A flood of innovative financing techniques has changed the face of corporate fund-raising in Australia. The growth of management buy-outs has added to the variety of structures and deals.

FINANCING TECHNIQUES

NEW WAYS TO FIND FUNDS
SEARCHING FOR THE ‘DO-ABLE’ DEAL

Financing techniques have been affected recently by changes in dividend imputation, negative gearing, capital gains tax, preference shares (Section 46 changes), interest rates, exchange rates, general deregulation and aggressiveness of financial markets and the Acquisition of Shares Code. We have also seen the emergence of a venture capital industry in Australia, second boards (and their continued growth) and cashbox companies.

All of the above, and prevailing stock market conditions, have contributed to much more volatile, fluid and aggressive financial markets. People are more willing to "have a go" and financial institutions have realised that their businesses are as much about the provision of money as the collection of money. This in turn has seen tremendous competition for the lending of funds.

We have seen examples where financial institutions have lent money at a margin above their cost of funds which would not even cover their administration costs. That is the good news; the bad news, of course, is that you need to be appropriately qualified as a blue-chip customer to obtain those rates.

We have also seen — I believe as a result of the above factors — the emergence of management buy-outs in Australia. Management buy-outs are highly leveraged, with large amounts of debt funds and with small amounts of equity capital. There are management buy-out specialist funds. We are currently looking to do a management buy-out in the range of $15-20 million which will almost be totally debt-funded.

The table shows the growth in management buy-outs in the US. It is expected that Australia will experience the same rate of growth in management buy-outs.

<table>
<thead>
<tr>
<th>Year</th>
<th>No. of Deals</th>
<th>Value in US billion</th>
</tr>
</thead>
<tbody>
<tr>
<td>1981</td>
<td>4</td>
<td>1.04</td>
</tr>
<tr>
<td>1982</td>
<td>12</td>
<td>2.26</td>
</tr>
<tr>
<td>1983</td>
<td>21</td>
<td>5.93</td>
</tr>
<tr>
<td>1984</td>
<td>26</td>
<td>8.83</td>
</tr>
<tr>
<td>1985</td>
<td>25</td>
<td>12.32</td>
</tr>
<tr>
<td>1986*</td>
<td>32</td>
<td>22.40</td>
</tr>
</tbody>
</table>

* Based on 10 months only.
MBO of listed companies alone.

MANAGEMENT BUY-OUTS IN THE U.S.

<table>
<thead>
<tr>
<th>Company</th>
<th>Compound Annual Return PC</th>
</tr>
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<tbody>
<tr>
<td>LPL</td>
<td>614</td>
</tr>
<tr>
<td>Devon Group Inc</td>
<td>339</td>
</tr>
<tr>
<td>Panill Knitting</td>
<td>269</td>
</tr>
<tr>
<td>Leslie Fay Cos</td>
<td>230</td>
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<tr>
<td>Harley Davidson</td>
<td>115</td>
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<tr>
<td>Atari Corp</td>
<td>95</td>
</tr>
<tr>
<td>Capital Wire &amp; Cable Corp</td>
<td>46</td>
</tr>
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In obtaining finance there are always risks, which can be fairly mild to quite major and can involve not only business but political, geographic and other factors.

An entrepreneur or organisation is always trying to maximise returns and, generally speaking, the more debt-oriented the finance is, the greater the potential return — but the greater the risk if something goes wrong.

One of the fundamental decisions to be made in obtaining any finance is the extent to which one shares the risk, and the extent to which one tries to defund the project and thus take all the profits and risks oneself.

A surprising number of people do not think through the alternatives at a basic level before looking at more sophisticated variations on the debt-equity continuum.

In recent times there has been a blurring of debt-equity issues. Unless one can understand the fundamental risk-return preference of the client it is very difficult to structure an appropriate debt-equity mix or variations appropriate to the client’s circumstances.

Many people are paranoid about wanting control and they automatically translate this to ownership of more than 75 per cent of the share capital. I suggest that control can be achieved in a number of different ways — shareholders’ agreements, voting rights agreements, put and call options and other trigger mechanisms. All of these have their useful place in structuring finance.

The financing structure to be adopted will always be governed by the forecast cash-flows. This is an essential consideration for any project.

While the only thing one knows about a forecast is that it is wrong — one just does not know by how much — it is important to attempt such predictions so one can see the sensitivities with which one is dealing. In today’s climate, where there is such a volatility of interest rates and economic conditions, and where spreadsheets are readily available, there is no excuse for not running out financial models on any proposed acquisition or major financing to be undertaken.

Here are some selected structuring techniques and tools:

Inherent Funding Options: In many acquisitions there are opportunities to derive funding from the businesses being acquired; for example, through increases in trade creditors; reduction of stocks; reduction of debtors; sales of property; and leasing of plant and equipment.

These should be looked at automatically. It is surprising how much finance can be generated from a tight control of the working capital.

