



HELPING LEADERS **SUCCEED**

FINANCING - STRATEGY FOR SUCCESS

By Rick Williams

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Financing – Strategy For Success

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EXECUTIVE SUMMARY

What is the right financial structure for your company where it is today? What are the best sources of capital? And what is the right finance strategy for your business over the next two to five years - business model, growth, investment, and profits in mind? To be successful, you must be excited about the potential for your company and what you and your team can accomplish for your customers and yourselves. You must also be good at playing the money game.

FINDING MONEY CAN become the primary job of company founders. Funding cash flow demands is the focus of a growing business. And reducing the cost of funds is the larger company's charge to its CFO. In each case, the immediate demand for funding the business can distract from being thoughtful about financing as a core element of the business strategy. What is the right financial structure for your company where it is today? ***What are the best sources of capital? And what is the right finance strategy for your business over the next two to five years - business model, growth, investment, and profits in mind?***

BUDDY - CAN YOU SPARE A DOLLAR?

I am often asked if I know of someone who would invest in an exciting company with a great new technology product. The founders have put their time and money into the project. Now they need outside investor funds to move their project ahead. Questions about what other options the founders have considered for getting to the next de-

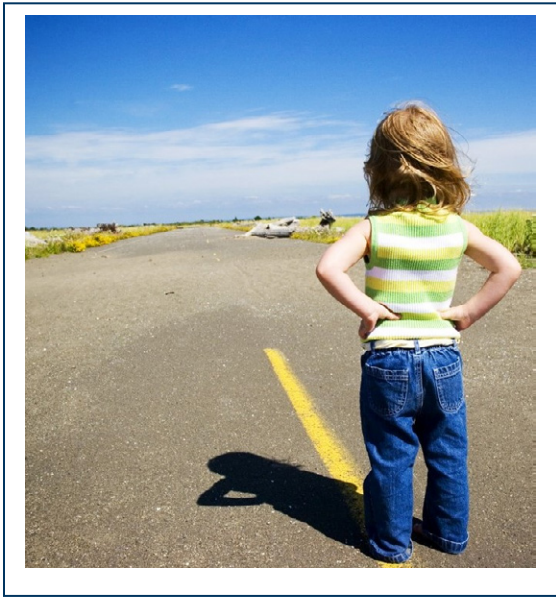
velopment stage or what critical valuation steps the funding will achieve are often not addressed. In the minds of the founders, the clever technology is all investors need to know about before putting up the \$1 million.

In an earlier phase of my career, I was a management consultant with Arthur D. Little. ADL was a highly respected international consulting firm. When OPEC needed help capturing the value of their oil production on the world market, they went to ADL. Two of the instruments landed on the moon were developed at ADL. After my time at the company, ADL purchased part of a large US Army arsenal property outside Boston planning to consolidate its headquarters operations into one location. At the same time, the company spent heavily preparing to spin out several operating sections into the skyrocketing dot-com public market.

The first rule of finance - Don't run out of cash!

The dot-com bubble burst. Property renovation costs soared. And ADL ran out of cash. The first rule of finance - Don't run out of cash! Notes were called and the 110 year old public company was put into bankruptcy.





Neither ADL's leaders, nor the technology company founders, developed a sound financial strategy for where the company was, and did not consider the benefits and risks of one financing path over another.

STRATEGY - MORE THAN A CLICHÉ

At some level, recommending that your company needs a "finance strategy" is similar to saying that the company needs a "business strategy." You know your business. *Do you really need a "strategy?" What does that mean anyway?*

Successful leaders step back from the immediate and the obvious and take time to understand the context in which the company operates.

