



GUEST COLUMN

Is your firm ready for institutional capital?

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Capital is the lifeblood of expanding, technology-based businesses. When an early-stage company develops to the point where institutional capital is a consideration, it should have an established track record of increasing success (on a trend basis) and the ability to apply the capital to improve its competitive advantage and growth rate.

Many entrepreneurs think only in terms of equity investment. As a company matures and adds to its assets base (equipment, accounts receivable, etc.) it is often in a position to consider debt in the overall mix of funding. Presented below are three institutional capital sources and a brief description of what to expect when approaching them to invest in your company.

Venture Capital

Venture capital (VC) firms have a long history of investing in high growth companies. While some have a reputation for perfidiously gaining control from a company desperate for capital, the vast majority are solid organizations that seek to gain a return for their own investors by helping entrepreneurial organizations improve and expand their businesses. Venture capital firms span the gamut of investment preferences along the following variables: company stage of development, investment amount, industry, revenue run rate, location, and other attributes. Researching a potential funding source is a valuable exercise to understand their investment philosophy and typical deal structure.

Funding is a process and must be orchestrated to achieve the most beneficial effect. It is often best to rank order a list of funds by those most likely to find interest in the investment opportunity. To attract the attention of a VC firm it is always best to be referred by someone in your network: accountants, attorneys, consultants, or other business associates. VCs will always put a personal recommendation above a cold call.

Regardless of the funding source you are soliciting, be prepared for hard questions that will challenge fundamental components of the business model, as well as the inevitable, "what is your valuation?" Determining the value of an early-stage company is part science, part art, and mostly negotiation. An early-stage company often lacks enough track record to compute an

accurate valuation. And any future earnings-based valuations will be highly suspect. Some VCs will have a range of equity they want to acquire through one or two funding rounds. The company founders should have their own range in mind as they approach investors. The founders should have an idea (or goal) of their ultimate equity ownership following all anticipated funding rounds.

Venture firms interested in exploring an investment in your company will go through a detailed due diligence process. The timeliness and quality of everything presented to the VC - from an executive summary to financial projections - forms an opinion in their minds and will help build confidence in your management team. The due diligence period can be as short as a few weeks or as long as several months. One of the most important things an entrepreneur can do during this period is to continue to run the business and hit milestones. Nothing derails an interested investor faster than losing focus and missing projections.

Banks and debt resources

Banks fill a very important role in the development of high-growth businesses. Some of the advantages of debt include: 1) debt is less expensive than equity, as the entrepreneur does not have to share the upside with creditors; 2) debt financing is typically easier to obtain than equity; 3) debt leverages the equity investor's return on investment; and 4) interest payments are tax deductible. The downside to debt is that it requires the ability to make regular payments regardless of the company's profitability, potentially starving the company of cash necessary to grow the business. Creditors can also have covenants in their agreements that impose restrictions on how a company is run. All lenders will seek to secure their loans with tangible assets, such as equipment or real estate, and accounts receivable. Other assets, such as product patents, source code, or other intellectual property is often pledged as well.

Most early-stage companies will only be able to secure recourse debt. A recourse loan requires the entrepreneur to personally guarantee the repayment of the loan. If the business becomes unable to make further debt payments, the lender has the legal right to seek repayment of the loan from the guarantors. The company's assets are liquidated first and the guarantors must repay any remaining unpaid debt.

Non-bank lenders

There are several organizations that provide financing to early-stage companies in the form of debt, but requiring far less collateral. Organizations making these loans typically have some affiliation or sponsorship from a state government or state or local economic development office. These loans are unsecured, or risk-based. The scrutiny and process required to attract such funding, however, mirrors that of venture capital. These loans are repaid under many different formulae, with a common approach of repayment in the form of royalty payments. The benefit to the entrepreneur is that, unlike conventional debt, payments are only made when products or services are being sold. The downside to non-bank debt is that it is often very expensive. When the repayment schemes are analyzed to determine an adjusted interest rate, it is frequently in excess of 20 percent.

Summary

Funding is a process! As potential investors are identified, they should be approached in a similar fashion to selling a high-priced product or service engagement. The "leads" should be qualified during each conversation or meeting. Information should be presented at a high-level for the first meeting and add more and more detail during subsequent meetings. This "peeling of the onion" helps to maintain interest and begins to build a relationship between investor and entrepreneur.

While even the best businesses led by top entrepreneurs cannot be guaranteed of achieving funding, odds are increased by understanding the process and planning ahead. After the check clears the bank and the celebration is over, applying funds to building a quality company based on solid business fundamentals will increase shareholder value and position the company for realizing a successful exit strategy.

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