Looking For Money In All The Wrong Places *

Categories Of Private Equity Investors for Smaller Private Companies

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As advisors to middle market companies we see clients who in retrospect might have made different choices in their earlier financings and have avoided the consequences of having raised capital from less than optimum sources.

Notwithstanding that these companies may nonetheless have been quite successful, they nonetheless provide valuable lessons in 20/20 hindsight.

The purpose of this article is to review the characteristics and pros and cons of a spectrum of sources of private equity capital for small to medium size companies. These break down as follows:

1. Personal sources: Individuals you know, family, friends, partners
2. "Angel Groups" (investment clubs, e.g. the *Tech Coast Angels*)
3. Serious High Net Worth Individual(s) or family offices
4. Private Placements with Individuals and Institutions you don't know.
5. Private Equity Funds (including SBICs)
6. Venture Capital Funds (VCs)
7. Small Business Administration (SBA) and other government sources.
8. Small Business Innovation Research (SBIR) grants
9. Crowd Funding / the JOBS Act.
10. Strategic Corporate Investors.

1. Personal sources: Individuals you know, family, friends, partners

These are people you already know directly or indirectly for whom financial return or security is often secondary to a desire to help and/or participate. Although such investors may not require a formal business plan, it is imperative to document the terms of their investment as well as their participation, if any.

Pros:

a) They usually don't demand much in the way of control, documentation or reports; but if they do, be careful; it can get messy.
b) They may not even ask for equity or collateral, e.g. offer an unsecured, low interest loan or guarantee bank borrowings.

Cons

a) Typical investments tend to be relatively small.
b) Unfulfilled expectations may jeopardize personal relationships, or worse.

A variation on an investment by an individual with resources is to have them guarantee bank borrowings, which is *equity* in that their capital is at risk.

* *Thank you, Johnny Lee*

2. "Angel Groups" (investment clubs, e.g. the *Tech Coast Angels*)

Angel Groups are typically assemblages of successful businessmen or professionals trying their hand at venture capital, usually with total investment aggregating in the low to middle six figures.

Angel groups normally have a prescribed format for business plans. About half a dozen pre-screened prospects make brief presentations once or twice a month. *Angels* may say they will consider any good deal but are really looking for high tech or novel ideas with high growth potential. In any case, the key to success is having one or more *angels* emerge as a "champion" to rally other members.

Pros

a) *Angels*, by definition, are predisposed to invest.
b) They usually don't seek or even want control.

Cons

a) It's a hobby, not a business for the members, who can consume a lot of time doing their personal due diligence.
b) They tend to seek tough venture capital deal terms, even for small amounts.
c) You end up with a number of relatively small, individual shareholders.
d) Your new shareholders, although successful in their field, usually aren't professional investors and can be opinionated about their investment.

At best only a small minority of aspirants are funded, but preparing a business plan and presentation for an angel group can be a valuable exercise.

3. Serious High Net Worth Individual (s) or family offices

There are wealthy people and families, albeit in short supply, who are capable of, and sometimes do, invest millions in a relatively small company that catches their fancy (think Paul Allan or Eric Schmidt). The challenge is finding such individuals.

Pros

a) If you find one, it can be one stop shopping.
b) They typically don't try to control or require board seats.
c) Knowledgeable ones can be great boosters and contributors.
d) A high profile one can add considerable credibility and panache.

Cons

a) Hard to find unless you move in those circles.
b) They may become more demanding than you want. They may not legally control, but are still the 800 pound gorilla.
c) The well can dry-up if their personal circumstances change.
d) You often end up dealing through their financial advisors.

4. Private Placements: Individuals and institutions you don't already know

Once investment opportunities are offered to any number of investors beyond your circle of personal contacts, you are coming under federal and state securities laws and regulations. An offering to a limited number of "qualified" or "accredited" investors" is called a "Private Placement". [1]

Although technically a company can manage a private placement by itself, very few entrepreneurs succeed unless they have a substantial stable of well-connected or wealthy friends. Rather, private placements are usually managed by an investment banker or broker who places the securities with individuals, trusts, institutions or investment funds.

