Module 5: Capital Formation

Section 1: Sources and Types of Equity Capital

Overview

There are two basic forms of capital formation—equity and debt. Equity capital is raised by selling part of the ownership in the company, typically in the form of capital stock. Equity investment thereby represents the ownership interest held by the shareholders of the corporation. Debt capital is raised by borrowing against the real (tangible) and perceived (intangible) value of the corporation. Borrowing is achieved through bank loans, the bond market (if the company is publicly traded), or through individuals, including the owners themselves (who may lend to their company from personal resources using an "arm's length" debt instrument). The entrepreneur most often is at least a minority, if not majority shareholder. In most small business financing in which bank loans are obtained, the business owner and major shareholders are expected to provide personal guarantees. In the case of bond market related debt, individuals are most often exculpated, or excused, from personal liability.

A successful firm should be adequately capitalized, most often using an optimal combination of equity and debt. A potentially successful business can fail for a lack of the sufficient funds, or undercapitalization, necessary to acquire assets or pay bills. Too much debt, in terms of the income stream and compensating equity, can impede the entrepreneur's ability to manage the business, because profits will be eroded to carry the excessive debt burden.

At first glance, it may appear that a business capitalized almost exclusively through equity, and thereby incurring only minimal debt, is the desired company situation. Although a debt-free business may be desirable, it may also indicate that the owners are at significantly more risk in terms of their capital investment than they would be if they borrowed the capital. In addition, overemphasis on equity may dilute the entrepreneur's control of the business because ownership (and most likely decision making) must be shared with the other investors.

The dilemma, then, is that by obtaining debt, the entrepreneur puts financial pressure on the company, because all debt must be repaid with interest to avoid diluting ownership or the investment of personal funds. By obtaining equity, the owner avoids incurring debt, and thereby the demands of creditors. At the same time, however, ownership is diluted, sometimes by new owners not necessarily compatible with the entrepreneur.
It should be noted, of course, that losing ownership control may put considerable pressure on earnings, as is the case with debt (especially short-term debt), if new or empowered shareholders focus on maximum short-term profits, rather than long-term growth.

The investor is motivated by a desire for capital appreciation, while the lender is driven by a predictable income stream through interest payments and principal curtailment. Thus equity is more risk oriented, with the expectation of greater gains realized over a longer period, whereas the lender is more risk adverse with a desire for a more immediate, comparatively modest, and predictable return on investment. In capitalizing the business, the entrepreneur must weigh the costs (financial and management) and availability of debt and equity capital to determine the optimal capital structure.

Successful capital formation, whether through equity and/or debt, requires that it be adequately apportioned for optimal business use. There are three principal types of capital which are generally required for a successful business:

1. working capital—used to support short-term business operations (e.g., payables, short-term debt)
2. fixed capital—used to acquire permanent or fixed assets (e.g., capital equipment, real estate)
3. growth capital—used for business expansion (including acquisitions) or repositioning

Section 1 will focus on equity capital, discussing types and sources of capital, as well as the concept of private and public capital. Section 2 will focus on debt instruments, discussing the types and sources of loans, including conventional and government guaranteed loan programs.

Section 1: Sources and Types of Equity Capital

Objectives

After completing section 1, you should be able to:

- explain the difference between equity and debt financing
- understand issues pertaining to raising equity capital to initiate or expand a business
- describe the sources of equity capital and the advantages/disadvantages of each
- describe the roles of private investors and venture capital firms in providing capital for the entrepreneur
- discuss the key legislation pertaining to equity markets, as well as the principal exchanges where publicly traded securities are listed

Section 1: Sources and Types of Equity Capital
Lecture Outline

I. Equity capital
   A. key advantage of equity is that it does not have to be repaid (as does a loan)
   B. key disadvantage of equity is that when investors inject equity, entrepreneurs risk losing control of the business

II. Personal resources
   A. an entrepreneur should first look to his/her own resources
      1. savings
      2. personal investments
      3. credit cards
         a. interest rate is higher because cards are unsecured, but credit line can generally be used as entrepreneur wishes without investor/lender oversight
         b. interest may or may not be deductible as an expense if payments are adequately documented
   B. the next source of funds should be family and friends
      1. they know the entrepreneur best, and therefore can emphasize character issues
      2. may be more patient regarding results
      3. this may be the time to call in lifetime IOUs
determine an adequate ROI, which may be below market terms for similar investments (after all, family and friends may still want their investment to produce an acceptable return)

