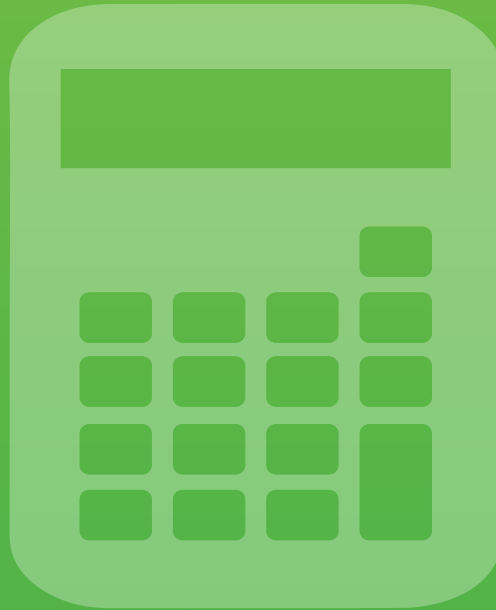
ACCESSING FINANCE GUIDE



RAISING EQUITY FROM PRIVATE INVESTORS

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THINGS TO DO WHEN TRYING TO RAISE EQUITY FROM PRIVATE INVESTORS:

Who are private investors?

Private investors are high net worth individuals looking to invest cash in private businesses in order to gain an acceptable return, based on their perception of the risks. They are not benefactors and can often take a hard and cynical view of the hundreds of business plans they receive, but essentially they are ordinary folk like the rest of us.

What should you look for in a private investor?

- Chemistry: Ensure you feel you can work with the investor to reduce the chances of the 'business marriage' going sour. This ideally is a long term relationship and it should be based, at best, on friendship and, at worst, on mutual respect.
- Evidence: Find out where their capital has come from and confirm that it is available to invest so you can avoid those who just like window-shopping.
- Reputation: Understand the background of the investor. Getting to know what businesses they have been involved in in the past will help you decide on the value they can add to your own business.
- Track record: Ask to speak to the owners of other businesses in which they have invested to establish the investor's credentials.

What are the advantages of a private investor?

- Equity finance is typically a long term investment. There may be a requirement to pay dividends from profits but there should be no sudden requirement to repay the monies invested or to give personal security.
- As well as finance, the right investor can bring skills, contacts and experience to help the business grow.
- Equity investments may create flexibility for future borrowing opportunities because it may be easier to raise bank debt on the back of equity provided by the investor and their reputation.
- The investor's interests are closely aligned to those of the entrepreneur in helping to make the business work.
- It can bring discipline to the management of the business through the implementation of policies, risk management, procedures and external reporting requirements.

What are the disadvantages with a private investor?

- Ownership of the business is shared amongst the equity investors and can be further diluted with successive funding rounds.
- The cost of equity can be expensive in the long term as investors may look for high returns to reflect the investment risk, particularly in early stage businesses.
- It takes effort and time to raise private equity, anything between three and 12 months.
- It is hard to find the right investor, who needs to be someone you can get along with.
- Reduction of the founders control over the business if the investor has input into key strategic and financial decision making.

What are the chances of raising equity from a private investor?

- An investor will make an initial assessment of a business based on a business plan and financial projection.
- On average, 60% of business plans are rejected after a 30 minute review; 10% are rejected after a full day evaluation; 3% are rejected following failed negotiations and only 2% succeed in raising funds.

What do investors look for?

Investment criteria for private investors and investment funds vary quite significantly although generally speaking, most will be looking for ventures which meet the following criteria:

THE TEAM

- Honesty: Honesty and transparency in discussions about the business.
- Management: A full time management team of at least two people. Make sure you have identified someone to manage the business's finances.
- Commitment: Investors like you to have a vested interest in the success of the business, **not** just financially but also in terms of time and commitment.
- Chemistry: Investors back people they like and trust and who are receptive to their input.
- Determination: You need to be focussed, tenacious and show a 'bias for action'.
- Low starting salaries: Don't expect to earn a good salary until the business is doing well.

THE BUSINESS

- High returns: A realistic chance of achieving a high return on capital. 50% per annum is a good starting point which may seem high, but reflects the risk involved in investing in early stage businesses.
- Stage: Investors prefer businesses which are already generating some kind of sales.
- Realistic financial forecasts: Be realistic with your financial forecasts. Investors can hold you to your forecasts and penalise you if they are not achieved.
- High growth potential: Investors like highly scalable businesses.
- Intellectual property: IP needs to be secured within the company.
- Local: Many investors prefer companies close to their home so they can attend board meetings and keep an eye on their investments.
- Market knowledge: Private investors tend to back businesses which interest them, preferring those in sectors in which they have experience.
- Investment ready: Make sure you have a comprehensive business plan with detailed financial forecasts
- Exit route: After putting their money in, most investors want to get it back within three to five years, either through trade sale, sale to other shareholders, refinancing, or, rarely, flotation.

