Deal Structure 101:

7 Practical Considerations of Debt & Equity for Founders

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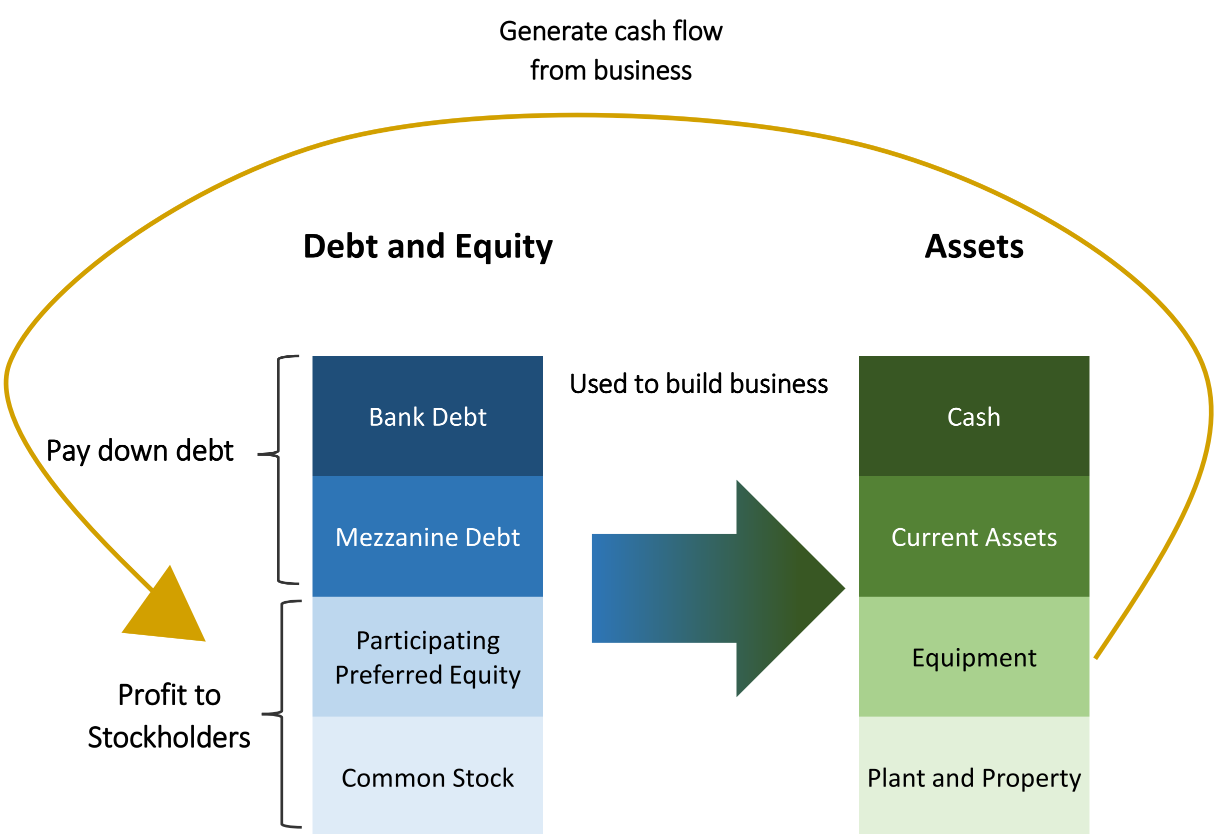
INTRODUCTION

We've all learned the basic theory behind capital structure in our Finance 101 class: that there is some optimal mix of equity and debt in capitalizing a company that yields the best outcome—usually defined as the lowest cost of capital. But that argument assumes a perfect world where any company has uninhibited access to all the debt and equity it wants and that pricing debt or equity is as simple as its yield (how do you calculate yield on equity anyway?). In reality, entrepreneurs prioritize the ***availability*** of the capital first and foremost, before considering pricing. Most startup, growth-stage, or middle-market companies take capital where they can get it. Yet many founders simply don't grasp all the strings attached, the true cost, nor the value afforded to them with outside capital. So one of the things Heritage sets out to do when we first engage a client is to educate them on the details.



For brevity, we won't go into an extended discussion on the variants of debt and equity. There's a chart at the end of this article that describes debt and equity in its primary forms. Readers can use this as a handy reference to quickly understand major differences between the subcategories of debt and equity, or as a refresher on their corporate finance. Instead, we'll present our discussion as a Q&A based on common questions we hear. Our discussion revolves around private transactions conducted by institutional investors. Keep in mind, a discussion involving high net worth investors or publicly-traded securities could tweak our commentary.

