

10

EQUITY CAPITAL

Our combination of great research universities, a pro-risk business culture, deep pools of innovation-seeking equity capital and reliable business and contract law is unprecedented and unparalleled in the world.

Marc Andreessen

Sweat equity is the most valuable equity there is.

Mark Cuban

I think this is also a great time to invest in private equity, helping companies grow from the ground up.

Jim Rogers

CHAPTER LEARNING OBJECTIVES

Upon completion of this chapter you will be able to

- List sources of equity financing
- Discuss which source of equity capital is appropriate for different ventures
- Define the role of angel investors
- Explain the role of venture capital firms in equity financing
- Describe the most common forms of equity instruments
- Evaluate which factors impact a company's ability to raise capital

EQUITY CAPITAL

Equity capital is the basis of entrepreneurship. Equity investors are risk takers. Entrepreneurship is dependent on individuals and venture financing organizations that are willing to risk their financial capital intelligently by investing in new businesses. Without experienced risk takers, only entrepreneurs who have their own financial resources would ever bring a new business to market.

The biggest test of an entrepreneur's ability is to access and utilize financial resources that the entrepreneur neither possesses nor controls. The ability to attract and manage these scarce resources effectively to launch and grow the enterprise is the singular distinguishing characteristic of the successful entrepreneur. Entrepreneurs learn to become resourceful and skilled in the art of converting ownership in game-changing ideas into financial support for building the new venture. This process of converting participating investor ownership in the new business into financial resources generating returns that are substantially above prevailing market rates is what equity capital is all about.

In this chapter, we will explore the various sources of equity financing, the different stages of raising equity capital, the various types of equity capital available to the entrepreneur, the factors influencing the success of raising equity capital, and the various issues the founding entrepreneur should consider as he or she utilizes equity capital to finance the new company.

SOURCES OF EQUITY FINANCING

Equity financing is defined as the sale of a portion of the ownership of a new venture to an investor through the purchase of a percentage ownership in the venture. These percentages of partial ownership are commonly referred to as “shares” or membership percentages in the company (in the case of limited liability corporations, or LLCs, for example). As opposed to the entrepreneur who has multiple objectives and reasons for creating and growing the company, the professional investor has one primary reason for securing equity in the company—to generate a substantial return on the financial investment placed into the company. How large the expected return may be will depend upon the nature of the business, the length of time necessary to harvest the investment, and the risk of the investment in the venture, among many other competitive factors. To accomplish this goal of harvesting the investment with increased value, the investor must be provided an exit strategy through a liquidity event. The most common ways to accomplish this goal are through the acquisition of investor ownership by new investors, sometimes referred to as recapitalization; the merger of the company with another company; the sale of the company; or the public listing of the company on one of the public stock exchanges. This listing is most commonly accomplished through an initial public offering (IPO) of the company's securities (discussed further in Chapter 14), but it can also be accomplished through the reverse merger of the private company into a publicly traded company. The use of equity capital to grow a company therefore necessitates that the entrepreneur have a well-defined strategic plan to grow and harvest the company.

Equity Capital for Small Businesses

New ventures that will become what are considered family-owned businesses could lack the potential for dramatically expanded growth; nevertheless, financial capital will still be needed. In these situations, investment most often comes in the following ways or from the following sources:

