximately $4M. Venture debt is also expensive, and usually businesses turn to it only when they cannot tap into traditional funding sources.

Nonetheless, venture debt is an attractive option where a business has identified a clear growth opportunity and is confident of delivering the anticipated return on investment.

The amount of venture debt that can be raised can range from $1M to $20M. Providers offer custom and flexible structures, such as credit line, term loan or convertible notes.

As with junior debt, the cost of borrowing can be reduced by providing equity upside to venture debt providers via stock warrants or convertibility of debt.

Venture debt complements equity capital by preserving ownership and extending the runway for the business and its existing investors.

06 Debt: Risks

It is important to note that changing economic conditions can have a significant impact on lending and debt.

During recessionary times the availability of debt can dry up (remember the credit crunch), as lenders are less willing to lend. A recession can also place a severe burden on business cashflow, particularly where a drop in business activity coincides with rising loan interest rates.

Any financial projection should take into account the business's ability to meet repayments, and its sensitivities to fluctuations in interest rate and business performance.

Depending on their risk appetite, business leaders may choose to mitigate the risks related to high levels of debt by bringing in growth capital from investors in the form of additional equity.

We will now look at the key considerations when raising growth capital from investors.

07 Growth Capital: Equity

Leaders of established companies can rapidly scale their business by attracting growth or expansion equity capital – also known simply as ‘growth capital’.

Growth capital enables leaders to raise enough capital from investors to fund their expansion plans without losing majority shareholding or control of the business.

Investors of growth capital look for businesses with good potential that are run by highly capable management teams with ambitious growth plans.

08 Key Benefits of Growth Capital

Growth capital enables leaders to rapidly scale operations, hire the right people, grow revenue, and add significant value to their business. Additionally, investors of growth capital can bring with them experience and expertise from scaling other business in similar industries, and they may have useful networks.

Bringing additional equity may enable existing shareholders to eliminate significant personal guarantees provided to suppliers and lending institutions. And, unlike debt, any equity raised doesn’t have to be paid back, so it doesn’t create a cashflow burden on the business.

There are great examples of Kiwi businesses that have used growth capital to rapidly scale their operations and revenue. A brief case study follows.

Growth Capital Case Study

Manuka Health

Founded in 2006, Manuka Health NZ Limited exports honey and propolis products to more than 45 countries.

In 2012, Manuka Health raised growth capital, for a 20% stake in the business, to help fund construction of a $10M processing facility that would treble its production capacity and lead to operational efficiencies and margin expansion.

The investment also enabled the company to appoint key senior staff and make further investments in R&D, along with myriad other initiatives. The growth capital allowed Manuka Health to grow sales from $17M in 2012 to $80M in 2017 – an almost fivefold increase over a period of five years.

“Raising capital before you need it will give you time to negotiate the best deal.”

09 Sources of Growth Capital

Sources of growth capital generally fall into two categories: financial investors or strategic investors.

Raising capital from financial investors is the focus of this e-book. Some examples of financial investors are private equity funds, high net worth individuals, financial institutions and investment funds.

A strategic investor is generally a larger company, perhaps from another country and/or from a similar industry, that is looking to invest in and partner with a business for mutual benefit.

10

Raising Growth Capital: Some Pointers

Raising capital, debt or equity, can be a time-consuming process, taking as much as six to eight months from start to finish.

Going through the whole process – from preparation, to engaging and closing with investors – also requires considerable senior management time and resources from within the business, which is time taken away from running the business.

Raising capital *before* you need it will give you time to negotiate the best deal. From a business cycle point of view, the best time to raise capital is when capital is available in abundance. Thorough preparation in advance will help ensure the business is well presented and the process is efficient.

11 Raising Growth Capital: Preparation

To have meaningful conversations with potential investors, you need to be able to show them what your business does and how they will benefit from investing in it.

This is generally communicated through a presentation document, which articulates the strengths of the business, its achievements to date, the growth aspirations, and the plans to realise its potential.