THE DEAL

- Realistic valuation: The business valuation will determine the share of the business relinquished in return for the funding. An unrealistic valuation is a classic deal-killer.
- Simple shareholder structures: Investors want transparency in any deal and may be suspicious of complicated shareholder or corporate structures.
- Due diligence: Make sure you have everything an investor will require for the due diligence process.
- Exit opportunities: Investors don't want their money locked up in illiquid businesses and will need convincing that there will be a viable way for them to exit their investment.

What are the most common reasons investors reject proposals?

- Lack of skills in the management team
- No track record or proof of concept
- Financial forecasts based on weak assumptions
- Too complex
- Inadequate financial returns
- Not scalable
- Lack of trust
- Lack of market awareness
- No clear exit route

What needs to be in your business plan

- Don't make it boring: Like any selling document, keep the reader engaged by making it exciting, colourful and interesting. You also need to show why this is a much better proposition than the hundreds of other business plans they wade through.
- It must be written and understood by you (rather than getting consultants to write it for you), although it is helpful to get an objective critical friend to review it.
- Include all the relevant information:
  The business plan should be short and concise (20 pages maximum plus appendices) and needs to answer all the basic questions:
  - Does it clearly articulate the problem that creates the market opportunity?
  - What are you selling?
  - Who will buy it?
  - How do you divide the market into targeted segments?
  - Who are your competitors and why is your product/service better?
  - How much will it cost and what will it sell for?
  - How will it be promoted and distributed?
  - What are the risks and threats?
  - Who is the team behind it? Include CVs should be in the appendices.
  - How much funding do you need to raise?
  - How will the investors get their money back?
- ''Knock-your-socks-off' executive summary: Your summary needs to cover all the key issues. It is useful to have a one-page and a two-page version to cater to the specific needs of different investors.
- Clear financials: You must have clear and realistic financial projections showing three to five year monthly forecasts, perhaps with a 'Target' version (assuming all goes well) and a 'Survival' version (if things don't quite go to plan).
- Overall the financial model should be an illustration of how your business operates and makes money. If financial modelling is not your strength, it's best to seek advice.

- Prudent financial management: You must explain how you will implement financial controls and procedures to give investors and funder's additional comfort that the business is being well managed.

Keep it real

Your business plan needs to be a realistic statement of the business and the opportunity in order to attract the interest of investors. These are flaws that lead to an early rejection:

- Top heavy management and board but nobody driving the business: A highly qualified team/ board often with senior management experience but without the knowledge of developing an early stage business.
- Unrealistic valuation: A great business but a valuation which implies the founder is neither realistic nor prepared to compromise and let go of the business.
- Serial dabblers: The founder of the business professes to be an experienced entrepreneur but none of the previous ventures have successfully grown and exited.
- Flawed revenue assumptions: Top down sales approach based on achieving a % of market share or sales assumptions that simply grow too quickly.
- Too dilutive in future funding rounds: The business is going to require a lot of additional funding and the structure of the deal will mean early investors and founders risk having their shareholding diluted to nothing.
- Too complicated a deal structure: Most private investors prefer straight forward ordinary shares and not complex deal structures.
- Raising too much money or not raising enough money: An investor wants you to raise only what is required and certainly won't pay for 'fat' in the system.
- No significant stage reached with funding: The investment should get the company to a definable stage such as either break-even, profitability, new markets.
- Momentum: Make sure when you communicate with your investors that it sounds as though your business has momentum and is moving forward. Investors are looking for entrepreneurs who don't see a lack of money as a total barrier.

What not to say in your business plan

- 'This is a wonderful and exciting opportunity.' They all are. Just give the facts and let people make up their own minds.
- 'There is no competition.' If there really isn't any competition you have to persuade the investors that there is a sufficient market.
- 'Can you afford not to invest?' On most occasions, investors feel that they can.
- 'The product will sell itself.' This is never the case.
- 'Our target market is X million.' When on closer scrutiny it is much smaller.
- 'We will achieve a return of £Xm for the investor after 5 years.' You cannot give guarantees of returns.

How to value your business

- Broadly speaking, the valuation of your business determines how much of the business the investor is buying for their investment.
- Before marketing your proposition as an investment opportunity, you have to be clear about the valuation of the business. There is no point skirting around the issue as this is one of the key pieces of information required by an investor to enable them to assess the investment opportunity. Too many people say 'we will talk about valuation when someone is interested' which, in reality, is not the way it works.
- There are established market values for early stage deals and an investor will compare the risks and returns of your deal against other deals being evaluated. If your valuation is too high, you will receive a lot less interest and find it harder to raise money.

How to move forward on a deal

- Once you get an investor interested in your business, it can be a nerve-wracking journey to get them from 'just looking' to 'writing the cheque'. Initially it will be meetings to elaborate on your business plan but the moreyou can bring your business to life, the better. Look to arrange site visits or for the investor to meet other members of staff. There are details to discuss including the valuation, the investor role, conditions that will need to be met before completion, and a detailed list of representations and warranties that need to be provided before drawdown of funds.
- All significant aspects of the deal should be set out in the Term Sheet (also known as Heads of Agreement), in plain English, which will determine the form and content of the other legal documents.