Vendor Finance: Vendor finance of an acquisition can range from the simple delay of settlement to agreeing with the vendor that certain assets will have an agreed value and that they will remain the property of the vendor while the vendor and purchaser undertake their best efforts to dispose of those assets. Any “unders or overs” are taken by the purchaser.

This has the benefit to the purchaser not only of saving stamp duty but also of raising part of the finance which would otherwise be required; in addition it encourages the vendor to undertake some more work on the assets. Thus whilst the vendor is guaranteed a certain price it is in his interest to quit the assets as quickly as possible.

Again, it is surprising how often negotiations do not extend to identifying the real needs of each party and then working out mutual solutions so that the amount of finance required by the purchaser is reduced.

Another aspect of vendor finance which should not be overlooked is that of agreeing to pay, say, $100 for an asset but with the payment to be made in 12 months, rather than $100 today with the vendor providing finance and interest accruing at current rates. Often the vendor will be selling an asset which will be pre-September 1985, so that the increase in sale price may not incur additional tax while the receipt of interest would incur additional tax. On the other hand, the purchaser is denied the benefit of any tax deductibility for interest that would have been paid, but achieves an immediate higher cost base for the asset and thus a future potential capital gains tax saving. Most importantly, the purchaser achieves 12 months’ finance.

Convertible Notes: With the advent of dividend imputation there is and will be a re-emergence of convertible notes. The interest normally will be fully deductible by the paying company and assessable in the hands of the receiving company.

However, should the receiving company be a non-tax-paying institution, then a net gain is achieved (over the issue of ordinary equity). At the same time, a financing is arranged with a higher level of security than a straight equity issue and the provider of funds has an option to convert to equity.

A real attraction of convertible notes is the ability to determine the conversion terms, which are important both in the time over which the notes can be converted to equity and the effective exercise price; i.e., if they are $1

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convertible notes, are they convertible into ordinary shares on a par basis ($1 convertible note for one $1 ordinary share) or on some differential basis (e.g., two for one)?

One technique that we have used with convertible notes is to make them the initial seed capital for a company, conditional upon other agreements being entered into for subsequent stock exchange floating etc., and with conversion rights into A class shares immediately prefloat. This gives the initial investors the security they require (as they are, in effect, initially investing in a private company) together with an equity sweetener and good interest returns. The benefit to the company is that it obtains the initial finance to enable it to grow through to the stage where it can be floated.

Repayment Holidays: These holidays can relate to interest and/or principal.

If the requirement for a holiday is spell out at the outset, a number of financiers are willing to consider them provided reasoned cash-flows are presented which show that to be appropriate, and provided that their risk-return relationship is not harmed by a holiday.

Negative Pledges: Instead of providing specific pieces of security to individual lenders an organisation undertakes that it will not breach certain balance-sheet ratios. In this way it is free to continue borrowing within its balance sheet ratios and is not limited by the specific pieces of security which it can give.

Negative pledges are becoming much more common. Existing holders of security do not like changing from their existing security to a negative pledge situation, but where it is a question of doing that or losing the business altogether, clients can achieve negative pledge situations.

Shareholder Agreements:

These apply only to private companies. They are very useful in providing the level of comfort required by minority-equity or quasi-equity investors, while allowing the company to run its own business.

Contributing Shares: These are most useful where the promoters or owners of the company do not have a large amount of capital but wish to retain a substantial equity position.

Options (as a sweetener): One way of creating value in today’s stock market conditions is by issuing options.

The market values options quite highly compared with their actual worth (according to the formal option valuation formulae). In a market which is volatile, an equity issue which has options attached has good chances of succeeding as the takers of the equity shares place a relatively high value on options.

Options used to be preferred to contributing shares because contributing shares have a liability to pay a call if and when made. With the advent of capital gains tax I believe we will see a lot more contributing-type shares being issued in non-listed companies because of their taxation benefits.

Options on Options: This technique says that if you exercise your series A options and subscribe for more shares, then you will be issued with series B options — an added inducement for the exercise of series A options.

Preference Shares: Although the Section 46 dividend rebate for preference shares has been abolished, preference shares will come into their own.

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The basic concept of preference shares is that they are preferential in terms of dividend receipt and/or repayment of capital. With full dividend imputation the preferential receipt of dividends, particularly franked, has some attraction; if the dividend rate is set high enough, a preference dividend can be as attractive to some institutions as very finely-priced debt. Add to this the ability to redeem them and/or convert them (to ordinary shares) and/or issue them in association with options and you have a very flexible instrument. (Redemption has to be made out of profits or share premium reserves; thus we have seen the technique of issuing very low nominal value preference shares at a very large premium.)

Equity Sweeteners: The financial markets are becoming increasingly competitive; as institutions realise that they cannot continually hon their rates to the bone in order to compete, they are beginning to use other techniques to obtain business at a profit.

