

NORTHSTAR CAPITAL

In February of 1998, Jeff Brimhall was faced with the difficult decision of how best to fund his specialty finance start-up venture, Northstar Capital, LLC. Brimhall and co-partner Bill Sadleir had invested initial seed capital in the new entity and were now under financial and time pressure to fully fund Northstar. At least four different financing options were available to Northstar, each of which presented its own set of challenges and trade-offs. The financing options for Northstar revolved around partnership possibilities with a group of wealthy individuals, a private investment banking firm based in New York, a publicly traded specialty finance company, and a regional bank. Each funding scenario had implications that went beyond ownership equity and return on investment. Factors such as growth potential, synergy, and culture ultimately had to be assessed to determine the viability of each option.

BACKGROUND

In 1997, Jeff Brimhall and Bill Sadleir founded Northstar Capital as a specialty finance company with the ultimate goal of providing \$250,000,000 to emerging growth companies over a ten-year horizon. Northstar's investment strategy was based on the idea that the capital markets had not adequately addressed the needs of emerging growth companies in the Rocky Mountain and Pacific Northwest regions. By 1996, the average size of venture capital funds had grown to more than \$100 million. To efficiently invest such large amounts of money, venture capitalists had to invest increasing amounts of capital per transaction to justify their time and attention. In 1996, venture capitalists invested an average of 4.7 million per transaction. As a result, many emerging growth companies with capital needs of less than \$5 million were being overlooked by the venture capital industry. In addition, venture capitalists preferred to invest in companies located within close proximity to their offices. In 1996, 60% of companies receiving venture capital funding were located in California and the Northeast region, the traditional hubs of the industry.

As a result of these two trends, many promising growth companies in the Rocky Mountain and Pacific Northwest regions were being underserved by the venture capital markets. For example, a development stage medical instruments company in Utah, led by an experienced management team, shipping innovative products in increasing quantity, projecting annual revenue growth greater than 50 percent, and expecting profitability within the next 12 to 18 months, would find it quite difficult to secure \$1.5 million to purchase essential production equipment or to fund market development. The demand for financing by a rapidly increasing number of exceptional companies located in the fastest growth regions of the West, combined with the lack of available capital in these same regions, created a compelling and timely market opportunity for Northstar.

VENTURE LEASING

Northstar's inaugural step to capitalize on this market opportunity was to create Northstar Venture Leasing LLC, a \$30,000,000 venture lease fund. This was the first of several funds that the company planned to launch over the next several years. Venture leasing offered the opportunity to reach a more efficient balance of risk and return than was available in traditional venture capital activities. Like venture capital, venture leasing focused on providing capital to emerging growth companies without an established earnings history, and therefore required a higher rate of return for investors than traditional leasing activities. However, unlike a venture capital investment, which depended upon a liquidity event for success, venture leasing produced a stable stream of quarterly income from lease revenues. In addition, venture leasing provided for less risk in the event of a workout situation. Under a venture equipment lease, the lessor owned the equipment and, therefore, was not required to go through lengthy bankruptcy proceedings in order to repossess collateral.

What distinguished a "venture" equipment lease from a more traditional equipment lease was the credit strength of the lessee and the economic structure of the transaction. Lessees tended to be risky growth companies in industries like telecommunications, medical devices, or life sciences, where equipment purchases represented as much as 70% of the use of funding proceeds. Typically, these growth companies did not have a strong enough balance sheet to qualify for traditional lease financing through a bank. To offset the risk posed by these companies, Northstar was very selective in its leasing decisions. In deciding whether to invest, Northstar assessed factors such as growth potential, liquidation value of assets securing the loan, sophistication of equity shareholders, experience of the management team, profitability of operations, and exit strategy.

