Techniques and Strategies for Financing and Valuing Your Small Business

HOW TO RAISE CAPITAL

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small business owners. The earlier the capital enters, regardless of the source, the more costly it is. Creative bootstrapping strategies can be great preservers of equity, as long as such parsimony does not slow down the venture's progress—a problem with many small businesses.

There are three central issues to consider when beginning to think about obtaining risk capital: (1) Does the venture need outside equity capital? (2) Do the founders want outside equity capital? (3) Who should invest? Although these considerations should be the focus of your management team, it is also important to remember that a smaller percentage of a larger pie is preferred to a larger percentage of a smaller pie. Or as one entrepreneur stated, "I would rather have a piece of a watermelon than a whole raisin."[1]

After reviewing the venture opportunity screening exercises and the free-cash-flow equations (including OOC, TTC, and breakeven), it will be easier to assess the need for additional capital. Deciding whether the capital infusion will be debt or equity is situation specific, and it may be helpful to be aware of the trade-offs involved. In the majority of the high-technology early-stage companies, some equity investment is normally needed to fund research and development, prototype development and product marketing, launch, and early losses.

Once your *need* for additional capital has been identified and quantified, you and your management team must consider the desirability of an equity investment. Bootstrapping continues to be an attractive source of financing. For instance, *Inc.* magazine suggested that entrepreneurs in certain industries "tap vendors"[2] by getting them to extend credit.

Other entrepreneurs interviewed by *Inc.* recommended quick payments from customers.[3] For instance, one entrepreneur, Rebecca McKenna, built a software firm from scratch that did $8 million in sales in 2001 with customers in the health-care industry. The robust economic benefits to her customers justified a 25 percent advance payment with each signed contract. This up-front cash has been a major source for her bootstrap financing. These options, and others, exist if your management team members feel that a loss of equity would adversely impact the company and their ability to manage it effectively. An equity investment requires that the management team firmly believe that investors can and will add value to the venture. With this conviction, your team can begin to identify those investors who bring expertise to the venture. Cash flow versus required rate of return is an important aspect of the "equity versus other" financing decision.

Deciding *who* should invest is a process, more than a decision. Your management team has a number of sources to consider. There are both informal and formal investors, private and public markets. The single most important criterion for selecting investors is what they can contribute to the value of your venture—beyond just funding. Angels or wealthy individuals are often sought because the amount needed may be less than the minimum investment required by formal investors (i.e., venture capitalists and private placements). Whether a venture capitalist would be interested in investing can be determined by the amount needed and the required rate of return expected.

Yet, small business owners should be cautioned that only a small percent of the companies seeking private equity actually wind up getting it at the end of the process. Additionally, the fees due the investment bankers and attorneys involved in writing up the prospectus and other legal documents must be paid whether or not your company raises capital.

Angels and Informal Investors

Who They Are

Wealthy individuals are probably the single most important source of capital for start-up and emerging businesses in America today.[4] To meet accreditation standards, angel investors are required by the Securities and Exchange Commission to have assets of at least $1 million.[5] According to the Center for Venture Research at the University of New Hampshire, there are approximately 400,000 active angels in the United States. In 2000, as tech stocks sank, U.S. angels invested an estimated $30 billion in start-up financing, compared with about $50 billion by venture capitalists.[6]

New Hampshire's Bill Wetzel has found these angels are mainly American self-made entrepreneur millionaires. They have substantial business and financial experience and are likely to be in their forties or fifties. They are also well educated; 95 percent hold college degrees from four-year colleges, and 51 percent have graduate degrees. Of the graduate degrees, 44 percent are in a technical field and 35 percent are in business or economics. According to Scott Peters, cofounder and co-CEO of AngelSociety, 96 percent of angels are men. One growing movement to involve female entrepreneurs and investors is Springboard, a not-for-profit organization that organizes a series of meetings with venture capitalists. Springboard venture capital forums in the United States have showcased more than two hundred companies and helped raise nearly $600 million in 2000 and 2001.

Because the typical angel will invest from $10,000 to $250,000 in any one deal, informal investors are particularly appropriate for the following:[7]

- Ventures with capital requirements of between $50,000 and $500,000
- Ventures with sales of $1–$2 million and the potential for $20 million within five to ten years of the equity investment.
- Small, established, privately held ventures with sales and profit growth of 10–20 percent per year. This is not rapid enough to be attractive to a professional investor, such as a venture capital firm, but can be attractive to angels.
- Companies who project high levels of FCF within three to five years

These investors may invest alone or in syndication with other wealthy individuals, may demand considerable equity for their interests, or may try to dominate ventures. They also can get very impatient when sales and profits do not grow as they expected.

