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Capital Challenges

Turbulent economic conditions are forcing small to mid-sized manufacturers to look harder and longer for financial solutions to help them grow. But access to capital hasn't dried up for companies doing all the right things.

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Oh, the toll the subprime mortgage crisis has taken. Not only on the former home owners who defaulted on their subprime mortgages when the housing market took a dive, or on the financial institutions that suffered huge losses as people grew unable, or unwilling, to make housing payments, but also on manufacturers and other businesses in need of capital.

That's because the subprime mortgage crisis, combined with an already stagnant U.S. economy, has resulted in a credit crunch that has made obtaining capital for plant expansion, for equipment purchases and for acquisitions a much different ballgame than it was even 12 months ago.

"It's like night and day," says Nick Chini, director and principal with Bainbridge, a management consulting and mergers-and-acquisitions advisory firm. "We are in a tenuous, dynamic capital market environment" that is constantly changing, he says, depending on the industry, the capital structure, the news. "The need for real-time information is more critical than ever," he states.

"[Investors] are looking at the P&L and the projections for companies with a very different set of projections and assumptions about the future than before," he continues. "You have to work harder to get capital; you have to work harder to get debt."

It's true, according to Steve Hughes, a director at KeyBanc Capital Markets in the industrial corporate and investment banking group. "The debt capital markets are in utter turmoil," driven more by home loans and residential construction than anything, he says. "But it's had a ripple effect on everything else in the market."

What does this environment mean for small to mid-sized manufacturers in search of capital to grow or improve their businesses? It doesn't mean that capital can't be found. Indeed, "It's still out there. You can still fund large equipment or a process or expansion," Chini says. "[But] you have to work harder. You can still fund an acquisition; you have to put a little more time and effort into it."

Others agree. "There's capital still looking to be deployed," notes Hughes. Dick Cook, senior advisor for Focus LLC, a national investment banking focused on the middle market, points out that a large number of high net-worth investors have taken their money out of the stock market and shifted it into private equity.

And deals are happening. For example, earlier this year QPM Aerospace, a manufacturer of precision machined parts for the aerospace industry, received a $15 million investment from Key Principal Partners, a private-equity and mezzanine firm that invests in growing middle-market companies. In May, Bank of America Business Capital provided a $120 million credit facility to Sauder Woodworking, a privately held ready-to-assemble furniture manufacturer. The secured credit facility was used to refinance existing debt and for working capital purposes, according to a press statement.

Still, what the tumultuous capital environment does mean is that small to mid-sized manufacturers likely face fewer options in their search for financial assistance, as well as greater scrutiny. They can take steps, however, to improve their likelihood of achieving success.

Who's Not Feeling the Pinch?

The tightening of the credit markets is impacting all segments of the economy -- retail, services and manufacturing. "The one advantage for the manufacturing arena is they have fixed assets, which always makes it a little more advantageous from a lending perspective," says Richard Bradshaw, senior managing director at UPS Capital, the financial services business unit of United Parcel Service of America.

Within manufacturing, Focus' Cook says he observes particular interest by investors in clean manufacturing, green manufacturing and power-saving technologies. And manufacturers with a strong international customer base, who are thus able to capitalize on the cheap U.S. dollar, may attract added interest, notes Bainbridge's Chini.

Largely, however, attributes other than industry sector play a more significant role in determining whether a small to mid-sized manufacturer makes an attractive customer for a lending institution, experts agree. It's all in how they run the company. "It's the operating company that will pay you back," notes Bradshaw. "Certainly the collateral is very positive if they *don't* pay you back, but in the end it's the operating business that will pay you back."

Celebrating its 10th anniversary, UPS Capital offers a variety of financing options to small manufacturers, including operating as a lender in the U.S. Small Business Administration loan program. Bradshaw says that approximately a third of UPS Capital's small business portfolio is privately held manufacturers.

What's important for manufacturers seeking financing solutions to refinance debt or purchase equipment, Bradshaw says, is to have a well-thought-out business strategy going forward (although he acknowledges, "If a company has taken large losses in the past two years, it's going to be difficult to get financing."). "For instance," he says, "you've got a company doing okay, but they're looking at buying this new piece of equipment. We want to know, ‘What is the

Vehicles to Growth

In many instances, small to mid-sized manufacturers are seeking capital to pursue growth strategies. A recent survey by the Economist Intelligence Unit shows the top strategies being pursued by mid-sized manufacturers around the globe. The top responses for North American manufacturers are provided here.

60% Organic growth via the use of wholly owned resources

60% Internal research and development initiatives story? What is that new piece of equipment going to do for them in the business?'"

42% Mergers and acquisitions

32% Marketing and/or distribution alliances

29% Joint ventures

Source: The Economist Intelligence Unit

The Attraction of Strong Leadership

Approximately two-thirds of Key Principal Partners' investments are in manufacturing, explains managing partner Tim Fay. "When we began we generally found the U.S. middle market, in particular, had an abundance of interesting and quite often very profitable middle-market manufacturing companies," Fay says. "And despite what you read, manufacturing is still here in the U.S. in a very big way."

