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Sources of capital change along with a company's growth stage

One of the great challenges for entrepreneurs in building companies is to understand the stages of capital formation.

Business startups typically emanate from one of two places — the serial entrepreneur doing deals or a seasoned business executive who exits the corporate environment with a dream to run his or her own company.

BUILDING BUSINESS

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In trying to get started and sustain growth, these business leaders are often frustrated with the realities of capital formation and lack of resources.

Nevertheless, the capital markets have become more linear in the last six or eight years and have developed a certain rhythm that makes the process somewhat more predictable. Here's how it works in order and in stages:

The start-up stage — the "A" round.

The initial stage consists of company formation, concept or product development and building an initial management team.

The source of capital for the start-up phase is private sourcing from friends and family, and professional early stage investors who are sometimes called "angel" investors.

The structure for such investments is typically a limited partnership or limited liability company designed to provide the most efficient and flexible structure for allocating profits and losses and for tax purposes.

The investment structures are typically preferred equity, bridge loans with an equity component and convertible debt. Start-up stage investors have return expectations of in excess of 20 percent for debt and in excess of 35 percent to 50 percent for equity.

The second stage — the "B" round.

The second round of financing is typically used to fund initial operations, recruit additional staff and deepen the management team, further prove up the company's business plan and provide working capital.

The source for such capital is a function of where the company is in its development cycle. If the company is still pre-revenue, the second round of capital will be more of the same. If the company has begun to realize revenue, early stage venture capitalists might be attracted to the opportunity to invest.

Investment structures and investment return expectations are similar to the start-up stage, although valuations might improve based on where the company is in terms of revenue and cash flow.

The venture capital/private equity stage — from idea to reality.

Once the company begins realizing material revenues or, depending on the industry, approaches break-even cash flow, the early-entry institutional investors can be a source for the next round of financing. This group of investors includes early-stage private equity funds, early-stage venture capital funds, corporate venture investors and, occasionally, industry strategic partners.

Companies need to build to a planned destination. That destination should influence the decisions made at each stage of the capital formation journey.

Often, at this stage, a conversion to a corporate entity is required to attract venture capital or private equity. Critical issues of valuation, control and corporate governance often dominate negotiations and trouble the deal sponsors. Investment structures include convertible preferred stock, convertible debt with warrants and a split between preferred and common stock. Targeted debt returns are typically in the high teens and equity returns in the mid-20 percents.

The venture capital/private equity investors will participate in management at a board level and have either board control or veto rights on major decisions depending on the amount of their investment and their percentage of fully diluted ownership.

The institutional stage — accessing cheaper capital.

More mature companies with demonstrable business models, recurring revenue and positive cash flow that need growth capital can attract institutional investors providing less costly capital. Later-stage venture and private equity funds, investment banks, corporate investment funds, asset-based lenders and commercial banks make up this sector of the market.

Structures include commercial bank credit facilities, asset-based loans, preferred stock, participating preferred stock, convertible preferred stock, common stock with warrants, and straight common stock. The structure, terms, valuation and disposition of issues such as control, governance and exit depend on the condition of the company and where it is in its development. The more mature the business, the less costly and less intrusive the capital.

The exit.

Everyone likes to talk about the exit. Do we build to sell, build to an initial public offering, build to a strategic partnership, build to realize cash flow? These are several of the options and the answer should drive the decisions that management makes along the capital pathway.

Companies need to build to a planned destination. That destination should influence the decisions made at each stage of the capital formation journey.

Selecting the right entity structures, deal structures, capital structures and governance models for the company at each point is critical to ultimately reaching the desired destination. Reaching that destination does not just happen or happen accidentally; it can be orchestrated with thoughtful planning and an understanding of the process, markets and expectations of the investment community. And with patience.

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