

## What it takes to be Investment Ready



This paper takes a closer look at the issues to consider when taking on board a new cornerstone investor, partner or shareholder in your business (i.e. when other persons look to become joint participants in your business), and how you can prepare to deal with those issues.

(Note: this paper does not cover the sale of your entire business e.g. trade sales, IPO's, joint ventures or other funding arrangements such as mezzanine or leveraged finance or off balance sheet techniques.)

### INTRODUCTION

#### ■ Why bring in new investment?

There are three key reasons this commonly occurs:

- You want to cash out of part of your investment in the business (lifestyle capital)
- You want to restructure the balance sheet of the business (restructure capital)
- You want to grow the business (expansion capital)

The primary driver for taking on board investment into your business will have a significant impact on the key issues which you'll need to address and consider in order being investment ready.

Interestingly, in a June 2003 NZ Business article, under capitalisation was named as "mistake number 1" in a listing of the ten biggest mistakes entrepreneurs make and how to avoid them.

### IT ALL STARTS WITH STRATEGY

Before you take any action, you need to think about the strategy underlying your approach to this next phase of your business. Sir John Anderson, CEO, ANZ – National Bank, calls it "Strategy before Structure".

#### ■ Ask yourself fundamental questions, such as:

- What are your objectives?
- What are you trying to achieve?
- What do we need this money for?
- What is the expected return from that investment?
- What will happen to the business financially if we don't get the capital?

These first steps are all part of what Neil Richardson, Chairman OHL, calls "digging your well before you need it" – in other words, planning ahead.

#### ■ The key questions you need to ask yourself are:

- What are you trying to achieve?
- How much funding do you need?
- When do you need your funding?
- What's the optimal type of funding to enable strategy?
- What cost are you prepared to pay for your funding?
- Who would your optimum investor be?

## BUT FIRST, LOOK AT YOUR OTHER FUNDING OPTIONS

Planning ahead is crucial and you have worked out your capital requirements, but it's also important to look at whether there are sources of capital within the existing ownership structure or business.

■ For that reason, it pays to explore these areas first:

- Owners' available equity
- Retained earnings – “boot strapping”
- Sale of non-core assets
- Outsourcing of production
- Leasing of assets
- Cash flow management (eg seeking credit terms)
- Taking on more debt

## ITS MORE THAN JUST ABOUT THE MONEY

■ Most growing companies need more than capital, they need:

- Enhanced governance
- More management resources
- Distribution networks overseas
- Battlefield experience
- Evidence to foreign investors of New Zealand backing
- Capital markets / M&A experience

As Bill Gallagher, CEO of Gallagher Group, says, “Life's too short to make all your own mistakes – better to learn from the mistakes of others”.

## THE INVESTOR'S PERSPECTIVE: EXTERNAL FUNDING OPTIONS

The core principle here is that the more risky the financing, the more return the investor will require.

■ The usual equity options are:

- Private capital / private equity / venture capital
- Public listing NZSX / NZAX / AIM

## PRIVATE CAPITAL / PRIVATE EQUITY / VENTURE CAPITAL

- You generally need an angle to attract private equity
- Investors require 25% plus compound return on investment
- You need a defined vision and strategy with implementation plan
- You need a willingness to compromise and take advice
- Management retain control
- Added value by providing advice, networks, mentoring
- Two paths of exit – three to five years out

Typically, friends, family, angel investors fund start-ups and deliver early stage investments.

■ The key investment trends we have seen are:

- Swing back towards early stage investments
- Co-investment among fund managers – signals a maturing of this asset class
- Amount of new capital raised (GSJB Were \$76 million, ABN / Direct Capital \$53 million)
- \$1.5 billion committed, \$0.8 billion available
- Private equity investors prepared to pay higher multiples (than before) to invest



- Large number of New Zealand entrepreneurs have realised capital here or offshore
- Investors with significant value to add to growing business. Battle experienced in getting to market offshore
- Institutional investment focused on investing alongside management
- MBIs (Management Buy-In), MBOs (Management Buy-Outs) or BIMBOs (Buy-In / MBO Combination)
- A financial investor is neutral as to whether exit is achieved through secondary MBO, float, trade sale
- Finance could be sought from a trade player, e.g. a larger competitor who could also bring access to distribution networks, but these companies will usually require the opportunity to take a controlling shareholding
- So needs to be considered in the context of your exit strategy
- Need for due diligence on partners – it is a long-term relationship
- Culture, expectations on value, exit, growth, preferences (sector, size, shareholding %)

How to woo a venture capitalist, (Andrew Janes: Unlimited Magazine, October 2004):

‘There’s an ancient Chinese proverb: “A peasant must stand a long time on a hillside with his mouth wide open before a roast duck flies in.” If you really want something, don’t just stand around waiting for it to happen.’

#### PUBLIC LISTING – NZSX / NZAX / AIM

- Need a clearly defined strategy – with a clear voice to deliver it
- Structured business – policies and procedures
- Business no longer ‘private’ – now in the public eye
- Corporate governance – carefully select the Board
- Public relations plan – maximise your exposure
- Be realistic about the costs – e.g. up to NZ\$1m to list on AIM

Points to consider include: the trend towards public to private transactions; the fact Kiwi share market investors look for more mature, yield investments; more recently listings have been used as an exit mechanism versus capital raising.

The NZSX (main board) listing is for companies valued at \$50 million plus. The NZAX market, which was established in 2003, offers lower costs and more flexibility (e.g. 50 versus 500 shareholders). At time of writing the NZAX had 19 companies listed, – most from the former secondary board. Their average market capitalisation was under \$20 million.

