

The Capital Markets Debutante: “Do I Need a Date for the Ball?”

by David Olson
Managing Director, Westbury Group LLC

So, you are the CEO or CFO of a growing middle market company with annual revenues greater than \$10 million and things are finally getting better.....so much better that you now view the glass as "half-full." Orders have picked up, you have called some of the part-timers back and the "what-ifs" have begun. *Good* "what-ifs", like "What if orders increase 20% from here next quarter? What if we need more capacity? What if we need to hire more skilled workers? And so on.

Immediately following the "what-ifs" come the questions "Do I need to look for more capital? Do I need to look for an investment banker? Or should we raise the capital ourselves?" Tough questions, particularly if the company is contemplating approaching institutional investors in the capital markets for the first time.

Today's capital markets "debutante" has a much wider range of options as to how to go about raising funds compared to the 1980's and into the early 1990's. Then, the only option for a first time issuer of securities was to hire an investment banker. From the mid 1990's to the present, the solution has increasingly been to "do it ourselves." In the "old" days of the 1980's and early 1990's, investment bankers held the keys to the capital markets kingdom as they held a near-monopoly on capital markets information and relationships. As the information society took root and proliferated, information has become much more freely obtainable, and in recent years, any CFO worth their salt has the ability to scan the capital markets universe and hone in on sources of capital pertinent to the company's needs.

Today, it has never been easier for a solid middle market company to obtain financing directly from sources of capital such as mezzanine and private equity funds. It can be as easy as updating the business plan, emailing it to a few private equity or mezzanine funds and waiting for the call back Ideally, a deal is negotiated with minimal disruption to the business and under acceptable terms. Unfortunately, ideally doesn't always happen, especially with first-time issuers. Often, the first time issuer, in retrospect and with perfect hindsight, regrets the decision to go it alone.

In any decision to hire an investment banker, many factors come into play, with perhaps the major factor, [unfortunately], being the banker's fee. For middle market capital raises, fees paid to investment bankers generally range from 3% to 5% of the capital raised for mezzanine debt to 5% to 10% for equity. In addition, the investment banker may be issued warrants to purchase a small amount of stock for a period of time at a strike price equal to the price paid by the private equity investors (there are many variations which I will not delve into here). So, is an investment banker worth the fee? In attempting to answer that question, first-time issuers should be aware that due to the "democratization" of the capital markets, investment banking fees have never been lower, and good investment bankers are competing more fiercely than ever to provide value added

services to their clients.

In preparing a first-time issuer for institutional financing via the capital markets, the investment banker will, concurrent with its due diligence and in advance of preparing "offering materials" describing the proposed financing, analyze the business plan as a first step in assessing the company's enterprise value, prospects and structuring the transaction. Compared to the business plan, the offering materials will concentrate less on "granularity", e.g. month-by-month projections keyed into budgets, and more on strategy, markets, prospects, management's ability to execute and valuation. The goal is to make a case for the investment and to engage the prospective investor. Since lenders and investors will likely review the business plan after showing interest based on the offering materials, the investment banker will work with management to update and improve the plan.

To further prepare a client for its "coming out party", an investment banker provides additional services as well. Perhaps of most value is the ability to objectively assess the client across all operational areas. Similar to a management consultant, an investment banker assesses the client from all angles, primarily from the view of a lender or investor. For middle market companies whose management often wear many hats and can be consumed by myriad issues compared to larger firms, this third-party assessment is often invaluable and can result in long-lasting improvements to key areas of the firm. In many cases, an operational review across such areas as marketing, manufacturing, human resources, accounting and management control systems expands to include beneficial recommendations regarding strategy (short, intermediate, and long-term), particularly when the investment banker has deep experience in the markets in which the client operates.

An effective investment banker can also prevent the capital raising process from morphing into a complete "time sink" for management. By efficiently shepherding the capital-raising process, including preparing offering materials, screening and vetting prospective investors as part of an efficient auction process, and structuring the transaction based on experience and knowledge of the markets, a good investment banker can optimize the time management needs to devote to the project, particularly when the banker has been successful in garnering interest from several competing investors.

Maintaining momentum is also key as it is important for a transaction to not languish in the market as investors are a close-knit community and generally know who is in the market and how long the deal has been "shopped", whether directly or through an agent. A slow-moving deal may suggest "problems," while in the case of a direct deal, the lack of momentum may simply have been caused by a management team distracted by other matters. A retarded process may lead to investors' perception that the company is unable to manage the process effectively or that the company has internal problems that need to be addressed. All this can lead to less favorable terms and can cast a pall on the company's next foray into the markets, whenever that may occur.

So, you are leaning toward hiring an investment banker. Now the question is "what to

look for?" Keep in mind that a good investment banker will take the time to learn the ins and outs of your business and work with management to identify and address factors that could be perceived as weaknesses by investors. Consequently, the investment banker will be something akin to a management consultant or even a partner, so personal chemistry is a plus. They will also have experience in working on transactions for companies at the same stage of their development, and perhaps in your industry, and therefore be in the best position to present your firm to the investment community, negotiate and close a good deal. Some investment bankers are even asked to join the boards of middle market clients as a result of their in-depth understanding of the company, its markets, and their ability to work effectively with management.

In summary, while firms are increasingly approaching the capital markets directly, particularly in the area of capital raising, the cost-benefit analysis still works in favor of an effective investment banker with relevant middle market experience, particularly for a growing middle market company raising institutional capital for the first time. With disintermediation an increasing threat to investment bankers, and fees slowly declining as a result, investment bankers increasingly need to provide better, more comprehensive service to their clients. Besides structuring and closing an attractive financing, a good investment banker can, as a natural by-product of its core capital raising services, provide recommendations and suggest solutions to operational and strategic issues that can translate into long-lasting benefits for the firm - truly a "win/win" situation.

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