Carol Roth's Dirty Dozen Capital Raising Mistakes:

The 12 mistakes EVERY entrepreneur MUST avoid when raising money

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Raising capital for businesses is hard and often misunderstood. I know; I have helped my clients raise over $1 billion in capital over the past 15 years, plus seen myriad others who have failed to present a compelling, fundable story about their businesses (and themselves). In my generally unscientific but thorough poll of entrepreneurs, 99.99% of them rank raising capital amongst their five least favorite business activities.

Hopefully, I can help make the capital raising process a bit more tolerable and understandable for you. So without further ado, find below the 12 (well 13, I threw in a bonus) mistakes that you ***must*** avoid to save yourself time, money and energy and increase your chances of success when raising money for your business.

Mistake #1- Putting All of Your Eggs in One Basket

The very first capital raising mistake actually relates to not raising outside capital at all. Statistics show that the typical start-up business in the US is self-funded by the entrepreneur from his or her savings and supplemented with some personal credit card debt. However, part of balancing risks and rewards is using diversification.

We have all been told that it is important to diversify our investments. You don't want to have- sorry for the cliché phrase - all of your eggs in one basket. This is why many stock market investors choose to invest in mutual funds versus picking individual stocks. If you have diversity, one bad investment isn't going to ruin you financially. It will hopefully be balanced out over your whole fund or portfolio; the really bad investment will be averaged with the really good and the mediocre, to give you a fair combined investment return.

When you are starting your business, you are also investing in it. If all of your money is in your business, you will not have the opportunity to diversify with other investments. So, if your business doesn't do well, all of your eggs will be in a basket that is broken.

I am not sure why the agricultural analogies work so well here, but another way to say it is *don't bet the farm on your business*.

It is important for you as an entrepreneur to show your commitment to your business by investing some of your own capital. This is a safeguard to ensure that you are incentivized to do everything you can to make the business successful. However, if you are putting your every last dime into the business, all of your eggs will be in that one darn basket.

How to avoid this mistake:

- Make sure that you don't bet the farm on your business
- If you don't have enough money to live on, invest in your business and have other savings and investments, then: (i) wait until you have more money saved, (ii) see if you can revise your budget or (iii) consider taking on outside capital

Mistake #2- Undercapitalizing Your Business

A large percentage of businesses close because they don't have enough money to survive the rocky first couple of years of business.

I have found that early-stage and new business owners underestimate the cost of starting and running the business virtually every time. In each early stage business I have seen, the entrepreneurs say that their financial projections are *conservative* in terms of revenue and expenses (and then I roll my eyes). They also always claim that they are raising more money than they need and that they have a cushion. When I tell them that their projections, as with all entrepreneurs' financial projections, are too aggressive, they lecture me about why they are the "exception to the rule". Then, a year later, after their revenue estimates fell short and their expenses were greater than expected, they give me the reasons why they too have missed their projections. There has yet to be an exception to this in my personal experience. *Note: seasoned investors know this and it is why they always take a "haircut" to the projections; they assume that they are overstated on the revenue line and/or understated on the expense line when they evaluate the investments*.

Most entrepreneurs expect to generate revenue the day they officially open for business. Making sales usually takes longer than you expect and comes at a slower pace than you expect.

Another issue arises when you don't raise enough capital upfront and you start to run out of money. It is much more difficult- often impossible- to secure capital to stay afloat when things aren't going so well.

How to avoid this mistake:

- Do yourself a favor when you do your projections: go back and revise them so that the amount of money you actually need is one-and-a-half to two times the amount you originally thought you needed. So, if you think you need $10,000, you really need $15,000 to $20,000. If you think you need $3 million dollars, you really need probably around $4.5 million, maybe more

Mistake #3- Not Understanding Valuation

When you raise money for your business, you are usually dealing with one of two types of capital: (i) equity, where you give up an ownership stake in your business, or (ii) debt, where you can take on an obligation for your business that you agree to pay back instead of giving up ownership. There are hybrid scenarios that incorporate both of these (as well as options and warrants), but at a basic level, you need to at least understand equity and debt. If you raise equity, you end up setting a value for your business, which is based on the stage of your business, the milestones you have reached and the ultimate potential of your business.

