Chapter 1

RISK, REWARD, SIZE AND TIME TO EXIT

INTRODUCTION

Businesses from street vendors to billion dollar multinationals need capital to grow, even to exist. Many businesses look to banks for capital, but banks only lend to companies that fit a narrow profile and banks are not always the most cost effective or reliable source of funds.

The objective of this book is to equip entrepreneurs, as well as corporate executives, with an understanding of the options they have in raising capital, how they can find funding, and reasonable expectations about what it takes to close a deal. The important thing to know is that there are many alternatives to banks. Some are more expensive than others in terms of cash payments, equity and loss of control.

This book discusses more than a dozen alternatives to traditional bank loans. Some only work for the biggest, most creditworthy companies, others are designed for companies on the brink of failure. Some capital sources provide permanent financing, while others provide financing for as short as a day.

Raising capital is difficult because the company seeking it and the source providing it must fit together like a lock and key. If they do not, funds will not flow. The best capital source for any company will depend on four factors: (i) risk, or creditworthiness of the company, (ii) reward which is how much the company must pay, (iii) transaction size, some sources cannot provide large amounts of capital, others are too expensive to raise small amounts, and (iv) the time to exit, that is the time until the source wants its money back.

A good way to understand the interaction of these factors is to consider the plight of the entrepreneur from the time he or she starts a

company until that company grows to the point where it requires hundreds of millions in capital. Let us start at the beginning.

Entrepreneurs have special problems raising capital because they generally do not fit into the tried and true, steady state mold that banks prefer. Rather than rely on banks, entrepreneurs must live off the land and find capital when and where they can. As a company grows from start-up to early stage, to rapid growth, to maturity, its capital needs will change, and so will the best source of capital.

In this chapter we will list some of those alternatives, but more important we will set the foundation for deciding which capital source is best for any particular company. Business people are very competitive and they can succeed in any game where they know the rules.

UNDERSTAND YOUR NEEDS

Capital is an indispensable fuel for growth because of timing differences between expenditures and customer payments. For capital goods such as plant and equipment, this timing difference may be years. For inventory, that delay might be weeks or months. Capital is also important for product development because expenditures must be made long before products are shipped and customers pay. Capital is also important to fund marketing and advertising and to develop a sales force.

One of the most important rules in raising capital is that a company must understand itself and its needs at a deep level. Those providing capital will probe that understanding and if they find it lacking they will walk away. Two key questions capital suppliers will ask are: (i) why is the money needed? and (ii) how much is needed?

Why Does the Company Need Capital?

If a business doesn't have a well thought-out idea of what it is going to use the capital for, no one will provide it. Those providing capital want to know if the company's object is to:

i) Reach cash flow "break-even?" Cash flow break-even is the point at which a company generates more cash than it needs to sustain operations.

ii) Fund Research & Development? Research and development is essential to keep technology companies from falling behind. However, a company is more likely to get funding for a specific project than for research