Raising Capital Manual: Capital Raising from a Position of Strength - A How-To for Small Business Owners

ABSTRACT:

Business owners seek capital from venture capital and private equity often from a position of weakness due to poor foresight, undefined business models, inadequate advisory support, and lack of a capital raising plan.

A common misperception is small businesses must forgo a large portion of equity to raise investment dollars – this is only true if the business raises capital from a position of weakness.

Benefits of capital investment include affordable cash to grow (working capital for marketing and sales, merger and acquisition activities, and other resources needed for growth); but more importantly "Useful Capital" contributes expertise and guidance to ensure a steady path to wealth creation.

Often capital raising is difficult because business owners and investors do not speak the same language, nor have the same interests, and have disparate perspectives on everything from what defines success to management control.

This report details how to raise capital from a position of strength and was written for entrepreneurs, owners and executives that are currently or will one day be entertaining funding options for their business beyond money from friends, families, and banks.

solving the value equation

About the Author: Garry E. Meier

Garry Meier founded the Ephor Group to apply the performance improvement methodologies and shareholder value enhancement processes he and his associates developed over his thirty plus year career to a diverse group of service based businesses.

Mr. Meier is highly recognized as an industry thought leader in the business and technology services arena as well as outsourcing sectors. He is a noted speaker on strategic effectiveness, value creation, industry trends, capital appreciation, performance improvement, outsourcing and customer satisfaction. Additionally, he is an advisor to private equity firms and venture firms on their investment strategies and portfolio companies.

Mr. Meier currently focuses on providing board, institutional and C-level guidance to maximize strategic, operational, and equity effectiveness for mid-cap service and technology companies.

"One of the most common mistakes owners make is ignoring the timeliness of the market opportunity – failure to capitalize can be disrespectful to the market opportunity."

About Ephor Group

Ephor Group increases equity valuations for mid-market businesses. Our approach is proven, pragmatic, and performance oriented. Our methodology, the Perform Business Process™ fills in the gaps where functional expertise and capital are constraining the business.

Garry Meier Background

Thirty plus years of strategic management, P&L management, investment banking, institutional investments and operating company experience with broad depth of knowledge and expertise in service companies including:

Operational & Executive Assignments

- IBM Corporation, Corporate Development
- Edward Jones & Company, Partner
- FFMC, Corporate Development, M&A
- Automated Information, President/CEO
- Technology Service Solutions, COO
- Global Integrity Outsourcing, President
- Medaphis Physician Services, COO
- Outsource International Inc, CEO
- SmartTime Inc., Interim CEO

BOD & Advisory Assignments

- Achilles Group, Chairman
- Certus Corporation, Director
- CentriconHRA, Chairman, Director
- Latin American Card Services, Chairman, Director
- Baird Capital Partners, Advisory Director
- Baird Venture Partners, Advisory Director
- Global Integrity Outsourcing, Director
- Outsource International, Chairman
- Personalogy, Chairman
- Workplace Solutions, Chairman
- TalentTree, Chairman
- SmartTime Inc., Chairman
- The Cap Street Group, Advisor
- Economic Development Authority Board, State of Missouri, Director

Inappropriate Times to Raise Capital

When you need cash – The majority of fundings come in times when cash is needed most so ownership buys capital at its most expensive point. Sun-Tzu said "The victorious only seek battle after the victory has been won, whereas he who is destined to defeat first fights and afterwards looks for victory."

To end shareholder disputes – Negotiating from a position of strength means aligning all constituencies towards a shared vision. Many times, additional cash is raised to enable earlier investors to exit, but excludes these investors from future risk and reward.

When cash is available – Without a shared vision and defined business model capital is treated as a commodity which erodes the long-term value of the business. There is an abundance of cash available, invested capital is at an all-time high of $150B that was previously nonexistent to smaller companies as well as particular industries like service businesses. Today, funding is available for emerging firms in technology and high profile service industries such as outsourcing, human capital, marketing, and healthcare with proof-of-concept customers and a repeatable and scalable business model.

Is Capital Available for Your Business?

