



Dawn Miller & Associates

ACT-BC

Assisting the Commercialization of Technology
in Rural British Columbia

MentorLinx: Access to Financing

Getting Ready for Investors

Dawn Miller & Associates
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MentorLinx: Access to Financing

Getting Ready for Investors

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MentorLinx: Access to Financing

Getting Ready for Investors

1. Introduction

If your company is looking for outside investors, then you need to answer the following questions:

- Where are you now?
- Where do you want to go?
- How much money do you need?
- What for?

This workbook outlines the different financing options that are available to technology companies, based on their stage of development.

Whether or not you are able to access specific options will depend upon your business intentions, the amount of money you need, and the commercialization potential of your intellectual property or business concept.

Review this workbook, and determine your company's current stage of development. Then, complete the checklist in Appendix A to determine if you have the information you will need to proceed with looking for capital. You may also want to do the on-line investor-readiness quiz at http://strategis.ic.gc.ca/sc_mangb/stepstogrowth/engdoc/readiness/irt-1.php. After completing these steps, contact your regional council to see if a mentor would be available to help you.

2. Development Stages of Companies

Companies move through a fairly predictable series of developmental stages as they evolve from start-up to maturity. While there are few hard boundaries between the stages of development, and the reality is that companies often transition between stages, generally it is possible to recognize the stage of growth your company is in. While distinctive issues and challenges mark each of these stages, it is important to be able to identify the stage of development, as different types of financing are available to companies at different stages.

Irrespective of the type of financing that you can access, at each stage you will need to be able to identify how much capital you need and why you need it.

2.1 Concept Stage

- The idea is in development.
- Preliminary work to investigate whether this is simply a smart idea or is really a business opportunity

2.2 Start-Up Stage

- The concept is a business opportunity and the next steps are underway, including: company registration, market research, product development plan and development of a business plan
- Generally very limited income at this stage

2.3 R&D / Team Building Stage

- The company is fully engaged in developing and proving the product, including scalability to production runs, and working models, patent and license searches
- The enterprise must assemble a qualified and balanced management team with the ability to implement well-defined strategic objectives with the support of external advisors (founders/owners, board of directors, current investors, accountants, lawyers, consultants).

Note: Most venture capitalists would rather have a B product with an A management team than an A product with a B management team. They recognize the *crucial* impact that leadership has on the future prospects of a company.

- The company burns (spends) cash at a tremendous rate with little offsetting income.

2.4 Pre-Commercial Stage

- The enterprise has perfected its business proposition, undertakes beta testing and begins to seek the key initial sales that build credibility in the marketplace. There is a continuing demand for significant capital investment with only minimal revenue.

2.5 Market Entry Stage

- The company has perfected its initial product, secured some initial sales (lighthouse sales) and is actively pursuing customers. This involves building a sales and marketing team, a marketing program, developing distribution channels, expanding inventory levels and developing critical customer service processes.
- The business is growing by using cash flow from operations, and has established relationships with leasing companies and other traditional lenders to finance fixed assets, inventories and receivables. However, there may not be sufficient retained earnings to fund market penetration and expansion.

2.6 Market Penetration & Expansion Stage

- The company has developed an initial customer base within a limited industry segment or geographic area

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- Once established within a specific geographic area or market segment, the company may turn its attention to diversifying its industry focus and/or broadening the geographic scope of its markets
- The enterprise has established itself by growing aggressively in its markets. It is likely to have achieved initial profitability. There is a strong probability of future growth in current and new markets.
- The Company now has a more predictable cash flow, may have developed some retained earnings and can likely borrow on the strength of its own fixed assets: term loans, mortgages, leasing.
- As the predictability of sales and profits becomes more certain, conventional financing no longer requires full collateralization, which may increase dramatically the amount of capital available to a company.

2.7 Maturity Stage

- The Company is an established business within its market sector. It has achieved success and now can grow new products and services for current and new markets.

2.8 A. At which stage is your business?

- ? Concept
- ? Start-up
- ? R&D Team Building
- ? Pre-commercial
- ? Market Entry
- ? Market Penetration & Expansion
- ? Maturity

3. Business Intentions & Potential

“Where do you want to take your company? What will be the founder’s role?” Company owners must ask themselves these important questions. Although there is no “right” answer, *how* you answer will likely determine the way potential investors categorize your company.

