Chapter 9

• Demonstrating Personal Commitment: Sweat Equity

  • Restricting cash outlays to those areas that are critically important to winning over support from external financiers, and by
  
  • Designing a business model that minimizes capital requirements from the start, for example one start-up that I am familiar with was able to convince customers to "pre-pay" for services by charging a retainer fee up front

9.4.1. Family and friends

As the entrepreneur exhausts personal funds, initial approaches are often made to those individuals best positioned to assess their personality and intentions, their immediate family members and friends. In fact, family and friends is the second most important source of capital after personal funds. Approximately one in ten of the Inc 500 fastest growing companies relied on family and friends for seed capital. Typically, family members and friends are financially unsophisticated, place small amounts of capital at risk and exercise little real influence over the business. Two caveats need to be raised, however. The presence of a large number of active, minority shareholders can dissuade professional investors from participating later on. As importantly, if you decide to bring on family and friends as investors, you must be prepared to lose them if things go wrong down the road, as they often do with new ventures.

If you wish to raise capital from family and friends, I have two bits of advice. First, be very clear with the family member or friend that you do not want their active involvement in the business unless their skills and experience investing in or managing a new venture warrants it. Second, I recommend that you draft a shareholders agreement clarifying your joint understanding of each other's rights and responsibilities. Of great importance at an early stage, is to agree on the manner in which family and friend investors can be bought out.

9.4.2. Commercial banks

For many entrepreneurs, the logical first place to seek out "equity capital" is a visit to the local bank. In most instances, this initial approach is a disappointing one for entrepreneurs as they discover two fundamental truths about debt. First, debt instruments by design are not well suited to finance the needs of young businesses. Second, the return earned by the bank on debt finance is far lower than that required by external equity investors. In short, banks are in the business of low risk, low return lending not high risk, low return investing. Banks exist by ensuring that loans are made to applicants who can and do
repay. Their very existence depends on their ability to avoid costly "loan mistakes".

When advancing any loan, banks look to the applicant's character, capacity to repay, and the collateral or security available to pledge in support of the loan. In assessing character and capacity, an established track record, as demonstrated by financial reports, is often a necessary prerequisite for any deal. Not surprisingly, a start-up or very young venture has not been in existence long enough to establish a "track record" to evaluate. Moreover, as the asset base of many new ventures is largely intangible in nature, there is little in the way of "hard security" (such as land, buildings, equipment) to support a loan request.

A few words of advice when considering raising debt finance. First, approach the bank with the "right request". Banks are most comfortable providing working capital loans and fixed asset financing. Second, approach the bank at the "right time". By this I mean, when your venture has an established track record of performance. Third, be prepared to be asked to pledge your personal assets in support of business loans, so-called "personal guarantees", particularly in situations where the relationship with the bank is relatively new. Fourth, a proportion of the finance required to acquire assets on a term loan basis will need to be provided by you from outside sources other than the bank. Finally, fifth, bankers do not like surprises, you are well advised to keep them thoroughly informed of your plans and progress well before and particularly after raising debt finance.

9.4.3. Business angels

There is growing international awareness of and appreciation for the important role played by private individuals, so-called business angels, as a source of equity capital for entrepreneurial firms. Many prominent firms including Ford Motor Company, Amazon.com and Apple Computer, among countless others, have been started on the back of capital provided by business angels. Collectively referred to as the informal venture capital market, business angels are by far the largest source of external capital for particularly early stage firms in most major capital markets, including the USA and UK. By some accounts, there are more than three million business angels in the USA who invest more than $50 billion per year in thirty to forty thousand businesses. To put these figures into perspective, compared to the entire US venture capital industry, business angels invest five times as much capital in thirty to forty times as many ventures as do venture capitalists.

Based on extensive international research, the emerging portrait of a "typical" business angel is a middle-aged male who has started, and likely
successfully cashed out, of at least one venture in which they have had a direct role in building. They are attracted to situations in which their business experience and contact base is of relevance and where the prospect of capital gain in four to seven years is present. From the outset, most business angels are also intent on being actively involved in the businesses in which they invest. Rather than being a way for investors to "check up" on the entrepreneur, active involvement is a key non-financial driver for the investor. They see their involvement as potentially improving the odds of success and, importantly, being a "fun thing to do".

Much like venture capitalists, a proposal must offer the prospect of substantial capital gains on invested capital and hence must be a "growth" story. Both want to see a detailed business plan that will be critically reviewed. Unlike venture capital funds, that invest other people's money, business angels place their own capital at risk and as we shall see in the section that follows, they "do not need to invest". Aside from this, another critical difference between these markets is that of visibility. There are many public directories available providing contact details of venture capital funds. However, in an effort to control the level of unsolicited deal flow being brought to their attention, business angels prefer to keep an anonymous profile. The challenge for entrepreneurs, therefore, is to find the right business angel and the task is not easy as the informal venture capital market has been aptly described as: "a giant game of hide-and-go-seek with everyone playing blindfolded!"