- *Self-financing.* The entrepreneur will be expected to have a substantial amount of her or his personal assets invested in the business. Other potential investors considering the new venture will expect to see that the entrepreneur is “all in,” as the saying goes. That normally means that the entrepreneur has a mortgaged home, maxed-out credit cards, and a substantial personal debt, having borrowed all the money he or she possibly can to invest in the business. Remember, it is expected that entrepreneurs are themselves risk takers. Potential outside investors are normally reluctant to invest unless the entrepreneur, who has the greatest amount to gain, demonstrates his or her full commitment to the business venture.
- *Bootstrapping.* Entrepreneurs will normally employ what is termed *bootstrapping* the start-up, which involves conserving the firm’s limited resources by finding others who are willing to provide material assistance at little or no cost. As an example, the entrepreneur could find a friend or associate willing to provide technical advice or the use of facilities and equipment when building the product prototype. The goal of bootstrapping is the preservation of the firm’s limited financial capital. In the early phase of growth, “cash is king.” Although this approach to capital management and equity retention by owners provides a viable avenue for early-phase growth, many entrepreneurs find that they quickly outstrip their capacity to obtain operating capital from close associates and will need to turn to outside sources of investment capital to sustain the growth of the enterprise.
- *Personal Savings.* Personal savings is the first place the entrepreneur is expected to look for start-up expenses. The more that entrepreneurs employ their personal financial resources, the less of their ownership they will need to sell to someone else, and the more confident investors will be that the founders are committed to the enterprise’s growth and success.
- *Friends and Family.* The next step in funding a smaller start-up business is normally obtaining financial capital from family and friends. They are investing in the entrepreneur or entrepreneurial team above the return on the future enhanced enterprise value. Many know of your desire to start a business; they know how you have worked and studied in preparation to launch your business. They know you as a person. They trust you. They respect your knowledge, dedication, tenacity, and character. Because of this positive personal knowledge, friends and family are a very likely source of financial investment. The entrepreneur must be careful, however, never to misrepresent (either intentionally or unintentionally) to their friends and family the risks associated with a new

business venture. The reality is that most investors of this sort are not what we would call sophisticated investors. They most likely have not been involved in investing in a start-up business. It is imperative to explain to family and friends the risk associated with investing in a start-up business.

Inherent dangers lurk when your family and friends invest in your business, however, no matter how carefully you explain the risks. Unrealistic expectations or misunderstood risks have destroyed many friendships and have ruined many family reunions. To avoid such problems, entrepreneurs must present the investment opportunity honestly and as clearly as possible, detailing the nature of all currently understood risks. Here is some guidance to help you avoid alienating investors who are also friends or family members:

1. *Consider the impact of the investment on everyone involved.* Will the investment or loans work a hardship on anyone? Are relatives and friends putting up money because they want to or because they feel obligated to? Can all parties afford the loss if the business folds?
2. *Keep the arrangement strictly business.* The parties should treat all loans and investments in a businesslike manner, no matter how close the friendship or family relationship. Professionalism avoids problems down the line. If the transaction is a loan exceeding \$10,000, it must carry a rate of interest at least as high as the market rate; otherwise the IRS may consider the loan a gift and penalize the lender.
3. *Set the details up front.* Before any money changes hands, both parties must agree on the details of the deal. How much money is involved? Is it a loan, an investment, or a hybrid financial instrument such as a convertible note, which carries elements of both an investment and a loan? How will the investor cash out? How will the loan be paid off? What happens if the business fails? Is there a personal pledge by the entrepreneur to repay the note?

If the entrepreneur self-finances the start-up, he or she bears the risk of the initial investment and raises funds through pooling resources (personal securitization) and pledging assets. Sometimes, additional founders also contribute and bear this initial risk. In this scenario, the founders are taking the highest risk by betting their own resources on the success of the venture and the capabilities of the entrepreneurial management team. The advantage of bootstrapping and using founder financing is the preservation of ownership in the company. The disadvantage of self-financing is the size of the personal investment that the entrepreneur might need to make in the venture. For many companies, significant additional resources will soon be required to grow the company.

Close associates, the entrepreneur's personal or professional friends, and family members generally provide the next wave of financial resources, beyond those provided by the founding company's entrepreneur. Usually but not always, these individuals are not professional investors, as will be the case in latter rounds of equity financing. These close associates and friends are investing in the concept of the venture, in its promise of return, and specifically in the entrepreneur. The funds raised from these investors range

from several hundred dollars to as much as several hundred thousand dollars. They are used to support the development of the company, the creation of its initial products or services, and the initial operations of the business. The challenge for the entrepreneur is to try to separate personal relationships from business decisions. The entrepreneur will most likely have frequent social interactions with these investors outside of the business. Managing these relationships can be difficult, especially if the venture does not meet the expectations of the investors. For this reason, the entrepreneur should weigh carefully the risks of accepting initial financing from this potential pool of investors. Another challenge faced by the entrepreneur is in structuring the investment for this round of financing. The tendency for inexperienced entrepreneurs is to value the company more highly than it is worth. This sets unreasonable expectations for the value of the investments purchased and may adversely affect the entrepreneur's ability to structure later rounds of equity financing.