- *What are the requirements for success in this business sector?*
- *How can my company compete and succeed in this sector?*
- *What will this business sector look like in 5 - 10 years?*
- *Where is my company going?*
- *How will we get there?*

Companies in a static business environment - rare today - can get by with a notion of how to stay successful and maintain banking and other financing relationships. For most companies, the competitive and financial environ-

ment is continuously changing. Developing some form of two to five-year business strategy and financial strategy is required for smart adaptation to an evolving competitive landscape and the firm's changing internal requirements:

- Changing strengths and weaknesses of competitors
- Changing customer requirements and expectations
- Obsolescence of plant and equipment
- Acquiring new customers and entering new markets
- Responding to the broader economic and business climate
- Adopting new technology fundamental to the business
- Satisfying cash demands of growth
- Adapting to changing business models such as shifting from products to service
- Changing tax regimes nationally and locally

Survival requires adapting to change. For larger companies, a systematic and quite formalized strategic plan including a financial strategy is needed. Smaller companies more reliant on one technology, business sector, customer or competitive advantage are more at risk when their underlying business model changes. A clear business and financial strategy for these small and mid size-firms is essential for long term success.

If you are General Motors or Ford, the introduction of driverless cars and trucks will dramatically change your business model and your financial requirements. The same is true for the regional hospital facing rising compliance costs and fixed patient reimbursements. Their position as a standalone institution may no longer be viable. Amazon seems to be everywhere. In fact, robotics and digital technology are changing the fundamental economics of product distribution and retailing throughout our economy. The business model and finance strategy for most companies in these sectors will change.

Survival requires adapting to change.

Developing your company's strategy means taking the time to understand the fundamental dynamics within your business sector and where your company fits into the picture. Within that context, develop a business strategy for your company that will guide your team's decisions for the next few years - including a finance strategy. With these in hand, your chances for success will be greatly improved.

A FINANCE STRATEGY - IT'S NOT JUST THE MONEY

At the core of a business strategy is the finance strategy. Delta Airlines has a large inventory of expensive aircraft. Delta's financing requirements are completely different from a regional accounting firm with few capital assets. The medical device company outside of Philadelphia growing 30% annually cannot self-finance its growth. Its finance strategy is different from the New England based Christmas Tree Shops chain with a major share of income in November and December.



Every company needs a plan for financing its operations over the next several years.

- *Required outside funding*
- *Funding schedule*
- *Sources of funds*
- *Cost of funds*
- *Tax minimization*
- *Cash flow from operations*
- *Important funder requirements*
 - *ownership changes*
 - *loan covenants limiting operations*
 - *board seats and control*
 - *limits on future financing*

Unless you are a nonprofit, no one is giving your company cash. Your customers exchange their cash for your product or service. An investor is buying ownership in your company - and diluting your ownership. A lender is allowing you to borrow their funds with clear requirements that you pay interest and will repay the loan on schedule. These are simple concepts, but taking the money places material obligations on your company. Too often, companies do not consider the full implications of their financing choices.

Too often, companies do not consider the full implications of their financing choices.

Taking on debt can reduce the costs for financing the company but the debt will also materially increase the risks for the company. If a major customer does not renew their order, and you do not have the cash to stay current on the loans, then the lender will call the loan as happened with Arthur D. Little. If those funds had been from outside equity investors, a fixed repayment schedule would not have been in place - no note to call - but the investors might have enough ownership to demand changing the board or management of the company.

It's not just the money. Your company's finance strategy controls the following:

- Ownership of the company
- Control of the board
- Investments in R&D, plant & equipment, marketing
- Risk exposure to business changes
- Rate of growth
- Flexibility to act opportunistically
- Access to future funding

A FINANCE STRATEGY - SOME EXAMPLES

Think of the finance strategy as a set of the controlling principles under which the company operates. The finance plan is the tactical plan for getting access to the needed capital on the required schedule, at the projected cost, and on terms and conditions acceptable to the company. Strategy is about how we play the game - will we be a passing team or will we grind it out on the ground.