However, a lot of entrepreneurs don't understand valuation. Imagine that your business is symbolized by pie (better than farm analogies, I suppose?). Pick whatever pie you want- I will take lemon meringue. Anyways, you start off having a generally small pie. You have 100% of the pie and then you give up a slice (or percentage) of that pie in exchange for equity capital. The hope is that in the future, your business becomes a huge pie, so that even though other people have percentages/pieces of the pie, your piece of that larger pie is bigger than when you owned 100% of a small pie (i.e. your stake is worth more in terms of absolute dollars).

However, entrepreneurs don't understand how the pie works. They will say that they have a business idea and that they need to raise $200,000. Then arbitrarily, they will decide that they only want to give up 10% of the equity. However, that establishes a value for the business (and a big one!). If 10% of the pie is worth $200,000, then 100% of the pie (the whole pie) is worth $2 million! That $2 million number includes the $200,000 in cash the investor is giving you, so that means before you raise any money, you value your company at $1.8 million ($2 million minus $200,000).

Most established small businesses aren't worth $1.8 million dollars, let alone a brand new business!

Setting unrealistic valuations can increase the amount of time it takes for you to raise capital, prevent you from raising money altogether and also create credibility issues for you as an entrepreneur. Even if you can find a fool to invest at your crazy valuation proposal, beware; you may have to raise capital again in the future and having a silly upfront valuation can impede your ability to raise capital in the future (again, credibility issues). It can also damage the relationship with your investor who is now, in effect, your business partner.

How to avoid this mistake:

- Make sure you understand what you are implying in terms of valuation- if you need help, ask a professional!
- Think carefully about the pros and cons of a ridiculously high valuation, even if you can get one
- Consider an investment structure (using debt, or if you have good advisors, perhaps convertible debt or something else fancy-schmancy) that either doesn't require you to set a business valuation or sets one in the future based on achieved metrics and benchmarks

Mistake #4- Being Greedy

Let's say that there is a treasure chest of gold located several hundred miles away from your house. If you are the first to get to the treasure chest, you can claim it as yours. The problem is that you don't have a car. You could walk or ride your bike, but by the time you got there (if you ever did- it is a long distance), someone else may claim the gold. So, you ask a good friend if they can drive you to the gold and you will share some of it with them if you get there first.

Now, in this incredibly transparent analogy of mine, the gold stands for the potential upside rewards of your business and your friend with the car is the investor and investment capital, respectively, that you need to build your business and try to claim those rewards in a timely fashion.

So, how much do you give your "friend" for driving you there? Now, many entrepreneurs take the stance, "well I came up with the idea", and offer to give their friends a token amount, like 10%. However, the reality is that you can't execute, that is, get to the gold in enough time to claim it, without your friend and his car. So, what if you gave him 30%, 40% or even split it? There will still be enough value for it to be worth both of your whiles. True, the friend wouldn't have known about the gold and couldn't find it without your navigation, but you can't get there without the car.

Valuing a business is an art, not an exact science, and splitting hairs over percentage points is often missing the entire point!

How to avoid this mistake:

- Other than understanding valuation implications (from Mistake #3), don't get too caught up in the percentages that you give up for raising equity capital. Capital is a necessary component of growing a business which also a great deal of risk for the investor
- Be fair- which is usually the point where both parties think they got just slightly a raw deal- and realize that if the opportunity is large enough, there will be enough to go around for everyone. If not, then you should be rethinking the opportunity to begin with

Mistake #5- Underestimating How Much Time it Takes to Raise Capital

Most everything in business, particularly those things outside of your direct control, takes more time than you want or expect. Raising capital is one of those things. This is especially the case when raising money from individual investors. Even when people tell you they are going to invest in your business, it is really hard to get them to write the check. Getting people to part with their money is like trying to get food away from me when I am hungry; a tough task!

People will wait as long as possible to part with their "benjamins". Just ask the US government what percentage of tax returns get sent in at the last possible moment (on or around April 15th) and how many taxpayers file for an extension. You may find that you have to literally pry that investment check out of your potential investors' hands.

Even with loans, documents need to be put together, processed, reviewed, put through bureaucratic processes and ultimately signed. This takes time and lots of it.

