



## **Consider Strategy before Seeking Equity**

*By Tom Stephenson, Managing General Partner, Verge Fund*

Once an entrepreneur decides that equity capital is the best way to finance his business, the next questions are how much and when should it be raised? One approach is to determine from the business plan how much cash shortfall is projected early on and raise that amount. But raising money in multiple rounds is often a better choice, allowing the entrepreneur to retain a greater portion of ownership.

If a business plan calls for \$3 million in total financing to achieve profitability in three years, a startup raising that money all at once will give up a large portion of the company — perhaps as much as 75 percent. New companies are high risk; if investors put in less at the beginning, they will be willing to bet more money on a promising venture later, taking fewer subsequent shares of the business in the process.

Ideally, raising money in rounds will give the entrepreneur and early investors the most profit when it is time to sell the business.

### **Balance Ownership with Cost**

Raising money involves cost, the biggest being the time spent negotiating specifics of the deal — and the more money involved, the more complex the negotiations. After a financing source is in place, at least 200 hours goes into any transaction, and more if there is protracted negotiation. The entrepreneur often must pay the investor's legal fees in addition to her or his own — meaning two sets of legal fees on the entrepreneur's tab — easily reaching \$20,000 or more. So fewer rounds are less expensive, and an entrepreneur should have a minimum amount in mind for each. Verge usually considers \$250,000 as the absolute minimum, with \$500,000 being more attractive.

These costs are comparable to those a homeowner incurs when refinancing a home. Just as a homeowner should not refinance more often than every few years in order for the home's appreciated value to cover the costs of a refinance, an entrepreneur should not refinance his or her business more than once a year.

## Types of Rounds

Seed capital, typically the first phase of investment, is used to pay for preliminary operations such as product development and market research needed to launch a product. Investments are usually lower because risk of loss is greater than at other investment stages. Entrepreneurs often raise money from friends and family or angel investors at this stage.

While some venture capital firms specialize in seed capital, most make investments at later stages of product development or market entry. Venture capital rounds are often denoted by consecutive letters of the alphabet and refer to the number of investments made so far. For example, a B round is usually the second investment a company has received. Major restructuring of a business sometimes causes letters to revert back to the beginning of the alphabet, often with double letters such as AA.

## Benchmarks Spur Rounds

Reaching benchmark successes is important to the value of a business and can help attract investors for another round of financing. For example, a business that requires regulatory approval will increase in value when that milestone is achieved.

Many, but not all, professional investors hold additional money in reserve for emergencies or to participate in later rounds of funding. Generally, professional venture-capital firms plan to participate in future rounds, but this should be confirmed. If they can't or won't commit to a second or third investment, other ways must be found to get the needed funds – or enough capital must be raised at the start to carry the business through to a new round of financing with new investors, or better yet, to take the business to cash-flow breakeven.

Most businesses that pursue equity financing end up raising one to three rounds of equity to reach profitability — and this should be a result of careful strategic planning to benefit the entrepreneur and financial investors.

Learn more about Verge Fund at [www.vergefund.com](http://www.vergefund.com).

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