Strategy can be expressed in different measurements of financial requirements and performance:

- Debt equity ratio on the balance sheet
- Annual outside capital requirements
- Gross operating margin
- EBITDA as a percent of revenues
- After-tax income

- Fixed and variable costs
- Annual capital investments
- Annual growth rate
- Allocation of investments in new revenues or cost reduction
- Distribution of profits to shareholders

Your company's financial position is quantified by these and other measurements of financial structure and performance. **But they also express a unifying concept for how the company competes and its unifying financial strategy.**

CONSIDER FOUR HYPOTHETICAL “PHARMACEUTICAL COMPANIES”

Creative Pharma: This innovative drug development company will identify a new molecule and demonstrate that it could significantly reduce the symptoms of an important disease with fewer side effects than existing drugs. The company conducts animal trials and perhaps limited human trials. This company will not take the drug through full FDA trials or take the drug to market. The company's business model is to license the molecule to a major drug company and receive licensing fees or perhaps sell the company. Creative Pharma's funding will come from the founders and private and institutional investors with a two to five- year time horizon. The company will not have access to bank financing. Several of the core team members will not be paid market rate salaries. Their compensation will come through their ownership of the company when it is sold or their share of the licensing fees. *The finance strategy of Creative Pharma is to own nothing except its Intellectual Property, have no debt, minimize costs, and create revenue by selling the company or licensing the technology.*



Blockbuster Pharma: This well known international drug company creates proprietary drugs which are sold globally. Often it licenses new drugs from smaller development firms like Creative Pharma. Bringing a new major drug to market will cost Blockbuster about \$1 billion. If the drug gets through the ten-year process of regulatory approvals and market introduction, then the drug will be highly profitable for the duration of the patents covering the proprietary technology. *Blockbuster Pharma's finance strategy is to access equity funds with a long term commitment to the company and the market - usually public markets. If the company has profitable products on the market, long term debt will be available. Investment in internal IP creation versus buying external IP is an issue. The finance strategy has a 10 to 15 year time horizon. Management of investor expectations on the public market will be a continuing issue.*

Think of the finance strategy as a set of the controlling principles under which the company operates.

Generic Pharma: This relatively unknown international drug company manufactures generic drugs whose patents have expired. Blockbuster Pharma will still have its products on the market promoted and distributed by a vast network of direct and indirect channels. Generic Pharma's strategy is to be the low cost substitute for the high priced drugs of Blockbuster. Generic does not have the huge development and permitting costs of Blockbuster. Generic will make a long term commitment to low cost manufacturing facilities. Marketing and distribution will promote cost savings for insurance companies and other payers rather than brand awareness. *Generic Pharma's finance strategy centers on reducing costs. Manufacturing can be located in less expensive parts of the world. Revenue and costs should be relatively stable over longer periods of time - free of the large development budgets of Blockbuster - allowing higher levels of debt.*

Compounding Pharma: This firm takes drugs from many manufacturers and combines them into a pill or injectable liquid that can be administered to a patient. Hospitals and nursing homes are typical clients. Compounding Pharma is a drug wholesale company. These are often regional firms though some specialize by serving unique clients or formulations. Cost reduction is important as is reliable service to the customer. These firms are often family or privately owned. They may not have or want “outside investors.”

Compounding Pharma's finance strategy is stability and reliable compensation for the owners. Debt financing will be available for inventory and cash flow management, but the firm will be risk averse and not have a large debt burden. The owners of the company may own the real estate in a separate corporation to keep the real estate off the company books.

These four pharmaceutical companies have fundamentally different finance strategies. The strategies reflect the business sectors in which they operate and the goals of their owners. Within each of these four business sectors, competing companies may pursue somewhat different finance strategies depending on their competitive position within the sector. Companies trying to grow will keep profits in the company and pursue external capital. Firms in a more dominant position may generate excess cash and distribute it through dividends, buying back its stock or making acquisitions.

FINANCE STRATEGY - WHAT YOU CAN DO TO IMPROVE YOUR CHANCES FOR SUCCESS

Funding your company involves obligations and risks. Here are steps you can take to make your finance strategy a powerful tool for the company.

1. A finance strategy - and a financial plan - will be unique to each company. The strategy will reflect the economic dynamics of the business sector, the position of the company in that sector, and where your company leadership wants to take the company.
2. Whether your company is big or small, think about your company's financial plans over the coming two to five years. Identify possible financial strategies over that time period - particularly the amount of outside funding and where it will come from. Be specific about the implications of alternative approaches and their risks.
3. Actually choose - make a decision. Choose the set of financial principles that will control all financing decisions going forward. Be clear that you have made a decision and what that decision means to key staff who must implement the strategy. Without being clear that you and the board have considered the options and made a clear decision, "we will be careful but we have always done it this way" will control what actually is done by the staff.