To account for the higher degree of perceived risk associated with these companies, venture leasing transaction economics were substantially more lucrative to the lessor than traditional leasing activities. In general, venture lease pricing was composed of three components. The first of these, the implicit rate, was the internal rate of return on the payment stream. The implicit rate in a lease was similar to the interest rate in a loan, but characterized differently because the lessor maintained ownership of the asset. Implicit rates ranged widely across venture leasing transactions, but tended to vary from 12 to 18 percent. Northstar's internal target rate was 14 percent.

The second pricing component was end-of-term options built into the lease. Typically, leases were structured as full-payout leases which meant that the payments fully amortized the cost of the equipment and provided the lessor with a base rate of return. However, since title to the equipment did not automatically transfer to the lessee, the lessor and lessees negotiated end-of-term options. Northstar typically provided lessees an option to purchase the equipment at the end of the lease term at its then existing fair

market value, or to continue renting the equipment for a pre-determined period of time at a significantly reduced rental rate. Northstar's target for end-of-term options was an incremental 8 percent yield.

The final component of pricing, which was unique to venture leases, was equity participation. Equity participation was normally achieved in the form of a warrant agreement. "Warrant coverage" was typically expressed as a percentage equal to the quotient of (1) the number of shares of a company's stock that Northstar is entitled to buy pursuant to a warrant agreement, multiplied by a strike price, divided by (2) the amount of financing being provided to the company by Northstar. While only a minority of stock warrants actually resulted in value, those that did more than offset any potential losses from troubled portfolio companies. The extent of warrant coverage that Northstar received typically ranged from 10% to 15% of the lease amount. Northstar targeted an incremental yield of about 8 percent from the benefits of equity participation in warrants. Altogether, the three pricing components yielded a target rate of 30 percent return on portfolio investments.

Venture lease financing, in addition to providing a very attractive return for investors, was also a very attractive source of funding for start-up companies. For companies with growth rates in excess of 25%, it made far more sense to lease equipment than to purchase it with equity. By leasing equipment, it was possible to match the monthly lease expense with the monthly revenues generated from the equipment's productivity. This allowed equity capital to be more effectively applied toward working capital expenses. In addition, venture leasing was attractive to entrepreneurs who wished to maintain control of their companies because it required substantially less equity participation than a typical venture capital fund.

CAPITALIZATION PLAN

Brimhall and Sadleir proposed a novel structure to capitalize the venture leasing fund which integrated an infusion of investment capital and a revolving credit facility provided by a money center bank. Under this plan, investors, rather than directly investing principal, leveraged existing liquid resources in the form of cash, certificates of deposit, stock, bonds, etc., by pledging it to the bank. The aggregate amount of credit support collateral needed to fully capitalize the venture leasing fund was \$10,000,000. Once a money center bank had a commitment for credit support collateral in this amount, a credit facility would be made available to Northstar Venture Leasing LLC in an amount up to \$30,000,000. This funding mechanism had the advantage of allowing investors to receive up to 3 to 1 leverage while continuing to earn returns on pledged collateral such as CDs, stocks and bonds. Investors would receive a 60% share of the upside, or net cash flow from the portfolio of lease transactions including the current monthly lease income (net of the cost of the credit facility, any losses, etc.), end-of-term residuals, and income from warrants. The bank, in return for providing the financing, would receive a projected internal rate of return of approximately 16%. (See Exhibits 1, 2, and 3 for projected Future Performance Summary, Balance Sheet and Income Statements for Northstar

Capital. Note that the financials present data for only the first in a series of funds to be launched by Northstar.)

FINANCING SCENARIOS

Individual Investors. Northstar's initial financing scenario was to have private high net-worth individuals invest the \$10,000,000 in credit support collateral. Northstar's founders hoped to find one large investor to fund the entire project. However, venture leasing was not a well-understood business even within the financial community, and no single individual investor could be found who was willing to take on all the risk for the whole venture. Brimhall and Sadleir did succeed in finding at least four private investors willing to put up between 1 and 1.5 million dollars apiece. The difficulty with this approach, however, was that each private investor often took several months to make the decision to commit capital to Northstar. According to Brimhall, "by the time you get 3 or 4 investors and several months have passed by, the first ones in the door begin to get cold feet. Private investors have many investment options and are typically less patient than institutional investors." At this level of financing, in order to fully capitalize the fund at a level of operational viability, Northstar needed to find at least 4 or 5 million dollars in additional financing.

