Are You Ready To Raise Capital For Your Company?

It’s a fact. Starting and building a business is grueling. You dream up and design a better mousetrap, hire employees, find office space and build a client base. Plenty of challenges confront you along the way, none of which are considered to be as daunting as raising capital.

Say good-bye to the days of pitching investors with the latest and greatest technology ideas while expecting them to write you a check. Say hello to this day and age of the post “dot bomb” era investors who lived to talk about it. That is why it is now more critical than ever to discipline yourself to learn the types, processes and important tasks involved with raising capital for your company.

The purpose of this article is to help educate you on how to raise capital. This article will touch on three primary areas for you to consider in determining if you are ready to raise money for your company:

1. What type or stage of capitalization do you need?
2. The importance of the business plan and a sound business model.
3. What are investors looking for?

What Type or Stage of Capitalization Do You Need?

It is important to understand the type or stage of capitalization you need when talking to investors. Most experienced investors will want to know what type of funding you need, and why. They will also expect you to somewhat understand the stage you are in, so as to qualify how their dollars will be spent.

Although there are exceptions, the stages of capital roughly follow the stages of business:

- Embryonic capital is sought for concept research
- Seed capital is sought by entrepreneurs with concept and business plan validation
- Start-up capital is sought by new ventures ramping up for operation
- Mezzanine or expansion capital levels one and two for growing and mature companies
For the purpose of this article, we will concentrate on the traditional forms of equity and not touch on the traditional and non-traditional forms of debt a company can use. The capital marketplace essentially uses two key principles to guide investment decisions:

- Risk - measurable probability of losing or not gaining value on a security or capital investment
- Return - the expected or necessary return on investment (ROI) that a capital investment is expected to provide to an investor to compensate for the risk associated with that capital investment

Traditional equity sources are willing to assume relatively higher levels of risk and expect relatively higher rates of return.

**Traditional Equity**

Equity investors invest to participate in your company’s future value. Equity investors literally "buy" ownership in your company, in exchange for the opportunity to sell that ownership at a later time when the company’s value has significantly increased. Generally speaking, your company has five groups (or rounds) of equity sources to potentially tap:

1. Founders
2. Friends and family
3. Suppliers, business vendors or customers
4. Angel investors and wealthy individuals
5. Venture Capital - A and B Rounds

**Founders:** It only makes sense that those closest to the action and passion are the ones to usually provide the initial funding and start-up capital for a new business. Usually, the founders and partners provide just enough money to get through the embryonic stage of the company, yet enough money to prove there may be something there. Founders invest “sweat equity,” personal time, energy and credit to get a business started. They typically make direct investments by tapping personal savings, credit cards, home mortgages and small bank loans.

**Friends & Family:** Most businesses, rapid growth or otherwise, also turn to friends, relatives, business associates and other nonprofessional investors who have personal connections to a company's founders. Such investments, usually made in businesses at early stages of capitalization, are loans from friends and relatives, or through loan guarantees.
Suppliers, Business Vendors or Customers: Most people never even consider how valuable a source for funding potential suppliers, strategic partner vendors or customers can be to their efforts to raise money. Sometimes, larger suppliers have special funds within their company to do nothing but invest in up and coming companies that could help expand their business and investment portfolios. They will usually know your vertical market very well and will help ensure a steady supply of their products or services at market, or better than market, rates.

The same concept applies to business partners such as potential VARs (Value Added Resellers) or OEMs (Original Equipment or Private Label partners). Existing or future customers can surprisingly be excellent sources for funding. In every vertical market are those ‘innovator’ types of organizations that always want to be out in front of their competitors, and may be great resources to tap for funds that will also help them in the short and long term from the product or service standpoint.

