Title:
New Business - Trading Equity for Cash

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Summary:
You awake in the middle of the night with a business idea that will change the world. The only problem, of course, is you need money to get the business moving. What do you do?

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Article Body:
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Investors and Equity

Practically every economy is built upon the backs of small businesses and entrepreneurs. Every day someone comes up with an idea that will make a great business. Every day, these same people wonder how they will come up with the cash to get the business off the ground. The classic answer is to look for investors, and this is where things can go bad.

If you're seeking investors for your business, you are going to need to form a business entity. Corporations and limited liability companies are the most popular, and give you the ability to trade ownership interest in exchange for cash contributions. With a corporation, investors will buy shares in the corporation. With limited liability companies, the investors will buy membership interests. Regardless, this traditional exchange gives rise to a problem common among small business owners, to wit, giving away too much equity.

From Joy to Misery

A common mistake made by new business owners is to give away too much equity when getting initial cash contributions. This occurs because you let insecurities impact you evaluation of the business. Instead of giving away two percent of equity in exchange for $50,000, you give away ten percent. Let’s look at an example.

I start a business selling digital gadgets. I prepare my business plan and realize I need $250,000 to get everything up and running. I have $50,000, but need to find the rest somewhere. I form a corporation with 1,000 shares and start approaching potential investors. I offer 100 shares for $25,000. I find five investors that give me $125,000 in exchange for 500 total shares. In summary, I now have $175,000, but have given away half the equity in the business. While I am not happy about this, I am still so enthused about the business idea that I shrug it off.

The business gets rolling and I start selling gadgets like a madman after one year. This gives rise to a serious cash problem. I am getting orders, but can’t fill them because of cash flow problems. To make a proper go of the business, I need another $100,000.

Where am I going to get $100,000? My business is only one year old, so a bank won’t touch it. My investors haven’t seen penny one back, and are unwilling to put more money in. My only option is to sell another 400 shares for $100,000. Fortunately, I sell the shares, raise the money and stay in business. However, there is a major problem.

In raising all of this money, I have now sold off ninety percent of the equity in the business. I am left owning 100 shares and only 10 percent of the business. This is going to severely impact my physical, emotionally and overall motivational well being. Slowly but surely, I am going to become very bitter. It was my idea and I am doing all the work! It isn’t fair that I only own 10 percent of the business!

On second thought, this impression may come on very quickly. Regardless, the business is destined to experience major problems because the primary motivating force is no longer motivated. Unfortunately, many people with business ideas run into this problem.

If you are starting a business, guard your equity at all costs. Selling equity should be a last resort. Try to get loans or trade profit sharing in lieu of selling equity. If you must sell equity, do so only in small percentages. You do not want to the small business person in the example above.