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1. Should I raise debt or equity?

That depends on many factors. And the answer changes throughout the genesis of the company's life or based on what the capital is being used for. Sometimes, the answer may be both.

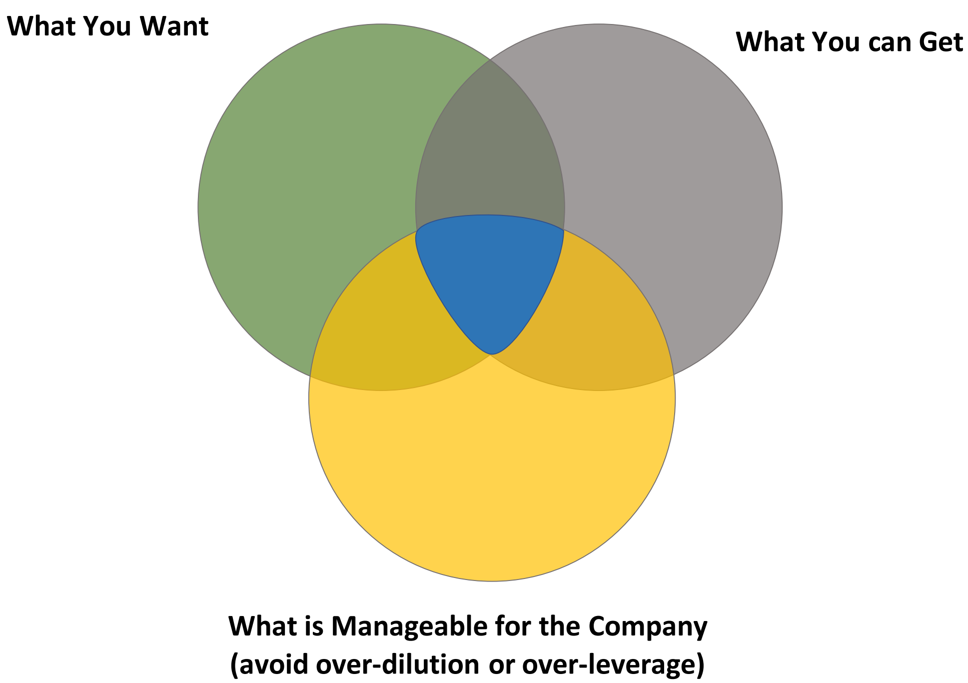
Questions to consider include: Where is the company in terms of its life maturity? Does the company need permanent capital, or a bridge to the next inflection point? What is the primary use (making new hires may result in a different answer than making an acquisition)? What can the financial fundamentals of the company support?

It's also important to understand that equity investors' tolerance for risk is higher and that the majority of earlier stage companies can only access equity financing because some (not all) equity investors are willing to take a bet on an unproven business concept, a company with few customers, or one that does not yet have positive cash flow. Equity investors think "how much money can I make in the long run" whereas debt investors think "Will I get my money back first and foremost? If so, can I earn some interest on it?"

Further complicating the answer is the fact that lines between equity and debt can often blur when a single investor invests in both forms. Often times, debt may carry equity-linked instruments such as a warrant, and these types of structures are becoming increasingly popular.

2. How much can I get?

Start with how much you need. Add in a contingency to account for unexpected events. Weigh that answer against how much you think the market will give you (Heritage can help with this).



For a company with positive EBITDA, the total amount of debt that will be extended will be between **3-5x** the annual EBITDA, depending on the company, the industry, and other characteristics of the business. If the company is not cash flowing or is going through distress or a restructuring, then the

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answer can really vary. Lenders will look to the assets of the company or some other way to gain comfort that they will get their money back.

With equity, most seed rounds are **<$1 million**. A "middle of the road" Series A round is between **$1-5 million** although there are anomalies that stretch much higher. The ranges for later stage rounds and private equity deals will vary widely.

Finally, sanity check the amount you're raising with what the fundamentals of the company can support (Heritage can help here too). This is where running debt servicing models to understand interest and fixed charge coverage, as well as payback ability is crucial. With equity, this is less of a concern as there are no fixed payments to be made. However, the existing owners will own a smaller percentage as more equity is raised (all other things being equal).