On close inspection, we find that most new ventures (as high as 75% of all new business creations) are initially capitalized using the financial resources of the founding entrepreneurs. These companies generally begin with an average start-up capitalization of around \$10,000. As mentioned, entrepreneurs decide to provide initial funds for their ventures for two main reasons. First, doing so preserves their ownership equity. Second, it demonstrates to future investors and lenders (i.e., other sources of equity capital) a clear and dedicated commitment of the entrepreneurs to the creation and growth of the business. This initial pool of funds may be used by the entrepreneur to complete the development of the company's product or service and generate initial sales for the enterprise. Further, the initial funds may be used to recruit and hire additional key personnel to augment the entrepreneur's skills and capabilities. Even with the founder's seed capital and other early-stage private investments, the company is not guaranteed success, but without both sources of initial financing, the venture cannot grow.

Angel Investors

After dipping into their own pockets and convincing friends and relatives to invest in their business ventures, many entrepreneurs still need more seed capital. Frequently, the next stop on the road to business financing is private investors. These private investors—called *angels*—are playing an increasingly important role in financing business start-ups. Originally used to describe investors who put up high-risk, early-stage seed capital for Broadway shows, the term *angels* now refers to private investors who will back an emerging entrepreneurial company with their own money.

Angel investors are private investors or groups or syndicates of private investors. These investors are high-net-worth individuals (HNWIs), as defined by some segments of the financial services industry and state and federal statutes. As investors, many angels specialize in financing the early-growth phase of companies. Their investments tend to be geographically centered, meaning that they invest in companies that are within a short drive from where they live. These investors generally fall into one of two broad categories. Some are called “strategic angel investors.” These individuals invest in types of businesses in which they have personal and professional experience. Further, a strategic angel investor often participates actively in the venture, assisting the entrepreneur not only with

financial resources (equity) but also with professional experience and networks, helping the company to grow and develop new products and services. Other angel investors are generally referred to as “financial angel investors.” These individuals, unlike strategic angel investors, generally do not take on an active role in the operations of the business but view their equity investment from a financial standpoint. Either strategic or financial angel investors could play an active role in the operations of the entrepreneur’s business, however. If active, they may serve on the board of directors, in advisory roles, or as executives within the company. Many angel investors participate in equity financing through pooling their financial resources and creating syndicates or angel firms, clubs, associations, family agencies, or angel networks. Depending upon the type of the company (e.g., whether it is a partnership or an S corporation) and stage of the company’s development, these angel groups could be useful investors.

This source of equity financing (generally offering \$50,000 to \$2,000,000) contributes significantly to the pool of investment capital available for small entrepreneurial companies. It has historically provided many times the volume of investment capital dollars to small companies than that provided by venture capital firms. According to Huang and Wu, “Recent estimates suggest that annual US angel investment activity may total as much as \$24 billion each year.”²¹ As opposed to friends, family and associates, and other sources of investment capital (e.g., venture capital, public markets, private equity firms) that are readily identifiable, although not always easy to access, angel investors are neither easy to locate or access. Because they are private individuals, prospective angel investors may not be readily known to the entrepreneur. They are best accessed through networking with other business owners, professional service providers (bankers, attorneys, and accountants), or local, regional, or state angel or venture forums.

This first stage of external financing generally requires a working business plan, be it a traditionally structured business plan or one based on the “Lean LaunchPad” approach championed by Dr. Steven Blank, which focuses more heavily on early customer discovery as a test for the validity of the business concept and of the business’s product or service offerings. In addition, the entrepreneur will need a well thought out financial plan, a thorough description of the use of investment proceeds to build value and to advance the company’s development, a working demonstration of the company’s new product or service, and, if possible, an analysis of the company’s unique and defensible position against existing competitors, one that identifies customer demand through the early stage of the company’s sales. (Being able to distinguish a new venture from competitors’ businesses provides a compelling value proposition to both prospective customers and investors.) The funds raised during this round of equity financing should be used to recruit and complete a strong management team, refine the business model, and better define the product or service offerings.