Dawn – I was trying to reduce the number of spaces between 3 and 3.1, but don’t seem to be successful!!!

3.1 Business Intentions

Generally, founders / owners are grouped into three different categories, depending on their attitudes towards growth and the founder’s role within the company.

- **Normal Growth:** The variety of business intentions is almost as large as the range of products and services sold by the businesses they operate. Comprised of companies that are established and operated by founders or successors to the founders, these companies generally operate within a specific geographic area and market segment. They may expand to neighbouring communities or market segments over time, but their orientation is usually to the local or regional market.

While all of these companies may have growth opportunities, most will not attain the next level of growth because the founder / owner **has decided not to invest the time, effort or capital to do so**. These businesses may be very profitable and generate significant wealth for the limited number of shareholders in the companies.

- **Aggressive Growth / Retain Control:** Another group of small business people exhibit well-defined objectives for significant growth (albeit not the rapid, exponential growth exhibited by many biotech or dot-com companies). However, they insist on maintaining control of their companies, and will refuse to access certain types of financing if it means that they unduly dilute their control. They accept the slower growth, even at the risk of losing a competitive technological advantage. This may be due more to their desire for a high level of independence and ability to control their own future than to the intrinsic potential of their business concept.
- **Aggressive Growth / Exit Strategy:** A third category of business owners and founders are those who are willing to, or recognize that they need to, sell all or part of their business in order that the business may grow to the next level. These individuals will sacrifice operating control in order to access the financing necessary to grow their company exponentially. In other cases, they accept that they may not have ‘what it takes’ in terms of management skills, and thus relinquish control to a new management team. Still others recognize that their competitive advantage (intellectual property) may be time-limited, and if they do not get their product to market right away, someone else will.

It must be noted that ‘bigger is not necessarily better.’ Generally, small businesses are categorized as those having sales up to \$5 million.

3.2 Business Potential

The intrinsic potential of the business concept is vitally important in determining what kind of capital to try to access. Not all types of capital are available to every type of business.

- **Personal Service Business:** This category is made up of businesses whose business concept revolves around, and is dependent on the owner / founder. It is the knowledge, expertise and / or services provided by the founder that are the foundation of personal service businesses. Included in this category are many of the professions, like lawyers, doctors, engineers and architects, but it also can include teachers, consultants and project managers. Obviously these firms possess some intellectual capital, but unless they modify their business concept dramatically it is very difficult to grow the companies significantly.

- **Known Services & / or Products Businesses:** These businesses provide the many hundreds of thousands of products and services that we use every day. While there may be many innovations, new products or new services introduced by these companies regularly, most of these are variations on the same theme - the basis of the business concept is well understood. Included in this category are retailers, wholesalers, national franchisers of personal services (like the laser eye surgery centres), manufacturers of consumer or industrial products, and producers of agricultural products. These companies may have significant growth and profit potential, but rarely exponential growth.
- **‘Growth’ enterprises:** This category of firms (5 to 10% of all firms) is classified this way because their sales and profit projections present a steep upwards curve – like a hockey stick. Once their product/business concept is taken to market, the growth potential is almost vertical, and is based on their competitive advantage and dominant market position. These businesses produce totally new products or new services that create an entirely new category of product or service. Some of these businesses sell known products or services in a totally new way – a new business concept. Recent examples include iPod or eBay. Most growth enterprises migrate to the “Known Services &/or Products” category after a number of very successful and profitable years.

Growth-oriented enterprises must have either the **proprietary intellectual property or a dominant business concept** to provide for explosive, extremely profitable growth.

In addition, the founders must have the **attitude and willingness to do what is necessary** in order for the company to attain this explosive level of growth and exceptional wealth for the owners. Less than one percent of small businesses, in any given year, are considered a potential investment target as growth enterprises by Venture Capital firms.

3.3 A. What are your Business Intentions?

- ? Normal Growth
- ø Aggressive Growth / Retain Control
- ? Aggressive Growth / Exit Strategy

B. Where do you see your company?

- ? in 5 years?
- ? in 10 years?
- ? How many employees will you have?
- ? How much revenue growth will you have in 3 years?

C. Have you determined your level of willingness to give up a portion of the ownership, and potentially the control of your company?

