

Helpful Tips for Negotiating Major Financing Transactions

For business owners that are raising capital, negotiating financing terms with a venture capital or private equity firm is compared by some to a visit to the dentist. It starts off with some irritating poking and prodding, apprehensions rise as you inspect a rack of unfamiliar instruments, and then tension really sets in as you have no idea how long and painful the process will really be.

But unlike the vulnerable perch of the dentist's chair, business owners can position themselves to manage negotiations and the process of raising capital efficiently so they can move on to the more important task of growing their business.

Understanding the process of raising capital and preparing up front goes a long way to making the financing process less stressful. The process of raising capital consists of an orderly series of steps: the initial communication of the business plan, negotiation of the deal structure, and final due diligence and closing documentation.

To point out that a well thought-out business plan is a prerequisite to your financing process is like telling people to brush and floss every day—all too obvious. Well before venturing out to the capital markets, business owners have often completed a business plan, but as business owners undertake a significant financing transaction, a more concerted evaluation of capital structure scenarios is merited for negotiating and managing the financing process efficiently. Business owners are well advised to evaluate varying capital structure scenarios with different debt, subordinated debt, and equity components to become

comfortable with a range of reasonable alternatives and most importantly the sensitivities of different factors in your business to your after-tax cost of capital (interest vs. dividend) and your investors return. Investors can generally be flexible with respect to the structure of the investment provided, so the business owner should determine the type of capital that is best suited to the need. The extra level of discipline, like actually flossing daily leading up to your dentist appointment, will produce noticeable results.

For equity-driven transactions, the valuation of the business is a prime negotiation point. Valuation of private companies is negotiated on the basis of the market. Business owners should ascertain valuations using the metrics most common for their industry, be it a multiple of an earnings variant (i.e., EBITDA), book-value driven metrics, or other industry specific rules of thumb (i.e., multiples of flowing oil barrels). Research can be conducted online or by inquiring with acquaintances in your industry. Companies in the earlier stages of development may show significant growth potential but many do not produce significant earnings for a few years. In this case, valuations may be established through discounted cash flow models, where the negotiation of value comes down to more subjective views on the achievability of the business plan. Whichever valuation methodologies are used in the negotiation process, the goal is usually to arrive at an acceptable range of valuations, at which point the parties can often reconcile gaps through more refined financial instrumentation.

Subordinated debt instruments such as convertible debentures can address a variety of risks from an investor's point of view and can be a way for a business owner to reduce the cost of capital. Although subordinated debt instruments can be structured to function much like equity (i.e., multi-year principal abatements), they do carry a



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slightly different bent from the standpoint of negotiations. Valuation is typically much less central to negotiations but still important as it pertains to warrants, conversion options, or other equity-like features.

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It's important to know the market for capital and to give yourself options. Pricing out the market can be a challenge, acknowledging the wide range of pricing you will encounter from different businesses, funds, and instruments. It is still useful to speak with other similar business owners, bankers, or accountants and lawyers to simply seek out reference points and give you a ballpark sense of the capital markets.

Just as you as a business owner have options in your capital providers, so too do investment firms have options. Fund managers must balance and diversify risk across companies and sectors and are seeking optimal risk return thresholds for their shareholders and manage their risk through the due diligence they perform up front. Be sure to take time at the beginning of your financing process to clearly understand what the investor's needs are in terms of return, risk thresholds, and exit strategy as well their usual processes. This is a partner you may have for a period of many years so this should be reflected in your approach to negotiations—the process should not be an adversarial one.

After your preliminary level of mutual interest is established, the term sheet is a document that outlines the business points of the investment structure between the parties. The intent is to concisely capture the spirit of the investment, while the definitive legal documents developed in the closing process will detail the mechanics of how the business points will be enforced. The five basic areas commonly seen in venture capital or private equity term sheets are:

- Investment description;
- Conditions precedent to closing;
- Debt covenants/shareholder rights;

- Representations made by the business owner to induce the investor to invest in his company; and,
- Conditions on which the commitment was made to the business owner

It is easy to get hung up on relatively unimportant points. With the discipline to do your own financial sensitivity assessments upfront, understanding how the common financial instruments affect your business and your investor's, you will know which hills you are willing to die on, as well as the ones where you can give way on. Choose your battles, and keep the big picture in mind—which is getting the financing you need from an investor you trust.

As the parties work toward the execution of the term sheet, it is important to keep final due diligence and closing processes in mind. Akin to the x-ray at the dentist's office, this is the stage where investors get down to the very root of the representations and warranties made by the business owner in the term sheet. It's a rigorous process that commonly covers key contracts, such as employment agreements, registration rights, shareholder agreements, financial statement accounting practices, and so on. The timeframes for final due diligence and closing are mutually agreed upon in the term sheet but process can be time consuming so it is helpful to prepare in advance by assembling due diligence binders that includes these types of documents.

The right preparation, open communication, and a partnership mentality will make your financing process both productive and efficient. Whether it's negotiating financing terms or an appointment with the dentist, the process is simply a means to an end—a good sharp bite to feed the hunger that lies in every business owner.