This is resulting in two things: first, a speed of service, from the more aggressive institutions and, second, a requirement for some equity sweetener where debt funds are provided at a very fine rate of interest.

One of the best ways to demonstrate innovative financing techniques is to give some case examples. Names, dates, facts and figures have been changed in the following examples to preserve confidentiality.

Instead of acquiring outright, for several million dollars, plant and equipment, land and buildings and stocks, Company X proceeded as follows:

- Acquired 48 per cent of the share capital for a nominal consideration,
- Organised the remaining 52 per cent into two lots and took separate options to acquire part or all of those two holdings,
- Required the other major holder of shares in the company (who also held shares prior to the acquisition by Company X) to contribute additional debt funds.
- A high interest rate was payable on the additional debt funds, provided profits are made; if not, they are accumulated (this effectively means the debt is quasi-equity).
- On take-out of the options any outstanding loans and accumulated interest are paid out.

The benefits of that particular arrangement are fairly obvious.

They include:

- The reduction of risk by Company X — some of the funds required for the company were provided by another party,
- The company is not a subsidiary and does not need consolidating.
- The loan interest is tax-effective for group purposes.
The financial markets are becoming increasingly competitive; as institutions realise that they cannot continually hone their rates to the bone in order to compete, they are beginning to use other techniques to obtain business at a profit.

products, technology and plant and equipment of another company. A series of agreements were made under which the vendor company was required to keep all leases etc. up-to-date and maintain everything in good condition. A holding fee was payable by Company Z until necessary approvals were obtained. If they were not obtained, the agreements would be null and void.

This provided the necessary comfort level required by all concerned so that formal financing arrangements could be put in place with some certainty.

Entrepreneur A had relatively little cash but wished to retain control over Company Q, which was to be floated in due course. Two techniques were employed.

The first involved Entrepreneur A forming a private company in which he had over 51 per cent control and in which his friends and associates invested. That company then invested just over 50 per cent of the funds required for the funding of Company Q up to the time of listing.

On listing and the issuing of a public prospectus, the original shares were held as A class shares and the other shares as B class. (On the Adelaide Second Board, A class shares have three votes a share while B class have one.)

If you follow this through it is possible to have voting control over a company with a capitalisation of $2 million with an initial equity of $250,000; if your fellow A class shareholders do not sell down and/or will vote along the same lines as Entrepreneur A then it is possible to control a company with a capitalisation of $4 million for an initial investment of $250,000. (It is possible to pyramid this structure.)

The second technique tackled the problem of how to raise the equity in Company Q. Detailed cash requirements were worked out and the stockbrokers and potential debt providers were all brought together (literally) in one room. Each party undertook to commit its portion of the layers of finance provided that all the other layers were committed. The result was a series of mutually conditional agreements and the company was able to go about its manufacturing operations.

(That is a gross simplification of some complex negotiations.)

Company B believed it was on the threshold limit of its debt-equity ratios but wanted to secure additional markets through further acquisitions. It structured a new debt package with a panel of bankers which moved away from secured collateral mortgages to a negative pledge situation. In tandem with that, it made an issue of preference shares to existing shareholders which gave them an interest rate (dividend yield) above that which they could have obtained on the open market.

The funding of a preference shares issued to the individual shareholders was co-ordinated by the company as part of its new debt-financing package. This was not additional debt of the company as it was an issue to shareholders.

The company achieved a better debt-equity ratio and additional freedom to raise further funds when required for the acquisitions it is now investigating.

Company C was in financial strife.

It required a relatively small amount of cash to oil its wheels and enable it to restructure. An investor was identified who agreed to put in the necessary funds on a mortgage basis (there was one unsecured piece of real estate). This was to be provided at preferential rates of interest but concurrently an option was entered into whereby the provider of the additional finance was given call options on 10 per cent of the share capital of the company and had a subsequent put position to sell those options back to a major shareholder in six months at a predetermined price. This effectively gave the investor a very high rate of interest or the option of remaining with a 10 per cent investment should the company perform very well.

Company D wished to issue additional equity but realised the market for its equity was thin.

A deal was structured whereby it issued convertible notes to its existing shareholders together with a series of options. By selling the options on market an investor could obtain sufficient cash to be able to service the debt used to fund the convertible notes. Debt finance was arranged to provide 100 per cent of the convertible note.

The major shareholders in the company suffered a small dilution in their shareholding but obtained the benefit of the company receiving additional funds. An investor in the convertible notes had positive cash-flow throughout and effectively was taking a credit risk on the public company.

The potential reward, however, for a zero outlay in cash was significant in terms of the potential conversion into ordinary shares and the future market price of the ordinary shares.

These examples demonstrate some financial engineering techniques.

At the end of the day, a deal has to be "do-able" for there to be benefits for everybody. As intermediaries we look to see that deals are done.