Fay echoes some of Bradshaw's sentiments when outlining the kind of company that attracts Key Principal Partners. A disciplined, focused approach to executing its business plan is important, he says. "We're looking for fairly contemplative, disciplined people who know how the business got to where it is and who are prepared to approach a partnership with us. Because that's essentially what we become, we become financial partners with them -- in such a way that we can agree what the appropriate timeline and operating plan is going to be for the company."

A strong leader is important. "It's not uncommon for middle-market manufacturers to have incomplete management teams. That's okay," Fay notes. However, the company does like to be sure that a manufacturer under consideration has a strong leader. "He tends to be the CEO and frequently is the majority owner as well."

UPS Capital's Bradshaw shares a similar sentiment. Leadership plays a key role, and management experience is an enormous consideration if the loan is for a business acquisition, he says. Lack of leadership, UPS Capital has found, is the No. 1 cause for companies to not pay them back. Having management experience in the industry is a positive, Bradshaw says. Even more important is management experience either running their own business or a division in which they hold P&L responsibility.

Key Principal Partners also seeks "reasonably defensible niches," Fay says. "What I mean is that they may have had very strong positions in the past, but perhaps there's been some erosion in their market share that we feel we can actually help correct. The company needs to pass what we call the 'raison d'être' test, a real reason for being. If not a market leader, then a strong market competitor -- one that has a real desire to get better, and the management is hungry to make the entity better."

The private equity firm asks for a lot from its potential investments. Enthusiasm also is a preferred attribute. "There are a lot of folks out there who are just going through the motions. They may have made enough money, and their hearts really aren't in it. And it shows in the cleanliness and organization of the operation, in the quality of the company employees," Fay says. "It's amazing just how much influence a well-organized management team has on the entire operations. It's all the little things that show up as a result. Those are the companies that we like to invest in."

Typically, Key Principal Partners is unsecured in its deals, so it doesn't perform plant appraisals. Enterprise value is what's important, Fay says. The investment firm typically examines five years of historical performance data, as well as monthly numbers leading up to the investment. Due diligence can last 30 to 40 days prior to close, and a forensic accounting team generally peruses the numbers "to make sure there's nothing amiss."

Having all that financial information complete and readily accessible to a potential investor can be beneficial to the manufacturer in that it may result in less-expensive money for the company, Fay notes. "But if they're fairly embryonic or unstable or incomplete in their operations, it's not as if we're less interested. We're looking to the future."

Avoid These Mistakes

Even as there are many tactics a small to mid-sized manufacturer can employ to improve its ability to obtain capital, or at least obtain less expensive capital, there also are moves to avoid. A common mistake otherwise successful small entrepreneurs make is failing to establish business credit as soon as possible. That's according to financial planner Howard Milove of wealth management firm Access Wealth Planning.

"Many companies fail to establish proper financing not only during the very beginning, when personal credit may be the only option, but also during the growing stages of the business," Milove states. "Without proper financing, businesses often cannot grow -- unless owners sink their own money into it, which can inhibit their ability to invest properly in their personal financial future. The recommendation is to acquire a minimum line of credit early on in the business's name and to increase it over time to show banks and other institutions the business is a good credit risk, which in turn will help sustain business growth."

An error Bainbridge's Chini has observed is the mid-sized manufacturer that waits too long to begin the process of finding capital. Companies are not taking into consideration the length of time it takes to complete a deal. "It's taking much longer now than ever before," he says.

It may be the wrong move, but it's understandable. "These guys are smart guys; they've been around a long time. They're generally pretty frugal guys who didn't make their company into what it is by suffering fools or being foolish with their money," Fay says. They tend to be debt-averse, don't want to be leveraged and try to finance themselves with internally generated cash flow as long as possible. "Quite often the demand curve is such that they can't wait much longer."

Other errors? Assuming there is capital available when the manufacturer is not as profitable as it could be, "which goes back to waiting too long," Chini says. Instead, make sure that you've gotten those few extra customers and that their revenues are reflected in the P&L, for example.

Don't withhold information, says Hughes of KeyBanc Capital Markets. "Put all your cards on the table up front and say, ‘Here's the good; here's the bad. And by the way, here's how we mitigate the bad,'" he says. Indeed, Bradshaw says it's good to be able to see how companies react to ebbs and flows in the business cycle. "If they see sales going down and they immediately cut expenses, that is going to be looked upon very favorably," he says.

Another obvious error would be not shopping around for the best cost of capital, Chini notes. Chris Risey, president of Lantern Capital Advisors, echoes that same advice in a recent white paper. "Competition can dramatically reduce the overall costs of capital," Risey notes. Beyond that, multiple funding sources give a company a back-up plan should the proposed funding institution or the company reconsider the financing, he adds. The competition also provides the company an opportunity to learn from meeting with different institutions, and may make a firm's current lender try harder to retain the business.

All that said, Chini tells manufacturers not to be discouraged as they seek out capital in today's turbulent markets. "The sky's not falling. Export growth is stronger than ever. And there's still a good demand base here in North America," he says. The lending has simply become more rational.

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