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Inherent Complexities of Matching Capital Raising with Business Owner's Needs

By Eugene O'Malley

When a business owner determines that it has a need to raise capital, a number of inherent complexities, related to the process, need to be considered and resolved:

Size of Transaction:

The initial screen in any financing transaction will be the compatibility of the amount of the financing sought and financing offered. There has to be symmetry in this area or the transaction will never get off the ground. Some groups will make seed or later stage investments in \$1 to \$10 million range, others are only interested in deals that are \$50 million and above.

Types of Funding Sources:

Funding sources need to be viewed as a "business partner."

When considering your funding requirements and relationships, owners must keep in mind, that Private Equity funds have particular characteristics for investment profiles. Each Private Equity fund has industry, location and financial-specific investment guidelines. Private Equity funds will follow 5 to 8 very specific investment guidelines they present to their investors: pension funds, endowments and others. The funding sources commit money to the Private Equity Fund's General Partners subject to following these investment guidelines. Once the Private Equity fund has gathered the committed funds, they will begin the process to invest only in opportunities that meet the guidelines.

There are over 300 funds that offer capital to family owners and can make investments over the \$50 million range. Selecting the right "lead investor" fund will help to streamline the process and consolidate the capital. It is virtually impossible to get multiple funds to work together that have not worked together previously. The dialog within the funds syndicate is critical.

Industries Served and Industry Knowledge:

Some funding sources are helpful to the business on operational matters and others are passive investors that do not bring operational expertise to the table. It is important to match the capabilities and the needs between the investor group and the business owner. Most investors will want to be on the Board of the company.

Length of Investment and Exit Strategy Approach:

The length of the financing period and the exit strategy approach is another important consideration in any financing transaction. Some financing sources are long-term investors and others are looking to harvest investments within a shorter time frame. It is critical to match these requirements between the funding source and the business owner.

Instrument: Equity versus Debt:

There are two broad categories of financing: equity and debt. When evaluating financing alternatives, the debt to equity ratio of the business needs to be taken into consideration. Generally, the more equity in a business, the easier it is to attract debt financing. An evaluation of the business's debt to equity position is an important consideration before planning a capital raising campaign.

Valuation:

Like a mutual fund, each venture fund has a net asset value, or the value of an investor's holdings in that fund at any given time. However, unlike a mutual fund, this value is not determined through a public market transaction, but through a valuation of the underlying portfolio. Investments in private companies are illiquid and at any point, the partnership may have both private companies and the stock of public companies in its portfolio. These public stocks are usually subject to restrictions for a holding period and are thus subject to a liquidity discount in the portfolio valuation.

The company is valued, at the time of financing, at a mutually agreed-upon amount. In subsequent quarters, the venture investor will usually keep this valuation intact until a material event occurs to change the value. Venture investors try to conservatively value their investments using guidelines or standard industry practices and by terms outlined in the prospectus of the fund. The venture investor is usually conservative in the valuation of companies, but it is common to find that early stage funds may have an even more conservative valuation of their companies due to the long lives of their investments when compared to other funds with shorter investment cycles.

Proper Preparation, Involvement and Follow-through:

Preparation is key to pulling off a capital raising transaction. Initially, an Executive Summary is necessary to generate initial interest and get the ball rolling. Once initial interest is reached, a full-blown discussion of the business and historical and prospective financial statements will be necessary. Finally, due diligence will require even more detailed documentation with respect to all facets of the business operation.

A capital raising operation will require significant management time and effort. The process generally will take 3-6 months to close.

Many potentially achievable financing deals have failed due to lack of proper preparation, involvement and follow-through.

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