III. Angels
   A. Angels are typically private investors, either sophisticated or unsophisticated
      1. typically invest small amounts (less than $1 million), and expect more modest returns on investments than venture capitalists (25 percent, as compared to 35 percent – 50 percent, annually)
      2. tend to invest locally in specialized niches in which they are either knowledgeable (for example, biotechnology) or have a specific interest (for example, adult assisted care)
      3. often seek an intangible, as well as a monetary, return (for example, they contribute to the betterment of a community by supporting a new or improved senior healthcare clinic)
4. often successful or wealthy individuals who want to give back to an industry or community
5. usually like to stay local (they like to be able to observe progress and "kick the tires")

B. Angels by classification

1. angels amounts from $5,000 to $10,000
2. Angels amounts from $25,000 to $100,000
3. Super Angels from $100,000 to $1,000,000

C. what angels want to see

1. business plan (30 page maximum) with a strong two-page executive summary (this always gets read)
2. should include business plan information described in module 2, sections 2 through 4 (these sections will be read if the angel is impressed by the executive summary)

D. where to find angels

1. Private Investor Network (PIN) in Maryland is network of 75 accredited private equity investors. Contact Dingman Center for Entrepreneurship, University of Maryland, College Park
2. Grubsteak Breakfast in Virginia is a network of leading Northern Virginia business leaders and investors. Contact the Small Business Development Center, George Mason University
3. U.S. Small Business Administration (SBA) has designed a network to bring angels and businesses together
4. personal contacts

IV. Corporations

A. large corporations may be interested in investing in smaller corporations that provide unique services for the large corporation, for example, the large corporation decides it is more economic to "outsource" to the entrepreneur, rather than do the product or service "in-house"
B. foreign corporations may be interested in investing to secure entree to a local market

V. Venture capital firms (or risk capital)

A. private, for-profit companies that acquire equity positions in new, emerging, or turn-around businesses forecasted to produce significant returns on investments within 5 to 7 years.
B. investing results in future profit orientation, rather than short-term ability to repay note, because the emphasis is on capital appreciation not short-term gain. Some investors prefer to lend, with an option to convert the loan to equity, known as convertible debt.

C. venture capital firms are very selective

1. typical venture capital firm will approve one deal per 1,000 that they receive
2. venture capital firms typically look for
   a. competent management
   b. competitive edge
   c. growth industry
   d. intangibles that indicate significant success potential (i.e., chemistry or vision)

D. general expectations for ROI vary with the stage of venture finance and the perceived level of risk (Morris, 1990)

1. seed and start-up companies—minimum 50 percent compounded annual rate of return (high-end risk)
2. second stage financing—minimum 30% - 40%
3. later-stage financing—minimum 25% - 30% (low-end risk)
4. profit target matrix of venture capital firms

<table>
<thead>
<tr>
<th>Profit Target</th>
<th>Compounded Annual Pretax Rate of Return</th>
</tr>
</thead>
<tbody>
<tr>
<td>triple investment in 3 years</td>
<td>44%</td>
</tr>
<tr>
<td>triple investment in 5 years</td>
<td>25%</td>
</tr>
<tr>
<td>quintuple investment in 3 years</td>
<td>71%</td>
</tr>
<tr>
<td>quintuple investment in 5 years</td>
<td>38%</td>
</tr>
<tr>
<td>seven times investment in 3 years</td>
<td>91%</td>
</tr>
<tr>
<td>seven times investment in 5 years</td>
<td>48%</td>
</tr>
<tr>
<td>ten times investment in 3 years</td>
<td>115%</td>
</tr>
<tr>
<td>ten times investment in 5 years</td>
<td>58%</td>
</tr>
</tbody>
</table>

E. not all venture capital firms inject equity funds as their primary financial role; "camp followers" are venture capital firms which either seed, or initiate, the deal in order to establish price and credibility, or include well known individuals who act as advisory and add credibility (Kingsley 1990).