3. What portion of my company can I expect to give up?

In early VC rounds, founders can expect to give up **15-40%** of the equity of their company. Again, the range of ownership ceded can vary based on the maturity of the company or its technology, the type of investor, whether the company is in distress or not, and a range of other factors. We see that most deals get done in the **20-30%** range. Subsequently, the investor or consortium gains a significant say in the direction of the company. These rounds are colloquially called "growth rounds".

The general norm is dilution of 20-30% in each growth round. So, if you expect to go through three growth rounds before the company gets to the state you'd like to take it, you can estimate you'll end up owning **34-51%** of the company.

(80% x 80% x 80% = 51% on the high end; 70% x 70% x 70% = 34% on the low end)

Perhaps your company is worth $5 million today, but after three growth rounds, it will be generating significantly more revenue and be potentially worth $50 million, so your stake carries a value of $17-25 million.

4. Will I lose control?

The growth equity scenario described above involves the sale of a minority stake in the company (<50% ownership stake of a company). On the other end of the spectrum, entrepreneurs can exit their company in its entirety through a private equity buyout or a sale to a corporate (aka strategic acquiror).

In between these two ends are majority sales where the investor will take a >50% stake in the company, but less than 100%. While growth rounds often entail the award of a board seat or two to the investor(s), the ability to vote the majority of the shares still resides with the incumbent. In a majority sale, control will shift to the entering investor(s) and the founders may stay on as management. In majority sales, it is even more crucial for the recipient of the capital to understand who they are getting in bed with because the final say on decision making will now revert to the capital provider.

We've seen good and bad partnership outcomes in both growth rounds and majority sales for entrepreneurs. This is where investors really have the opportunity to distinguish themselves from the crowd. One corporation we know has had a contentious relationship with the institutional investor

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that owns them, because they view themselves as a "start-up" company with growth potential that requires significant additional investment to take advantage of. Unfortunately, their majority shareholder is a private equity firm that is seeking cash yield and believes expansion capital should be funneled from the cash flow of the company. Philosophical differences like this lead to long term mismatches in capital allocation decisions.

5. Can I swap older investors out?

The answer is yes. There are several ways to do this, and some are harder than others. This type of transaction is called a recapitalization, or "recap" for short.

<u>Equity to swap out debt:</u> this is the easiest form to do a recap because debtholders, whether a bank, a credit fund, or a non-bank lender, are most inclined to be repaid their capital with an injection of new equity. This may carry prepayment fees if the term of the loan is not over, but this type of recap can be executed with least amount of friction.

<u>Debt to swap out debt:</u> this is also common. It's known as a refinancing and most of the time it happens when a company has graduated: their financial condition is now able to support taking on lower-cost bank debt to replace higher cost non-bank debt originated by a commercial finance firm or a credit fund. In some cases, the debt is maturing and needs to roll over. And yet in other cases, the company can now take on a larger loan, of which the excess (after retirement of old debt) can be used to refill the company coffers.

<u>Debt or equity to swap out equity:</u> while these types of transactions occur, recapping equity is difficult to effectuate. When new investors hear that old equity investors want out, their immediate reaction is "what's wrong with the company that I don't know about?" As such, a transaction where the use of funds is purely to trade out existing equity investors (in which the company receives no new capital) is rare unless the existing investors are willing to take a haircut to their stake. A more common structure is to have a buyout of existing investors (and even then with a discount to market value) coupled with an injection of fresh capital into the company.

6. Can I take money off the table?

We hear this question a lot. This is another form of a recap and has been coined a "dividend recap". The answer is "NO" if your company is in an early round (Seed to Series B) or losing a lot of money, with few exceptions. If your company is later stage or making money, the answer might be "YES". A number of elements have to align for the existing owners to be able to take money off the table.

The good news is that more and more, investors recognize the need for entrepreneurs who have invested all their time and net worth into a company to achieve a degree of liquidity. While this acknowledgement has always been the case in the private equity world, where a growth round or a majority sale for a performing company involves founders taking some chips off the table, this has not been the norm in the VC world. This is changing as VC funds are borrowing pages from the playbook of private equity funds. Why? As good deals become more and more scarce, venture funds have become willing to allow founders to monetize a portion of their stake in order to distinguish themselves from other venture investors.