- Yes
- No

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- D. What is your type of business?
- Personal Service
 - Known Service &/or Product Businesses
 - Growth Enterprises
- E. Does your company have the potential for explosive growth that characterizes companies that can attract risk capital?
- Yes
 - No
 - Does it have totally new product or service categories?
 - Yes
 - No
 - Does it have a new business concept?
 - Yes
 - No

4. Understanding Investors

Although the decision on whether to invest in your company is made by the investor, you can increase your chances by ensuring your company is investor-ready.

Investors look for opportunities where there is sufficient, credible information on which they can make an informed decision. They invest where they can receive the best returns.

When making a decision on an investment, they must be satisfied that there is:

- A return on their investment
 - Repayment of their original invested capital plus an additional sum
- Safety and security for their invested capital
- Liquidity for their investment
 - An understood exit strategy so they can get out of the investment
- A relatively low cost to access the information necessary to understand the deal and make the investment in it
 - Ease and convenience reduce the costs of due diligence

More attractive deals get made while less attractive deals, if they attract financing at all, will demand a higher rate of return.

Companies seeking financing must satisfy the investor's expectations. Investors look for:

- Character
 - The abilities of the founder and management team are carefully assessed as an indicator of repayment

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- Conditions
 - Economic conditions that may affect the investment. This may include the situation within a specific industry, geographic area or the general economic situation in Canada or the world
- Capacity
 - The ability of the company to repay the investment (based on the company's proposed business strategy or history)
- Capital
 - The amount of owners' equity in the business as an indicator of their commitment to the success of the business
- Collateral
 - Assets that can be attached and sold in settlement of a debt
- Collaboration
 - The number of other investors already committed to your company: past, current and future, including private sector investment, banks and/or government programs.
- Cash
 - The amount of cash you need and what you need it for.
- Control
 - Extent to which the investor can monitor the investment, i.e. the quality of the accounting system, management processes
- Communications
 - Amount of information available and their confidence in its quality: the planning and foresight employed. These build a trusting relationship between the investors and the founders and management group of the company
- Cross-Selling
 - In today's very competitive financial market, many investment agencies (commercial banks, etc) value the ability of the investment to bring in new business.

The company's ability to meet the "C's of Investing" will determine both the availability of capital to them, and the rate of return they will pay.

5. How money is Raised - Capital Markets¹

Generally, the Canadian economy is considered to have a reasonably well-developed, mature capital market where deserving organizations can access sufficient sources of capital.

In practice, this means that companies that perform well – good sales, adequate profit margins and assets - can access financing.

There are four basic sources of capital for a company (one internal source and three external sources), each with a range of options: self-financing; conventional capital; risk capital; and government programs. They are listed below with the positives and negatives of each.

5.1 Self-Financing (internal)

5.1.1 Sweat Equity & Personal Resources

The entrepreneur is the initial source of company financing, through investing labour and effort (sweat equity) and other personal resources.

Positives: The entrepreneur is demonstrating commitment to the concept and the business, which is essential before a company can attract other sources of financing. Many early-stage investors expect a substantial personal contribution from the entrepreneur.

Negatives: The limited amount of capital (money) available to the entrepreneur may limit the company's growth. Some innovations may lose their "competitive advantage" due to the length of time it takes to grow the company.

5.1.2 Retained Earnings

The amount of capital the company generates and retains after paying all of its expenses.

5.2 Conventional Capital (external)

Medium- and Long-Term Conventional Financing

5.2.1 Term Loans

Typically extending from 3 to 7 years (some are up to 15 years), term loans are the principal form of medium term financing. The lender, life of the asset being financed, and the borrower's capacity to repay determine the length of the loan. The security may include a specific charge over fixed assets, a floating charge over all assets, mortgage over real property, debentures and mortgage bonds.

Positives: Longer repayment terms at lower cost (relative to other long-term sources), tax deductibility of interest.

¹ This discussion on the sources of capital is adapted with permission from *Steps to Growth Capital*, which may be found on Industry Canada's *Strategis* website.

Negatives: Ties up your assets, commits you to cash payments of principal and interest, often includes restrictive covenants

5.2.2 Mortgages

Land and buildings are often financed by lending institutions (such as life insurance companies, commercial finance companies, pension funds) through mortgages with a length of up to 25 years. Up to 90% of the asset may be financed.

Positives: Based on the value of the asset, not the business, tax deductibility of interest, maturity matches the long life of the asset.