How to avoid this mistake:

- Take whatever time frame you think is needed to raise capital and increase it by 50% to 100%. If you have budgeted six months, it will probably take nine to twelve months (and if you are thinking one month, wake up, because you are dreaming)

Mistake #6- Assuming Your Business is Fundable by Sophisticated Investors

Most business models aren't big enough to attract the attention of sophisticated investors like angels or venture capitalists. These investors want to invest in businesses that have the ability to give them a 30% to 50% return (or sometimes higher) on their capital on average for every year they hold the investment. They use this benchmark because they know a large percentage of their investments are going to fail (as most new businesses do) or be limited in the scope of their success, so they need the one that really succeeds to make up for the nine others that flop. These investors also need a way to get their investment out of the business, so they expect that in some realistic time frame (usually five to seven years) the business will be big enough to sell or to take public in an IPO.

Based on the above, there are many more venture capital firms focused on industries like technology, rather than consumer or service businesses.

This set of criteria means that your business may not be a fit for an angel or venture capital investment. Venture capital firms only fund ***a fraction of one percent*** of all businesses in the US each year. Sophisticated angels also fund a tiny portion of all businesses.

If you are one of the few that do have a business that meets the potential criteria of venture capitalists, it will still be tough to get funded. Every venture capital firm gets hundreds to thousands of business plans submitted for review each year. They dismiss many plans that are received over the transom, that is, plans that aren't introduced by someone that they know and that can vouch for them. So, if you are not in the inner circle of the venture capital community (and if you need the money, you often aren't), your plan may not even get glanced at, even if your business has merit.

How to avoid this mistake:

- Be realistic on whether you have a business model that is likely to scale quickly and be of interest to venture capitalists or sophisticated angel groups. If not, don't waste your time going to them for funding- look elsewhere
- If you do have a plan that meets the above criteria, try to get an introduction through someone who has a relationship. Spend time with your network seeing "who knows who", as a direct introduction will keep you from the bottom of the business plan (or pitch deck) pile

Mistake #7- Taking Investments from "FFFs" or "DDLs" Lightly

If you don't qualify for an investment from a sophisticated investor group, you may turn to folks who you know- friends, family and acquaintances who may consider investing in your business. Two acronyms are usually used to describe these investors- either "FFFs- friends, family and fools" or "DDLs- doctors, dentists and lawyers"- generally people in your network that may have some extra cash lying around.

These people often don't truly understand your business- in fact, they may not really understand business at all- but they invest either because they believe in you, they have some infatuation with your business idea or model or because of peer pressure (someone else is investing and they invest alongside them). As investors, these people can become co-owners of or lenders to your business.

Going to FFFs or DDLs is challenging. It is hard to ask people you care about or who are in your social circle to give you money. Once you accept it, you make a deal with the devil of sorts, because now your relationship with this person has gone from its existing form to also being business partners. Sometimes, you will have to make decisions for the sake of the business that will not make your friends and family happy. This makes for some seriously uncomfortable future interactions.

Because they don't work with you on a daily basis and yet, you are using their money, your FFFs/DDLs may now:

- Want to get updates on a regular basis
- Want to put in their two cents worth of ideas (e.g. telling you, "don't you think the store would look so much better with a singing plastic fish on the wall"?)
- Want to come and hang out at your office or place of business

- Demand free or discounted products and services
- Ask you to employ your lazy cousin Nick, or
- Ask you for a million favors in return

You will have to answer to these people, who are now your co-owners or lenders and therefore, people you can't ignore. These people, based on their lack of business sophistication, can take up a lot of your time at best and at worst, will make crazy demands on you and the business.

How to avoid this mistake:

- Think about both the pros and cons of taking an investment from a friend, family member or acquaintance
- Make sure you don't take any money from someone you have a relationship with that cannot afford to lose 100% of the investment
- Make sure that you discuss the implications on your relationship if the investment is lost in whole or in part with the other party and decide if the relationship can endure if a problem occurs
- Think once again if you can handle an awkward birthday party or family dinner if things don't pan out as planned

Mistake #8- Not Achieving Milestones First

Everyone thinks they have a great idea for a business and many try to raise money for their business idea. However, the biggest bummer about business is that the ideas behind them aren't worth anything.

