"All Financing Sources Are Not Equal"

by Joe Hadzima

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Most entrepreneurs would love to be in the position of having multiple sources eager to invest. However, when you dig beneath the surface, you find that the choices are not easy.

The decision about financing sources involves fundamental choices in deal structure, valuation, cost, and even business strategy. These choices are a function of the different business and legal requirements/realities imposed by the financing source. Unfortunately, there is not much written material available on the subject, but here are some of my observations:

Venture Capital.

The structure and functioning of the professional venture capital industry follows a typical pattern. Professional venture capital money managers form a venture capital limited partnership fund in which they are the general partners, and through which money is raised from wealthy individuals, private and public pension funds, educational endowments, insurance companies, and sometimes operating companies.

The fund typically has a ten-year life, at the end of which the partnership dissolves and distributes its assets to the partners. A typical life cycle of a venture capital fund is as follows: Initial investments are made during years one to four of the fund. Years two to six primarily involve follow-on investments in portfolio companies. Harvesting or "cashing out" of the investments typically occurs from years four through ten. Somewhere in the middle of the fund's life, after the bulk of the initial investment is made and perhaps some harvesting of the early "winners" has occurred, the general partners may start to raise an additional fund, recycling some of the investment success money and adding new limited partner investors. What does this life cycle mean to the entrepreneur? First, you should focus on funds which are in the initial investment phase as opposed to funds which are in their eighth or ninth year.

The entrepreneur also needs to know how the venture capitalists are compensated. General partners receive a management fee of from 1 to 2.5 percent of the assets in the fund. This fee is used to run the operations of the general partners, e.g. pay rent, annual salaries to the general partners, etc. Obviously the larger the fund, the bigger the cash management fee. Larger funds are usually not interested in investing small amounts of money, say under $1M, because the general partners are legally required to monitor the investment, and it takes as much effort to monitor a large investment as it does a small investment. Although the management fee is nice, the real payoff to the general partners

comes through participation in the fund's profits. Typically the profits of the fund are distributed 99 percent to the limited partners, and one percent to the general partners until the limited partners receive all of their investment back, at which time a "flip" occurs and the split is 80 percent limited partners and 20 percent general partners. This structure drives the venture capitalists to invest in potential high-growth and big return situations because it is only through "home runs" that the general partners' 20 percent carried interest is worth much. Moral for the entrepreneur: don't bother pursuing venture capital unless you have a potential "home run" venture. I leave it to you to think through some of the other implications of the institutional attributes of venture capital funds.

Private Placement Through Brokerage Firms.

Two clients are talking with a Wall Street brokerage firm to do a private placement to wealthy individual clients of the firm. They can expect to pay commissions or fees of 10+ percent with some equity "kickers." Why? Brokers receive a small commission by getting their clients to buy and sell securities. The more times this happens, the larger the dollar volume of commissions to the broker. If the broker puts his client in an illiquid private placement, it reduces the amount which the client can use to buy public securities on which the broker makes his normal brokerage commission. The higher commission for the private placement is to compensate the broker for giving up the opportunity to earn his regular commissions. In addition, these private placement deals may have an implicit quicker "exit" requirement than the more patient venture capital funds having a ten-year life.

Strategic Partners.

The strategic partner investor may give higher valuations than other investors because it is more knowledgeable about the business. Sometimes it is not a valuation issue, but the synergies which the strategic partner sees with its own business, which makes it willing to do the deal when others won't from only a financial analysis perspective. A strategic partner which is not financially driven may not be there for future rounds if its technology transfer goals are not being met, if the technology falls out of favor with the partner, or if there are other managerial issues which get in the way.

Private Investors.

Experienced private investors, often former entrepreneurs, can be worth a lot more than the money they invest by adding value through hands-on advice, contacts, etc. On the other hand, do they have the depth of pocketbook to fund multiple rounds of financing if needed?

Summary.

As this quick overflight of investor types shows, not all money is the same, and not all funding sources are equal. The entrepreneur must carefully consider the implications which may follow from the institutional and other requirements of various financing

sources. There are few written materials which cover these points. *Pratt's Guide to Venture Capital* and the *Venture Capital Journal* are good sources for information about professional venture capital. The entrepreneur will have to do some digging to find information about the other financing sources—ask other entrepreneurs, your lawyer, accountant, banker, and other advisors. Once you have amassed as much information as possible, don't hesitate to discuss these issues directly with the financing sources you are considering.

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