The three criteria for raising capital today are: First, a business must have the potential for rapid and sustainable growth. That's why investors invest and owners need investors – to rapidly transform a small business into an emerging enterprise - doubling, tripling in size every year.

Second, a well defined market opportunity where market opportunity is defined as total revenue potential in the hundreds of millions, with a clear shot to be #1 or #2 in the market niche.

And last, sustainable profitability – i.e. a competitive advantage that is unique has been established; (unique means durable, repeatable, and non-transferable).

All businesses need cash to capitalize on great market opportunities. If a business does not need to grow to claim customers and market position before competitors or substitutes then the industry sector is most likely unattractive to investors and thus non-investable. A business should only raise capital when a "happy ending" for owners has been clearly delineated and an action plan with MAT (milestones, assumptions, tasks) has been developed to guide the way.

Fundraising Process

Make no mistake about it: there is an art to raising capital. Raising efficient and appropriate capital means maximizing shareholder wealth which requires attracting “Useful Capital” at the right price at the right time. Here's how to do it.

Pre-fund raising process: (before institutional investors are involved)

Detailed Due Diligence Assessment (“Dry Run”)
1

Relevant Financial Model
2

Size Capital Requirements
3

Preliminary Deal Structure & Pricing
4

Confidential Memorandum
5

Fund raising process:

Evaluate Investor Suitability
3b

Develop Preliminary Interest
4b

Solicit Indications Of Interest
5b

Negotiate Binding Letter(s) of Intent
6

Document and Fund
7

Benefits of using an experienced advisor:

1. Expert guidance on valuation – i.e. pay less for capital and retain more equity
2. Leverage deal experience to protect the company, founders, and management
3. Lean on advisor for coaching and deal management as needed
4. Raise capital from “Useful Capital” investors
5. Aligned interest with management

> “Attracting capital is a given for the businesses we work with.”
> - Ephor Group Chairman Garry Meier

How To Negotiate from a Position of Strength: Tools & Techniques

First, identify the businesses strengths, weaknesses, opportunities and threats. Do a gap analysis of where the business is today versus what an investor considers an **investment grade business** (*see page 6 and 7 for Investment Grade Scorecard*).

Find the right partners and investors. Make sure they provide "**Useful Capital**" which has the following characteristics:

1. Board advisors that provide guidance, industry contacts, and operating expertise
2. Invested in the particular business sector before i.e. know the players, customers, partners, and key performance indicators intuitively
3. Understand and appreciate what is needed to have a unique business model

Useful Capital can take the form of either a strategic buyer or industry partner. There are a number of buyers who continue to pay top prices for entrepreneurial companies. Useful Capital can typically short cut the due diligence process because of their experience acumen, and track record in a particular industry sector. Useful Capital will help firms

Types of Available Capital

Growth capital is the most common reason for businesses to acquire capital. Equity investments to fund accelerated growth and working capital can result in a minority ownership position.

Additional Reasons for Capital Investment:

1. Management buyout
2. Leveraged recap
3. Industry consolidation
4. Acquisitions
5. Shareholder liquidity

Getting Started - Raising Capital 101:

Today's reality is that a business needs momentum to attract investors. Momentum can mean a variety of things, but what is clear is that entrepreneurs can no longer use a napkin and a brilliant idea to raise capital.

Therefore, generating momentum for a business is job #1. Step two is to determine the gaps between the current business and an investment grade enterprise.

The final step is to bridge the gap. It is not about finding an investor that will invest in the company. Creating wealth is about building a great business.

The vast majority of the time, owners need to identify credible industry advisors or functional experts first. With today's capital markets, investors will find the businesses they are going to invest in.

avoid some potentially troubling issues from valuation to compensation. Useful Capital often comes from private equity and wants the existing team to run the company – this leaves founders with the opportunity to convert a modest business into significant wealth. This is certainly the answer to owners' prayers.