Crowdfunding

Modern crowdfunding began in the late 1990s as an alternative to both equity and debt financing. In many cases, crowdfunding does not dilute the ownership of those seeking investment funds. Currently, the two primary forms of crowdfunding used by entrepreneurs are rewards and equity crowdfunding. Rewards crowdfunding allows the business owner to presell a service or product without incurring debt or diluting equity ownership.

In equity crowdfunding, the business owner sells shares of a company in exchange for money pledged. The shares may be nonvoting, so as not to dilute the entrepreneur's control of the company. To execute this financing strategy requires a platform or moderating organization that brings together the entrepreneur and the individuals who might be interested in supporting the entrepreneur's idea or business venture. Often, that crowdfunding platform receives a cut. Yet crowdfunding can be extremely profitable: in 2015, \$34.4 billion was raised globally through crowdfunding platforms, according to Massolution.²

Crowdfunding is generally used to launch efforts that are strongly customer focused and that have capital-raising goals between \$1,000 and \$250,000. They may take the form of an "all-or-nothing" proposition, which sees the entrepreneur setting a goal and keeping nothing if that goal is not reached. This approach is similar to the traditional processes of raising capital in which a minimal goal is required to "break escrow" or release investment funds to the entrepreneur. The other form of crowdfunding is the "keep-it-all" type in which the entrepreneur sets a goal for the capital to be raised but keeps the entire amount raised regardless of whether the goal is achieved.

Reward-based crowdfunding has been used successfully to finance civic projects, motion-picture production, and software development, just to name a few examples. A variation of reward-based crowdfunding is the "sale" of software value tokens: an investor receives a token to be used toward the purchase of software products that will be developed using the proceeds of his or her investment. Crowdfunding using debt provides a "marketplace lending" format to make money by providing loans with repayment,

Blue Apron

Beginning in 2012, cofounders Matt Satzberg, Iliia Papas, and Matt Wadiak began sending customers boxes containing the ingredients necessary to prepare meals. From the humble start of packing and shipping their first 30 orders from an industrial kitchen in Long Island City, these entrepreneurs have established a company, the Blue Apron, with centers in Richmond, California, and across the country. The company quickly grew to national prominence through 2016, bringing in between \$750 million and \$1 billion in revenue that year. This pioneer in meal-kit

delivery now offers multicourse dinner-party boxes that serve six and a direct-to-customer wine delivery service. According to the company's website, Blue Apron delivers about 8 million meal kits each month.

At its peak, the company's market valuation was in excess of \$2 billion, but since then other companies have entered the meal-kit delivery market. Because Blue Apron now faces strong competitors in a highly competitive market, the company's market valuation post IPO has decreased to \$560 million.

Sources:

1. Jing Cao, "Inside Blue Apron's Meal Kit Machine," *Bloomberg*, April 10, 2017, <https://www.bloomberg.com/news/articles/2017-04-10/inside-blue-apron-s-meal-kit-machine>.
2. "Our Story," Blue Apron website, accessed July 2018, <https://www.blueapron.com/>.
3. Rich Duprey, "Can Blue Apron Survive After this Latest Meal-Kit Buyout?" *The Motley Fool*, June 4, 2018, <https://www.fool.com/investing/2018/06/04/can-blue-apron-survive-after-this-latest-meal-kit.aspx>.

loan-servicing fees, and interest repayment on the loan. Litigation-based crowdfunding has provided a means for plaintiffs or defendants to obtain donations or even investors; sometimes donors are offered a reward for funding based upon the expected settlement of a claim that they have financed. Another form of crowdfunding is real estate crowdfunding, which has provided financing for both commercial and residential real estate purchases. A final form of crowdfunding is donation based: individuals with common interests contribute to opportunities that may have social benefits and that require resources beyond those of a single individual.

Though crowdfunding serves as an alternative to more traditional, established sources of investment capital, risks exist relating to the protection of the entrepreneur's intellectual property. Also, an entrepreneur using crowdfunding risks failing to meet her or his fund-raising goals due to a wide variety of circumstances, including donor exhaustion and the public fear of being scammed by the crowdfunding platform or the fundraiser.