From the investor's point of view any offer to invest in a company may also be 'subject to due diligence' i.e. investigations about the company's financial and legal state (references, credit checks and whether there are any judgements against you). It is useful to resolve the due diligence list early on to avoid delays.

What documentation do you need?

- Term Sheet: The Term Sheet states the significant terms of the deal and it is tactically a good approach to use one to summarise the agreement in broad terms before any documents are drafted by the lawyers. When the time comes to instruct lawyers, ensure you find a lawyer experienced in handling early stage investments. Remember to closely manage your legal costs.
- Shareholders Agreement: This sets out the relationship between the shareholders and covers areas such as who the directors should be and non-compete undertakings.
- Subscription Agreement: Sometimes combined with the Shareholders Agreement, this sets out the terms of the Share Subscription, including pre-conditions of the investment (e.g. the current owners to sign Service Agreements and confirmation of bank finance), warranties about the existing business and details of any options or bonuses to be awarded.
- Service Agreement: This would include employment contracts with the managers and directors incorporating non-compete restrictions.
- Disclosure Letter: This makes disclosures against the warranties in the Subscription Agreement.
- Investment Agreement: In certain situations, such as smaller deals under £50,000, the matters within the documentation above might be dealt with only by a Letter of Agreement/ Conditions of Investment Letter. These letters may be drawn up with little involvement from a lawyer. The advantage is that this process is simply quicker and cheaper.
- Memorandum and Articles of Association: The Memorandum sets out the formal powers of the company, such as its ability to borrow money, to carry on its business, and the company's authorised share capital. The Articles of Association deals with the company's internal regulations and shareholder rights.

What protection does the investor look for?

An experienced investor will use an array of tools in an attempt to protect his or her investment. These might include all or some of the following:

- Liquidation preference: Specifying which shareholders get paid first and how much in the event of a liquidation
- Tag/Drag rights: which protect minority shareholders in the sale of the business
- Pre-emption rights: give existing shareholders an automatic right to take part in new share issues in proportion to their shareholding
- Rights to appoint Executive and Non-Executive Directors
- Service contracts: contracts used to appoint Board level directors
- Good leaver/bad leaver clauses: regulate the valuation of share in the circumstances where an employee shareholder leaves the business
- Future funding rights: specify the rights existing shareholders have to take part in future funding rounds
- Veto rights: the right to say 'no' in certain circumstances
- Key man insurance: insurance for the key people (often the Board of Directors) involved in the business
- Confirmation of existing lender support
- Liquidity event rights: defining the circumstances when initial investors can exit the business
- Information rights: sets out the frequency and type of information that the business must supply to shareholders

How much does it cost to raise equity finance?

There is a lot you can do to prepare yourself beforehand and give yourself the best chance of raising finance as going out to the market without having all the required legal, financial and market information will waste time. In total, the cost of raising finance can be around 8% to 10% of the funds raised.

If you have identified an investor and do not require the assistance of a corporate finance intermediary (who would market your business to the investment community), you are likely to have to pay for the following:

- Legal fees: This is for advice and preparation of all the relevant documentation as described above. You may also need to make adjustments to the Memorandum and Articles of Association.

- Bank fees: If you are also raising bank debt you will need to pay arrangement fees.
- Monitoring fees: Most investment funds will require you to pay monitoring fees once the funds are in place.
- In some cases, you may be able to increase the amount of finance raised to cover some or all of the costs. Like any service, the cost and quality of advice varies significantly, so you need to be selective. In the first instance, make sure advisors are authorised and regulated by the UK Financial Services Authority or the Jersey Financial Services Commission
- Other fees can include:
- Success fees: If you use an intermediary these are payable as a percentage of funds raised through the intermediaries' contacts.
- Advisory fees: Advisers tend to charge fees to review and amend the business plan and financial forecasts, in order to help you become fully 'investment ready', before approaching sources of finance. Rarely do advisers operate on a success-only basis so you need to establish precisely what the fees cover.
- Registration fees: There are networks which charge registration fees to enable entrepreneurs to promote their businesses to the networks' databases of investors, either by email, newsletter or through company presentations.

How long does it take to raise private equity?

Rarely does the fundraising process take less than three months, from distributing the business plan to having the money in the bank. Even when an appropriate investor shows interest, it can take time for them to complete the due diligence process and to conclude negotiations on issues such as valuation and service agreements.

How can you ensure confidentiality?

You should always try to protect your idea, although in practice many venture capitalists, investment funds and investor groups do not sign confidentiality agreements or Non-Disclosure Agreements. This is mainly because they see hundreds of business plans a month and there is far more duplication of ideas than entrepreneurs realise. Having said that, they usually have a duty of care not to use or distribute commercially sensitive information.

If possible, it is best to avoid putting in any truly confidential information in the business plan, since you can never be sure who will read it once it has been distributed, and suing people can be costly. This is particularly important if the information is patent-related. Information that has entered the public domain prior to registration is not patentable. (www.patent.gov.uk). Also, keep in mind that investors looking to see your business plan may be potential predators conducting a bit of industrial espionage to find out what you're up to.

This guide has been provided by Envestors, a Jersey and UK focused angel investor network. For more information on Envestors email ed@envestors.je.

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