Usually, these informal investors will be knowledgeable and experienced in the market and technology areas in which they invest. If the right angel is found, he or she will add a lot more to a business than just money. As an advisor or director, his or her savvy, know-how, and contacts that come from having "made it" can be far more valuable than the $10,000–$250,000 invested. Generally, the evaluations of potential

investments by such wealthy investors tend to be less thorough than those undertaken by organized venture capital groups, and such noneconomic factors as the desire to be involved with entrepreneurship may be important to their investment decisions. And in fact, there is a clear geographic bias of a one-hour radius of the investors to the venture's location. A wealthy individual, for example, may want to help build businesses in his or her community.

Finding Informal Investors

Finding these backers is not easy. One expert noted: "Informal investors, essentially individuals of means and successful entrepreneurs, are a diverse and dispersed group with a preference for anonymity. Creative techniques are required to identify and reach them."[8] The Internet has provided small business owners with an effective method of locating such investors. Formal sources like Garage Technology Ventures (garage.com), Business Partners (businesspartners.com), and PrivateInvestor.com provide invaluable advice, assistance, and information regarding potential investors and help forge the link between investors and small business owners seeking capital. Specialized assistance for women include womenangels.net and the Center for Women and Enterprise (cweboston.org).

Invariably, financial backers are also found by tapping a small business owner's own network of business associates and other contacts. Other successful entrepreneurs know them, as do many tax attorneys, accountants, bankers, and other professionals. Apart from serendipity, the best way to find informal investors is to seek referrals from attorneys, accountants, business associates, university faculty, and entrepreneurs who deal with new ventures and are likely to know such people. Because such investors learn of investment opportunities from their business associates, fellow entrepreneurs, and friends, and because many informal investors invest together, more or less regularly, in a number of new venture situations, one informal investor contact can lead the entrepreneur to contacts with others.

In most larger cities, law firms and private placement firms syndicate investment packages as Regulation D offerings to networks of private investors. They may raise from several hundred thousand dollars to several million. Directories of these firms are published annually by *Venture* and discussed in other magazines such as *Inc.* Articles on angel investors can also be found in *Forbes*, *Fortune*, *Wall Street Journal* (WSJ Start-up.com), *Business Week*, *Red Herring*, and *Wired* and at their respective websites.

Contacting Investors

Obtain permission to use the name of the person making a referral when contacting the prospective investor. A meeting with the potential investor can then be arranged. At this meeting, you must make a concise presentation of the key features of the proposed venture by finding answers to the following questions:

- What is the market opportunity?
- Why is it compelling?
- How will/does the business make money?
- Why is this the right team at the right time?
- How, as an investor, does one exit the investment?

It is noteworthy that in this era following the crash of the dot-coms, investors throughout the capital markets food chain are returning to these fundamental basics for evaluating potential deals.

However, we recommend that you avoid meeting with more than one informal investor at the same time. It is unnecessary to hear negative viewpoints raised by one investor to be reinforced by another. It is also easier to deal with negative reactions and questions from only one investor at a time. Like a wolf on the hunt, if you isolate one target "prey" and then concentrate on closure, you will surely increase the odds of success.

Whether or not the outcome is continued investment interest, you need to try to obtain the names of other potential investors from this meeting. If this can be done, you will develop a growing list and will find your way into one or more networks of informal investors. If the outcome is positive, often the participation of one investor who is knowledgeable about the product and its market will trigger the participation of others.

Evaluation Process

An informal investor will want to review your business plan, meet your management team, and get to know your business by talking to employees, customers, vendors, and bankers. The investor will conduct background checks on your venture, usually through someone who knows both you and the product. The process is not dissimilar to the due diligence of the professional investors (see pages 120–21) but may be less formal and structured. If given a choice, you would be wise to select an informal investor who can add knowledge, wisdom, and networks as an advisor and whose objectives are consistent with your own.

The Decision

If the investor decides to go forward, he or she will have some sort of investment agreement drafted by an attorney. This agreement may be somewhat simpler than those used by professional investors, such as venture capital firms.

Most likely, the investment agreement with an informal investor will include some form of a "put," whereby the investor has the right to require the venture to repurchase his or her stock after a specified number of years at a specified price. If the venture is not harvested, this put will provide an investor with a guaranteed cash return.

Venture Capital: Gold Mines and Tar Pits

There are only two classes of investors in private companies: value-added investors, and all the rest. If all you receive from an investor, especially a venture capitalist or a substantial private investor, is money, then you may not be getting much of a bargain at all. One of the keys to raising risk capital is to seek investors who will truly add value to the venture well beyond the money. Research and practice show that