Business angels are an integral element of a firm's financing strategy because they place smaller sums of capital at risk at earlier stages of development than do venture capital funds. More importantly, the breadth and depth of business, industry and new venture experience are critical resources in the inceptive stages of venture development for any business. But how can you find a business angel if the market is practically invisible? First, there are a number of organizations that provide forums to bring together entrepreneurs and business angels. For instance, here in Finland, there is a Business Angel Matching Service managed by SITRA. In the UK, Professor Colin Mason compiles a listing of business angel matching services on an annual basis available on line from the British Venture Capital Association (www.bvca.co.uk). Second, specialized publications have emerged profiling potential investment opportunities to business angels. The longest established of these is Venture Capital Report (www.vcr1978.com). Third, entrepreneurs have been able to identify potential business angels by asking companies that have raised finance externally from these individuals and through intermediaries such as lawyers, accountants and consultants.

From my long experience of dealing with business angels in the UK, USA and elsewhere, here are a few words of advice. First, your business plan must not only be a convincing growth story but must captivate the imagination of
the private investor; expect a long fundraising process and numerous false
leads because many individuals will respond "nice opportunity but not for
me". Second, you must want more than the business angel's money: if it is just
money you are after, look elsewhere. Active involvement is a major non-
financial motivation for investors, you must specify very clearly what you
want from them. Third, you must be able to demonstrate that the prospect of
substantial capital gains is available. Business angels are not philanthropists,
at least not the successful ones, and need to be convinced of the business
merits of the deal presented. Fourth, entrepreneurs should do their own back-
ground checks of the investor as the investor will do of them. Ask to speak to
entrepreneurs who have raised money from this individual before. Fifth, the
personal chemistry between the parties has to feel right or the deal is not
worth doing at all. Finally, sixth, the most productive way to meet private in-
vestors is to be referred to them from an individual who is known to them and
trusted by them. Most successful deal completions start from an introduction
made by a close business associate or personal friend of the investor.

9.4.4. Venture capital funds

Venture capital has been in existence for hundreds of years but in its
modern organized form has only flourished in the past decade or so. A ven-
ture capital fund is typically a tax efficient vehicle for institutional investors,
such as pension funds, insurance companies and banks, to pool their resources
together around a team of fund managers who acquire equity stakes in aspir-
ing entrepreneurial ventures. Most venture capital funds are arranged as term
limited partnerships. The fund is established in a way that "limits" the poten-
tial losses of fund investors to the amount of their capital contribution and is
set up with a limited lifespan, typically ten years. Fund managers are incen-
tivized by a small annual fee to cover operating costs and, more importantly,
by a percentage carried interest in the capital gains realized by the fund, typi-
cally 20% - 25% net of any preferred returns to fund investors. Over the term
of a fixed life fund, the focus of activity moves from finding new deals,
through to follow-on investing in existing portfolio companies and finally to
realizing value through exits (trade sale, public listing).

While the odds of finding a venture capital fund is highly probable, the
prospect of actually securing venture capital backing for your venture is very
remote. When a prominent venture capital fund manager in London was
asked: "What proportion of deals presented to you actually get funded?" His
reply was: "Two or three in a hundred." When asked how the odds would
change if the business plan were simply sent to him "cold" (no referral), they
lengthened to: "One in five thousand or practically zero!" Why is this the
case? Experience has shown that for every ten deals a venture capital fund actually does do, two are failures (involving some capital loss), six are disappointing (the so-called "living dead"), and two offer spectacular returns ("golden geese"). The search for "golden geese" is the essence of venture capital investing. How do fund managers compensate for their inability to always pick "golden geese"? They evaluate the merits of proposals on the basis of very high hurdle rates to compensate for the risk. To them, the younger the company, the greater the risk and thus the higher expected return. While difficult to generalize, the expected returns on a first round seed investment (no sales yet) is in the order of 80%+ per year compounded. Expected returns for companies that are selling and profitable can also be as high as 30% - 40% per year compounded. To put this in perspective, a $1 seed investment made today would have to grow to almost $20 in five years just to meet the return expectations of investors. This illustration reinforces the importance of a strong growth story if an entrepreneur is seeking out venture capital.

Table 9.1. Venture capital fundraising activities - Source: Venure Economics

<table>
<thead>
<tr>
<th>Year(s)</th>
<th>United States</th>
<th>European Union</th>
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</thead>
<tbody>
<tr>
<td></td>
<td># funds</td>
<td>amount raised</td>
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<tr>
<td>1990-1995</td>
<td>633</td>
<td>35,2</td>
</tr>
<tr>
<td>1996</td>
<td>186</td>
<td>13,5</td>
</tr>
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<td>1997</td>
<td>247</td>
<td>18,8</td>
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<td>300</td>
<td>32,2</td>
</tr>
<tr>
<td>1999</td>
<td>449</td>
<td>65,9</td>
</tr>
<tr>
<td>2000</td>
<td>640</td>
<td>113,0</td>
</tr>
<tr>
<td>2001</td>
<td>228</td>
<td>34,6</td>
</tr>
</tbody>
</table>

9.5. Fund Raising Climate

There has been a virtual explosion in both the number of new funds being formed and the amount of capital inflows into the US and European venture capital markets in recent years as demonstrated in Table 9.1.
9.8. ♦ Initial Public Offerings (IPOs)

Many aspiring entrepreneurs dream of taking their company public. However, in reality, relatively few actually do. Throughout history, there have been periods where public equity markets have been able to offer investors spectacular returns and entrepreneurs access to large pools of capital to finance growth. In fact, we have just lived through an unprecedented period of "public equity frenzy" that peaked in 1999 and 2000. Past history also sug-
gests that what rises also falls back to earth and such is the case with public equity markets in 2001 as we shall soon see.

