

## It's Not Just the Money Capital Structure Critical to Development

By Joe Broecker and Bob Shortle

**B**usiness owners and corporate executives are continually faced with the question of the adequacy of their company's capital structure or capitalization. Do we have the capital resources to meet our current operational cash needs? Will we have the capital to support the growth of our business? Can we attract capital on competitive terms and conditions?

Capital structure is a strategic issue and not a tactical one. A company's options will vary depending upon the industry's competitive environment and operating cycle, as well as the scale and stage of the company's development.

Many executives view capital structure in a very pragmatic way, such as the cash flow necessary to meet current business obligations and the repayment of indebtedness. This "businessman's" view does not meet the more sophisticated definition of most participants in the financial community. The generally accepted understanding of capitalization is the amount of the company's stockholders' equity plus its funded long-term debt. Capitalization structure is considered very important by financial institutions, capital markets and in most financial reporting environments.



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sub-groups:

- Angel investors: Provide the majority of the capital for most company formations, including the high-tech sector
- Venture capital and private equity funds: Active across a broad array of development stages (start-up to buyout) to a highly selective type of company. The typical company would normally be expected to grow rapidly, creating substantial increases in the enterprise's valuation over a period of five years or less
- Public markets: For a very selective group of companies, the initial public offering (IPO) is available to provide significant infusion of equity capital for recapitalization or growth financings. Larger and more mature companies are constantly accessing the public markets for both equity and debt

### Cost of capital

Business owners and executives need to understand the price or cost of capital in order to evaluate most economic issues facing their business.

Some typical current financing costs per annum for capital by source are:

	Current Stated Cost	Implied Equity Return	Total Stated and Implied Cost
Vendors	-0-	-0-	-0-
Commercial Banks	4-8%	-0-	4-8%
Mezzanine Investors	10-12%	10-15%	20-25%
Equity Investors	6-8%	19-44%	25-50%

The availability and cost of these sources of capital are dramatically different. As investor/lender risk increases, the return is appropriately priced higher by the market.

### Typical capital structure

The capital structure of the company will vary by the industry, operating cycle and stage of development the business is in.

Manufacturing companies usually require greater physical resources and working capital. They generally have substantial investments in tangible assets, including accounts receivable, inventory, equipment and facilities. A large portion of their capital can be financed by commercial banks.

Service companies generally have fewer tangible assets, therefore limiting their leverage with commercial bank financing. However, during economic periods when banks are providing loans based primarily on the cash flow of the company, service companies can consider commercial banks for a part of their capital structure.

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### Sources of capital

Capital is formed from internal as well as external sources. Internal capital comes through equity contributions of stockholders as well as earnings after taxes from business operations. External sources of capital come from the following primary sources:

- Vendors and other trade creditors
- Financial institutions
- Mezzanine capital institutions
- Capital markets

Vendors provide significant access to capital through normal trade relationships by the extension of credit between the buyer and seller. Vendors play a significant financing role in certain industries such as wholesale distribution and retail, and a minimal financing role in high-tech product companies such as software and service companies.

Financial institutions play the most significant role in the capitalization and capital structure of most small and middle-market businesses today. Through asset based and cash flow based lending programs, financial institutions such as commercial banks are critical players in the capital structure of most companies.

Mezzanine capital providers are active participants in the capital market through structured loans and investments, financing growth for companies with positive cash flow or assisting companies with acquisition financing.

Equity capital markets are generally categorized into three

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Development stage enterprises require greater capital to support the losses inherent in a company’s product development programs and cycles. Development stage companies require very little in the nature of physical assets, but typically require a highly educated and trained employee base, as well as intellectual property, until the company passes through to the commercialization stage.

The accompanying schedule illustrates how the capitalization of a company with \$10 million of assets might look if the company was a manufacturer, service company or development stage business. Note the differences in the debt and equity ratio illustrated for each type of company – the higher the ratio, the lower the cost of capital.

	XYZ Manufacturing Company	XYZ Service Company	XYZ High-Tech Development Stage Company
<b>Current Liabilities</b>			
Accounts Payable	\$2 million	\$1.5 million	\$500,000
Accrued Expenses	\$1 million	\$1 million	\$500,000
<b>Long-Term Liabilities</b>			
Revolving Bank Debt	\$3 million	\$2.5 million	\$1 million
Term Debt	\$2 million	- 0 -	- 0 -
Shareholder Equity	\$2 million	\$5 million	\$8 million
<b>Total</b>	<b>\$10 million</b>	<b>\$10 million</b>	<b>\$10 million</b>
<b>Debt to Equity Ratio</b>	<b>2.50 to 1</b>	<b>.5 to 1</b>	<b>.15 to 1</b>

### Capital planning

Capital is scarce, costly and requires careful planning and time to secure the best financial solution. PC-based computer tools enable business owners and executives to build sophisticated cash flow models that can be integrated into most business decision-making. Such models should be dynamic and capable of analyzing business decisions and scenarios from a financial standpoint on a regular basis as business conditions change. Understanding the cash flow impact of business decisions is key to the prudent management of capital.

Planning for the capital needs of a company is critical to

success. Many businesses ultimately fail for lack of capital.

Company owners should allocate sufficient time and effort and secure the appropriate resources to ensure the company has the capital to sustain itself and grow.

#### INFORMATION LINK

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