

Strategic Approaches to Raising Capital

## Strategic Approaches to Raising Capital

**“Begin with the end in mind.”** That's one of best-selling author Stephen Covey's "seven habits of highly effective people." It is also a critical principle for an emerging growth company faced with the need to raise capital. We believe the best approach for such companies involves setting an endpoint—a specific level of liquidity, for instance, or a future financing event—then determining the amount of capital necessary to get there.

### *How much is enough?*

When deciding on a funding target, a young company should try to project its future needs in several categories:

- Operating capital to cover anticipated day-to-day and project-specific costs until the next financing event;
- Opportunity capital to enable both planned and unforeseen strategic initiatives over this same period;
- Negotiating capital to maintain a position of financial strength during protracted negotiations with strategic partners, which are generally larger and acutely aware of a young company's "burn rate;" and
- "Murphy capital" to provide sufficient protection against the old adage that anything that can go wrong, will go wrong—one of the abiding principles in technology-rich young companies.

All too frequently, private companies underestimate their needs and raise insufficient funds. In many cases, the shortfall is a result of founders and existing investors worrying about dilution. For companies raising capital, we warn that less is not more—it is usually less. Dilutive financings, if sufficiently large, enable the company to stay in the game, while undercapitalization will threaten the survival of a firm. At the very least, raising insufficient funds may simply ensure the need for a painfully dilutive bridge financing at a later date.

### *Is it time to go public?*

During boom times, a private company is often enticed to go public simply because it can. Feasibility alone is not a good enough reason to take on the responsibilities of being public, however.

We advise companies to go public when it is both possible and necessary. There are, generally speaking, four compelling reasons to become public.

1. The company needs more capital than can be raised in the private markets.
2. The company needs a public security underlying options to attract management.
3. The company needs a public security for currency in making acquisitions.
4. The company needs to be public to build credibility with its customers.

In addition, certain threshold criteria should be met. These criteria will vary by industry, but at the very least a company on the verge of a public offering should have its complete infrastructure in place, visible positive events in the near future, and an expected valuation that will be large enough to attract institutional investors. (At the moment, that means a valuation of at least \$300 million.)

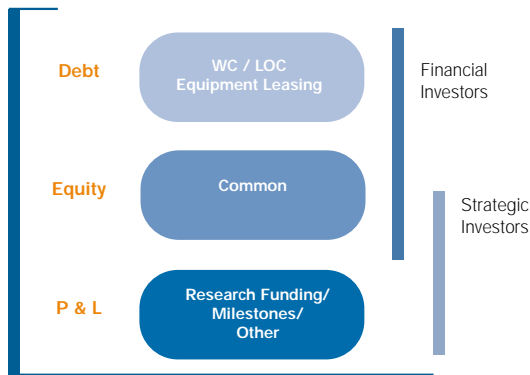
There is no denying a "public to private" discount exists, justified primarily by the relative illiquidity of private paper versus public equity. Because private equity investors routinely apply this discount when valuing prospective investments, companies may be (somewhat rationally) tempted to favor the public markets. However, forcing an IPO before a company is ready is not prudent, as any short-term valuation gains must be weighed against a long list of public-company headaches. Perhaps most important to consider is the reality that, for most companies, the IPO is not the last financing event. Raising equity as a recently public company with a cratered stock price can be extremely disadvantageous. In short, a premature IPO can come back to haunt you.

If a company is not yet ready to go public, it will need to take an integrated approach to the right side of its balance sheet.

#### *Types of Funding*

Numerous financing options exist for private companies. We advise firms to think strategically about sourcing capital. **Short-term debt**, such as lines of credit that provide working capital

### Types of Funding



*Investors:  
what to look for and  
what to expect*

and enable equipment leasing and similar expenditures, is both necessary and useful. However, **long-term debt** often hurts a young company more than it helps, as it creates a periodic cost that can cause cash flow problems. **Emergency debt** arrangements, while sometimes unavoidable, can be even more perilous.

**Equity Financing** requires its own balancing act. The issuance of common stock for employees is fine, but most financial investors (and many strategic ones) demand convertible preferred stock.

**Non-balance-sheet or "P&L" capital** that is generated by milestone payments or research revenue can sometimes provide the kind of recurring revenue stream that an emerging growth company needs. Such infusions are non-dilutive to equity holders, but usually mean decreased participation in future profits.

Finally, **government funding** from the likes of the Defense Advanced Research Projects Agency (DARPA), the Small Business Innovation Research (SBIR) Program, and the National Institute of Standards and Technology (NIST) is available to fund research and development efforts. Cooperative Research and Development Agreements (CRADAs), project-specific alliances between private companies and government agencies, offer another option. One drawback to raising capital through government programs is the attendant reporting requirements, which can often be Byzantine at best.

In addition to traditional venture capital firms, emerging growth firms may secure capital from **hedge funds**, which are bound by relatively few rules and regulations and are able to invest in private companies; **"crossover" investors**, which are the private equity arms of large fund organizations; and **strategic investors**, which are often willing to invest simply to gain access to technology. We also encourage companies to look across the Atlantic, as changes in the European investment environment have created significant financing opportunities for U.S. firms, and American investors have recognized the recent growth in European entrepreneurial activity.