Negatives: fairly rigid, pre-payment will incur penalties, increases financial risk due to fixed stream of repayments for principal and interest.

5.2.3 Leasing

There are three types of leasing arrangements:

- *Direct Leasing* (medium term), where the company acquires the use of the asset for an agreed upon series of cash payments, which are then expensed
- *Capital Leases* (long-term), where a third party finances the acquisition of the asset where the asset is capitalized (made an asset and amortized).
- *Sale and Leaseback*, where the company sells an asset it already owns and then leases it back

Positives: up to 100% of asset can be financed, can be tailored to the life of the asset, cancellation options are available

Negatives: relatively easy for lessor to seize the asset, cancellation costs are high, fixed stream of cash payments

Short-Term Conventional Financing

5.2.4 Secured and unsecured term loans

Secured (covered by collateral) and unsecured (this loan is backed by the lender's faith in your character and ability to pay) are common forms of short-term conventional financing.

Positives: Secured loans are relatively easy to obtain, as long as you have the assets to pledge as security.

Negatives: Unsecured term loans may be difficult to obtain in the amount required until the company has developed a positive history and value

5.2.5 Bank Lines of Credit

Bank Lines of Credit (often called operating loans or working capital loans) provide short-term debt for short-term needs like seasonal inventory, and are secured by your current assets.

Positives: easy to access, flexible, maximize cash management, minimal reporting requests

Negatives: amount limited by ceiling, lender can ‘demand’ repayment, cash servicing required, not suitable for long-term investments

5.2.6 Supplier Credit

Supplier credit is the time the suppliers grant their customers to pay their invoices for goods and services already received. As a company grows, its supplier credit also grows.

Positives: Very inexpensive source of financing, limited documentation, easy access, no costs

Negatives: Very short term in nature, usually insufficient to meet growth needs

5.3 Risk Capital (external equity capital)

Long-Term Risk Financing

5.3.1 ‘Love Money’

Family, friends and business acquaintances often provide the needed resources in the early stages, and the amount that they may invest varies greatly.

Positives: Investment from friends and family is often cited as evidence of ‘first believers’ in what you are doing.

Negatives: These friends and family may not be sophisticated venture investors. They invest because of the close connection to you. The consequence of the loss of their investment is something that you should carefully consider.

5.3.2 Angel Investors

They are looking for a management team (not necessarily complete) with relevant expertise and a willingness to partner. Angels look for unique products/services with a clear value proposition, as well as tangible, sustainable competitive advantages.

The amount that Angels will invest varies greatly, and since the dot.com bust, the size of Angel investment is smaller and there is more interest in syndicates of Angels making

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investments. Most Angel investors do not give out their names/addresses; therefore networking is critical in order to find and access angel investors.

Angel investors can increase returns by taking advantage of the 30% tax credit for 'Direct Investment' under the BC Venture Capital Program. See details at www.cse.gov.bc.ca.

Positives: Provide initial funding for product development, putting the management team in place, leasing office space, initial equipment purchases and getting the first sale. Many angels invest both their money and their business experience.

Negatives: Angel investors may want significant influence in the operation and direction of the company.

Tips for making a good impression and attracting potential angel investment: Develop a strong, quick (30-second) description of the business opportunity (an “elevator pitch”) in addition to a professional Executive Summary. Then create an interest in what your company wants to do: network within your community; find other business people or recently retired business people with similar interests; ask for input and advice; find a mentor. You may want to host an event to introduce your company to local business leaders. Any of these activities could assist you to communicate your business opportunity to an investor.

5.3.3 Venture Capital

Venture capitalists are looking for unique, proprietary intellectual property, a business concept, business plan and marketing plan that addresses a very significant market. Prior to making an investment, the Venture Capitalist wants to make sure that all of the pieces have been addressed.

Venture capitalists need confidence that the concept or technology is scaleable, the market need exists, the market is large, the profitability and projections are realistic and the management team can deliver on the concept presented.

Venture capital companies need to be able to see that they can liquidate their investment in the company and make a good return for their investment and risk, normally called an exit strategy. Investments can range between \$500,000 and \$3 million, but can vary widely depending on the industry.

Positives: Venture Capital firms will take an equity position that reduces the company's debt servicing requirement. Often they provide access to experienced board members, mentors and an ability to leverage investor relationships. The infusion of capital definitely allows the company to accelerate its growth.

