Wrightlines Air Service (B)[1]

Recognizing that borrowing to acquire Wilbur's interest in Wrightlines would be more valuable than seeking funds from an investor who would hold common stock claims that are identical to the claims Orville would hold, Orville is still interested in seeking an equity alternative. If he can find a way to structure an equity deal with the right investor, he believes the probability of success will be improved compared to the credit financing alternative and compared to involving a group of investors who would not be very heavily involved with the venture.

For an equity financing arrangement to have any potential to dominate a buy-out that is financed with straight debt, Orville would need to work on three margins. First, he would have to focus on an investor who would evaluate the opportunity in the context of a diversified portfolio rather than concentrating on the total risk of the venture. Second, the investor would need to contribute significantly to the potential for success and this would need to be factored into the comparison of financing alternatives. Third, he would need to find a way to increase the investor's confidence in Orville's projections about expected performance.

One possibility is to seek venture capital financing. While Wrightlines probably would not appeal to the conventional venture capital firm that concentrates on early-stage investment in high-risk ventures, it could be a candidate for investment by a buyout fund. Such an investor would probably want a financing arrangement comprised of debt with a significant equity component. The investor would be able to assist with an eventual IPO, including possibly enabling the venture to go public at a higher multiple of earnings. Additionally, the fund manager would be investing on behalf of institutional investors who would be committing relatively small fractions of their total capital to Wrightlines.

Before searching for a buyout fund that would invest in Wrightlines, Orville would like to assess the potential that finding such an investor would actually increase the value of the interest in the company that he is able to retain. To assess the potential for an alternative financing arrangement to add value, he is considering a financing arrangement of raising $18.4 million dollars, three-fourths as debt with an interest rate of 9.5 percent, and one-fourth as equity. He believes that by combining debt and equity he can shift the investor's perception of expected net income in year three to about 95 percent of his own expectation if $5,715 million adjusted for the increase in interest expense. In addition, he believes involvement of a credible buyout fund manager could increase the year-three continuing value multiple by about 30 percent (to 13 times). Uncertainty of the cash flows would not be expected to change from the earlier assumption except due to the impact of greater interest expense on net income in the three scenarios.

[1] Names, industry, and financial data are disguised to preserve confidentiality.

Orville wonders how likely the changes in financing structure and financing source are to affect the investor's valuation and the continuing value multiplier to the extent that he has assumed. What is it about a private company like Wrightlines that would make these effects larger or smaller than he has assumed them to be? He also questions whether some other structure might be more effective for overcoming the information problems that affect the current capital raising effort and the eventual value at time of harvest.