To give you a sense of just how unprecedented 1999 and 2000 actually were, consider the following example. Sycamore Networks (Nasdaq SCMR), a well-known Boston-based optical networking company, was established by Desh Deshpande and Dan Smith in early 1998. At the time of going public, eighteen months after starting (October 1999), Sycamore had never posted a profit yet was able to command a capitalization of $1.5 billion based on an offering price of $18 to $20 per share. The share offering was oversubscribed by a factor of 11, the offering price was subsequently raised to $38. On the first day of trading, the opening share price was $270, valuing the business in excess of $20 billion, a business that had been in existence less than two years and never produced a profit! In the judgement of investors Sycamore was worth as much that day as such established corporations as Kodak, Fuji Film, Nike, Heineken, BMW, or Seagram. Clearly investors were placing a lot of weight on the future prospects of this company. What has the stock done since you ask? As I write this, the stock is trading at under $20 per share, split adjusted; many investors are clearly "licking their wounds" from this story. What should you as entrepreneur consider in seeking to raise capital from public markets? It is to this question that we now turn our attention.

9.9. ♦ Going Public: Some Considerations

We shall briefly summarize some of the key advantages and drawbacks associated with the decision to take a firm public. Some of the most often cited advantages or benefits from going public include:

- To enhance corporate visibility and profile as a means for securing new sources of finance, building strategic partnerships and attracting talented employees
- To raise large sums of capital to support future growth and development of the business
- To provide an exit mechanism for outside investors in the business
- To create partial liquidity for the entrepreneur while retaining a measure of managerial influence over business operations

Among some of the most significant drawbacks of going public include:
Chapter 9

♦ Going Public: Some Considerations

- The costs involved in the process of going public including the preparation of a prospectus, legal documents, underwriting fees and the like can be quite large (up to 10% of the amount raised in some instances)

- Entrepreneurs are expected to retain a significant equity stake post IPO, thus they cannot expect to achieve total liquidity

- Being public implies increased time and attention being devoted by senior management to matters related to disclosure of material facts that could have some influence (positive or negative) on the share price

- An increased focus on meeting short-term earnings per share targets often to the detriment of the longer term growth of the business

In my experience, the other factor that is absolutely critical in the decision to "go public" is timing. Companies that raised capital in 1999 and 2000 found investors that were eager to put their money down at valuations that would make any entrepreneur and venture capital investor breathless. What we do know from past experience is that the health of the venture capital market is inextricably tied to the health of public equity markets. When public markets are providing healthy returns and are receptive to initial public offerings, the level of venture capital fundraising and investing activity increases almost lockstep. However, the other thing that experience suggests is that "what goes up can and does go down".
9.11. Concluding Remarks

In my experience, the keys to successful fund-raising are in knowing what to ask, who to ask and when to ask. Making a clearly inappropriate request to the wrong source at the wrong time sends a very powerful signal to resource providers that you have not carefully thought through your fund-raising strategy, an easily avoidable mistake. In this chapter, our aim was to provide you with a framework for thinking about what types of finance are appropriate as the project develops. Your ability to successfully negotiate will critically depend on the information you can give resource providers as to the inherent risks of the project, and crucially your anticipated responses for dealing with them. In this respect, the experience of 3M in matching risk and resource commitments is insightful. Throughout much of its early life, the 3M philosophy was "spend a little, make a little, sell a little", "spend a little more, make a little more, sell a little more", and so on. In short, projects were financed as a series of experiments with 3M maintaining an option to abandon the project if circumstances warrant. Entrepreneurs are well advised to think about the major development milestones in their own ventures and tie fund-raising efforts to these milestones, such as developing a prototype, making the first sale, establishing an international office, and so on. In so doing, both you and your external financiers maintain the option to reevaluate whether to finance the next milestone based on information and experience from the previous one.

In closing, here are four bits of advice. First, be prepared to face resistance. Few outsiders feel as passionately about the uniqueness and the path-breaking potential of your ideas as you do. Second, be prepared for tough questioning, particularly from private sector financiers. The more information you can provide them about the associated risks and competitive landscape the better. Third, be prepared to hear "no" a lot. True entrepreneurs are not deterred by "no" and persistently seek out someone "more enlightened" who will say "yes". Finally, "timing is everything". As we have demonstrated in this chapter, private equity markets can be "white hot" (1998-2000) or "freezing cold" (2001). While it appears that venture capital funds have temporarily "lost hope", I can assure you they have not "lost faith" in financing promising start-up ventures. Recent market sentiment cannot hide the fact that developments in the communications sector are both exciting and potentially disruptive. The question in every one's mind at the moment is "when does the fun really start?".
REFERENCES