Venture Capital

Venture capital firms are professionally managed closed-end funds organized in limited partnership arrangements. These legally chartered and regulated firms manage equity investments for other investors. Sources of funds may come from private equity sources, other professionally managed investment funds (e.g., a fund of funds, or FOF), or institutional sources of capital, including professionally managed public retirement funds and corporate investment funds. Through the partnership arrangement, the professional managers within the fund function in the role of general partners. This business arrangement provides managing partners with the flexibility to operate the business on behalf of the remaining investors or limited partners. Venture capital funds are closed-end funds with a defined fund life of typically 7 to 10 years. The assets of these funds must be converted into liquid assets and the proceeds distributed to the partners in accordance with the terms of the preapproved partnership agreement.

Venture capital firms may organize themselves to finance companies in a variety of ways. Some organize themselves according to the stage of development of the company in which they plan to invest. In this scenario, a venture capital fund may be a seed stage fund (investing during the first round of post founders' investment), an early stage fund (investing in companies that have received their first round of post founders' investment), a growth-oriented or middle stage fund (investing in companies that are seeking capital to expand their business operations or capture market share with new products or services), or a late stage or mezzanine fund (investing in companies that are positioning themselves either to be acquired or to acquire additional assets or businesses or that are preparing to transition from a private company to a publically reporting one through an initial public offering).

In addition, venture capital firms can also be organized according to the particular interests, professional experiences, and competencies of each firm's partners and analysts. Examples include venture capital firms that invest in companies having to do with the life sciences (biotechnology and related businesses), real estate, health care, energy exploration, alternative energy production, or some other business interest. Another approach that has gained interest is investing in businesses that have more than economic benefits to offer. Some venture capital firms have as a precondition that they will only invest in ventures that are socially conscious and ecologically friendly. Finally, among a wide range

of other options, venture capital firms can be organized to place investments within specific geographic regions and locations.

Venture capital firms look for investors themselves. They compete for access to future sources of private investment funds through the performance of the funds that they manage. A venture capital firm's fund performance is monitored and measured against the performance of other venture capital funds by the venture capital investment industry. The funds are placed into quartile rankings according to performance, from highest performing to lowest performing funds, for the selected period of review and analysis. The top performing venture capital funds, those in the top two quartiles, generally have an easier time raising subsequent venture capital. However, the lowest performing funds, those in the bottom two quartiles, have increasing difficulty in securing investments for future funds. Venture capital funds operate in a highly competitive, free-market environment, so only the most successful venture capital firms survive. They do so by carefully identifying high-value opportunities, clearly understanding the financial horizons of the investment instruments, and skillfully analyzing the competitive landscape for each investment. They also ensure a defined exit strategy for harvesting each investment.

Venture capital fund managers, who are the general partners of a venture capital firm, make money in two ways. As managers, they are entitled to an annual percentage of the total amount of the fund—to pay for their expenses and the fund's management usually 1% to 3% of the fund's value. Upon successfully exiting a fund they manage (harvesting an investment), they also receive a lump sum payment, called “the carry,” which is approximately 20% of the fund's liquidated asset value, after distributing the other 80% or so to the limited partners. In some circumstances, fund managers must repay the limited partners first, giving them back their initial investment before allocating whatever proceeds have been generated by the managing partners of the fund.

ENTREPRENEURIAL SPOTLIGHT

LIAM BERRYMAN—NELUMBO

Liam Berryman is the cofounder of Nelumbo, a business venture based on new technology that creates an advanced heat exchanger—the primary component in any refrigeration system. Nelumbo was formed in 2015 to develop new materials that can increase the efficacy of existing refrigeration equipment. The firm is applying nanotechnology in the heat-transfer process.

The firm's initial product, Ice-Nein™, reduces defrosting times while maintaining the cleaner operation of cooling coils. The product both extends the life of the refrigeration equipment and improves energy efficiency by up to 30%.

If the firm's product achieves widespread market acceptance in this country, the United States could save \$11 billion annually in energy costs.

Sources:

1. “Liam Berryman: Profile,” *Forbes*, accessed July 2018, <https://www.forbes.com/profile/liam-berryman/>.
2. Alberto Moñino, “Two Innovative Tech Startups Created by Engineers Like You,” *Ennomotive*, May 10, 2017, <https://www.ennomotive.com/innovative-tech-startups/>.

