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# EASY MONEY?

**Private capital providers are fighting to finance middle market firms. But finance chiefs should proceed with caution.**

**BY RUSS BANHAM**

**I**f money makes the world go 'round, Earth must be spinning like a top. Plentiful private capital from myriad sources has created an unprecedented supply of financing. Midmarket and smaller companies that have historically relied on a commercial bank loan or an initial public offering to fuel robust growth ambitions have access to massive amounts of both private debt and equity. The private sources include pension funds, sovereign wealth funds, family offices, hedge funds, mezzanine funds, business development corporations, and traditional private equity firms.

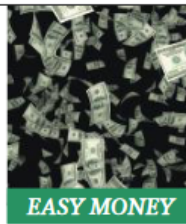
"There's a ton of dry powder out there," says Jimmie Lenz, assistant professor of finance at the University of South Carolina's Darla Moore School of Business.

John Deering, a managing director at Deloitte Corporate Finance who has advised on financings for 25 years, says his firm has never been busier. "Entrepreneurial companies now have the opportunity to consider a wide range of more flexible and creative capital options."

The sudden availability of so much debt and equity capital comes at an opportune time, as growth companies look to spread their wings geographically, enter new markets, streamline internal operations, and enhance customer experiences through the use of digital technologies.

That so many different kinds of providers are jumping in is good news as well. Says Steven Horowitz, CFO at CareCentrix, a provider of at-home health care to 26 million customers: "The more sources of capital, the better a CFO will find the right fit to grow the business or raise money to sell it at a better price."

Abundance also means large capital raises. Companies with a market value of half a billion dollars in the past almost always had to become a public entity to access the large amounts of capital needed to achieve scale; now they can tap large private sources even if they have negative profitability and cash flow, says Michael Balistreri, managing director, investment banking, at Alvarez & Marsal. They just have to be able to "prove an ability to achieve high growth and capture market share."



## Momentum

Why is private capital seeking out investments in midsize businesses, and why are midsize businesses eager to tap these funds?

Jeff Majtyka, president of investor relations communications firm Ellipsis, explains: “Investors are having a hard time finding growth in the public markets and are looking for new places to invest. With more public capital moving to exchange-traded funds, the change in the traditional role of stock markets is causing the pendulum to swing back to private capital.”

There are also fewer public issuers to invest in. The number of publicly held U.S. companies has fallen precipitously—down more than 50% from the 7,400 public entities tallied in 1996. New issues have also dropped: from June 2018 to June 2019, the number of IPOs fell 14%.

On the demand side, more companies are staying private longer. They are also finding that they can achieve ever-higher valuations through several rounds of this kind of financing. What’s more, being publicly held is expensive; rife with oft-changing reporting and regulatory compliance obligations; and time-consuming. Listing on an exchange also increasingly exposes corporate boards of directors to securities class-action lawsuits. Such lawsuits more than doubled in number this year from just four years ago, according to insurer Chubb.

“The common refrain I keep hearing from people wanting to join boards is that they won’t even look at a public company because of the liability potential,” Horowitz says.

Finally, leaders of entrepreneurial businesses are concerned about relinquishing equity and ownership. They also don’t want to dilute the value of their holdings. Private capital, fortunately, bypasses some of these obstacles. “If you can take in a lot more money from investors to acquire other companies, grow the business internationally, and achieve the owners’ plans for a rewarding exit,” says Horowitz, “it almost doesn’t make sense anymore to go public.”

## Limited Options

Prior to the Great Recession, there were only two forms of capital available to the middle market—bank debt provided by traditional commercial lenders and private equity, Balistreri says. Each had disadvantages.

Bank loans were (and are) dependent on the financial value of a company’s tangible assets like property, equipment, accounts receivables, and inventory. If companies needed capital beyond what the bank offered, private equity was an option. However, PE firms generally insisted on obtaining strong management control positions. “You had this big gap between bank financing that could only stretch so far and control-oriented private equity,” Balistreri says.

Other traditional private capital sources shied away from midsize and smaller companies (generally, under \$500 million in revenue). Things got worse when “the local banks



(1) DoorDash Co-Founder and CEO Tony Xu. (2) Sandi Mays, EVP & CIO, Zayo. (3) A driverless car from technology company Cruise Automation navigating the streets of San Francisco, California. (4) Ultimate Software’s office.