Founders can also take on debt to cash themselves (or other shareholders) out. This is the equivalent of using your house as an ATM and refinancing to cash out. We alluded to this above, but it should be done with caution as there are a number of conditions that have to be in place until this structure

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could be effected. First, the company has to have a history of profitability for the last few years. Second, not all of the incoming debt capital can go towards the founder's dividend recap—a portion needs to be allocated towards the business to help grow it. Third, because this is an investment structure usually extended by non-bank lenders, the cost of the funds is higher and will impose significant interest costs on the company, which the company has to demonstrate it can adequately service going forward.

7. Why do institutional funds invest in the form of preferred stock versus common stock?

Preferred stock ranks higher than common stock in the pecking order. In the event of bankruptcy or liquidation, the preferred stock will be paid out first before any residual left will go towards paying off the common stockholders. Similarly, "participating" preferred stock carries the benefits of regular preferred stock but will also participate in the profits to common stockholders. Virtually all equity investments, whether from private equity or venture capital investors, will be made in the form of preferred or participating preferred stock. This places the capital provider senior to the founders or management team in terms of distributions and value allocation. While seemingly unfair on the surface, it is an arrangement that has been the norm for decades, and not something we see changing anytime soon.

By default, participating preferred stock carries a so called "liquidation preference" of 1x, which enables the holder to achieve, at a minimum, return of capital, on top of participating in its pro rata share of the common profits. However, there are deals where the liquidation preference clause can be 1.25x, 1.5x, or even 2x, which would place the preferred holder at a wider advantage.

WRAP-UP

The world of corporate finance and capital structure can be confusing, riddled with strange rules, and complicated by minutia. Each of these rules, clauses, or terms, however, is intended to achieve a very practical purpose—to align the financial incentives of the capital provider with the operating partner or to provide adequate protection for the risk that is being extended. With the right guidance, however, founders can optimize the use and composition of debt and equity capital as they grow their company.

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Forms of Capital

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Debt	Cost of Capital	Loan Duration	Requirements	Pros	Cons	Use
Bank Debt Originated by regulated banks and will always be in the form of senior debt	Usually priced as Prime Rate plus a "spread". Example: prime + 300 means prime (3.25%) + (3.0%) = **6.25%** Currently rates between **5 - 8%.** Banks have a first lien on borrower's assets making this a "secured loan"; this enables the loan to be priced very attractively.	Two Forms: • Term loans come due (mature) in 1-10 yrs. Principal payments however, are calculated over a longer (+10 yrs). • Revolvers work like credit cards. In place for 1-5 yrs before renewal is required.	Banks have long checklists and rigid criteria such as: • Established operating history • Personal guarantees from owners for small companies • Substantial and verifiable assets on balance sheet • Strong creditworthiness	• It carries the lowest interest rate • Generally large loans that can be used immediately • Medium to long term maturities • No ownership is given up • Interest payments reduce tax payments • Wide range of allowable uses	• Reporting requirements • Limitations: dividend issuances, large capex, acquisitions etc. • Creditors will not extend excessive debt • Borrower will be subject to covenants	• Working Capital • Purchasing Equipment • Buying Inventory • Hiring • Business Expenditures (marketing, admin, etc.)
Non-bank Debt Secured by assets; can be senior or 2nd lien (i.e. next in line to payback in event of bankruptcy/ liquidation)	Typical interest rates between **8 - 20%** Originated by commercial finance firms and specialty lenders (ABL lenders or equipment financing firm)	• Similar loan duration to bank debt • Structured as term loan or revolver • Typically carry 1-2% prepayment penalties	• More substantial assets required as collateral • Personal guarantees from owners for small companies	• Good for borrowers that don't qualify for bank debt • Stepping stone to bank debt by establishing borrower institutionality/legitimacy • Plus all the benefits listed above • Can provide additional debt funds (albeit at a higher rate) beyond just bank debt	• Higher interest rate due (debt is subordinated) • Similar limitations on actions of borrower • May overlap with banks' security (both lenders are entitled to same asset)	• Similar uses to above • Subcategories exist for purpose-specific loans (e.g. equipment financing, real estate, inventory) • Financing for less established companies unable to tap bank debt
Mezzanine Debt Mezzanine debt or "mezz" sits below senior debt It is often called junior or subordinated debt and may or may not be collateralized. Usually originated by hedge/credit funds etc.	**Similar to non-bank debt rates on the cash interest piece**, but often has an "equity kicker" attached which increases cost of capital. (Gives lender a small piece of the borrower's equity **(1-5%)** in addition to debt in the form of a warrant)	• Mature in 2 – 10 yrs • Interest paid in cash or accrued (added to principal balance and paid at maturity) • Amortization of loan principal is often deferred and "bulletized" at the end of the loan term	• A viable and sustainable business • Enough value in the company after payment of senior debt • Borrowers do not have to meet a "checklist" of criteria	• Accrued interest payments can be negotiated (vs. cash payments) • Less restrictive in actions a borrower can take and minimum levels of liquidity • More flexible as borrowers do not have to meet a "checklist" of criteria • If structured as preferred equity, has no definite maturity	• Highest cost of debt • Typically lenders of mezz debt/preferred equity are more restrictive when things do not go as planned	• Same uses as above • When borrower cannot tap the lower cost forms of financing and does not want large ownership dilution
Convertible Debt "Converts" can be converted into stock of the borrowing company, affording lender a chance to participate in the equity upside	• Avg. interest rates between **4%-10%** • Conversion feature which allows lender to own significant portion of company (**+10%**)	• Mature in 1-5 yrs • Interest can be cash or accrued • At maturity, outstanding principal + interest is either paid back or converted (at preset conversion ratio)	• Equity value in the company to entice investors with conversion feature • Earlier stage companies that sometimes aren't viable candidates for other forms of debt but could potentially have high upside	• A good option if the above are not viable • Adds legitimacy to the borrower as lenders of convertible debt are considered "sophisticated" • Allows borrower to conserve cash (interest payments is accrued	• Could significantly dilute ownership • Requires strong due diligence • Lenders may required board seats or governance control	• Quicker (and cheaper) than issuing equity • Range of uses is far-reaching and can be applied towards items that senior debt often restricts (acquisitions, large capex)