Angel Investors and Wealthy Individuals: Early stage investors include most high net worth individuals, or "angels." Such investors are usually looking to place anywhere from $250,000 to $5,000,000 in capital. They typically expect returns ranging from 30-100% per year, and want to be able to exit from the company (i.e. able to sell their ownership) within three to five years. Wealthy quasi-professional investors will make direct investments of $5,000 to $250,000 per investor, often based upon the personal character of, and their relationship with, the founders.

Venture Capital - A and B Rounds: The later stage investor pool consists largely of venture capital firms and institutional investors often recruited by investment bankers. However, in recent years it has expanded to include pension firms and mutual funds. Later stage investors are usually looking to place at least $2 million in companies and will often find co-investors for a total of $5 million in investments. This helps spread out their risk. They expect their financial return in a three to five-year time period. They expect at least 10 times their investment in return. Out of 10 deals they would do, four to five of them will never see a return, two will do 20-30% returns and two to three will be the 10 times “home runs” they covet.
Rapid growth companies, well into the startup or first expansion stages, will often require even larger sums of outside capital to further expand their marketing efforts, launch new products, open new plants, etc. Later stage investors can be particularly helpful in financing these types of endeavors. This group is important because many early stage companies, particularly rapid growth companies with large research and development, fixed capital, or marketing needs, will often need to seek outside professional, early stage investors to infuse larger sums of capital and to provide guidance to the firm.

**Typical Capital Uses:** Capital is usually invested based in part upon how the capital will be used. Accordingly, it is important to understand how capital uses differ depending upon your company’s business type and stage of development. An overview of different capital uses at different development stages is shown in Table 1 below:

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<tr>
<th>Source of Funds</th>
<th>Rapid Growth</th>
<th>Steady Growth</th>
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<td>Founders</td>
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<td></td>
<td>• Research and development</td>
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<td>• Raise seed round of capital</td>
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<td>• Building prototype and pilot</td>
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<td>• Hiring initial management</td>
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<td>Founders</td>
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<td>Friends and Family</td>
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<td></td>
<td>• Operating and refining pilot</td>
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<td></td>
<td>• Equipment, facilities and inventory</td>
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<td>• Working capital for better management, more staff, marketing and sales, and raising capital</td>
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<td>Angels</td>
<td>Mezzanine or Expansion Rounds A &amp; B</td>
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<td>• Additional production capacity</td>
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<td>• Marketing and sales</td>
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<td>• Facilities, equipment &amp; inventory</td>
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<td>Venture Capitalists</td>
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*Table 1. Overview of Different Capital Uses*
As a company's growth stage and the capital sources available are compared, a road map of traditional equity can be constructed over a company's growth cycle.

With the V2R Group Business Capitalization Road Map in mind (shown above), you should be able to select which types of capital can most likely be sourced to meet your company's financing needs, depending on your company's development stage. Of course, V2R Group can help guide you through this process.

**The Importance of the Business Plan and a Sound Business Model**

Imagine the look on your bankers’ faces if you asked them to finance your dream home or office building without a set of blueprints or architectural plans. That would be the same look you will get from your future management team and potential investors if you asked them to be part of your brainchild and business without showing them your business plan. Plans are assumptions you make as a way to memorialize where you want to go with what you know as of that point in time. The plan is used as a foundation for all decisions.

The importance of planning is essential to the success of any business venture. Everyone knows that changes will be made along the way, and the plan is not gospel. The plan is a road map that proves you are willing to think through all the issues relating to why this venture will succeed and that you are willing to point out any potential challenges you forecast along the way.

The first step to any successful venture or your process of raising capital is the business plan. It is not only important that you have your business plan ready to show to any potential investor, but also that it contains the
right information. Here are some questions you need to ask yourself and answer in the business plan:

1. **Who are we?**
   Define your business.

2. **What do we want to do?**
   Detail your product, market, revenue and margin objectives.

3. **Why do we think we can?**
   You need to do a competitive analysis of you vs. other players, and make the case that you have a value proposition that will attract buyers. Sun Tzu in the *Art of War* says, “One who does not know the enemy and does not know himself will be in danger in every battle.” Make sure you spell out how and why you will win the battles.