## BIG DEALS

DoorDash raised \$600 million in a series G funding, valuing it at \$12.6 billion, while self-driving car company Cruise Automation secured \$1.15 billion, bringing the total venture capital it has raised to \$7.25 billion. Hellman & Friedman’s \$11 billion purchase of Ultimate Software topped the private equity buyout tables, while Zayo co-founder Sandi Mays helped steer the fiber company to the second-largest deal on the list, a \$10.6 billion go-private transaction announced in May.

“serving the borrowing and other needs of those companies got absorbed by larger banks or closed up shop,” says Muhammad Azfar, managing partner at Auctus Capital Partners, a financial services and investment banking firm.

In the last few years, the supply picture has really turned around as private capital has rushed in to fill the void left by banks. “We’re seeing some really significant allocations of private equity and private debt—I don’t mean 5% of a pension fund, for example, but 25% and 30%,” says Lenz.

Private equity funds are equally eager for their slice of the midmarket pie, diversifying their portfolios beyond venture capital and buyout funds, the “two main flavors” of the past, Azfar says. Funds also are less insistent on taking majority positions, with many very open to a minority stake on a partnering basis, he says.

Moreover, “many funds are interested in being long-haul investors of ten years and more, which is a lot different from the four to five years we used to see,” Azfar adds. “They still want the traditional 20% internal rate of return, but on more of a long-term basis with a lower risk-return.”

## Doing the Homework

As with anything that looks too good to be true, accepting a large amount of private capital requires reading the fine print first. Some investor oversight demands are potentially intrusive. The provider’s timing for liquidating the investment may not be in sync with the company’s expectations.

And the fund's vision may be vastly different from that of the management team. As a result, the borrower can easily bite off more than it can chew.

"When investors are flush with cash and money is easy to get, the company might not have the same discipline, scale, and structure [it needs] to stay out of trouble," says Mark Partin, CFO of BlackLine, a developer of cloud-based accounting solutions.

The expanse of available private capital calls for prudent due diligence, particularly in choosing the right investor partner. "You need to do as much homework on them as they're doing on you," says Balistreri. To perform that diligence and vet the provider or fund, midsize and smaller companies may want to retain the deal-oriented services of an investment banker, financial adviser, or law firm.

Regardless of who does it, it is important to reach out to other companies in which the provider previously staked an investment. Horowitz pursues this approach at CareCentrix. "Over the last five years, I've met with 40 private equity firms," he says. "In each case, I find people who have worked with them in the past to solicit what the experience was like. The responses run the gamut. ... Investors have different personalities."

Management teams should seek out financing partners that have expertise in the company's industry and market space. This is especially important for new companies with young leaders, as the capital provider's opinions can be a competitive shot in the arm. "Money is just table stakes; look for what else they can bring—their expertise and introductions to help you grow the business and tap international markets," says Jeff Grabow, U.S. venture capital leader at EY.

## Finding a Fit

The crafting of the business narrative justifying the need for capital is a key part of the process. Just like an IPO road show, companies must assemble a pitch deck presenting a quick overview of how much capital is needed, what its



## High Stakes

**\$2.9 trillion**

Amount raised in private markets in the United States, 2018

**\$2 trillion**

Amount of uncalled capital at private equity firms\*

**\$53.2 billion**

Venture capital investments, 1H 2019

**\$120.4 billion**

Buyout-stage investments, 1H 2019

**\$109 billion**

Money raised by private debt funds, 2018

\*As of August 2019

Sources: Securities and Exchange Commission, Renaissance Capital, Refinitiv, Bain & Co., McKinsey & Co.



EASY MONEY

purpose is, and how it will be deployed. Expect the provider to ask questions about past performance—market challenges, key competitors, business processes, working capital. If interested, the provider will present its rationale for a return on the investment.

Internally, the company should look to the CFO to be the lead on these activities.

"Really the CFO is in the best position to know how much capital is needed and who best to take it from, since the investors have different track records and aims," Horowitz says.

Partin agrees: The CFO is the crucial person "in narrowing down the choices to who the company wants to work with, how much the capital costs, and what is the value derived. The CFO is in the best position to measure the use of the proceeds for the intended purpose. And he or she is pivotal when it comes to negotiating the terms and conditions."

In contrast to CFOs, many CEOs tend to be overly optimistic when capital is bountiful. "The entrepreneurial CEO sees business going to the moon and nothing blocking the way," says Partin. "It's the CFO's job to point out what can go wrong—if 'this problem' rears, it will cause these risks."