But both exchanges have similar compliance regimes, e.g. “Continuous disclosure” rules. Examples can be: winning major contracts, trading materially below / above market expectations. On the flipside, an unsuccessful listing can make future capital raising difficult.

There has been a recent trend towards identifying an AIM market listing as either a primary or secondary listing strategy. Costs are high and the logistics challenging, given the UK base for AIM listings. However P/E multiples continue to be attractive.

When you have, effectively, one shot at making it a success it certainly pays to do the groundwork correctly – including getting your management structures, reporting systems and other companies’ processes optimised.

Think about how long the whole process will take too: in our experience it can take 18 months to fully prepare for a public listing.



## BEEN THERE, DONE THAT...

“We considered venture capital and debt, but we decided on listing as the best option because it was the most cost competitive.” *Geoff Ross, CEO, 42 Below*

“Prior to listing, Just Water didn’t have a brand. Nobody knew what sort of water cooler they had. Now, I think, anyone you talk to, particularly in business, knows who Just Water is.”

*Tony Falkenstein, CEO, JWI*

## STAGING OF CAPITAL NEEDS

- Usually there are two objectives in the staging of your capital needs:
  - Raising sufficient capital
  - Minimising dilution
- With those pieces of the puzzle in place you can then consider:
  - Successive capital raising on better terms
  - Break growth plan into chunks
  - Establish milestones

From our experience, many early stage equity investments are done in \$0.25 to \$1.5 million “chunks”. This is better for the investor, who puts more money in when milestones are achieved and better for the investee who faces less dilution of their equity.

The focus for management and investors should be on achieving the next milestone. Another factor that can come into play is that the major constraint is often not money but senior management having the time to invest in managing the process effectively – which is obviously important to ensure a focus. You may need to partner with investor who can support future capital raising.

## CHOOSING BETWEEN THE OPTIONS

- Things you should consider include:
  - Which option best facilitates growth strategy?
  - What non-financial needs do you have in the business?
  - Can you work with others at an ownership level?
  - Is maintaining control important?
  - Trade-off between dilution and speed to market?
  - Are you comfortable with being in public domain?
  - Do you know the all the costs associated with each option?
- In summary then, there is no “one size fits all” solution to your choice of external capital raising:
  - Bank finance is best for established business with good cash flow
  - Private equity is a good option for rapidly growing business
  - A stock market float is a good way to raise capital and realise some capital without losing control – for more established businesses

Think strategically about breaking up capital requirements and what non-financial goals can be met through the partner.

Any form of external finance will require higher standards of governance, reporting and communication.



## PREPARING THE BUSINESS FOR INVESTMENT

- We recommend working with your financial adviser on these areas early on in the process:
  - Groom the balance sheet
  - Clean up the profit and loss
  - Improve financial and operational reporting
  - Check for compliance with all legislation
  - Review accounting systems and procedures
- Other key points to focus on are:
  - Have your management team in place
  - Reduce owner dependency
  - Have a clear well-written business plan

## IMPLICATIONS OF TAKING IN INVESTORS

We are often asked how outside investors will change the nature of doing business. Mostly it comes down to these things:

- You'll face having more accountability to others
- You may have less flexibility in how you operate the business
- There will be more formality when it comes to dealing with company processes
- You may need to undertake an annual audit
- Defined dividend policies may need to be established
- Different investor requirements may need to be satisfied
- Tax issues will need further consideration

## LOOKING AT THE LEGAL ISSUES

- At Anderson Creagh Lai we are of course a specific resource for looking at some of the legal issues that may arise. These could include:
  - Investor relationship issues
  - Intellectual property issues
  - Significant contracts / permissions
  - Employment contracts
  - Due diligence

## IN DETAIL:

- Investor relationship issues
  - Where will the investor come from?
  - What are their objectives? Timetable?
  - Caution with trade investors
  - Warranties and long tail risk
  - Clear understandings in writing vital to both sides
  - Less power and control / more accountability to other stakeholders – get used to the idea
  - Minority shareholder positions – 50% + 75%+



## ■ IP issues

- Have you invested enough in IP (particularly for scaleable businesses)?
- Can take time to tidy up so don't delay
- Three step process:
  - Audit IP – What? Who owns? Where protected? Clear to use?
  - Correct any issues
  - Quarantine and protect IP
- Can be expensive, multi-jurisdictional issue

## ■ Significant contracts / permissions

- Who are your key suppliers?
- Who are your key customers?
- Do you have current up-to-date contracts?
- Unusual / onerous terms?
- The right parties? Signed? Dated?
- Current commercial terms?
- Any other permission the business needs?
- Change of control hurdles?

## ■ Employment contracts

- These are particularly important for shareholder employees
- Be realistic about roles going forward
- Should reflect market deals on arm's length terms
- Consider the use of restraints / non-competition provisions (but must stand up in Court)
- Key person insurance
- Can tidy up IP grey areas

## ■ Due diligence

- Is your non-disclosure agreement in place? Exclusivity?
- External or internal investor?
- Understand their requirements
- Corporate records up to date
- Assemble and keep due diligence material
- Due diligence effort pays off

## WHAT IT TAKES TO BE INVESTMENT READY – CONCLUSIONS

There are many steps involved in bringing investment into a company and while the pathway appears well-trodden a meticulous and diligent approach will help maximise a successful outcome.

As the investee, the key is to focus on the business plan and maintaining a grasp on the bigger picture while still taking care of the details. With that done, your investor can focus on their strategy coming in and their future expectations.

## ■ But remember, keeping an eye on the basics will always serve you well:

- Get good advice
- Start early – assemble due diligence material
- Keep the disciplines – be prepared
- Be realistic about your role