Negatives: Founders give up a substantial piece of the company. The Venture Capital companies may impose restrictions on operations, future financings and corporate transactions. In some cases, the control of the company may be at risk.

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Tip: Many Venture Capital companies focus on particular industry sectors. Ensure that you approach those that are involved in your sector, and that their investment range meets your capital requirements.

5.3.4 Initial Public Offering

The process of making an initial public offering of shares can provide the funds required to fuel the next stages of growth. An IPO can also provide an exit strategy for venture capital investors and a liquidity event (opportunity) for owners and other early investors to realize on some of their early investment. The IPO process is expensive and depends heavily on market conditions and the receptivity of institutional investors.

Positives: Low financial risk to the company as there is no obligation for cash payment, no restrictive covenants, it provides stability and permanency; investors generally seek to realize on their equity investment in the marketplace, which can be done at no cost to the company

Negatives: Dividends are not tax deductible, dilutes your equity interest, takes time to access, loss of voting, and potentially management control, set-up costs are high

5.3.5 Quasi-Equity (subordinated debt)

Growing a company may require large additional investments in working capital (production inputs, inventory, receivables), fixed assets (production equipment and facilities), marketing, distribution, management and human resources.

Subordinated debt is an investment that carries a fixed interest rate (like conventional capital), in addition to providing the lender a share of the expected success of the company through royalties, fees and/or share options.

In return for this participation feature, the risk capital investor accepts more risk than a conventional capital investor, and a lower rate of return than a true equity investor. Normally the quasi-equity investor expects between 15% and 25% per year.

Positives: Flexible and can be tailored to the situation, less expensive than equity, fills a financing gap and high leverage is available, not as much dilution as straight equity and available in a variety of industries

Negatives: Takes time to access, expensive relative to other sources of short and long-term financing, some cash flow servicing requirements, investors will take a more active role in your company than other lenders, set-up costs are high, restrictive covenants often apply and does not provide the stability of equity

Short-Term Risk Financing

5.3.6 Asset-Based Lending

The lender lends on, and takes a security pledge of, the accounts receivable and inventory. Generally, the lender is more concerned with the quality of the underlying collateral than the credit worthiness of the borrower.

Positives: Ideal for growing, highly leveraged situations because of the high levels of risk, increases the opportunity for leverage, no complicated financial covenants, easy to access.

Negatives: Not suitable for all industries, needs high levels of inventories and receivables, requires interest payments, onerous inventory and receivables monitoring requirements

5.3.7 Factoring

The company sells its accounts receivable under a continuing arrangement to a finance company that is now responsible for collecting the receivable.

Positives: Factors assume the risk of your receivables but not your business, so financing is generally available; increases turnover and thus the amount of working capital

Negatives: Relatively expensive, especially when invoices are numerous and small in dollar amounts; not commonly accepted in many industries; not suitable for most long-term needs; possible negative impact on customers

5.4 Government Programs

Government Financing Programs most often focus on specific activities, market segments or geographic areas where conventional and/or risk capital financing are hard to obtain, including: employment, research and development and may take the form of grants, loans or tax credits. It should be noted that the application, monitoring and reporting requirements may be very extensive. See the accompanying “*Funding Program Review*” for a complete listing of such programs complete with web site references as of October 2005.

6. Financing Availability by Development Stage

If the businessperson does not understand the nature of the capital markets and has not prepared adequately to secure the necessary financing, then accessing capital will be more difficult.

The cost and amount of capital available to a company will vary in proportion to the development stage, underlying value and stability.

