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Private Capital In the Pacific Northwest

Venture capital is one form of private capital, but many are confused as to other sources of private capital.

by William S. Hanneman

We recently raised capital to fund the purchase of a local company by its management. This purchase of an established manufacturing company from its UK parent was a traditional leveraged Management Buyout ("MBO"), sponsored by its existing management. Funding for the transaction required three types of capital: senior secured debt, subordinated debt, and equity. While we were able to arrange the senior secured debt in the local market, the limited choices for subordinated debt and private equity in the Pacific Northwest required that we seek these riskier forms of capital outside of this region.

And, while there has been a tremendous amount of venture capital raised in the Pacific Northwest in the past few years, this region has virtually no lenders of subordinated debt and very few private equity investors that are focused on later-stage, "old-economy" businesses.

PRIVATE EQUITY CAPITAL—DEFINED

Private equity capital is available from a variety of sources ranging from friends and family to sophisticated institutional investors. We find that there is tremendous confusion by those seeking private equity capital regarding whom they should approach. Venture capital seems to be the term that is commonly used to describe private equity investors. However, while important, venture capital is but one form of private capital.

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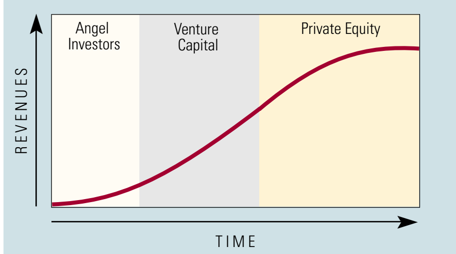
Different types of investors are attracted to different levels of risk, some want more, and some want less. Accordingly, different types of investors are appropriate at different stages in a company's life cycle.

Company Life Cycle



ANGEL INVESTORS

The earliest stage of funding, so-called "start-up" or "founding" capital is often provided by entrepreneurs themselves. If the business has merit, entrepreneurs quickly seek out wealthy friends and sympathetic family to provide the next increment of capital. These so called "Angel" investors often invest before the business has any meaningful customers, revenues or clearly articulated business strategy. This is truly the riskiest form of private capital.

Angel investors constitute an entirely unorganized market. By and large, there are no statistics available to measure the overall size of the market, just as there are no standard transaction terms and conditions. Our experience is that Angel investors are generally not adequately compensated for the risk they bear; hence, the term "Angel," which Webster's defines as "a) a kind and lovable person, b) one who manifests goodness, purity, and selflessness."

In the Pacific Northwest there have been various attempts to organize Angel investors. These organizations, such as the Alliance for Angels, have generally come together in informal groups. Most recently, organizational efforts seem to have abated, leaving the market for this earliest stage of private equity capital as an unorganized and fragmented market.

VENTURE CAPITAL

Once a young business can demonstrate that customers will pay for a company's product or service and that the operation is likely to generate a positive cash flow, venture capitalists become interested.

The funding for venture capital is primarily provided from pension funds and insurance companies that place a portion of their investment portfolio into partnerships managed by professional investors. Many new venture capital ("VC") funds have sprouted in the Pacific Northwest in recent years, raising over $2.0 billion.

Transaction terms and conditions offered by venture capitalists are more predictable than Angel investors. Although VCs may invest in a minority shares of a private company, such investments are typically structured to provide certain priority protections and preferences relative to the founder's capital.

Venture capitalists invest in companies that are still quite risky. Businesses at this stage of their life cycle remain vulnerable to a variety of shocks that could cause total failure. As a result, venture capital investors seek to earn internal rates of return ("IRR") in the range of 50%. In order for VCs to achieve such returns, the companies in which they invest must be capable of rapid growth. For these reasons, VCs are not interested in investing in stable, more mature businesses.

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PRIVATE EQUITY

The traditional source of outside capital for mature firms has been debt. However, such businesses often have capital needs that cannot be entirely funded by operating cash flow or borrowed money.

Some businesses with these needs can go public, that is, raise equity in organized

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public markets. However, that opportunity is not available for most companies, either because of their small size, moderate growth prospects, or simply because the owners do not wish to share the inner workings of their business with competitors. These situations are within the purview of private equity investors.

There are hundreds of private equity firms in the U.S., managing well over $100 billion. Most private equity capital originates from institutions that have long-term investment horizons such as pension funds, insurance companies, endowments or public authorities. Wealthy families are also meaningful contributors to private equity funds.

Transaction terms and conditions of private equity investors are reasonably predictable. While investments made by these firms are always structured to fit the needs of the particular situation, the return requirements and control issues are much more certain.

Because the businesses that private equity funds invest in are much less risky (already have established customers, assets and cash flows), private equity investors look to earn IRR's in the range of 25%-30%.

Private equity firms often buy whole companies or will take minority interests, if they can, through contractual rights, gain sufficient influence over the board and the exit strategy.

Private equity markets have not developed as thoroughly in the Pacific Northwest as elsewhere in the U.S. The small share of private equity in the Pacific Northwest is due both to the relatively small number of private equity investment opportunities, as well as the lack of long term investors (insurance companies and pension funds) located here. Interestingly, the wealth created in technology industries in the Pacific Northwest has not, on the whole, embraced later-stage private equity investment opportunities.

Clearly, distinguishing between the various types of private equity investors will greatly reduce the time and effort expended in raising capital. If requirements are for later-stage private equity, it makes sense to cast the net beyond the Pacific Northwest. ❖

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ABOUT ZACHARY SCOTT

Zachary Scott is an investment banking and financial advisory firm founded in 1991 to serve the needs of privately held, middle-market companies. The firm offers a unique combination of in-depth knowledge of the capital markets and industry competitive dynamics, sophisticated analytical capabilities, and proven expertise in structuring and negotiating complex transactions. For more information on Zachary Scott, please go to ZacharyScott.com.

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