Ideas may have had some value back in the day when there were very few businesses in any given sector. Now that almost everything has already been thought of, not only is it hard to be innovative, but extracting value comes not from thinking of an idea for a business, but from turning it from thoughts into reality through work.

I really wish that ideas were valuable. If they were, I could have retired years ago. However, the value is in the business execution. I have said it a thousand times if I have said it once, good ideas can fail and bad ideas can succeed. The difference is the risk, time, commitment and perseverance to take an idea, decipher if there is a market need for it, create a way to reach potential customers with that need in a cost effective manner, plus be able to make the product or service at a cost that will be desired by the customer and still leave enough money left over for you to profit from it. Not to mention working at it every day indefinitely, constantly innovating and providing outstanding service and value to your customer, so that someone doesn't steal your customers and business away from you.

The more you do, the more value and credibility that you create and the less risk there is in the investment, two things that will benefit you greatly when raising capital. Plus, you will have more confidence in the success of your business.

How to avoid this mistake:

- Focus on achieving milestones. Getting past the idea stage to milestones such as building a working prototype, landing paying customers or filing defensible patents will help you to create value

Mistake #9- Not Being Scrappy

Scrappiness is one of the hallmarks of being an entrepreneur. It is the ability to take lemons and make lemonade, get the max for the minimum and generally beg and barter to make things happen. It's about trying to find a way to make things happen in alternate ways. Think of it as being the *MacGyver* of entrepreneurship. How can you extend payment terms with vendors or get paid upfront for your goods and services? Both of those efforts will decrease the amount of capital you require.

Perhaps you can trade your products or services for legal, accounting or other help? Can you use interns to help you do selected business tasks? Can you get your website done for less money by using a company located in a less expensive area of the country? Can you outsource any of your tasks to a virtual assistant, maybe even one overseas?

While you certainly can't cut out all of the expenses of your business and as a new business, it will be more challenging for you to swing "sweetheart deals", if you can be scrappy in the early stages of your company, you may be able to achieve critical milestones with less capital, making it easier to do a formal capital raise down the line.

How to avoid this mistake:

- Review your plans to see if there are any ways to extend your payment terms (without incurring penalties)
- Review your expenses to see if there is anything you can beg, borrow or barter for
- Creatively think about ways you can get paid upfront (in part or whole) for your products and services
- Continue to think outside of the box

Mistake #10- Not Understanding Debt

Someone along the way must have sent out a memo that was grossly misunderstood, because there are lots of misconceptions around debt (loans) for businesses. From the government giving away money for free (it doesn't), to the government making loans through the SBA (it doesn't - it provides "insurance" type backing to lending institutions in the SBA program to lessen the institutions' risk when making small business loans), there are lots and lots of myths and misunderstandings on the subject.

Not only is debt not free and not provided to business by the government, but lenders take the business of making small business loans pretty seriously. Getting a loan requires one of more of: (i) a good personal credit history, (ii) personal assets/collateral, (iii) business history and/or (iv) business assets/collateral. If your new business doesn't have major assets, most lenders will want you to *personally* guarantee the loan with your *personal* assets, like your house, which adds to your *personal* financial risk.

If you don't have appropriate collateral, you may find it nearly impossible to get a loan for the business. Basically, you have to be somewhat successful and have proven your financial abilities to save towards your business in order to get a loan to start a business.

Plus, if you fall behind on payments for your debt or if your business is struggling in certain areas and/or if you aren't complying with the specifics of your lending agreement (called covenants), the lender may step in and take all kinds of actions that will piss you off, but are fully within its right as a lender.

Also, many businesses are financed by another type of debt, personal credit card debt. Credit card debt is very costly and can contain double digit lending rates. This makes credit card debt a very expensive option, one that may not be able to be made up by the rate of return you produce from your business.

How to avoid this mistake:

- Make sure you ask a lot of questions about what is required of you if you take on debt
- Don't sign anything that you do not 100% understand
- Make sure to keep bank covenants in the front of your mind- even if your business is not in trouble, breaking a covenant can wreak all sorts of havoc on the business
- Don't take out any debt (including credit card debt) at a rate of interest that is higher (or even anywhere near) the potential rate of return you expect from your business
- Don't use debt to bet (or fully mortgage) the farm
- Remember that your name (and perhaps your assets) is on the dotted line- you are accountable!