In recent years, two trends have shaped the availability of equity investments for entrepreneurs and their businesses. First, due to the economic pressures for funds to perform, venture capital firms have become increasingly risk averse, investing at later stages when the risk of failure is perceived to be lower and the risk of equity loss diminished for the fund's investment. This strategy shifts the risk-return ratio and favors investment in older, less risky firms rather than in younger companies that, while riskier, have the potential to yield higher returns. The second trend has been the formation of ever-larger pools of investment in each of the particular funds under the management of venture capital firms. This upward spiral of fund size has diminished how available venture capital funds are to smaller entrepreneurial ventures. To understand this condition in the venture capital market, consider the fund manager who, up until a few short years ago, managed an investment pool of \$100 million. Most likely, the fund manager would have spread the money among 10 to 20 companies, investing an average maximum of between \$5 and \$10 million and an initial investment per company of between \$1 and \$5 million. This scenario provided smaller fundable companies and smaller growing companies with reasonable access to venture capital. Today, the same fund manager might be managing a fund of between \$500 million and several billion dollars. Using the same strategy of investing in 10 to 20 companies, the manager would invest an average of between \$25 and \$50 million (on the low side) with an estimated average initial investment of between \$10 and \$25 million. Because of this scenario, many growing entrepreneurial companies will never reach the minimum threshold of being able to return between 5 and 10 times the investment within 7 to 10 years, the rates expected by venture capital funds. This has caused a significant gap in the availability of equity investments between \$2 and \$15 million from venture capital funds.

Mezzanine Financing or Pre-IPOs

A pre-initial public offering (pre-IPO), which is also known as mezzanine financing, is usually undertaken one to two years before the execution of a planned IPO of the company's securities on the stock exchanges (NYSE, AMEX, NASDAQ, and others). Access to these sources of funds is based on the market conditions for IPOs, the strength of the business sector of the company, and the valuation of the company. These funds are used as a source of bridge financing to help the company meet its financing requirements until it enters the public markets with tradable securities.

This pool of investors has traditionally been passive. Financial investors as well as mutual funds, financial institutions, and the private-capital divisions of larger investment brokerages are often sources of pre-IPOs. Although these investments are generally equity-type investments, in recent years, bridge financing has begun to adopt the use of convertible debentures that provide a hedge for funding sources by offering the option of interest-bearing financial instruments with an equity kicker in the form of warrants for the company's securities and a right senior to that of other shareholders.

Traditional mezzanine financing has also utilized convertible debentures. The term mezzanine financing refers to a type of financial instrument that lies between traditional debt and equity. The rate of interest on the debenture typically lies between 10 and 30 percent, with the rate of interest based upon the company's perceived ability to repay the note (perceived risk of failure of the loan). Mezzanine financing is available to developing

companies to support corporate growth and accelerate the sale of products and services. Sources of mezzanine financing include commercial banks and insurance companies. The advantage of mezzanine financing to the entrepreneur is the avoidance of equity dilution through the service of the debt component of the debenture.

TYPES OF EQUITY INSTRUMENTS

The most common forms of equity instruments currently used by entrepreneurs to finance their businesses are

- common stock,
- warrants and options,
- preferred stock, and
- convertible debentures.

Common Stock

Common stock is the simplest form of equity instrument or security currently available to the entrepreneur. Each share of common stock usually carries one vote. Common shares of stock are, in general, not convertible into another class of stock. When dividends are declared by the company's board of directors, common stock shareholders may receive, without limit, dividends. In the event of the liquidation of company assets, common stock shareholders receive asset value after the distribution of assets to all other classes of shareholders.

Warrants and Options

Warrants and options are securities instruments that give their owners the right to purchase a stock security at a fixed price, commonly referred to as the exercise price. Warrants function as short-term options to allow for the purchase of the company's securities. Warrants may be issued alone as investment instruments or in conjunction with the purchase of either common stock or other classes of shares of securities including preferred stock shares. Under this scenario, the warrant may be issued with a debt component attached (such as a convertible debenture instrument). Options, on the other hand, are generally issued to employees and may carry an exercise term as long as 10 years. Generally, these financial instruments are structured to minimize initial tax consequences for the option holder and to incentivize the holder to perform well for the duration of the option term. Many options are granted and vested over a period of time. Should the employee leave the company prior to the completion of the stock option vesting period, in most but not all cases, the unvested stock options are forfeited by the option holder and the remaining vested options are required to be exercised and converted into company stock. Both options and warrants, for accounting purposes, are considered as common stock equivalents.