Maximizing valuation techniques for increasing an owners equity valuation include auctions, valuation mechanics, strategic positioning, M&A, etc.. Generally, valuation is based on what a company has done to date, not what it can or is going to do. For businesses seeking funds this means that the executives' track records are even more important; if an entrepreneur is seeking capital and does not have adequate experience they must acquire the experience by partnering with seasoned management or they will either not get funded or have to give up more equity than is reasonable.

An entrepreneur without previous deal experience has a higher probability of wealth creation when outside help is utilized such that management can focus on core activities and outsources non-core functions like capital management, corporate development, and deal logistics to achieve higher returns.

Investor Scorecard

Once it is determined that a business wants to grow to create shareholder value (the majority of business owners are not willing to share control to accomplish wealth creation), realize that the valuation of the business is based on an investment grade scorecard. Scoreboards vary from investor to investor with different biases but it is a combination of the following elements:

Strategic Issues Checklist

- ☐ Have you verified that the target market is of sufficient size and that your firm can be the dominant player in your market or niche?
- ☐ Is the business model of such nature that it has the potential to be a "branded" model in the sector?
- ☐ Start with the end in mind: have exit opportunities and strategic alternatives been identified and created? (Strategic positioning is about mitigating competitive threats and substitutes while positioning for maximum valuation)

Management Discipline Checklist

- ☐ Is operational performance in the top quartile compared to similar companies?
- ☐ Does your organization administer and achieve corporate targets and rely on forecasting including measurement and metrics at the day-to-day operational level to ensure performance?
- ☐ Are the business processes scalable and will they stand the test of exponential growth?
- ☐ Does your organization provide a dashboard of ten to twelve metrics for top management and the Board of Directors?
- ☐ Do you have the functional support (in-house or outsourced relationships) that is needed at each position?
- ☐ Are there current incentive programs aligning all stakeholders?
    - Business goals and employees roles, compensation, rewards
    - Constituencies – shareholders, executives, and top staff
    - Relationships – partners, customers, vendors

Tactical & Operational Checklist

- ☐ Is the customer acquisition model optimized? (i.e. cost of sales less than 30 percent)
- ☐ Do you know to what effect customer satisfaction leads to referrals and cross sell opportunities?
- ☐ Does the business have monthly, quarterly and annual corporate targets broken down to daily activity metrics for each location, department, and team member?
- ☐ Does each team member from the executive team to front-line staff have a clear "definition of success"?
- ☐ Do you regularly identify classes of performers?
- ☐ Are IT, MIS and HR all contributing to the strategy and financial performance of the business?
- ☐ Do sales and operations manage to the mapped customer lifecycle?

Financial Economics Checklist

- ☐ Is your capital structure adequate to ensure growth?
- ☐ Does the capital structure motivate management and key employees? (10 points)
- ☐ Does the capital structure support the long-term strategy of the company? (Versus settling for "good for now")

For each checkbox on the preceding page add 5 points. (Maximum score is 100 points.)

Total Grade: __________________

Evaluating the Grade: The main point here is, 1) assess and evaluate the business, 2) then create a plan to shore up any deficiencies and to improve the strengths, last, 3) consider using an outside advisor to help structure your capital raising and guide the business from pitch to funding and beyond growth.

Conclusion

Start right, when investors and outsiders value a business' worth it is determined by historical performance: Wealth creation is not about where a firm is headed and what it could do…. the history and steps that led to today's landscape matter more than the promise of future revenues. Creating an investable business and maximizing wealth is available for small businesses with the right story.

The **right story** means thinking through details such as compensation structures, all contracts, and customer selection. At the very beginning, assume that all activities and decisions will become public knowledge. Be professional about the way the company is setup from day zero.

What's the best way to raise capital? To start, determine whether the business is, in fact, **investment grade** – i.e. fundable. Step two: Ingrain the fundamentals in the people, process, and systems. Then understand the economics and ensure the financials tell the story of the company. Understand that raising efficient capital is a long-term process. The fact of the matter is that not every company will be able to succeed, but those that do will realize sizable wealth creation.

***Did you enjoy this article?* Drop us a line and let us know your thoughts on solving the value equation at ephor@ephorgroup.com.**

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