4. Include your core team members, your board, and your outside advisors. Consulting support can help get all the options on the table and make sure you get this important work done. Your board and outside support can also help keep you honest about where you are going and what you are deciding.
5. Match the finance strategy to where the firm is in its life cycle.
6. Don't run out of cash!

The financial strategies of these four pharmaceutical companies reflect the business sectors in which they operate and the goals of their owners.

7. A paying customer is usually worth more than a great idea or patented IP. If your company is early stage, have a customer in hand before talking to the investor or banker.
8. Cash is very expensive, particularly for young, high risk companies. Find ways to get essential work done without paying cash for it.
9. Strategic alliances, customer pre-payments, delayed vendor payments, and government grants are alternatives to taking cash from investors or lenders.
10. Match equity sales to major step-ups in company valuation. Each incremental sale of company stock should be sufficient to pay for significant development progress - could be a new product introduction, clinical trials, or acquisition of a complementary company. Each development step such as these significantly reduces the risks for the next investors and materially increases the overall value of the company.
11. Raising equity for your company is selling ownership in the company. Carefully consider the implications of the ownership change with each equity raise. Do these ownership shifts and change in control make sense to you and your team?
12. Unless you are a successful company with ample cash flow, raising funds is hard to do, costs money, and takes time. Twelve to 15 months is often the rule of thumb for raising equity. If you are not realistic about the time and effort required, you will not be successful.

Find ways to get essential work done without paying cash for it.

13. The adage that bankers only lend to people who do not need the money is close to reality. Debt financing is less expensive than equity financing. But debt financing creates fixed obligations and higher risks. If your company has a history of profitability and borrowing is an option, you can reduce your overall cost of capital by having debt on your balance sheet. You will even find lenders offering more money than you need. Take what you need when you need it but no more.

14. Taxes are a major strategic consideration. Corporate organization, location of operations, transfer pricing, timing of purchases, timing of capital investments, compensation, offshoring of cash, dividend policy, and many other factors will determine the firm's tax liability.

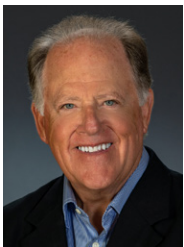
15. Major financial institutions are required to "stress test" their ability to withstand a financial downturn. Stress testing your financial strategy is a sound approach for every company. Make sure you can keep the bank happy even if things go wrong for your company. If things do go wrong, you will not have access to equity capital to pay off the bank.

16. Become a trusted partner for your investors and your lenders. Your success depends on their success.

To be successful, you must be excited about the potential for your company and what you and your team can accomplish for your customers and yourselves. You must also be good at playing the money game.

About the Author

Author | Corporate Leader | Board Member



Rick Williams is an inspiring writer and speaker sharing his experience as a company founder, CEO, scientist, management consultant, and board member. His new book *Create the Future* is a guidebook for making more creative and better decisions for your company and yourself.

Williams engages with an international audience through his newsletter, published thought leadership articles, and speaking engagements for leadership audiences.

He also brings his insights and experience to his service on boards of directors. He has served as board chair of a medical device company and a bank/VC firm. Williams started his career as a physicist followed by Harvard Business School, management consulting with Arthur D. Little, Inc., and then founding and leading a real estate investment and development company.

Rick Williams

Rick@RickWilliamsLeadership.com
www.Linkedin.com/in/RickWilliams100
www.RickWilliamsLeadership.com

Rick Williams brilliantly delivers a leadership compass for high-performing companies. With his wealth of experience, Williams provides a clear playbook that's indispensable for leaders seeking a practical approach to shaping their organization's destiny. Packed with structured team exercises, this book empowers leaders to make choices that resonate with their goals and values. Like an in-house management consultant, *Create the Future* is your invaluable resource for decision-making in turbulent times.

Hubert Joly, Former Best Buy CEO,
senior lecturer Harvard Business School,
Author *The Heart of Business*