And, though private capital might not feel as constraining as listing in the stock market, there are significant risks for a

company to consider, Partin says. For example, deal agreements often include downside protection for the investor. If the business doesn't perform as expected, the deal might have what is called a "ratchet," whereby the investor gets more ownership interest, more voting control, and maybe another board seat or two. There's also the question of exit strategy. At some point, the debt or equity provider will want to liquidate its holdings at the pre-agreed cash-out "landing" date. "It's important to carefully assess the timeframe the investor has in mind for the eventual landing; some capital providers like pension funds don't need the cash back quickly, but others may have a shorter duration in mind," says Alexander De Mol, a partner at Bain & Co. and a member of its private equity practice. "It really depends on the investor."

—Steven Horowitz, CFO, CareCentrix



**"The common refrain I keep hearing from**

**people wanting to join boards is that they won't even look at a public company because of the liability potential."**

## Opening the Floodgates

The SEC may ease restrictions on private placements, including allowing retail investors to participate in financings.

- The pool of capital available to
- midsize and smaller companies may grow even larger, as the Securities and Exchange Commission is exploring loosening restrictions on private placements.

In 2018, about \$2.9 trillion was raised in the private markets, compared with roughly \$1.5 trillion on public stock exchanges, according to the SEC. The SEC says it wants to examine ways to “simplify, harmonize, and improve” today’s highly complex regulations governing private placements. It conceded that current rules make it difficult for smaller entities to “navigate the most efficient path to raise capital.”

A June 2019 concept release from the SEC says the commission is in particular seeking answers to whether it should ease the restrictions on who can invest in private financings. Currently, only “accredited” individual investors with

a certain amount of wealth can participate in larger deals. The SEC asks whether it should also consider an investor’s sophistication, the amount of the investment, or both in deciding which investors can participate. To date, the SEC has erred on the side of protecting mom-and-pop investors.

The concept release also examines the issue of expanding issuers’ ability to raise capital through pooled investment funds. Pooled funds could give retail investors greater access to growth-stage issuers, which they have on a limited basis through some of the provisions in the Jumpstart Our Business Startups (JOBS) Act of 2012.



While the JOBS Act has been a catalyst for some kinds of private placements and for raising capital online, its success has been uneven. Rule 506(b) offerings got a boost, but Regulation

A transactions, which allow a company to raise up to \$50 million in a 12-month period, have proven difficult to execute. From the second half of 2015 through 2018, 359 businesses filed offering statements seeking \$7.7 billion, and 132 actually raised funds through Reg A (also called “IPO-lite”) for an aggregate total of \$1.4 billion.

Among the questions the SEC asks in the concept release is whether the costs associated with conducting a Reg A offering dissuade issuers from relying on the exemption. Reg A deals come with some heavy disclosure requirements, including filings with state securities regulators. | V.R.



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matters most is the CFO’s ability to handle the liquidity constraints when the payback is due.”

In this regard, Deloitte’s Deering advises CFOs to negotiate as much flexibility as possible into the terms and conditions. “The key term we use is ‘headroom’—space between the company’s projections versus those in the covenant package,” he says. Headroom ensures peace of mind, because if the business is 20% off of growth projections, it will still be in compliance with the covenants, says Deering.

### Just Right

Given the intense competition to invest in portfolio-diversifying sources of financial gain, providers may offer a company more capital than it needs. In these cases, caution is warranted.

“If the company takes too much money because it’s easy to get and it doesn’t put the funds to work, it will end up with a lot of unhappy investors,” says Horowitz. “If it takes too little, it may be stuck holding the cup out for more.”

Most of all, CFOs need to accept that the easy money won’t last forever; neither will today’s economic upswing. “Five years from now the economy may not be as buoyant,” Partin warns. “If a company is obligated to liquidate the investment when business is down, it can feel like a big balloon mortgage.”

Partin’s last piece of advice should resonate with all finance chiefs. “Typically, the CFO is the one who often has to say no. The investment banker says yes, the lender says yes, and even the CEO says yes,” says Partin. “But it’s the CFO’s job to make the tough decisions, particularly in situations where there’s a potential ratchet, default, or equity conversion in play.”

Concludes Partin: “All this capital is a great thing, but there’s a reason why money is supposed to be hard to get.” CFO

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