F. venture capital firms tend to specialize in five investment segments (Tankersley 1990)
1. location  
2. industry  
3. stage of investment  
4. capital required  
5. leadership role (i.e., active or passive)

G. Venture capital firms conduct a thorough due diligence, which can take at least 90 days, or longer, depending on the size, stage, and complexity of the deal.

H. Venture capital firms must be carefully analyzed, and relationships and objectives clearly defined (Pratt 1990)
   
1. The venture capitalist is a fully engaged partner with representation on the board and access to all financial information and decisions  
2. Chemistry and personalities are important

I. Sources for venture capital

1. *Pratt's Guide to Venture Capital Sources* a comprehensive guide to U.S. and Canadian venture capital firms, listing industry preference, project preference, geographic preference, preferred investment, and management team. Pratt's is published annually, and contains articles and other information pertinent to understanding and working with venture capitalists.


3. Small business investment companies (SBICs)
   
   a. SBICs and SSBICs are private for-profit venture capital firms licensed by the specialized small business investment companies that provide venture capital to small independent new and established businesses
   b. Two types (for the most part, the same rules apply to both)

- SBICs
- SSBICs that target socially and economically disadvantaged businesses

   c. Commercial banks may own an SBIC subsidiary, which enables banks to provide equity capital without violating banking laws
   d. To encourage the formation of SBIC, and thereby provide sources of equity, the SBA has generous matching funds programs for funding the SBIC capital resources

VI. Private offering (a.k.a. private placement)
A. investment offered to a small group of investors, generally under exemptions to registration requirements of the Securities and Exchange Commission and state laws (Friedman 1987)
B. monitored for compliance under the SEC’s Regulation D
C. encourage investments in small businesses or start-up companies
D. simplified options for small businesses

1. Regulation S-B simplifies initial filing requirements and ongoing disclosures; company must be in the United States or Canada, have revenues less than $25 million, and have outstanding securities of less than $25 million
2. Small Company Offering Registration (SCOR)
   a. maximum amount of capital raised is $1 million
   b. price per share at least $5
   c. for any type of investor and for any type of security
   d. recognized in 38 states, including Maryland, Virginia, DC
3. must file a standard Form U-7 disclosure, which consists of answering 50 short questions

VII. Going public, or selling shares of corporation to investors to raise equity in the public-sector capital markets

A. advantages
   1. capability of raising large amounts of capital
   2. improved access to future financing
   3. potential to attract and retain key employees by the company's ability to provide tangible incentives (warrants, stock options, etc.)
   4. marketability if listed on a public exchange

B. disadvantages
   1. dilution of entrepreneur's ownership
   2. SEC reporting requirements
   3. financial disclosure requirements

C. securities registration typically requires the assistance of financial professionals, including an investment banker, who is part of a firm, acting as underwriter or agent, that serves as intermediary between an issuer of securities and the investing public

Three basic types of underwriting formats

1. firm commitment—investment banker, either as manager or participant in a syndicate, makes outright purchases of new securities from the issuer and distributes them to dealers or investors, profiting on the spread between the purchase price and the selling (public offering price)
2. best efforts—the investment banker markets a new issue without underwriting it, acting as an agent, rather than a principal, and takes a commission on whatever amount of securities are sold.

3. standby commitment—the investment banker agrees to purchase for resale any securities not taken by existing holders of rights to the securities.

The investment banker's role begins with pre-underwriting counseling and continues after distribution is completed, usually with a seat on the board. Direct underwriting responsibilities include preparing the SEC registration statement, pricing the securities, forming and managing a syndicate, and identifying buyers. Many investment bankers also maintain broker-dealer operations for both wholesale and retail clients in brokerage and advisory capacity.

Investment banking, also known as merchant banking, also advises clients on mergers and acquisitions (M&A), and taking debt or equity positions on investments.

