OPTIMIZING YOUR CAPITAL STRUCTURE USING DEBT + PRIVATE EQUITY

PRESENTED BY:

River City Bank

DCA PARTNERS PRIVATE EQUITY

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QUESTIONS

If you have questions during this presentation, you may submit them through the Q&A button or email them directly to aschroeder@dcapartners.com

What We Will Cover

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What We Do

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& Private Equity

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Introductions

Craig Mitchell
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Craig Mitchell

Private Equity investing at DCA Partners

Private Equity investing at LP Capital Advisors

M&A at Wachovia

MBA from University of North Carolina

DCA Partners

Growth equity

Small and medium sized companies

$3 to $30 million investment amount

Minority or majority investments

Founded in 2001 by Curt Rocca

Also provides Mergers & Acquisitions

Dan Franklin
SVP, Commercial Banking Director
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Dan Franklin

12 years at River City Bank

MBA from UCD Graduate School of Management

Recipient of Chartered Financial Analyst Designation

River City Bank

Headquartered in Sacramento

Offices in Bay Area

Commercially Oriented

$3.4 billion in assets

Founded in 1973 by John Kelly

65% owned by Kelly Family

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Financing Situations

What are the most common use cases for capital?

Working Capital
Buy more inventory and fund operations while waiting for customer payments

Partner Buyouts
Buyout other shareholders and support ownership transition

Refinancing
Refinance existing loans, adjust terms, and reduce total debt

Equipment
Buy more efficient equipment, expand production, etc.

Real Estate
Redirect capital to support business growth

Product Expansion
Invest in R&D to develop new products or services

Acquisitions
Buy a competitor or enter a new market or geography

Geographic Expansion
Open new offices and hire new employees

Capital Structure

- Risk/Reward Tradeoffs

- Most appropriate capital source is often dictated by:
  1. Status of business
  2. Purpose of financing
  3. Owner’s risk tolerance

- Combination of debt & equity can often be optimal

Equity	Higher cost and give up a portion upside, but lower risk	Paid at exit or recapitalization
Mezzanine	Mix of equity and debt characteristics	Low principal payments (e.g. interest only)
Senior Debt	Lower cost and doesn’t reduce ownership, but higher risk	Principal payments

Step into the Shoes of a Senior Lender…

- **Economics of a bank loan:**

Profitability of Loan Portfolio	
Loan Balances	100
Interest at 3.5%	3.50
Associated Expenses	(2.50)
Net Profit of Loans	1

Hypothetical Bank Balance Sheet	
Assets (mostly loans)	100
Liabilities (mostly deposits)	90
Equity	10

Getting repaid only 90% of the time would wipe out equity → Need to get repaid 99%+ of the time

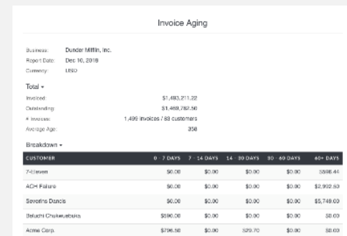
- **Banks don't take big risks**

- **Focus is on lack of downside, not potential upside**
  → adjust your pitch accordingly

Steve Fleming, CEO of River City Bank

Typical Forms of Bank Debt

1. **To finance assets with reliable values:**

Real estate	Equipment	Creditworthy A/R	Some Inventory
			
70-75% LTV for conventional 25-yr amortization schedule	Up to 100% financing 5 to 7-year amortization schedule	Availability commonly tied to a formula, such as: 75% of eligible A/R + 50% of eligible inventory	

Invoice Aging

Business: Dunder Mifflin, Inc.
Report Date: Dec 10, 2018
Currency: USD

Total ▾

Invoiced: $1,483,211.22
Outstanding: $1,469,762.50
Invoices: 1,499 invoices / 83 customers
Average Age: 358

Breakdown ▾

CUSTOMER	0 - 7 DAYS	7 - 14 DAYS	14 - 30 DAYS	30 - 60 DAYS	60+ DAYS
7-Eleven	$0.00	$0.00	$0.00	$0.00	$896.44
ACH Failure	$0.00	$0.00	$0.00	$0.00	$2,902.50
Severina Dancis	$0.00	$0.00	$0.00	$0.00	$5,749.00
Beluchi Chukwuebuka	$590.00	$0.00	$0.00	$0.00	$0.00
Acme Corp.	$796.50	$0.00	$29.70	$0.00	$0.00

2. **To finance the acquisition of a business with reliable profitability:**
   - Loan amount: 2 – 3x EBITDA
   - 5-yr amortization schedule

3. **Small Business Administration (SBA) increases availability of credit**
   - Facilitates 90% LTV CRE loans
   - Its guaranty encourages banks to make more loans

Case Study: Plumbing & HVAC Company

Financing Purpose: To finance the acquisition of the company's HQ and service vehicles

Business Profile: Well-established home-service business with history of stable profitability.