We've intentionally left angel investors off our list. While angels provide capital, we've found they are the investors that private companies are most likely to rue down the road. In general, they are the least professional investors: they invest at valuations not linked to the market, often lack industry experience, and have

been known to make unreasonable demands of management.

In an ideal world, an investor should offer something of value other than money—be it the experience of the venture capitalist, the savvy market read of the hedge fund manager, the cachet of the crossover investor, or the technology validation of the strategic investor. Angels fall short here as well, as they generally bring little other than capital to the table.

Every investor has specific filters for investments. Most, however, will look for the following:

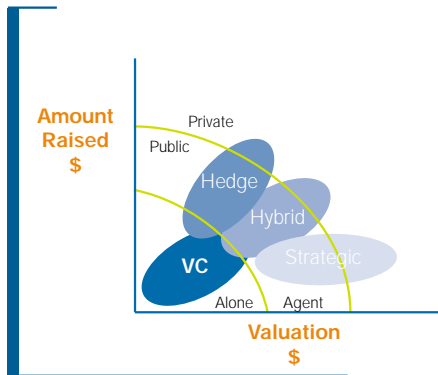
- Compelling technology
- An effective, experienced management team
- A clean and strong intellectual property position
- Third-party validation (a "proof statement" from partners, customers, etc.)
- A significant market opportunity
- A reasonably competitive environment

In addition, they may hope to see a recurring revenue stream, a rapid growth rate, a low valuation, and a monopoly or "monopoloid" competitive environment.

**One final note:** It takes time to raise money. Any investor of merit will perform extensive due diligence on the products and market opportunity of a company under consideration for his portfolio. As a result, it can be dangerous for a private company to underestimate the time required to close a financing deal. If a firm waits too long to start the process, its balance sheet can weaken, eroding its negotiating power. Generally speaking (though subject to market conditions), a company should never assume it can complete a private financing in less than 12 weeks. Further, we believe it is wise to have an additional "buffer zone" of at least another 12 weeks cash on hand (or roughly six months cash in total) when commencing fund raising. While this is relatively conservative advice, companies should never underestimate the utility of negotiating from a position of strength.

*Agents vs. Self-management*

Agent Use Depends on Deal Size, Valuation



Private companies seeking to raise capital are usually faced with two key decisions. The first, on which we've already touched, involves determining whether to turn to the public or private markets for funding. If the decision is made to look to the latter, the company must next decide whether to engage an agent to manage the process or to go it alone.

If the valuation and size of the financing deal will be small, it is likely that the investor audience will include only venture capital firms. In such cases, an agent will add little value. (Note: International companies seeking entry into the U.S. venture market, regardless of their size, will almost always benefit from the use of a representative.) As dollar figures rise, however, and the audience expands to include hedge, hybrid, and strategic investors, agents play an increasingly important role.

In short, the amount of capital needed and the expected valuation drive the tactics of raising money.

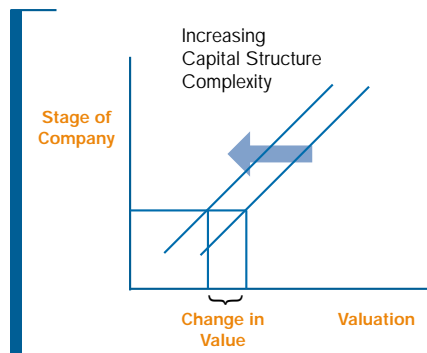
*Capital Structure: Keep it simple*

While creativity in business is almost always an imperative, creativity in designing capital structure is full of risk and rarely necessary. We advise young companies, especially those reliant on products or processes of technical complexity, to employ simple, transparent capital structures to counterbalance the business risks assumed by investors. Straightforward convertible preferred stock, surrendering as few added bells and whistles as possible, is best.

Stated differently, complexity has its costs. A company with a confusing or contorted capital structure, regardless of its stage of development, will always be penalized by investors. We've seen this phenomenon repeatedly with public companies that have been very creative in funding their technologies.

Historically, the opaque financial statements of these firms have dragged their shares below those of their peers. If a private company is forced to employ unwelcome capital structures, it may be necessary to clean them up prior to an IPO.

The Costs of Complexity



**The Costs of Complexity.** Even if a firm is raising money in the best of times, we advise it to structure its securities for the worst of times. The need for simplicity is even more pressing when financing in difficult environments. At such times, there are three proven safeguards that will help a company avoid dangerous financing terms: 1) a healthy cash balance; 2) competi-

tion among potential investors; and 3) existing investors with enthusiasm and deep pockets.

Finally, we believe there is a temporal dimension to the design of capital structure. While an emerging growth company should target an optimum capital mix, its capital structure should be elastic enough to respond to changes in the firm's development and shifts in the capital markets. Capital markets shouldn't alter the ultimate mix of a company's sources of capital—only the timing of using those sources.

*A final word*

There is no magic to the capital-raising exercise for the young, technology-rich company. Most of our tenets are common sense and hearken back to Covey's clear aphorism. If a company has a clear vision of its ultimate goal, it will gain access to capital in form and amounts that will prepare it for that goal. It should also be able to avoid the traps that come from taking cash with little thought to the strings that are always attached.



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