4. **What actions are necessary to make it happen?**
   These are the strategies and tactics that are needed to achieve the end objectives.

5. **How much will it cost?**
   This is where you will detail resource planning for such critical assets like capital, people, cash and hardware.

6. **Can we meet the objectives we set above with the resources and time we have set for ourselves, and what value can we create from this effort?**
   You have to be realistic in this section and present a plan that is credible when laid against existing benchmarks in your vertical markets and like businesses.

**Structure and Key Components of a Business Plan**

The key element of a plan is that the destination or goal will not change. If you were taking a car trip in the wintertime from Chicago to San Francisco, the odds are good that you will meet some challenges along the way. Such challenges could be road construction detours, snowstorms, ice patches and car trouble. However, despite all the unknowns that may happen, your goal is still to get to San Francisco. As with business, goals do not change, plans do.

Business plans have all the basic components that investors, from banks to angels to venture capitalists, expect to find. From the cover page to the
appendices, the plan provides detailed information on your company. The plan is a flexible and working document. Here is a sample outline:

**Components**

1. **Cover Sheet**

2. **Concept Overview**

3. **Market Analysis / Validation**
   a) Market Analysis
   b) Competitive Analysis
   c) Quantify Market Segment

These are very important components to validate if there is a need for your product or service. It is also critical to lay out the legitimacy of the problem you are solving in the market. Talk about the existing competitors in the market, as well as the existing issues that you will be solving.

4. **Business Plan**
   a) Cover Sheet
   b) Table of Contents
   c) Executive Summary
   d) Introduction
   e) Industry Analysis
   f) Competitive Analysis
   g) Market Analysis/Plan
   h) Management Team
   i) Business Operations / Technology
   j) Opportunities and Risks
   k) Implementation Schedule
   l) Financial Planning / Exit Strategy
   m) Appendix

**A Succinct Vision**

The normal business plan can be lengthy, sometimes numbering pages in the triple digits. But you will also need to be able to present an abbreviated version that tells your story in less than 15 minutes. Your key points will need to be convincing so the investor will be motivated to put money in your company to help you get there. Zero in on the unmet need and why it is needed, as well as how you will meet the need. This is often one of the most misunderstood steps in the process of raising capital.
Most companies get caught up in issues like technology and innovation, when all the investor wants to know is are you going to make money, and how fast will you do it? If someone asks you what time it is, give them the time; do not explain how the watch was built. The plan needs to consistently address the subtle point of “what is in it for them.”

**The Importance of a Sound Business Model**

In today’s economic environment, it is more crucial than ever that a sound business model be developed. That means putting the pricing and monetary methodologies in place to build recurring revenue for your business and the predictability of it. It is beneficial to show an investor how far in advance they can tell what the numbers are going to be. Investors look for recurring revenue, revenue growth, margin expansion and cash flow. These are all key elements to the valuation of your business, which will have to be known at the time of an investor’s investment.

You have to be prepared to meet the needs and expectations of risk capital investors. Look at your business from their point of view, and analyze its strengths and weaknesses. And, be ready to demonstrate that your company is a good risk.

**What Are Investors Looking For?**

In most cases, investors are managers of risk. It is their fiscal responsibility to ask all the tough questions in order to protect and enhance the value of the portfolios they manage. Investors are still reeling over their lack of sound investment decisions during the Internet boom. They have now retreated to the basic business fundamentals and how they used to invest prior to those black marks (actually red marks) in their recent history. In lieu of that, it is important to understand some of the basics of what investors are looking for in companies:

**Companies That Can Grow and Expand:** Entrepreneurs can be great visionaries and risk takers. However, they tend not to have the experience, knowledge and know-how to move through the different stages of the company’s life cycle. They need to transition to professional management, and acknowledgement of such is critical in the eyes of the investors. Conduct a SWOT (Strengths, Weaknesses, Opportunities and Threats) analysis of your company. Take this analysis as the foundation of your plan for growth and profit.
**Great Management Team:** Risk capital investors are like seasoned bettors at the racetrack. They would rather have a great jockey (management team) and a good horse (product/service) than a good jockey and a great horse. Why do investors put such a high priority on the management of a company? Because a weak management team is the downfall of many businesses. The emphasis on "team" is critical.