On another front, Brimhall wondered about the viability of managing Northstar with more than four principal investors. Each investor required a substantial time commitment from the founders. With more than four investors, it could become organizationally burdensome to make investment decisions at the executive level. However, Brimhall felt that if the right investors could be found, this approach would create a positive culture and allow Northstar to operate as a versatile entrepreneurial organization.

Private Investment Banking Firm. Another financing scenario available to Northstar was to partner with a private investment banking firm based in New York. The bank was very impressed by the growth opportunities in specialty finance. Recently a number of specialty finance companies had been acquired or gone public at market premiums. Linc Capital, a specialty finance company focusing on equipment leasing, recently had a successful public offering of 2 million shares at a price of \$13 per share. Leasetech, another specialty leasing company based in Boulder, Colorado, had been acquired by Key Bank at a significant premium. Other specialty finance companies such as Sirrom Capital, PMC Capital, Alliance Capital and Bando McGlockin had performed well over the past several years, averaging return on equity of close to 20%. (See Exhibit 4 for financial and ratio comparisons of specialty finance companies.)

Given the success of the industry, the investment banking firm saw an exit strategy investment opportunity in Northstar, where in a few years, Northstar could be taken public or sold to an acquiring company for a substantial return on investment. In order to benefit from an exit strategy, the investment bank wanted a 40% equity stake in Northstar Capital LLC, and 50% of the proceeds derived from the venture leasing fund. Brimhall felt that the 40% figure was somewhat troubling, especially considering that new partners

which he planned to bring in to Northstar would eventually demand equity positions in the company. However, for the time being, this was the best offer the bank was willing to negotiate. While Brimhall was optimistic that the culture and geographic location of the investment bank would allow he and Sadleir the freedom to operate the fund without major restrictions, the deal only made sense if they could achieve a strong enough equity position.

Publicly Traded Specialty Finance Company. Another financing option was to sell Northstar to MortgageCorp, a publicly traded specialty finance company. MortgageCorp specialized in real estate mortgage servicing - a very stable cash flow business. It wished to add some risk and growth potential to its existing line of business by acquiring Northstar. As part of the sale, MortgageCorp would buy out Northstar's capital partners with stock options and Northstar would operate as a small division within the specialty finance company. The stock options would serve as upside performance incentive pay for Brimhall and Sadleir as they managed the division. One advantage of this scenario was that MortgageCorp's stable balance sheet would allow Northstar to operate a \$100 million bank line. (See Exhibit 5 for MortgageCorp financial information.) In return for providing the credit facility, a money center bank would require a 30% equity stake in Northstar's activities. Under this funding option, there also existed the possibility that sometime in the future, Northstar could be spun away from the parent company.

However, in the near term, Northstar would be operated as part of a large publicly traded corporation. This meant that earnings per share would become the ultimate yard stick driving Northstar's decision-making process. This would clearly take some of the incentive for risk-taking out of business decisions. Ultimately, Brimhall was concerned that the entrepreneurial culture at Northstar might not fit with the riskless business environment at MortgageCorp. Aside from the lease servicing function that could be provided to Northstar, there were few synergies between the two different businesses. However, Brimhall knew that ultimately the decision to sell to MortgageCorp could produce a stable business environment and a potentially lucrative business opportunity.

Money Center Bank. Another financing option available to Northstar was to partner with a regional money center bank such as Wells Fargo. There were significant strategy advantages in this pairing. Typically, a bank's corporate customers were established companies with at least 3 to 5 years of earnings history. Under Federal Deposit Insurance rules, banks were prohibited from investing in certain risky investments including many start-up companies. Partnering with a venture leasing organization provided a "funneling" mechanism for the bank to develop future corporate clients. A partnership with a regional money center bank also benefited Northstar by creating a referral mechanism for promising deals. Over time, the bank's large network would assure a strong and continuous deal flow for Northstar.

