Business Transactions Solutions § 150:102

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Part VI. Finance
Chapter 150. Finance
V. Additional Practice Tools
A. Client Communications

§ 150:102. Executive summary for clients regarding financing activities for businesses

Financing is an essential element for establishing a new business, launching a new product or service, or expanding an existing business through internal growth or acquisition. It is likely that entrepreneurs and managers will, regardless of the size of their businesses, need to venture into the world of finance several times over the life cycle of the enterprise. In that world they will encounter a wide range of participants, including banks, venture capitalists, investment bankers, government agencies, and business advisors, each of which will provide unique resources and experience. Capital suppliers have become increasingly innovative in devising financing techniques that are tailored to their needs and the goals and objectives of the businesses they serve. However, before managers can begin the onerous process of securing funding, they must develop a careful plan for identifying the financial requirements of the business, the terms upon which the company hopes to secure the necessary funds, and the potential sources for the funding. In addition, in order to be effective in raising and managing their capital, managers must also develop and implement financing strategies supported by a wide variety of specific tools such as budgeting and forecasting and a strong internal finance department. Finally, managers should be familiar with certain generic activities that must be completed in every fund-raising situation including preparation of disclosure documents, presentations to prospective capital providers, due diligence and financing documentation.

Key topics relating to financing activities for businesses include the elements and determinants of the capital structure; the determination and classification of capital requirements; development of a financing strategy; identifying and selecting sources of capital and understanding general capital raising activities. This memorandum is intended to help managers and their professional advisors understand the sources of the cash element of the capital structure; explain the process of determining the capital requirements for the business; explain the process of developing a financing strategy; describe the various sources of capital for a business and the factor for selecting among them; describe the generic activities that must be completed in every fund-raising situation; and describe the form and contents of the documentation for a financing transaction.

Technically, the term "capital" includes the entire base of tangible and intangible assets of the company. However, an important and ongoing concern for managers is the cash that can be used to conduct the business, including acquisition of noncash assets, and which can ultimately be available for distribution to the owners of the company. The cash element of the capital structure comes from several sources, including cash and assets contributed by shareholders in exchange for equity securities; cash received from investors in the form of loans in exchange for debt securities; debt financing received from noninvestment sources, such as commercial lenders; and funds generated from the actual operations of the business and from appreciation in the value of the assets used as part of the business.

Management has an obligation to determine how much capital the company will need in order to properly conduct its business operations. Presumably, the capital requirements of the business will be established at the time of formation; however, the initial estimates should be periodically reviewed in light of changes in the scope of the business activities and other unforeseen factors. Identifying the financing requirements for any business involves a number of discrete activities, all of which must be carried out in an organized and disciplined fashion. The company must formulate and articulate its long-term objectives, including the desired return on the equity capital invested in the business. Once these parameters have been established, a search begins for new and profitable uses of the funds which are available to the company. In order to evaluate each of the new investment projects, engineering, marketing and financial forecasts, budgets and estimates must be prepared, analyzed and compared and the projects should be classified by financial use, duration of the obligation or functional use. Finally, once the company has decided which projects to pursue (e.g., the development of a given line of products or a marketing campaign), procedures should be established to monitor the performance of the company in relation to the anticipated benefits of the project.

As with other parts of their business, senior managers should approach financing activities strategically. This process generally begins with budgeting and forecasting to attempt to identify the capital requirements of the business. While budgeting and forecasting are commonplace activities in some countries, such as the US, they are relatively underutilized in other countries around the world. In addition to determining the company's capital requirements, senior management must develop a comprehensive financial plan and infrastructure to identify and evaluate financing opportunities and collect the information required to attract funding sources. Important topics in this area include general business analysis; development of a capital-raising marketing plan; preparation of business plans, disclosure documents and financial information; presentations to prospective capital providers; due diligence and negotiation of what is often extensive investment or loan documentation.

Today even the smallest business can, regardless of where in the world it is operating, choose from among a wide array of potential sources of capital. In most cases, however, the selection is dictated by the stage of development of the company and the anticipated growth potential of the business in the future. Among the possible sources to consider are bootstrap financing (i.e., personal savings and loans from family members and close friends), government financing programs, commercial banks and finance companies, new business incubators and so-called "venture catalysts," "angel investors," venture capitalists, institutional investors, public offerings and strategic business partners. In addition, companies will often tap into alternative financing strategies designed to manage the company's capital expenditures and increase the efficiency of its cash flows, including internal financing sources, trade credits, cash management techniques and leasing.

All of the potential sources of financing are not necessarily available to all companies at a particular time or suited to a specific financing requirement. In general, however, a company will have several different options to choose from and should consider a variety of different selection factors including the degree of economic and management participation will be granted to the funding party, the costs associated with choosing a particular financing method, the duration of the financing vehicle, and the degree of risk associated with the company's inability to meet the expectations of the funding party with respect to repayment and/or return on investment.

While the tone and substance of negotiations with a particular type of capital provider will vary depending on the circumstances, there are certain generic activities that must be completed in every fund-raising situation. Almost without exception, the company should plan on preparing a business plan or offering circular for prospective funding sources that describes the business and the investment opportunity, as well as the proposed terms of the investment. Assistance in locating potential funding sources is often sought from financial advisors that provide assistance with respect to development capital, start up financing, acquisition finance, securing short-term funds for working capital, and finance for troubled companies. Once potential capital providers are identified management must be prepared to make oral presentations that reflect a clear understanding of the business, including its strengths and weaknesses, a realistic appraisal of the company's potential, and a clear understanding of how the day-to-day operations are reflected in the historical financial performance of the company. If the presentation is successful, management must be prepared for the due diligence phase, which is the general process of investor review of the company's technical assets, financial condition and business prospects. If the capital provider is satisfied with the results of the due diligence investigation, the parties will often enter into a letter of intent or memorandum of understanding that sets out the basic terms of the proposed financing transaction and the expectations of the parties regarding the form and content of the financing documentation.

Once the offer letter has been negotiated and approved, the final hurdle is the preparation of the documentation required for completion of the financing transaction. Assuming the financing involves the issuance of equity securities (e.g., common or preferred shares) the key elements of the documentation, which may be dispersed among several agreements, include the investment agreement, which sets out the essential economic terms of the investment; representations and warranties from the company (and the founders in certain instances) covering the legal, technical, business and financial condition of the company; covenants and restrictions relating to the use of funds and the conduct of the company's business following the closing; amendments to the articles of incorporation (and bylaws) to modify the capital structure of the company to conform to the terms of the securities offered to the new investors; agreements with the founders and other senior executives regarding their duties and compensation, as well as restrictions on their other activities and the consequences associated with any termination of their employment with the company; and other closing documents such as officers' certificates and legal opinions. The documentation for other types of financing transactions is actually very similar to an equity investment transaction although the names of the documents may differ and other documents may be needed due to the type of investment and the specific institutional requirements of the funding party. For example, a credit facility provided by a commercial lender will be documented using a credit agreement that includes representations and warranties, as well as covenants, similar to those found in the investment agreement described below and the lender will also require a promissory note that describes the terms of the loan and security agreements that describe the rights of the lender with respect to any assets of the company pledged as collateral for repayment of the loan.