The right kind of executive with the right kind of experience is important too. You would not necessarily have Coca Cola executives come in to run a software company when they have never been in that space before. Investors also don't care too much for one-person operations, no matter how savvy they might be. They want to see a broad management team with a can-do attitude and sales oriented skill sets. They also want to see a plan for succession that will help demonstrate the depth of the management team.

**Prerequisite Work:** Have you done the work and preparation to survive an audit, as well as detailed due diligence? Audited financial statements send a strong message about your sincerity and professional management practices. Making sure the right documentation is in place goes a long way to build credibility.

**Board of Directors or Advisors:** A strong board of directors or advisors bring credibility, industry leverage and contacts to the company. In addition, they are great sounding boards. The composition of the board is also critical.

**Straight Forwardness:** Many investors look for strong listeners who are not intimidated or afraid to acknowledge holes in their business plan. Be honest and tell them what the challenges are. That can be far more impressive because those are the very issues that you are looking for the investor to help you solve. Investors generally have access to multiple sources and contacts in which to help you resolve issues as they come up.

**Gray Hair Factor:** Now that investors have gone back to the basics, the gray hair or the “been there, done that” experience carries a premium in their view. They know there are some critical success factors. They expect these managers to know the warning signs along the way and take corrective action. They are looking for those who have the “know how” and “know who” to get things
done and cut through all the issues quickly. They want someone who can navigate through uncharted waters when difficulties arise.

**Conclusion**

Raising capital requires that valuation and control issues come front and center. Due to the highly energetic, optimistic, infallible and arrogant nature of most entrepreneurs, the process of raising capital often gets hung up on the issues of valuation and control. They need to be reminded that the issue of control can easily be handled in the contractual part of the investment, which can easily be tied to performance. Investors will be glad for you to earn and keep your control as long as you deliver the agreed upon performance milestones along the way. That is only fair for the trade of their risk capital.

The concern about valuation can be resolved through the issuance of warrants and options, which can also be tied to performance objectives. Consider the potential increase in the value of your ownership, rather than the percentage of your ownership, when you consider the availability of capital. How much quicker will the capital allow you to take advantage of the window of opportunity that exists today, and create more value?

The math is fairly basic. Would you rather have 70% of a $3 million company, 30% of a $30 million company, or 10% of a $300 million company? Go figure it out!

Finally, when you have an investor on the line for some much-needed capital, for heaven’s sake, set the hook and reel them in! Even though the terms may not be your ideal scenario, you need to remember that, in today’s times, you may not get another opportunity. Do not get greedy, and realize that you will probably be much better off by having it, than not having it.

So, are you ready to raise capital for your company? Has this article helped you think through some of the issues to consider? Has it helped you start planning and organizing today for the capital raising process that could happen tomorrow? Has it helped you understand the importance of the many tasks associated with raising capital, while at the same time keeping yourself in business? It was our goal for you to say yes to any or all of the above questions, and if you have, then our mission was accomplished.
About the Author
Bahram Yusefzadeh, Founder, Chairman, and CEO of V2R Group, is an entrepreneur and technology pioneer with more than 30 years of experience in all facets of business development. From creating and managing high tech companies to acquiring and advising businesses and steering them to the public market, Yusefzadeh has employed his strong vision and keen insight to assess the needs and growth potential of organizations to strategically position them for success. You can reach him by email at by@v2r.com. More information on V2R Group can be found at www.v2r.com.