You will need to demonstrate that you understand the market and your competitors, and are aware of what you need to do to achieve your aspirations.

Your business plan needs to be supported by financial models, which must include sensitivity analysis.

Setting up a virtual data room will help you electronically share financial and company information (once non-disclosure agreements are signed).

12 Raising Growth Capital: Approaching Investors

Once the preparation work is complete, the next step is to make contact with potential investors. This can be done either directly or by bringing on board an advisor who can help make the connection with the right investors.

The idea here is to screen investors and make targeted connections, rather than take a scattergun approach. This reassures investors that they are looking at a unique opportunity, rather than something that has been shopped around.

Therefore, the ideal advisor is one who has connections within the investor community, understands their individual investment focus, and can make these targeted approaches.

Thought needs to be given to how to present the business to the investor.

13 What Do Investors Look for?

When raising growth capital it is important to know what investors are looking for.

A financial investor aims to invest in a business that gives a return on their investment over a period of time. Different investors will target different rates of return; it is not uncommon for them to target returns at exit that are at least double the original investment.

To increase the likelihood of a high return on their investment, investors look for businesses possessing some level of sustainable competitive advantage in an industry that has a favourable trend and space in the market to grow.

They also want to work with a capable management team that has the drive and ability to grow the business. They will expect the team to outline an ambitious yet realistic business plan, and to explain fully how the growth capital will be deployed.

Most financial investors will be looking to exit their investment within an approximate time frame. You should aim to find out their long-term plans and, if possible, outline some potential exit strategies.

14 Raising Growth Capital: The Process

Once investors have expressed an interest, they will want to know more about the business, which is done via management presentations. After this, the investors will usually issue an initial information request to formulate a non-binding expression of interest (EOI) and a term sheet, should they decide to proceed with an investment offer.

The term sheet will outline the valuation the investors are willing to place on the business and the amount they are looking to invest, as well as any other terms and conditions, including their proposal on the board make-up.

The term sheet forms the basis of initial negotiations between the two parties, and will outline conditions for completing the deal, including the due diligence process.

Completion of the due diligence is followed by the preparation of investment and shareholder agreements, and the signing of the deal.

The above process is a costly and time-consuming exercise, with the potential for the deal to fall over at any step. This illustrates why it is important for the business to engage with the right investor from the start.

15 Selecting the Right Investment Partner

A successful investment outcome for all parties will depend on a close alignment between the founder or the management team and the investors.

Ideally you are looking for an investor that has the resources to fund further capital input if the need arises – but you need to recognise first and foremost that you are choosing a partner, not money.

You will need to assess the specific value gaps that an investor can help fill, and to determine their ability to do so. It's also important to be clear about the investors' time horizon and their exit plans.

When it comes to due diligence and other forms of reference checking, ask your intended investor to share the names of founders and CEOs of businesses they have previously invested in.

Paradigm^5 Partners

Shakti Harduar, Director

Shakti has experience in working with founders, shareholders, CEOs and board members of businesses with revenues of up to $100m, helping them raise growth and expansion capital as well as assisting with business buyouts and exits.

He is the founder of Paradigm^5 Partners Limited and has a passion for helping businesses reach their full potential through access to capital and the right expertise.

Shakti is a Chartered Accountant (CAANZ) and a member of the New Zealand Venture Capital Association (NZVCA).

Who we are

At Paradigm^5 Partners we help businesses raise growth capital in the mid-market space, and our partners have experience in negotiating deal sizes in excess of $40M.

We work with a network of financial investors and debt funders in New Zealand, Australia and other countries. Our knowledge of their investment criteria enables us to make targeted approaches to suitable investors on behalf of businesses.

We can support the capital-raising process by helping businesses develop business plans and investor presentations.

Paradigm^5 Partners Limited

Level 26
PwC Tower
188 Quay Street
Auckland 1010
New Zealand

If you would like to discuss your capital raising options with us, you can contact Shakti Harduar on email shakti.harduar@paradigm5partners.co.nz or on mobile +64 21 679 849.

paradigm5partners.co.nz