Cherry Tree
& ASSOCIATES, LLC

PLANNING A SUCCESSFUL EXIT

Capital Structure

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ABOUT CHERRY TREE

Cherry Tree & Associates is a Minneapolis-based private investment banking firm with more than four decades of transaction experience.

We specialize in serving mid-market companies with revenue from $5M to $50M across many industries with transactions typically ranging from $20-$500M.

Our Managing Directors and Associates have comprehensive M&A and financing expertise. Many have held previous C-Level operating roles, sat on Boards of Directors, and have extensive networks of Executive, Venture Capital and Private Equity contacts.

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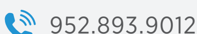

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Begin with the end in mind is Stephen R. Covey's second habit from his book, "The 7 Habits of Highly Effective People". As you think about a successful exit for your business, there are critical decisions you make early on in your company's life that could have a huge impact on your payday. One of those is your capital structure.

Capital is needed to fund the operations of your business. If your company is self-funded, it is 100% owned by you. Capital can be raised to fund the growth of a business by selling part of your business (i.e. Equity) or taking a loan that needs to be paid back (i.e. Debt). The combination of Debt and Equity makes up your company's capital structure. If you are self-funded, your company's capital structure is 100% Equity. If you were to take a loan, the capital structure would be part Equity and part Debt.

So why does it matter how you raise money for your business? Isn't all money green? Well, there are some major considerations that need to be weighed when picking your company's capital structure. For example, interest on Debt can be deducted before taxes and it does not impact the ownership structure (i.e. cap table). Equity raised from Venture Capital (VC) firms typically will involve Preferred shares with an accumulating dividend and a Liquidation Preference. These things will impact on-going earnings and the proceeds you receive when you sell.

Let's model these two scenarios over 5 years to an exit using current data from our Technology Enabled Business Services (TEBS) Report. We'll use the average SaaS company as our example which looks like this:

TEBS SaaS	12/31/22
Revenue Growth	19.6%
EBITDA Margin	7.6%
EV/Revenue	4.9x
EV/EBITDA	17.5x

Let's assume you are currently generating $8M in Revenue. Your company's financials would look like this over the next 5 years:

($1,000's)	Year 1	Year 2	Year 3	Year 4	Year 5
Revenue	$8,000	$9,568	$11,443	$13,686	$16,396
Growth Rate	*19.6%*	*19.6%*	*19.6%*	*19.6%*	*19.6%*
EBITDA	$608	$727	$870	$ 1,040	$1,244
EBITDA Margin	*7.6%*	*7.6%*	*7.6%*	*7.6%*	*7.6%*

To value a company, we typically use M&A and Public Company comps, Discounted Cash Flow, Leveraged Buyout, Sum-of-the-Parts and/or Precedent Transactions analysis. But in this case, to keep it simple, we'll use an Enterprise Value (EV) that is the average between the Revenue and EBITDA valuations from above. In this case your company is currently worth $25M.

	EV
Revenue x 4.9	$39.2M
EBITDA x 17.5	$10.6M
EV Average	$24.9M

Let's assume you need $10M to continue to fund your growth and you are offered two options for the money you need:

1.) Debt with 6% Interest from a bank.

2.) Convertible Preferred Shares with a 6% Accumulating Dividend from a VC firm. The post-money valuation ($25M + $10M = $35M) would result in a 29% ($10M/$35M) ownership stake.

The two offers would look like this side-by-side.

Funding Options	Amount	Rate	Ownership Stake
Debt	$10M	6%	NA
Preferred Equity	$10M	6%	29%

Let's assume your company has a 25% marginal tax rate and, for sake of simplicity, we will use a constant Interest Expense rather than amortizing it. If we compare the resulting financials, they would look something like this.

Debt ($1,000's)	Year 1	Year 2	Year 3	Year 4	Year 5
Revenue	$8,000	$9,568	$11,443	$13,686	$16,369
Growth Rate	*19.6%*	*19.6%*	*19.6%*	*19.6%*	*19.6%*
EBITDA	$608	$727	$870	$1,040	$1,244
EBITDA Margin	*7.6%*	*7.6%*	*7.6%*	*7.6%*	*7.6%*
Interest Expense	$600	$600	$600	$600	$600
Pre-Tax Income	$8	$127	$270	$440	$644
Taxes	$2	$32	$67	$110	$161

Preferred ($1,000's)	Year 1	Year 2	Year 3	Year 4	Year 5
Revenue	$8,000	$9,568	$11,443	$13,686	$16,369
Growth Rate	*19.6%*	*19.6%*	*19.6%*	*19.6%*	*19.6%*
EBITDA	$608	$727	$870	$1,040	$1,244
EBITDA Margin	*7.6%*	*7.6%*	*7.6%*	*7.6%*	*7.6%*
Interest Expense	$-	$-	$-	$-	$-
Pre-Tax Income	$608	$727	$870	$1,040	$1,244
Taxes	$152	$182	$217	$260	$311

Notice that the interest from the Debt is deducted before taxes which reduces your tax burden. After 5 years you will have paid $750,000 more in taxes with Preferred stock. Also, each year $600,000 of Preferred Dividends are accumulating which totals $3M after five years. Preferred Stock does give the company more working capital since the Preferred Dividends are accumulating and don't get paid until a liquidity event.