The only drawback to the deal from the bank's standpoint was the risk inherent in a start-up like Northstar. To make the deal a possibility, Brimhall and Sadleir proposed a leveraged acquisition of an East Coast venture leasing organization with a \$45 million

portfolio. Brimhall analogized the transaction to a “guppy swallowing a whale.” In the transaction, the bank would fund the purchase of the East Coast venture organization and Northstar’s founders would take a 10-20% equity interest in the new entity. The transaction was attractive because it virtually eliminated start-up risk, enhanced the credibility of the new venture, positioned the new entity for rapid growth with a \$70 to \$100 million credit line, increased the menu of financial services that the new entity could offer (e.g. to include services such as mezzanine financing in partnership with the bank), and offered the possibility of top management positions in the new entity for Northstar’s founders. In addition, the transaction offered the opportunity to work with a group of experienced individuals who understood the venture leasing industry.

The real difficulty posed by the deal was the time that it would take to actually put together. The time problem was compounded by the negotiation of difficult issues such as ownership and management interests. To a great extent these issues could only be resolved during the negotiation process. While the deal looked promising, the time frame for constructing the deal was such that in the end Northstar’s founders might not achieve the kind of ownership or management interests they hoped for and be forced to accept a sub-optimal financing decision. While this possibility existed with the other financing options, it seemed particularly acute under this scenario.

Brimhall had set a target date for funding Northstar by June 1, 1998. Although time was perhaps the most important factor in securing funding for Northstar, he placed a high priority on finding a funding scenario that maximized financial reward while balancing other factors such as autonomy, entrepreneurial culture, synergy, growth potential, and manageability of the enterprise.

Exhibit 1**NORTHSTAR VENTURE LEASING
PERFORMANCE SUMMARY**

Amount of Credit Support Pledged	\$10,000,000	
Maximum Amount of Warehouse Line	\$17,444,503	
Total Number of Transactions	50	
Lease Transactions	50	
Total Amount Invested	\$36,650,000	Maximum
Lease Transactions	\$36,650,000	\$1,400,000
Total Workout Transactions	13	
Percentage Workout Transactions	26%	
Total Transactions Resulting in Warrant Upside	9	
Percentage of Transactions Resulting in Warrant Upside	18%	
	Months	Years
Investment Period (months)	36	3.0
Harvest Period (months)	60	5.0
Fund Life (months)	96	8.0
Return to Credit Support Partner		
Total Cash Received by Credit Support Partner	\$10,512,384	
IRR to Credit Support Partner	15.81%	
Cash-on-Cash Return to Credit Support Partner		
Year 1	0.15%	
Year 2	0.93%	
Year 3	6.48%	
Year 4	12.33%	
Year 5	3.79%	
Year 6	49.18%	
Year 7	29.37%	

