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Creatively Leaning Toward Recurring Revenues
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In an increasingly competitive business world, equity investors and lenders are both attracted, more than ever before, to predictable future profits. One obvious way for business owners to demonstrate a high probability of the occurrence of such profits is to structure their customer relationships in such a way as to lean more towards recurring revenues than a "one time "sale. Creative investment bankers can then find ways to optimize balance sheets using the recurring revenue stream as a form of "virtual collateral" in order to reduce overall cost of capital.

In a recent example, Mayfair Associates, LLC was able to obtain a $35 million commitment for an enterprise software company by persuading the lending institution that the recurring stream of maintenance revenues could be maintained with a high degree of profitability under even the worst case scenario for the parent company. The lender calculated its loan amount by assessing the enterprise value under such circumstances and not by the more traditional advance rates determined via accounts receivable and other tangible assets. The traditional method would have resulted in a much lower senior loan, requiring our client to obtain larger amounts of more expensive subordinated debt and equity.

In another case, we were able to assist the management of an information technology outsourcing company to acquire control of their business from its parent (a public company). In this case, by creating guaranteed future contractual revenues from the seller and using those as non-traditional collateral, management was able to enjoy a majority interest in the company. They had not expected to be able to do so.

This has implications for almost every business we see. Capital equipment manufacturers, who operate some of the most cyclical of all businesses, can reduce volatility and increase enterprise value by creating a maintenance and spare part revenue stream. The semiconductor capital equipment sector, perhaps the most volatile of all, has seen some companies survive the recent downturn only because they had focused on this opportunity where their competition considered parts and maintenance a non-core distraction.

Many interesting examples can be found in the world of emerging technology consumer products which both illustrate the point and also show how it ties to that old marketing saw which says that it is less expensive, hence more profitable, to maintain existing customers than to obtain new ones. Consider the world of cellular phones, where the capital equipment is subsidized, sometimes subsumed entirely, in order to entice consumers into a longer term commitment. The same applies to both satellite and cable providers and to high speed Internet access. In all of these cases, the business model is designed to promote recurrent, preferably contractual, revenues to which Wall St attaches such a premium .

Franchising is another business model which can generate the desired effect. Unfortunately, too many franchisers fall prey to the temptation to maximize the up front element of the franchise fees while paying too little attention to the ongoing revenue streams. Furthermore, they tend to ignore some of the less obvious, but still attractive sources of recurring revenue available to them which go way beyond the traditional royalty and advertising fees. As CEO of a publicly traded franchiser in the early 1990s I was able to generate consistent and profitable revenue streams from multiple sources via the creation of beneficial group programs for franchisees. These included finance, insurance and other necessary products and services.

What this all points to is a creative and strategic role for the investment banker which goes to the very heart of the business model. We at Mayfair always like to challenge our clients to think in a very radical way about their businesses (and sometimes implement change) before we approach the capital markets. The ability to adjust the business model to create a higher percentage of recurring revenue is one of the first things we examine. We then are able to apply the results of our analysis directly to the task of obtaining for them the capital which they need both in the most suitable form and at the lowest cost.