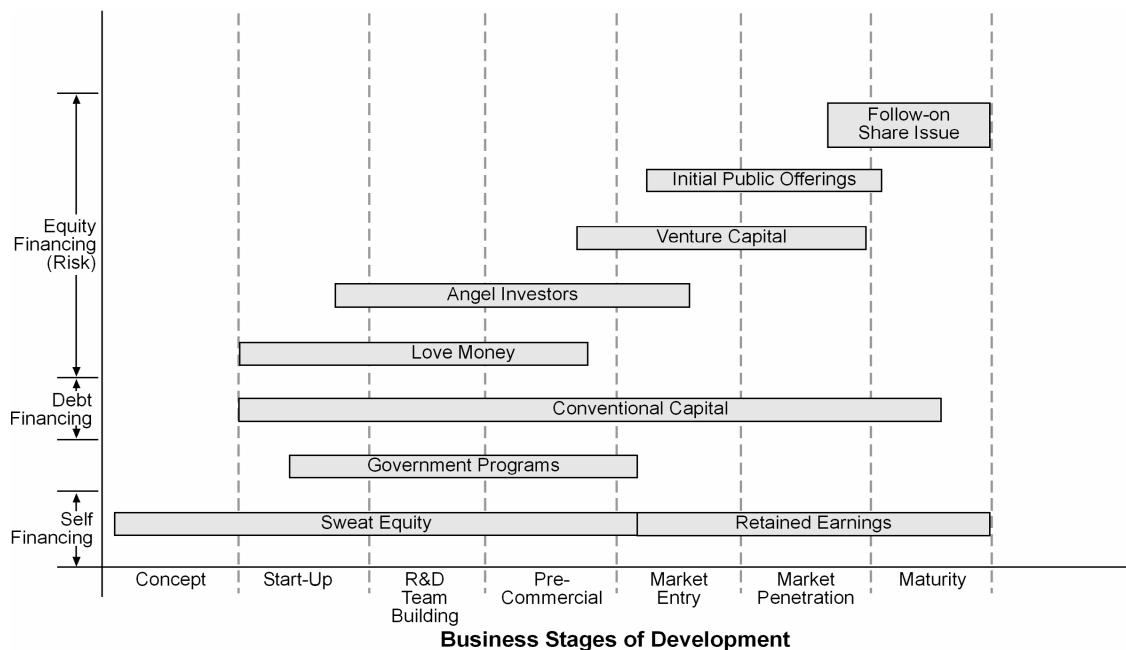
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Most risk investors invest in growth-oriented companies in the pre-commercial and market entry stages. The main characteristics of firms financed by risk capital are:

- High growth orientation
- International orientation
- High rates of return on equity
- High R&D spending
- Unique proprietary product
- Sustainable competitive advantage
- Strong management teams

The following figure illustrates what sources of financing are available to a company at each stage of its development, although investors can come in earlier or later, depending on specific opportunities. An organization's potential sources of funds will tend to become more diverse as it evolves and demonstrates its value, with debt becoming an increasing counterpart to equity.

Figure 6.1: Sources of Capital by Stage of Development



6.1 Your Potential Sources of Capital

Can you identify the potential sources of capital that would be appropriate for your company's development stage?

Yes

No

Have you prepared you and your company thoroughly and appropriately so that you can attract the required capital?

Yes

No

7. Are you Investor Ready?

The Industry Canada (Strategis) web site hosts an interactive *Investor Readiness Test* that allows participants to rate how well they understand the critical elements of financing their business.

While it is specifically designed for entrepreneurs seeking ‘Growth Capital’, the concepts apply equally well to most businesses.

Rate yourself on how ready you are for growth capital by taking the test at http://strategis.ic.gc.ca/sc_mangb/stepstogrowth/engdoc/readiness/irt-1.php.

You are an entrepreneur. Your ideas have been implemented; you have undertaken the research and development; you have gone into production; you have successfully completed beta testing; and you have made your first sales. Now comes the challenging part – financing growth!

Appendix A: Investor Readiness Checklist

- A. Can you identify the Development Stage your company is in?
- ? Concept
 - ? Start-up
 - ? R&D Team Building
 - ? Pre-commercial
 - ? Market Entry
 - ? Market Penetration & Expansion
 - ? Maturity
- B. What are your Business Intentions?
- ? Normal Growth
 - Ø Aggressive Growth / Retain Control
 - ? Aggressive Growth / Exit Strategy
- C. Where do you see your company?
- in 5 years?
 - in 10 years?
 - How many employees will you have?
 - How much revenue growth will you have in 3 years?
- D. Have you determined your level of willingness to give up a portion of the ownership and potentially control of your company?
- Yes
- No
- E. What is your type of business?
- Personal Service
 - Known Service &/or Product Businesses
 - Growth Enterprises
- F. Does your company have the potential for explosive growth that characterises companies that can attract risk capital?
- Yes No
- Does it have totally new product or service categories?
 - Does it have a new business concept?
- G. Can you identify the potential sources of capital that would be appropriate for your company's development stage?
- Yes
- No
- H. Have you prepared you and your company thoroughly and appropriately so that you can attract the required capital?
- Yes
- No