Now let's assume that you are approached by a strategic buyer to acquire your company after 5 years. Of course, you are looking to maximize your valuation and hire an Investment Banker. If we use the same multiples as before from the TEBS Report, we see that your company is now worth $51M.

	EV
Revenue x 4.9	$80.2M
EBITDA x 17.5	$21.8M
EV Average	$51.0M

We'll assume that your post-tax income went back into the company and there isn't any other Debt. Typically, transactions like this are "cash-free, debt-free" so here are the implications for you.

PREFERRED:

The VC firm would first get their $3M in Dividends paid. That would leave $48M remaining. They would then get the greater of 29% of the equity or $10M since Preferred shares have a Liquidation Preference over common shares. In our case 29% of $48M is $13.9M so the VC firm would not have to exercise their Liquidation Preference. They would then convert their shares to common shares and get $13.9M for a total of $16.9M ($13.9M Common Equity + $3M Dividends). You would ultimately get the remaining $34.1M less any debt and plus any cash the company has.

Sale Price ($M)		$51M
Preferred	Accumulated Dividend	$3.0
	Available to Common	$48.0
Common	VC Firm's 29%	$13.9
	Your 71%	$34.1
	Less Debt	$0.0
	Plus Cash	$0.0
	Total	$34.1

DEBT:

In this case you would still be 100% owner and get to keep $51M less the $10M in Debt plus any cash the company has. If we assume the $750k in tax savings is cash not reinvested into the business to keep things even, your payout would total ~$41.8M.

Sale Price ($M)		$51M
Preferred	Accumulated Dividend	$0.0
	Available to Common	$51.0
Common	Your 100%	$51.0
	Less Debt	$10.0
	Plus Cash	$0.8
	Total	$41.8

In summary, Debt would get you an additional ~$7.7M in the transaction and decrease the company's taxes by $750k. Preferred would get you an additional $2.3M in working capital over the five years. Even if you were able to keep the additional working capital, you would still get $5.4M+ more in the transaction from using Debt.

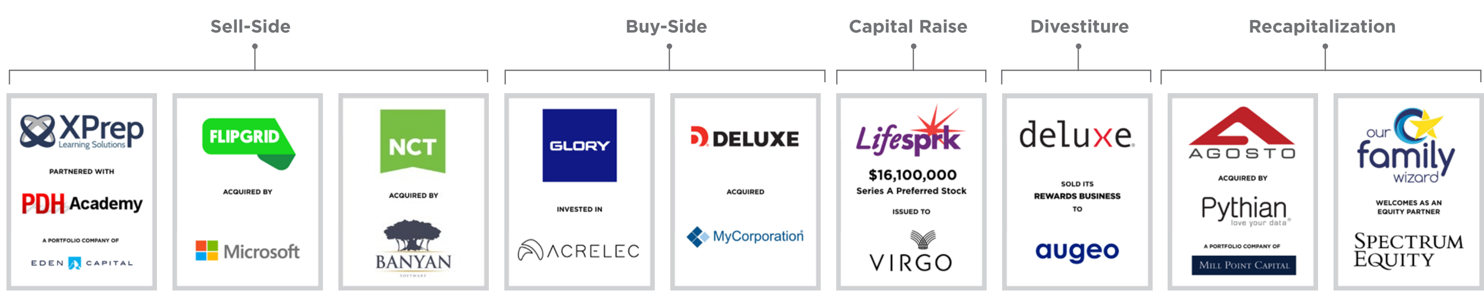
Let's take an extreme, but still realistic, case with Preferred stock. You get an offer at the bottom of the range in the TEBS Report because you didn't have an Investment Banker; There were previously multiple rounds of early Friends and Family funding so you were diluted down to 30% ownership of the equity after the preferred financing; And the Preferred stock was Participating Preferred with a 1.5x Liquidation Preference. Unlike Convertible Preferred, Participating Preferred gets paid the accumulated dividend and their liquidation preference before converting to common AND their pro rata common distribution. This is what your proceeds would look like for various sale prices.

Sale Price ($M)		$25M	$35M	$45M	$55M	$65M	$75M
Preferred	Accumulated Dividend	$3.0	$3.0	$3.0	$3.0	$3.0	$3.0
	1.5x Liquidation Preference	$15.0	$15.0	$15.0	$15.0	$15.0	$15.0
	Available to Common	$7.0	$17.0	$27.0	$37.0	$47.0	$57.0
Common	VC Firm's Participating 29%	$2.0	$4.9	$7.8	$10.7	$13.6	$16.5
	Other Shareholders	$2.9	$7.0	$11.1	$15.2	$19.3	$23.4
	Your 30%	$2.1	$5.1	$8.1	$11.1	$14.1	$17.1
	Less Debt	$0.0	$0.0	$0.0	$0.0	$0.0	$0.0
	Plus Cash	$0.0	$0.0	$0.0	$0.0	$0.0	$0.0
	Your Total	$2.1	$5.1	$8.1	$11.1	$14.1	$17.1

As you can see, small changes can have a huge impact on your business. If there is a downturn in the economy and/or you don't get as favorable terms as before, you could walk away with nothing! Even if you sell for a premium, you could still walk away with millions less. Make sure you evaluate your options when deciding to raise money.

Every company and situation is different but hopefully you have a better understanding of why your Capital Structure is an important factor when it comes to running your business and an exit.

If you are interested in understanding options for your business, feel free to reach me at sbrown@cherrytree.com or 952-253-6017.



PROVEN TRANSACTION EXPERIENCE

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