To P.E. or not to P.E.

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In last month's column, I presented an overview of capital sources that can be used to fund your urgent care start-up or expansion. This month I will discuss the different sources of debt and equity capital.

Much of the decision regarding which capital source is best for you is determined by your stage of development. For a startup, you will probably have to use traditional bank debt or raise capital, either in the form of debt or equity from friends and family. If your center has been up and running for a period of time, factoring receivables may be an option, as well as a bank-sponsored line of credit based upon your accounts receivables. If you have 5 to 10 centers open, a solid track record, and a proven management team, you may be able to garner some attention from a private equity (PE) firm.

Sources of Debt Capital

Debt capital is simply money supplied to a business from a loan. The loan can be from traditional sources, such as a bank. Or from less traditional sources, such as friends and family, credit card, mezzanine financing (a hybrid of debt and equity), and factoring. Debt capital is capital that typically is repaid based on a fixed annual percentage and may have a prepayment penalty.

Most of us start or started with the most traditional form of financing: a bank loan. These loans are generally at a "low" fixed interest, do not have a prepayment penalty, and require a personal guarantee as well as sufficient collateral. The days of getting "signature loans" are probably over. Physicians were historically considered good credit risks, thus finding a bank to loan 70% to 80% of the amount necessary to open and fund working capital was not terribly difficult. Although securing credit has become a bit more challenging, banks are still willing to lend physicians start-up capital, provided they have a good business plan, solid advisors, and a solid credit history and are adequately collateralized.

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Banks continue to lend on the 5 "Cs" of credit: Character, Capacity, Collateral, Condition, and Capital. However, even if you have mastered the 5 "Cs," the time to borrow money is when you don't need it. Going to a bank for a loan in the midst of a cash flow crisis is doomed for failure.

Credit card financing is simply using credit cards to get cash advances to fund your operations. I would strongly caution against this form of debt capital. Credit card balances usually carry very high interest and significant penalties are charged for not paying timely.

Mezzanine capital or "mezz financing" refers to a subordinated debt which is senior only to common stock. Mezz capital is more expensive than traditional bank debt because it is typically unsecured and subordinated. In other words, mezz financing is less likely to be paid back until all other obligations have been satisfied. A typical mezz note will consist of an interest payment to be made in cash; payable in kind (PIK) interest, which is not paid but added to the principle amount; and warrants that permit the holder of the note to buy a portion of the stock in the company at an agreed upon strike price.

Factoring is a financial tool used by businesses that carry a balance of receivables on their books. In most medical practices, the average time it takes to collect money owed runs between 35 and 65 days (DSO). A practice may consider selling part or all of their accounts receivable at a discount in order to receive cash on a timelier basis. Companies involved in factoring typically concentrate more on the value or credit worthiness of the receivable as opposed to banks, which focus more on the credit worthiness of the borrower. Most factoring companies allow a borrower to factor governmental and other third-party payors but will not factor patient self-pay receivables. Generally speaking, bank lending is much less expensive than factoring; however, by factoring, small companies can time their cash flows more closely to their cash needs, especially during times of growth.

Four Avenues for Equity

Generally speaking there are four ways in which to obtain equity financing.

Friends and Family: Convincing people who know and trust

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you that your idea and execution of that idea will be successful. A word of caution. Do this the right way. Find an attorney who drafts a note (debt instrument) or prepares the appropriate subscription and other agreements necessary for the purchase of an equity stake. As the old saying goes, "It's all fun and games until someone loses an eye." Translation:"If everything goes according to plan it's all good. If something goes awry, you may lose a friend in the process or family events can become very chilly."

Angel Investor: An offshoot of friends and family whereby you convince one or a few high-net-worth individuals to invest in your business plan. Again, have an attorney draft the appropriate agreements. If the angel investor has any sophistication at all, this is something upon which he or she will insist.

Venture Capital (VC): Early-stage or start-up equity. This is usually reserved for individuals who have great track records or an already proven model. VC firms always take a controlling interest in a company.

Private Equity (PE): Later-stage financing for companies that, generally speaking, have at least $10 million in revenue and $1 million in EBITDA (earnings before interest, taxes, depreciation, and amortization). PE groups want their capital deployed to grow the business, that is, to purchase other centers, build out de novo clinics, round out a management team, etc. In other words, they want you to put their money to work.

Typically, companies looking for PE capital are farther along in their life cycle. They have an existing track record of success, senior management and a well-thought-out game plan for growth. Although some PE firms may enter the business as a minority investor, they will ensure that they have a number of control levers they can pull if the business is not performing as planned.

A word of caution regarding the use of institutional capital: This is "smart money." Despite everything they will tell you, their obligation is only to their shareholders (as it should be). They have no obligation to you, your management team, the preservation of your culture, or even to your patients. They are in the game to make money and will have no qualms about replacing you or any practice that does not lead to the highest return on their investment (ROI) in the shortest amount of time. These firms typically want their money out within 3 to 5 years, therefore, long-term strategies, building "goodwill" amongst your staff or patients, and "over the horizon strategies" are not in their DNA because these types of activities do not produce a tangible, near-term ROI.

Conclusion

Despite our country's current financial challenges, there is money available for you to grow your clinic. It will take some work and some potential hardship to find it, but it is out there. Also, the knowledge you will gain by going through the process will be invaluable to your future endeavors! ■