CRE Loan Terms

- $1.5 million term loan
    - 70% of purchase price plus tenant improvement cost
- Portion allocated to TIs disbursed over time as expenses incurred
- 10-yr term / 25-yr amortization
- 10-yr fixed interest rate
- Deed of Trust on CRE only

Equipment Line of Credit

- $500k non-revolving line of credit
- Each disbursement becomes its own 5-yr fully amortizing loan and is secured by the truck it financed
- Disbursements at 80% of cost
- Floating interest rate
- Lien on equipment only

Case Study: Food Wholesaler

Financing Purpose: To provide cash to pay suppliers and related expenses while waiting to collect accounts receivable from its customers (i.e., finance working capital).

Net income: of $1 to $3 million historically

Assets: Essentially cash, A/R, and inventory of fluctuating amounts

Accounts Receivable

- Concentration (45% of sales to two customers)
- Creditworthy (zero historical bad debt)

Loan Terms

- $30 million line of credit
  - Limited to 80% of eligible A/R plus 60% of eligible inventory
- 2-yr term
- Guaranty from owners
- Monthly borrowing base certificate
- Annual A/R & inventory audit
- Various financial covenants

Case Study: Mature SaaS Business

Financing Purpose: To ramp up sales efforts (hiring sales staff and launching new versions of product)

Customer base:

- *Municipalities w/ contract cancellation clauses*
- *Company has 10-yr history of customer retention*

EBITDA: Approximately $2 million

Balance Sheet: Minimal tangible assets, $2.2MM in existing bank debt

Loan Terms

- $2 million loan amount
- 5-yr amortization schedule
- Guaranty from majority owner
- 1.20 debt-service-coverage ratio (waived in year 1 when loss anticipated)

Step Into the Shoes of a Private Equity Investor…

Private equity investors manage capital for high-net-worth individuals, family offices and institutional investors

- Investments are illiquid for 10 years or more
- Investors are seeking a 15% to 20% annual rate of return
- Subordinated to bank debt
  - → Lose entire investment before bank loses any money

Invest in established, growing, and profitable businesses

- Minority growth-equity investments
- Majority recapitalizations
- Buyouts

Aligned with owners

→ Want to minimize downside and maximize upside

Steve Mills, Partner at DCA Partners

Considerations for Private Equity

Pros

- Take measured growth risks. GO BIG!
- No payments along the way (no P&I)
- Retain control of your business or sell majority
- Strategic partnership with experienced operators
- No personal guarantees – shared risk model

Cons

- Limitations on owner lifestyle benefits
- Not ideal for multi-generational family businesses
- Expensive capital for lower returning assets
- Reduced levels of control / shared decision making
- Need exit or recapitalization for liquidity

Case Study – Mattress Manufacturer

Financing Purpose: Expand production and working capital to support large, new customer (Mattress Firm)

The Challenge

- Mattress Firm's parent company was in bankruptcy and collectability of receivables was questionable
  - Long collection cycle
  - Show beds provided at loss to hundreds of stores

The Result

- Launched across thousands of Mattress Firm stores
- 300% growth in revenue
- 0% EBITDA margins to 15-20% EBITDA margins
- New opportunities with other retailers following Mattress Firm

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Case Study – Sales Acceleration SaaS Developer

Financing Purpose: Fund development and sales team to drive growth

The Challenge
- Operating at a loss as they worked to achieve scale
- Asset light software business

The Result
- Added key capabilities to handle needs of larger customers
- Focused sales efforts on enterprise customers
- Tripled revenue

CONQUER

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Optimizing Your Growth Using a Blend of Debt and Equity

Utilize prudent levels of debt to finance <u>established operations</u>

Minimize cost associated with financing growth

Utilize private equity to <u>launch new operations and expand</u>

Reduces financial stress associated with excessive debt

When more capital is needed than a bank can provide (i.e., acquisition)

Case Study – Integrator of Food Manufacturer Controls

Financing Purpose: Carve out business from a parent that was not adding value

The Challenge

- Asset light engineering services business model did not fully support bank debt
- Capitalizing the business to appropriately prepare for growth
- Negotiating a palatable deal for all parties

The Result

- DCA negotiated the terms of the deal with all parties
- DCA and River City provided the capital needed to close the acquisition
- The Founder maintained control of the company and increased his ownership during the process

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Questions & Speaker Contact Information

Questions?

Submit questions through Q&A feature on Zoom

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