Exhibit 2

NORTHSTAR VENTURE LEASING

Financial Statements

Balance Check: OK

	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6	Year 7	Year 8	Year 9	Year 10
Balance Sheet										
Assets										
Current Assets										
Cash-Investment/Reinvestment Account	-	-	-	-	-	-	-	-	-	-
Cash-Income Account	0	0	-	0	0	0	0	0	0	0
Cash-Reserve Account	101,331	115,089	15,653	7	0	0	0	0	0	0
Total Cash	101,331	115,089	15,653	7	0	0	0	0	0	0
Current Portion of Long Term Investments	5,921,173	10,061,812	8,219,739	4,645,541	1,473,748	258,981	0	0	0	0
Total Current Assets	6,022,504	10,176,901	8,235,392	4,645,548	1,473,748	258,981	0	0	0	0
Long Term Investments										
Lease Transactions Receivable	9,546,222	14,731,756	17,444,503	7,373,461	1,478,950	213,107	0	0	0	0
Less: Current Portion	-5,921,173	-10,061,812	-8,219,793	-4,645,541	-1,473,748	-258,981	0	0	0	0
Lease Transactions in Workout	-	-	-	0	0	0	0	0	0	0
Total Long Term Investments	3,625,049	4,669,944	9,224,710	2,727,920	5,202	-45,874	0	0	0	0
Total Assets	9,647,553	14,846,845	17,460,102	7,373,468	1,478,950	213,107	0	0	0	0
Liabilities										
Current Liabilities										
Current Portion of Long Term Liabilities	5,921,173	10,061,812	8,219,793	4,645,541	1,473,748	258,981	0	0	0	0
Long Term Liabilities										
Credit/Term Loan Facility	9,546,222	14,731,756	17,444,503	7,373,461	1,478,950	213,107	0	0	0	0
Less: Current Portion	-5,921,173	-10,061,812	-8,219,793	-4,645,541	-1,473,748	-258,981	0	0	0	0
Credit/Term Loan Facility in Workout	-	-	-	-	0	0	0	0	0	0
Obligations Under Collateral Agreements	-	-	-	-	-	-	-	-	-	-
Total Long Term Investments	3,625,049	4,669,944	9,224,710	2,727,920	5,202	-45,874	0	0	0	0
Total Liabilities	9,546,222	14,731,756	17,444,503	7,373,461	1,478,950	213,107	0	0	0	0
Equity										
Retained Earnings	101,331	115,089	15,653	7	0	0	0	0	0	0
Total Liabilities and Equity	9,647,553	14,846,845	17,460,156	7,373,468	1,478,950	213,107	0	0	0	0

Exhibit 3

NORTHSTAR VENTURE LEASING

Financial Statements

Balance Check: OK

Year 1 Year 2 Year 3 Year 4 Year 5 Year 6 Year 7 Year 8 Year 9 Year 10

Income Statement

Income										
Lease Interest Income	474,975	1,702,170	2,097,870	1,538,911	507,414	92,161	6,465	(0)	(0)	(0)
End of Term Residual Proceeds	-	-	545,000	1,800,000	595,000	852,500	257,500	-	-	-
Lease Transaction Warrant Proceeds	-	-	-	2,610,000	1,730,625	7,312,500	4,635,833	483,000	-	-
Interest on Restricted Account	1,212	4,240	9,292	133	0	-	(0)	(0)	(0)	(0)
Income	476,187	1,706,410	2,652,162	5,949,045	2,833,039	8,257,161	4,899,799	483,000	(0)	(0)
Expenses										
Loan Interest Expense	282,815	1,035,467	1,308,186	1,004,264	341,363	60,828	4,226	(0)	(0)	(0)
Management Fee	76,864	266,681	533,874	1,977,859	996,671	3,278,530	1,958,229	193,200	(0)	(0)
Net Writeoff	-	297,772	261,443	1,749,773	1,116,367	-	-	-	-	-
Expenses	359,679	1,599,920	2,103,502	4,731,895	2,454,400	339,367	1,962,455	193,200	(0)	(0)
Net Income	116,508	106,490	548,659	1,217,149	378,639	4,917,794	2,937,343	289,800	(0)	(0)

Exhibit 4 Specialty Finance Ratio Comparison

Debt to Equity (Times)

	1993	1994	1995
Sirrom Capital	1.8	1.8	1.0
PMC Capital	0.8	0.9	1.4
Alliance Capital		1.2	1.6
1.5			
Bando McGlocklin	N/A	2.4	2.3

Return on Equity (%)

	1993	1994	1995
Sirrom Capital	4.7	24.2	22.2
PMC Capital	16.8	21.1	19.1
Alliance Capital		38.8	0.0
28.2			
Bando McGlocklin	16.3	16.4	17.3

Dividends Per Share (\$)

	1994	1995	1996
Sirrom Capital	N/A	.86	1.04
PMC Capital	1.06	1.08	1.18
Alliance Capital		1.47	1.44
1.16			
Bando McGlocklin	1.00	.96	.96

Price/Earnings (Times)

	1995	1996	1997E
Sirrom Capital	27.0	19.1	15.8
PMC Capital	13.3	12.0	10.7
Alliance Capital		29.4	N/A
N/A			
Bando McGlocklin	11.4	10.8	9.8

Sirrom Capital is a specialty finance company that makes loans to small businesses. These loans are typically in the form of senior secured debt and include warrants to purchase equity securities. Sirrom is geographically focused in the Southeast.