Higher in Capital Structure

Lower Cost of Capital

&

No Equity Dilution

Higher Cost of Capital

&

Some Equity Dilution

Lower in Capital Structure

Forms of Capital

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Equity	Ownership	Investor Types	Mgmt Role	Pros	Cons	When to Engage?
Full Buyout Highly involved/ active investors that either want to operate the company or direct a Mgmt team	Sale of entire company	• PE Firms • Buyout Shops • Family Offices • Investment Arms of Conglomerates • Strategic Corporate Buyers	Existing Mgmt team may fully exit or be asked to stay on and help run new company as an employee (in exchange for small grant of equity)	• Enables the current shareholders to fully exit and monetize their shares • May present an opportunity to stay on as an employee or consultant	• Relinquish full ownership of company. • Loss of decision making capabilities	When owners of a company have made the decision to fully exit and monetize their investment/business
Majority Share Active investors who rely on existing or new Mgmt team to execute their plan	> 50% of Outstanding Shares	In addition to the above: • Growth Capital Funds • VC Funds • Limited Partners	• Existing Mgmt team may fully exit or be asked to stay to help run the company • Mgmt Team will retain a portion of their ownership and may have the opportunity to receive additional grants	• Enables shareholder to monetize current stake while opening up the possibility for future upside • Mgmt might be able to stay on and continue operating day to day activities • Significantly enhances capital base, providing funds to grow • Backing of a large institutional equity investor can create many opportunities: a) Ability to attract/retain sought after talent b) Network of executives, board members, etc. c) Ability to identify and consummate acquisitions d) Avenues for exit	• Mgmt will not have controlling share • Mgmt may have conflicting goals with the investors (holding period, strategic direction, day to day operations) • Rolled equity (unsold portion) subject to risk that is out of Mgmt control	• When owners of a company have decided to fully exit and monetize their investment/business • When Mgmt of a company wants to step back from the business • When growth plan requires a large capital infusion and/or resources of a sophisticated investor
Minority Share Investors who "piggyback" off other investors' involvement or rely on Mgmt to continuing running operations	< 50% of Outstanding Shares	• Family Offices • Growth Capital • Mezzanine Funds • VC Funds • Limited Partners	Mgmt can expect to perform the same roles and duties as they did pre-investment	In addition to similar benefits as "Majority Share" above: • Shareholders can divest some of their investment • Mgmt continues operating day to day activities	• Investors may not be as involved (don't have a majority stake) • Multiple institutional investors who may have conflicting goals	• When shareholders want to divest, but Mgmt wants to stay involved • When a growth plan requires an infusion of capital but existing team is best equipped to execute

Full Exit

Less Involve-ment from Mgmt

More Involve-ment from Mgmt

Partial Exit

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