Employee Stock Ownership Plans

An employee stock ownership plan (ESOP) enables employees to gain an ownership interest in the company in which they are employed. This instrument provides potential benefits to both the employee and the company. The employee obtains stock with little or no upfront cost. ESOPs are viewed by the Internal Revenue Service as payment for work performed by the employee. While the employee remains with the company, the shares are generally held in an ESOP trust. When the employee leaves the company, the ESOP shares are either bought back by the company or voided, depending upon the conditions of the ESOP plan and under which conditions the employee exits the company. In the United States, the ESOP is currently regulated as a qualified retirement plan. Over 11,000 ESOPs currently exist in the United States, including at such companies as Publix Super Markets, Hy-Vee, and the New Belgium Brewing Company.

An ESOP, like other tax-qualified compensation plans, cannot discriminate in its operation in favor of any individual or group of individuals within the company. Employees are able to receive a distribution or payment from the plan when leaving the company and can roll the amount into an individual retirement account (IRA). The major potential disadvantage of the ESOP is that it can be risky for the employee. The entire value of an employee's shares is tied to the company employing the individual participating in the ESOP. Consequently, there is a lack of both investment diversification and of control, as, in most cases, the individuals participating in the ESOP do not participate in the senior management of the company. So, should the company fail, their entire set of options (investments and in most cases retirement savings) would be valueless.

From the company's perspective, the advantages of the ESOP include the anticipation of enhanced performance by employees because their interests are aligned with those of the company and a shared ownership among employees. Both of these advantages can lead to reduced employee turnover and better employee work satisfaction. Another benefit to the company is that, currently, ESOPs are the only retirement plans that are allowed to borrow money. This unique feature provides company owners and managers with the ability to use the ESOP as a vehicle to arrange corporate financing and owner succession.

Preferred Stock

Preferred stock as a class of securities comes in many forms depending upon the desired intent of the company issuing the security. The company can fix the privileges of the stockholders owning a particular preferred stock, as well as their voting and conversion rights. The preferred stock instrument can be viewed as a convenient way to adjust the relationship between cash and noncash investors by creating special privileges, such as increased or diminished voting rights, anti-dilution protection, and "super majority" veto rights. As contrasted with common stock, which generally carries one vote per share, preferred stock may be voting or nonvoting, or holders of preferred stock could be allowed to vote under very specially defined conditions. Also, those owning preferred stock usually have a higher claim on a firm's assets

and earnings than those owning common stock. Generally, the owners of preferred stock are paid first in the event of the liquidation of the company, and they often receive higher dividends than common stockholders. Further, preferred stock can be structured to grant specified conversion rights in the event the stockholder wants to convert preferred stock to common stock.

To summarize, preferred stock securities generally provide

- Preference for shareholders during asset liquidation;
- Preemptive rights or rights of first refusal to purchase the company's securities prior to outside investors;
- Preference to receive dividends, if granted by the company's board of directors;
- Conversion rights to convert preferred shares into common shares;
- The right to sell shares before other shareholders;
- Anti-dilution protection;
- Negotiated voting rights; and
- Negotiated veto rights.

RAISING EQUITY CAPITAL

With a clear understanding of the sources of equity financing available at the different stages of a company's development and a capital structure that allows for the growth of the company through investment, the founding entrepreneur is now ready to raise equity capital. Still, every successful entrepreneur must be cognoscente of the factors that influence her or his ability to attract investment. These include but are not limited to the following:

- The quality and experience of the management team
- The business model chosen by the company
- The proprietary positioning of the company's products and services
- The revenue model for the company
- The capital requirements of the company
- The strength of the business sector for the company
- The dynamics of the equities market

The importance of choosing an experienced and outstanding management team cannot be overstated. An excellent leadership team with demonstrated success creates

confidence in the company and helps reduce the perceived risk for potential funding sources of investing in the venture.

The choice of an appropriate business model is also an important factor in helping the entrepreneur to attract and close equity financing. If that choice demonstrates a clear understanding of which business models and strategies have been used successfully by other businesses in the industry, potential investors will see that the company's leaders understand their competition and can develop appropriate strategies to capitalize effectively on business opportunities.