PMC Capital is a diversified, closed-end management investment company that operates as a business development company. The company's operations include originating and servicing commercial loans for its own account, as well as selling the guaranteed portion of its loans originated under the SBA 7(a) Loan Program.

Return on Assets (%)

	1993	1994	1995
Sirrom Capital	2.0	8.5	10.0
PMC Capital	9.4	10.1	8.1
Alliance Capital		15.6	0.0
10.6			
Bando McGlocklin	3.4	2.9	2.6

Operating Margin (%)

	1993	1994	1995
Sirrom Capital	38.6	40.6	51.3
PMC Capital	59.5	60.1	53.7
Alliance Capital		18.6	17.4
23.6			
Bando McGlocklin	43.9	33.3	39.1

Price to Cash Flow (Times)

	1993	1994	1995
Sirrom Capital	56.9	33.0	29.4
PMC Capital	27.5	11.3	11.5
Alliance Capital		NM	NM
8.5			
Bando McGlocklin	NM	1.2	4.0

Price/Earnings to Growth (Times)

	1995	1996	1997E
Sirrom Capital	1.4	1.0	0.8
PMC Capital	1.1	1.0	0.9
Alliance Capital		2.9	N/A
N/A			
Bando McGlocklin	1.1	1.1	1.0

Alliance Capital provides investment advice and diversified investment management services to institutional and individual investors. Alliance operates mutual funds that specialize in a number of sectors, including small cap companies.

Bando McGlocklin operates several subsidiaries, including a small business lending corporation that makes real estate loans to small businesses, and two manufacturing companies that produce dolls and licensed products.

Exhibit 5 MortgageCorp Selected Financial Data
(dollars in thousands, except per share data)

	<u>1997E</u>	<u>1996</u>
Total Revenues	55,011	43,136
EBITDA	26,202	20,546
Interest Expense	14,007	10,490
EBITDA/Interest	1.87x	1.96x
Net Income	8,138	3,570
Net Income Per Share	1.20	.68
Shares Outstanding	6,781,808	5,077,321
Return on Average Assets	1.78%	1.69%
Return on Average Equity	22.71%	24.30%
Average Equity to Average Assets	7.86%	6.97%
Net Interest Margin	3.70%	3.45%
Operating Efficiency Ratio	73.95%	82.01%
Net Charge-Offs/Average Loans	.04%	.03%
Stock Price	16.50	

BALANCE SHEET (\$ Mil)

<u>ASSETS</u>	<u>1996</u>	<u>1995</u>
Cash & Near Cash Equivalents	2.9	1.4
Secured Inventory	192.6	132.7
Net Receivables	9.4	5.6
Total Loans	29.6	19.8
Loan Loss Reserve	0	.2
Net Loans	29.6	19.6
Other Long Term Investments	2.9	2.0
Total Long Term Investments	32.4	21.5
Net Fixed Assets	7.9	5.9
Other Assets	29.5	17.6
Total Assets	274.6	184.7
<u>LIABILITIES</u>	<u>1996</u>	<u>1995</u>
Total Deposits	90.2	48.9
Short Term Borrowings	48.4	50.8
Other Liabilities	9.1	11.0
Long Term Borrowings	51.3	33.3
Total Liabilities	242.3	175.4
Preferred Equity	0	0
Minority Interest	0	0
Share Cap & APIC	22.0	2.6
Retained Earnings	10.3	6.7
Shareholder Equity	32.3	9.3
Total Liabilities & Equity	274.6	184.7