

# Nashville Medical News

JUNE 2004

www.medicalnewsinc.com

## Capital “Spectrum” Determines Risk, Pricing

Like light and sound, capital for businesses comes in the form of a spectrum. On one end of the spectrum, there is the lowest risk and therefore the least expensive capital. On the other end, there is the most risk and the most expensive capital. To understand the capital markets and the availability of capital as well as its pricing, one must think of the supply in the form of this spectrum.



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There are basically two forms of capital available to businesses: equity and debt.

The pricing of debt depends on the risk associated with the loan from the perspective of the lender. On the least risky end of the spectrum, one finds the traditional commercial banks. These lenders typically accept little, if any, risk and price around the benchmark prime rate. They almost always demand to be in the most senior position on the collateral they accept to reduce their risk.

Next on this “spectrum” are lenders demanding senior position but willing to accept more risk. In fact, most people don’t realize it but about half the debt held by businesses in America today comes from lenders that are NOT traditional commercial banks.

Some of these lenders are willing to accept a little more risk for a little more return. Some are willing to accept significantly more risk but price significantly above prime. These lenders range from well-known financing entities, like GE Capital, to lesser known “banks” set up specifically to address the needs of highly troubled companies.

Overlapping the senior lenders on the spectrum is a second category of lenders known as mezzanine or sub-debt lenders. These are almost always non-traditional banks. Many are Small Business Investment Companies (“SBICs”) which are lenders licensed by the Small Business Administration and which match their private equity capital with funds loaned to them by the government.

By definition, a “sub-debt” lender is willing to take a “second” position behind a lender already holding a first, or senior, collateral position. This means the senior lender must be paid off completely before any funds are available to pay off the secondary debt.

Pricing on sub-debt is accordingly higher than senior debt. In today’s market, sub-debt lenders look for a total annual, compounded percentage return of high teens to low twenties. The way this is achieved is through a combination of note rate (often around 12-14 percent) plus an equity interest in the business.

Companies find this capital appealing because adding together the total amount a senior lender is willing to loan (in today’s market about 2-2.5 times cash flow) plus the amount a sub-debt lender is willing to loan (often another full “turn” on cash flow, sometimes more) means the company is able to borrow more and give up less of the more expensive equity than it would if capital consisted mostly of equity alone.

Finally, moving to the most risky and therefore most expensive, end of the spectrum, one finds equity investors. The great majority of equity capital today is provided by the private equity fund industry. Most would call this the “venture capital” market but, in reality, venture

capital investors are just those private equity investors willing to accept the most risk in the youngest, least proven companies.

More stable companies with more predictable cash flows are candidates for investment by private equity funds. There are about 1,700 private equity fund managers in the U.S. today with billions available to invest.

Most private equity investors are seeking an internal rate of return on their invested capital of about 35-40 percent annually. This means that \$10 million invested must grow by an imputed, annually compounded increase of about 40 percent each year of the investment period.

Compared to senior lenders seeking prime or sub-debt lenders seeking even 20 percent, equity capital becomes very “expensive” for a business. Unlike debt, equity investors are willing to assume risk, sometimes significant risk, in exchange for the potential that their capital will grow by these higher percentages or perhaps even more.

Venture capitalists, then, are the last stop along the spectrum. These are investors, sometimes institutional and sometimes wealthy individuals or just friends of the founders, who are willing to accept very, very high risk in early stage, pre-cash flow companies. Needless to say, the returns demanded by this marketplace exceed the 40 percent returns demanded for more established companies.

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