A Private Placement is most commonly done for a going business but can be used for a start-up or early stage entity with enough sex appeal.

In any case a proper private placement involves a Private Placement Memorandum, usually prepared by attorneys in conjunction with the company and the placement agent. Legal fees, paid whether or not the placement is successful, run in the tens of thousands of dollars, and placement fees and expenses can cost 5% to 10% or more of the funds raised. Given the expense, private placements are seldom done for less than several million dollars.

Pros

a) The Placement Agent should do the selling, or at least identify the investors.
b) The equity will probably be dispersed amongst a number of passive investors who typically aren't interested in control.
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Cons

a) A prerequisite is a company with a certain "investor appeal".
b) Cost of legal documentation and up-front fees with no assurance of success.
c) High placement agent commissions.
d) Not cost-effective for small raises.
e) An improperly executed placement can create liability exposure.

5. Private Equity Funds

The term ***Private Equity*** is often used to describe everything from hedge funds to venture capital funds. As used here it means private funds that typically buy-out, or invest in, mature companies, often taking a controlling interest.

[1] There are also what are known as quasi public/private "D504, D505 or D506" offerings (for Regulation D of the Securities Act of 1933) which exempt offerings meeting certain criteria from registration. They get complicated and in any case are really a form of private placement.

Private equity funds, of which there are hundreds or even thousands, customarily focus on specific industries. Since they are deluged with deals, an interlocutor such as an investment banker may be needed to get a meaningful hearing.

A Small Business Investment Company (SBIC) is a form of private equity fund chartered by the federal government, which will lend or guarantee additional borrowings to accompany an SBIC's private investments. Many venture capital funds and banks have captive SBICs to take advantage of the leverage. SBICs normally provide debt with an equity kicker for a minority interest.

Pros

a) PEF's are principals: They have money and know what they are doing.
b) If they have similar companies in their portfolio, they understand your business and can provide valuable support.

Cons

a) Their mission is buy-low, sell-high. They don't overpay.
b) It can be hard to get a serious hearing without a sponsor.
c) They usually want effective control and an exit within 5 to 10 years.
d) Usually only interested in companies with cash flow, not early stage.

6. Venture Capital Funds (VCs)

VCs are a form of "private equity" but in this context we mean funds that provide capital to early-stage businesses, usually with proprietary technology and high growth potential, and which typically focus on specific industry segments.
VCs are less risk adverse than private equity funds, but need to see big potential and aren't interested in mature, unglamorous, or slow growth businesses.

Pros

a) VCs are willing to take risks for the right potential upside.
b) They are principals who have money and know what they are doing.
c) If they are interested, they probably already know your industry.
d) They can provide valuable expertise and operational support.

Cons.

a) VCs drive a tough bargain.
b) It can be hard to get their attention. They see hundreds of deals.
c) VCs are only looking for high-growth home runs, e.g. medical, IT.
d) They require board seats and at least "negative control", i.e. restrictions on what the company can do without their approval.

A VC "cousin" is an ***incubator,*** where start-up companies share support, from just administrative services to help in marketing and financing or actual funding.

Also, some large companies have captive VC funds. (#10 Strategic Investors).

7. The Small Business Administration (SBA) and other government loans

Government loans are usually guaranteed by the business's principals and even secured by their homes in addition to the business's assets, and thus are very much at risk "*equity*" for the guarantor.

The SBA makes some direct loans, but most are by banks and guaranteed by the SBA. SBA loans are term loans (vs. lines of credit), making them more appropriate for purchasing a building, for instance, than for working capital.

In addition there are many focused Federal and state loan or subsidy programs, from export assistance to clean energy (Solyndra) to agriculture.

Pros:

a) The government does have the money and a mandate to place it.
b) You haven't given up any equity.
c) Interest rates as low as prime + 2.25%, depending on size and duration.
d) No requests for board seats.

Cons

a) Arduous, prolonged bureaucratic application process with no assurances.
b) They generally want secured first positions, which can limit later financing.
c) Principals are personally at risk as guarantors.
d) Loan agreement may have significant negative covenants.
e) May be hard to re-negotiate terms in the future with govt. bureaucrats.

