



I. Lehman Formula

A compensation formula developed by Lehman Brothers for investment banking services. The structure of the original formula is as follows:

- 5% of the first million dollars involved in the transaction
- 4% of the second million
- 3% of the third million
- 2% of the fourth million
- 1% of everything thereafter (above \$4 million)

Because of inflation and other circumstances (e.g. market conditions), investment bankers often seek some multiple of the original Lehman formula.

Private Placement Fees done by NASD dealers will usually cost 10% of the offering, plus expenses. IPO's generally have an 8% fee paid in stock of the initial IPO to the underwriters as an incentive fee for floating the issue.

In general, debt and other financing instruments are billed at one half the above rates and act like points. We have heard of some companies charging up to 10% or even 15% in fees alone. These should be avoided because the investor will not accept a fee that high.

Merger and Acquisition Fees or small business sales fees can range from 3% to 10% depending on whether the company is acting as a finder or broker. Broker fees are higher because they are involved in the negotiations and have higher risk.

II. Dissecting Investment Banking Fees

Investment bankers generally charge three types of fees: **cash reimbursement of expenses, cash as a percentage of the transaction and equity compensation.**

Percentage Cash Fees

The part of the investment banker's fee that usually draws the most attention during negotiations is the cash fee that is paid upon the closing of the transaction. This fee is usually based on a percentage of the money raised in the offering. Percentages vary from one deal to the next, but the range for a private placement is generally 5 percent to 10 percent.

Having a fixed percentage of the deal can be very lucrative for investment bankers as the size of the deal increases. For larger deals, therefore, a "Lehman" formula is sometimes used which charges a lower percentage as the amount raised increases. For example 5 percent of the first \$1 million dollars, 4 percent of the second \$1 million dollars, 3 percent of the third \$1 million, 2 percent of the fourth \$1 million and 1 percent above \$5 million. The "Double Lehman" formula uses 10 percent, 8 percent, 6 percent, 4 percent and 2 percent. The dollar break points at which the percentage is reduced are negotiable and vary from one deal to the next.

Some investment bankers charge a *monthly cash retainer*, as well as the percentage fee payable at closing. Usually the retainer that is paid can be applied as a credit that reduces the amount of the percentage fee payable at the closing. With the retainer, the investment banker reduces its risk by receiving some compensation whether or not a deal closes.

Equity Compensation

Most equity compensation paid to investment bankers is in the form of warrants. The warrants are generally for a number of shares equal to between 5 percent and 10 percent of the number of shares sold in the deal by the

investment banker. The warrants generally have an exercise price equal to 100 percent to 120 percent of the price of the securities sold in the deal and have a term of from one to 10 years. In some cases, the warrants terminate on IPO of the company.

Although investment banking fees for most transactions contain a combination of expense reimbursement, cash percentage fee and warrants, the amount in each category of fees varies from deal to deal depending upon a number of factors that include the following:

Size of the deal: The general rule is the lower the dollar amount to be raised, the higher the percentage the investment banker receives. This is the case because the amount of time and effort it takes to raise \$25 million is often not much more than it takes to raise \$5 million.

Stage of company: With younger companies there is usually greater risk that the deal will not close or that it will take more effort by the investment banker.

Industry: If your company is in a hot industry, the investment banker may agree to a lower fee because the deal will be easier to sell. Also, the warrants may be deemed to be more valuable.

Market factors: If a company has no other visible sources of funding, the fee will generally be higher than if other investment bankers are competing for the business or if the company's existing investors are willing to fund the company.

Although the size of the fee is important, it is often more important to assure that the fee is structured to provide an incentive for the investment banker to get the deal closed on terms that are favorable to you. Therefore, it may be in your interest to agree to a percentage fee that is at the low end of the normal range, but to agree to a higher fee if at closing the deal meets specified valuation criteria. For example, 10 percent if the pre-money valuation at closing is \$20 million or more, and 5 percent if the pre-money valuation is less than \$20 million.

III. Raising Capital Via Consultants

What you Get

Raising capital can quickly become a full time job for many entrepreneurs, so you may want to consider working with third parties such as consultants. In most cases, they should be able to shortcut your time to market, and help you negotiate the valuation issues. Variances in the valuation process can cost you hundreds of thousands or millions of dollars downstream if you don't know how to negotiate with investors, so the value a consultant can add may be significant in this area alone.

Most reputable consultancies will want a "success fee" (or retainer) that's structured for 2-4 months -- this is a monthly fee that you pay the consultant for their time, insight, and acumen. Make sure you get real value from these services by adding some tangible milestones to your contract, including some specific actions they will take on your behalf. What milestones could you incorporate? How about:

- Contacting a specific number of firms each month
- Sending a defined number of Executive Summaries to third parties
- Holding a particular number of "pitch meetings" (investor presentations)

However, as an example, the cost might be anywhere between \$10-25K (USD) for a comprehensive business plan that's around 25-45 pages long, and includes detailed financials (by month the first three years, then by quarter).