The proprietary positioning of the company's products and services through the thoughtful and prudent use of intellectual property protection provides a differentiated placement of the company among its competitors and yields unique opportunities for collaboration with and licensing to other companies. This strategy may involve a balanced portfolio of intellectual property assets, including the patents, trademarks, copyrights, trade secrets, and know how. With the proper management of these assets, the company increases its value to investors, mitigates the risk that investors assume, and provides additional opportunities for revenue generation.

The revenue model selected by the company is important because it enables the potential investor to understand how and when the company's revenue stream will grow, which helps the investor to understand the future financial requirements tied to the execution of the company's business plan. Further, it helps the investor to project how valuable the company will be in future years when revenue milestones are met.

The financing requirements of the company significantly influence the decisions of potential investors. They will consider, for example, whether the company's current financial requirements align with its stage of development and whether anticipated financial needs will allow the company to execute its business plan. The investors carefully weigh these considerations as they evaluate the possible success or failure of the venture, the anticipated return on their investment, and the length of time before they can harvest that investment.

The strength of the business sector in which the company has chosen to compete may dramatically influence a potential investor's decision. If the company's business sector is weak and underperforming compared to other business sectors, people may choose to invest in a more rapidly growing or better performing market sector.

The dynamics of the equities market can have either a positive or negative influence on the ability of the entrepreneur to both attract equity investment and close the deal under terms acceptable to the company. In an upturned, rising economy, the liquidity and availability of investments from all sources of equity financing are much stronger than in a slow-growing, stagnant, or downturned economy (recessionary). These external factors do restrict the flow of investment capital to entrepreneurial companies due to the conservation of investment capital by potential funding sources or the increased costs to entrepreneurs of acquiring investment financing. In adverse market conditions, conservation of investment capital takes precedence over the placement or flow of funds to support new venture creation or growth. Unfortunately, this dynamic is completely out of the control of the entrepreneur. Bootstrapping techniques and the effective and frugal use of all available financial resources still afford opportunities for entrepreneurs in difficult economic times.

Navigating the sea of financing options available to the entrepreneur may seem daunting, but entrepreneurship is all about identifying opportunities when others see challenges, marshaling the resources necessary to create products and services of strong value to customers, and creating financial rewards for the entrepreneur, investors, and employees.

The entrepreneur should also consider several factors when using equity financing to fund his or her company. Whenever entrepreneurs use equity financing to grow a company, they risk diluting their ownership. Such restrictions tend to ensure that the management team remains in place during the vesting period. The entrepreneur should always discuss with investors what his or her post-financing equity position will be. That entrepreneurs maintain adequate equity positions is important for their continuing commitment to the growth and success of the firms they establish. Additionally, entrepreneurs must ensure that they have adequate representation in their companies' governance and operations and that they experience a financial "upside" when their companies are successful. Also entrepreneurs may wish to negotiate earn-up agreements, which entitle the entrepreneurs to increase their equity holdings if the company exceeds the performance thresholds agreed upon by all parties. Finally, founders should consider active participation in performance options tied to their employee agreements.

ENTREPRENEURIAL EXERCISES

Entrepreneurial Exercise 10.1

Where do you plan to find the initial financing for your proposed business venture? How much from each source?

Self-financing (cash, securities, credit cards, etc.)	\$ _____
Bootstrapping (approximate value)	\$ _____
Friends, family, and interested associates	\$ _____
Angel investors	\$ _____
Venture capital firms	\$ _____
Total capital anticipated to be raised	\$ _____

How much are you above or below what you project is needed?

\$ _____

If below, what percentage of your initial capital needs will you need to find elsewhere? From what sources of equity capital?

Entrepreneurial Exercise 10.2

In no more than two paragraphs, write your proposed “pitch” to an interested angel investor.

Do not copy, post, or distribute

Entrepreneurial Exercise 10.3

Please detail the steps you would take to identify venture capital firms that would most likely consider investing in a business venture such as yours?

If the venture capital firm were willing to provide your business with 80% of its financial needs for the first year of operations, would you be willing to give the firm 50% of the equity in the firm? Why or why not?

If not, how much equity in your business would you willing sell to an investor and for what price?