8. Small Business Innovation Research (SBIR) and Small Business Technology Transfer (STTR) Programs

These programs manage grants to small businesses for specific projects requested by over a dozen different federal agencies on subjects ranging from aquaculture or methods to enforce anti-texting regulations to cooling for infra-red detectors or vacuum bagging technology.

RFP's are posted periodically on the internet. Phase I awards are in the low $100,000s. The government gets a royalty-free license for technology developed, but the recipient retains all commercial rights. There is no requirement to repay.

Pros

a) No interest, no repayment, no equity given up.
b) Retention of commercial intellectual property rights.

Cons

a) Very specialized. Useful to only a very limited number of companies.
b) The proposal process is exacting and time consuming with no assurances.
c) Often there are many competitors for the same money.

9. "Crowd Funding" / the JOBS Act

Crowd Funding refers to raising money from individuals on the internet. It has been used freely for years for contributions to seemingly worthy causes or projects, but without any promise or prospect of financial gain or ownership.

In 2012 Congress passed the JOBS (Jumpstart Our Business Start-ups) Act. Although originally conceived to enable crowd funding with minimal restrictions, the final law did not create the *crowd funding* free-for-all that was feared (or hoped for). It does, however, permit internet offerings up to $1,000,000 to investors meeting certain qualifications using a licensed broker as a funding portal, but requires audited company financials for raises over $500,000 and places limits on the amount of individual investments.

More significantly the Act mitigates regulatory requirements for Emerging Growth Companies (EGCs) (companies with revenues under $1 Billion) in selling shares publically or privately, reduces restrictions on advertising and solicitation, and also provides relief from certain requirements of the Sarbanes Oxley Act.

Pros

a) Crowd funding is a new option hitherto unavailable for small raises.
b) No large shareholders to make demands.

Cons

a) Crowd funding rules are significant and must be followed.
b) The business must have communicable internet appeal.
c) Limited disclosure and reporting requirements could result in 20/20 hindsight claims of inadequate disclosure and resulting liability.
d) Puts you in a category of smaller deals susceptible to abuse and fraud

10. Strategic Corporate Investors

One of the best and least expensive sources of equity are larger companies in a related business that are more interested in the synergistic benefits of partial ownership than a near term financial return. Included in this category are out of area or foreign firms seeking to establish a footprint in your area or market, as well as "captive" corporate VC funds that some large companies sponsor.

Such relationships can start with as little as a pre-paid order for products or services, which are the equivalent of equity financing, and progress from there. (Tesla raised over $60,000,000 through deposits for their electric car)

Pros

a) Price and profit are not the governing metrics.
b) They already understand your business.
c) They can bring additional resources: marketing, technology, sourcing, etc.
d) They usually don't want control and may even prefer anonymity.

Cons:

a) Possible conflict if their competitors are also your clients/customers.
b) They may require a future buy-out option, possibly limiting your upside.
c) For a given industry, there aren't a large number of candidates.
d) Getting the attention of larger companies can be difficult. Small investments aren't their core business.

Investments from any of these sources can take any of many different forms, e.g. straight common stock, multiple classes of common stock, straight or convertible preferred stock or debt, debt or stock plus warrants, limited partnership interests, LLC Member units, or perhaps a license to use technology. The choice of the optimum investment form and terms will vary with the source, the business, tax issues and other circumstances, but these are topics for another discussion.

Overall Conclusions and Recommendations

- Do not wait until the last minute. Do your homework before the money is needed. Establish relationships and explore options with knowledgeable professionals early to learn what are and are not likely sources and terms.

- At the same time, be patient, to a point. The longer you can bootstrap the operation, the less you will need to give up.

- All these sources require some form of business plan. It will vary by circumstances but get one ready well before anyone asks for it. Get help preparing it or at least reviewing it.

- Do not accept money of any kind without professional documentation of all terms, conditions and expectations.

- Do not advance payment to individuals who claim to be able to raise capital but can't provide convincing credentials and references.

The foregoing was prepared for general information and educational purposes only, does not constitute legal or tax advice and should not be relied upon without first seeking the advice of an attorney and/or a CPA.

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