Take Control of the Equity Raising Process

by Michael D. Fox and Steven M. Cherin

Obtaining early stage equity financing is almost always a critical step in the successful ramp-up of a business. After all of the family and friends have been tapped, the government grants have been exhausted, the strategic partnerships have been explored, the traditional debt financing sources have reached their limits and the credit cards have been maxed-out, still more money will be needed before most companies are able to survive and grow. Private equity financing, if not as inevitable as death and taxes, is a necessary process. Rather than ignoring the likelihood, founders should anticipate the need for private equity financing and take control of the process.

Unfortunately, this critical step in the life of a business frequently is undertaken by inexperienced founders in haste, under duress, without preparation and with a near pathological fear of involving experienced lawyers and other professionals until the last possible moment.

Fortunately, there is no reason for this to happen. Substantial returns will be generated from a little time invested in (i) involving the right professionals in advance, (ii) understanding the financing process and the critical issues for investors and founders, (iii) developing a realistic perspective of the value of what you are offering investors, and (iv) "cleaning up" the business (both figuratively and literally).

What should the founders of a growth oriented business be doing?

❑ Anticipate cash requirements, and start the process well in advance of need

A familiar adage provides that it is easiest to raise money when you don't need it. The corollary to this adage should be obvious, but many founders seem to forget that you can't negotiate a good deal when you are desperate. You can't maintain the momentum of your business and take advantage of opportunities if you are forced to retrench to conserve cash during the financing process. Don't wait until all other sources of funds have been totally exhausted; start the private financing process while you still have the opportunity to explore alternatives.

❑ Learn the steps of the financing process and what is important to each party

By understanding the process and everyone's expectations, not only will you do a better job for yourself, but you will receive higher marks from prospective investors evaluating the quality of your company's management. Remember, the process involves a securities transaction, as well as a variety of contractual relationships. And, lack of understanding of the process will be no excuse down the road when it is time to deal with any problems that result. In this regard, advisors who have handled other similar transactions will provide you with an understanding of both the process and realistic expectations.

❑ Learn the sources and forms of financing available to you

Private equity investors come in all shapes and sizes. They range from "angels" to strategic investors to locally based funds to national venture funds, each with an appetite for certain types and sizes of investments. Proper targeting of prospective investors increases the probability of success both in obtaining money and in realizing added value from the involvement of the right people with your company. The form of the investment often can be structured to meet the needs and preferences of a desired investor, while still maintaining necessary long term flexibility. Understanding potential options, problems and risks in advance will help you avoid agreeing to the "wrong" deal with the "wrong" investors, that is, a deal that you are forced to make because cash shortages preclude you from walking away.

❑ Eliminate inadvertent deal killers

Obtaining financing is like a mating dance. First, you have to attract attention, and then you have to survive a preliminary screening process that is designed to quickly reject most suitors. Good professionals and proper preparation will help you avoid unnecessary, front-end deal killers. Typical deal killers include poor presentations, bad timing, unrealistic expectations as to the level of risk, unrealistic estimates of time necessary to achieve business objectives or cash requirements and, often most importantly, differences in valuing the business. At this stage of the "dance", a frequent and often unnecessary investor turnoff is any business problem that presents an abnormal risk, such as a threat of litigation or regulatory problems, uncertain ownership of critical assets, or poor contracting practices.

❑ Avoid unpleasant last minute surprises

Deals can be lost at the last minute, or terms substantially toughened against the founders, when a last minute problem arises in the "due diligence" process. After the preliminary screening, the parties usually agree on the general terms of the deal pending completion of a more thorough due diligence review. The "cost" of solving the problems generally increases geometrically as the closing date approaches, because your negotiating strength typically is at its weakest. A critical internal review of your business before you begin the fundraising process in earnest can often identify, control, and eliminate problems before they interfere with your ability to raise the most money with the least dilution and restrictions on your activities.

❑ Get full value for what you are selling

Although the process of equity financing involves myriad details and agreements, the "pricing" of the deal is usually most important. After all, you are selling part of your equity and control because you need cash; the investors are selling cash (and, of course, their experience and contacts). The pricing process begins with a demonstration of sustainable earnings power, which in turn begins with supportable projections. Supportable projections require you to understand the strengths of your company, its market and market position, and its strategic posture, including its opportunity for growth and the capacity to accommodate growth. Whether it is technology, strong management, synergies with the investor's other activities, or a diversified and loyal customer base, you must develop in advance and then clearly articulate the investment merits of your company.

Even after a valuation of the company has been established, the pricing of the investment will depend upon the type of equity sold — common stock, convertible preferred stock, convertible debentures, debentures with warrants and any combination thereof — and whether there is any traditional bank financing to be obtained in connection with the equity. Creativity in this area can often provide the investors with protection while leaving the founders in control.

❑ Get the deal done quickly, properly, and on budget

Both the investors and the founders, as well as their advisors, want a quick closing. The paperwork and meetings will take longer than anyone likes, and tensions may develop. What many founders often fail to appreciate is that the negotiations and compromises reached are critical to achieving a balanced, properly documented deal. Advanced planning and experienced advisors can help smooth and expedite the process, which should keep costs down as well.

❑ Picking the "right" professionals

In order to be properly prepared and to close any private equity financing, you need the "right" team. You will want broad based, creative, business-oriented lawyers and accountants who understand your business and its present and future needs. These advisors should have experience from numerous private equity transactions to assist you with the planning process, the negotiations and the documentation. These advisors should be known within the investment and venture community and take the time to work with you directly rather than delegating responsibility for your financing.

If your business has growth potential, it is likely that you will have to seek private equity to fund that growth. With the proper planning and advisors, the short-term "pain" of the process can be reduced and the long-term prospects for success from such investment enhanced for both the founders and the investors.

This Article first appeared in the Forum Reporter – Vol. 10, No. 3, published by MIT Enterprise Forum – Pittsburgh Region

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