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Know the costs before you dive into equity

By Tom Stephenson

Over the course of this series, various columnists have provided insights into equity — how to determine if it's appropriate for your business, how to prepare your company, how to navigate the evaluation process and how to identify the right capital partner. Before you embark on the long and sometimes frustrating process of raising equity capital, however, you should heed an old adage: be careful what you wish for. Make sure that you actually want equity investment in your business.

Raising equity capital brings substantial benefits. If you have selected your equity source carefully, you gain far more than just cash — you gain a partner. Good equity partners bring experience, networks of contacts and energy to your enterprise. They should be able to help you think through strategic decisions and introduce you to important business contacts like vendors, customers or even, eventually, acquirers. They may participate in recruiting candidates and reviewing financial statements. And, lest we forget, they invest cash into the business to help cover operating losses during growth phases, as well as build working capital and make infrastructure investments in the business.

All of these benefits, however, come with costs. For most entrepreneurs, the most difficult is the loss of control that comes with having a partner. As others and I have described in past articles, when you accept equity capital from an outside source, the business is no longer your company; it is now our company. While the degree to which this is true depends upon how the deal is structured, even if you are still the CEO and the majority shareholder, you will have obligations to your minority shareholders. You cannot run the company in your own personal interests; you have to run it in the best interest of the shareholders as a group. While this may not be a problem if you are focused on building the value of the company, it can nonetheless be a large adjustment for any entrepreneur.

The situation is magnified if you take equity capital from a professional venture capital firm. New Mexico Community Capital and similar groups typically require representation on the company's board of directors. Even if we are minority shareholders (which we generally are), we put significant restrictions on the entrepreneur's ability to raise additional capital or sell the company without our approval. We do this to protect our investment, but also to make sure we have some level of say in how the company is run. For many entrepreneurs, particularly those who started the company to be their own boss, this means making significant changes in how they operate.

The other cost, of course, is direct cost — when you sell a piece of your company for a price today, you are giving up the potential future-value of that piece of the company. This cost can be a benefit if you understand how taking outside equity capital will ultimately impact the value of the business. Equity capital, if well-used, will result in a substantially higher endprice than that obtained by growing a company organically. How much? That is the magic question. I often ask entrepreneurs if they want a bigger piece of a small pie or a smaller piece of a much larger pie. As an entrepreneur, you need to truly believe in the ultimate value your equity partner will bring and recognize that you will now be entitled to a smaller percentage — likely a much smaller percentage — of the final proceeds of a sale of your company.

Taking equity capital is a significant step in the development of any company, and the

entrepreneur and management team should not take that step without first assessing both the benefits and the costs of doing so. After determining that the benefits do outweigh the costs, both real and perceived, the entrepreneur can focus on using that capital to maximize the benefits for all stakeholders of the enterprise.

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Print