Mistake #11- Not Getting Appropriate Help

So, capital raising can be complicated. You have to figure out how much money you need (which we have already established is usually more than you think) by putting together financial projections. Then, you have to think through the pros and cons of each source of capital. You may also have to put together and review various documents, whether they be loan documents from the bank or a term sheet from angel investors, or even just an agreement amongst friends and family. Plus, you may have to set a valuation and potentially even file paperwork with various governmental authorities.

If you have never done any of this before, it is complicated! Yet, it is incredibly important and you need to make sure that it is done right and that you understand fully what you are signing up for.

The mistake here is not being willing to get help (which in itself, costs money). You need to hire advisors who have experience with capital raising (not just Uncle Ira, who happens to be a lawyer) to make sure that you are getting the best advice and so that they can educate you as well- ignorance is not bliss in business. You may pay a little more up front, but you get what you pay for. Also, sometimes a bargain on very important items ends up being more costly in the end if the work takes more of your time or needs to be redone.

How to avoid this mistake:

- Be willing to ask for help
- Review credentials to make sure that the firm or people helping you have experience working with your size company and have capital raising experience too
- Make sure that you clearly outline expectations and understand exactly what you receiving in terms of advice and help
- Ask for explanations so that you can become educated too- since your name is on the dotted line, you will want to "sanity check" all work done for you by any advisors

Mistake #12- Raising Money to Replace Your Old Salary

Before you started your business, you may have had a good salary that helped you pay for nice things, like your home, car and yearly trips to Disney World. Once you leave that job to start a business, you may figure (as so many aspiring entrepreneurs do) that you need to replace that salary in full to maintain your lifestyle. You decide that since you could find another job that pays that much, you are obviously worth that much and that investors should be willing to pay you that kind of salary for working in your new business. Plus, if you are raising equity, you also figure that you deserve the lion's share of the equity stake.

Yeah, that's not how things work in the real world.

Nobody wants to invest in your salary. They want to invest in the business, more specifically, a business that will grow and make them a hefty investment return. If you think the idea is so great and you want to keep all of the equity, you better be able to either support that with your own capital or be willing to put in "sweat", aka hard work that you get in exchange for the equity- that is your payment.

If you want a large salary, that makes you a hired gun, not an owner.

You can expect some small amount of money to live on, but start-ups usually pay below market salaries to keep costs down. Asking for a premium salary throws up all kinds of red flags for investors (and they may, in turn, throw-up on your business plan). It says you care more about sustaining your lifestyle than doing everything possible to make the business work.

How to avoid this mistake:

- If you want to make the business a success and have a meaningful stake in it, then forget the big salary for a while
- If you want a big salary, then keep your day job

BONUS: Mistake #13- Assuming That Raising Capital is a One-time Event

So, you have written the plan, given your pitch, waited for months longer than you expected and finally the checks have been written and you have raised capital. Thank goodness, you think- you never want to go through that again. The problem is that the capital raising process is rarely a one-time event. As your business evolves and growth prospects present themselves, you have to have funding to grow the business. The more growth you have, the more money that is needed to cover working capital items like inventory and accounts receivable. This means, that if you have visions of growing, you are going to need to consider capital raising, whether through equity or debt, on an ongoing basis. Having no capital needs often means you are not growing, which is not a great prospect either.

How to avoid this mistake:

- Get comfortable with the notion that you will have to raise capital over the long-haul

About Carol Roth

Carol Roth helps businesses grow and make more money. An investment banker, business strategist and deal maker, she has helped her clients, ranging from solopreneurs to multinational corporations, raise more than $1 billion in capital and complete hundreds of millions of dollars in M&A transactions, secure licensing and partnership deals and more. She is a recurring featured guest on *Women Mean Business* (Pittsburgh Business Radio *WMNY*) and she blogs about issues affecting entrepreneurs and their businesses from her *Unsolicited Business Advice* blog at CarolRoth.com.

Her book, *the Entrepreneur Equation*, helps entrepreneurs evaluate the realities, risks and rewards of entrepreneurship. It is due out in Q4 2010.

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