

Private Placements: Raising Capital from Investors

Manufacturers need to implement financial strategies that ensure continued growth, provide for the replacement of expensive equipment and facilities, and position the company for the right expansion or acquisition opportunity. As traditional financing sources continue to be relatively tight, this often proves to be one of the more difficult tasks faced by a growing company. Strategic changes, such as rapid growth or acquisitions, often require companies to seek financing beyond their internal resources or traditional bank lenders. The private placement of equity remains one of the most viable capital formation alternatives for manufacturing companies.

Why Raise Equity When You Might Borrow?

Rapid expansion usually drains large amounts of precious working capital. However, increasing leverage by borrowing the needed capital is only a temporary fix. The new debt weakens the company financially until operating cash flow catches up with the new level of business activity. A private placement of equity allows the company to meet its strategic objectives without putting the company at greater financial risk.

Determining whether a private placement is appropriate requires the company to address a number of strategic issues. For example, in a simple private placement, the company might offer a minority interest in its common stock to individual investors. This will cause some dilution of the current equity holders' percentage ownership of the company. The company must also consider the projected profits to be generated by the new capital. Are the anticipated rewards enough to satisfy both new and old shareholders? How will these profits be divided? Enhancing the company's value while providing a sufficient return to attract investors can be a challenge.

Perhaps the most important consideration is how to value the company and determine how much equity capital must be raised. To enhance the chances of a successful private placement, a thorough and professional valuation of the company should be performed at least six months in advance. One valuation method is to use benchmarks, such as the price of shares in publicly-traded companies in comparable industries and lines of business, with adjustments for size and liquidity.

The owners need to offer an attractive investment in terms of current yield, potential for future appreciation, and eventual liquidity. One method of accomplishing this is "working backwards." For example, assume that an investor would require a current return of 10 percent and a total return on investment of 25 percent compounded over five years, followed by a sale of the investment back to the company or a public offering. Working backwards, the future value of the company may be estimated based on its projected profitability using standard net present value techniques. If the valuation based on projected fifth year earnings meets the investor group's requirements, then the issuance of equity should be fair for the company as well.

Mechanics of a Private Placement

It is critical for the company to work with competent legal counsel to structure the private placement and to ensure that the offering complies with federal and state securities laws and regulations. For limited amounts of capital raised from a small number of investors, a private offering is relatively easy. As the amount of capital and the number of potential investors contacted increase, the cost and complexity begin to approach that of an initial public offering.

The key to minimizing the transactional and ongoing costs of an offering is to ensure that it is exempt from SEC and state registration and reporting requirements. This can be done by complying with complex rules regarding the amount of money that can be raised, the number of investors, and the level of accreditation and sophistication of the investors. (An "accredited" investor meets certain income or net worth requirements; a "sophisticated" investor is one who is capable of evaluating the risks involved in the investment.)

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The offering should be made directly to prospective investors without the use of general advertising or solicitation. The number of prospective investors should be kept to a minimum and they should be provided with current financial information. Although a comprehensive disclosure document is not always necessary, it is strongly recommended to avoid misleading a potential investor.

The Private Placement Memorandum

The disclosure document commonly used in private offerings is called a Private Placement Memorandum. The memorandum is similar to a business plan, except that the emphasis is on the disclosure of facts rather than projected results. Legal counsel should be consulted to determine the appropriate level of disclosure to comply with applicable federal and state laws.

A Private Placement Memorandum typically includes a discussion of the terms of the offering, the allocation of proceeds, and the risk factors inherent in the business and industry. In general, the memorandum must contain all information about the company, its business, and the securities offered, that would be considered “material” by a potential investor.

The Private Placement Memorandum is accompanied by a Subscription Agreement and Investor Questionnaire.

The Subscription Agreement is a contract to purchase a specified amount of securities at an agreed price, and contains a statement that the investor has received and reviewed the Private Placement Memorandum, is aware of the risk factors, and is a suitable investor. The Investor Questionnaire elicits information about the investor’s background, employment, and investment or business experience. It is used in part to confirm the investor’s accreditation and sophistication.

Finding Investors

Investors may be officers or directors of the company, or other insiders. Outside investors may include professional investors or accredited individuals. Some may be acquainted with the company or its management. Others can be reached through the company’s contacts or networking activities (the company’s legal counsel or accounting firm may be able to help in this area). Potential investors don’t have to be individuals. A successful offering can also be accomplished with corporate investors.

Timing

A fully subscribed private placement generally takes about six to nine months, depending on the diligence of the investor search. Many companies begin their search for investors at least a year in advance. A company should have a ready and willing stable of investors before it prepares a Private Placement Memorandum.

Conclusion

With their higher potential for profitability and cash flow, manufacturing companies have always been favored by investors over distribution and service businesses. This fact, coupled with an expanding economy, has improved the private capital markets and made private placements easier and more cost effective for manufacturers in an expansionary phase.