D. other key players in a public offering
   1. securities lawyer
   2. accountant
   3. registration agent

E. typical initial public offering (IPO)
   1. 400,000 shares
   2. $10 to $20 per share
   3. $5 to $10 million (including commissions and fees) raised
   4. 25 percent – 40 percent of the total company
   5. underwriter's commission is 7 percent – 10 percent of total offering proceeds
   6. total costs for IPO are about 12 percent of the offering proceeds

F. key stock exchanges

1. New York Stock Exchange (NYSE)—The oldest exchange in the United States, founded 1792, also called the Big Board. Total voting membership consists of about 1365 seats that are owned by individuals who are usually partners or officers of securities firms. More than 1,600 companies are listed that meet the NYSE's listing requirements, and account for about two-thirds of all shares traded nationwide. To be listed on NYSE, corporations must have:
   a. at least 1,000,000 common voting shares outstanding
   b. 2,000 round lot shareholders
   c. $16,000,000 market value
   d. quarterly reports
   e. solicitation of proxies for annual meetings and selecting directors
   f. voluntary delisting—2/3 shareholder approval with no more than 10% disapproving
NYSE is a two-way auction market because there are competing buyers and competing sellers on the floor of the exchange.

2. American Stock Exchange (AMEX)—This exchange has the second biggest trading volume in the United States and is also known as the Curb Exchange. Most AMEX trading involves small and mid-sized companies, as well as options trading for many NYSE listed stocks. In addition, more foreign shares are traded on AMEX than on any other U.S. exchange.

3. Over the Counter (OTC)—Securities are not listed and traded on organized exchange, and securities transactions are conducted through a telephone and computer network linking dealers, rather than on the floor of an exchange. OTC stocks are typically those of smaller companies that do not meet NYSE or AMEX listing requirements. Many otherwise qualified companies choose OTC, believing that the system of multiple trading by many dealers is preferable to centralized trading at NYSE, where all trading in a stock must go through the exchange specialist in that stock. OTC is regulated by the National Association of Securities Dealers (NASD).

VIII. Key federal legislation impacting securities and equity (Christy and Clendenin, 1978)

A. the securities industry on the federal level. It requires registration of securities before public sale, and adequate disclosure of pertinent financial information and other data in a prospectus to facilitate informed decision by potential investors. It also prohibits false representations and disclosures. This act did not supplant state "blue sky" securities laws which deal with fraud prevention.

B. Glass-Steagall Act of 1933—The Congressional legislation authorizing deposit insurance and prohibiting banks from owning brokerage firms and investment banks. Banks are prohibited from investment banking activities such as underwriting corporate securities. The law was designed to protect commercial and savings bank depositors from securities industry risk. Banks have challenged this law by offering money market funds and discount brokerage services, and were recently allowed to underwrite corporate debt securities.

C. Securities Exchange Act of 1934—The law that created the SEC to enforce the Securities Act of 1933 and to outlaw misrepresentation. The law requires registration of all securities and periodic financial disclosures, the disclosure of holdings and transactions of insiders (officers, directors, and those who control at least 10 percent of the stock), SEC registration of broker dealers to assure compliance, surveillance of trading practices by the SEC, and the regulation of margin requirements for securities purchased on credit. This act was amended in 1975 by the National Exchange Market System Act, which enabled the SEC to establish a nationwide system of clearance and settlement of transactions.
D. Maloney Act, 1938—This act amended the Securities Exchange Act of 1934 to provide for regulation of the OTC market through national securities associations registered with the SEC (that is, NASDA).

E. Investment Company Act of 1940—This act requires registration and regulation of investment companies by the SEC, and sets standards by which mutual funds operate regarding reporting requirements, pricing, and investment allocation within a portfolio. The registration statement and prospectus of every investment company must state its specific investment objectives.

F. Securities Investor Protection Act of 1970—This act created the Securities Investor Protection Corporation (SIPC), which insures the securities and cash in the customer accounts of member brokerage firms against failure by those firms. All broker dealers registered with the SEC and with national stock exchanges must be members. It is similar to the Federal Deposit Insurance Corporation (FDIC), which insures banks. If a firm fails, SIPC will try to merge it with another firm. Failing this, SIPC will liquidate the assets and pay off account holders to a maximum of $500,000 per customer (a maximum of $100,000 of which can be cash).

Section 1: Types of Business Ownership

Relevant WWW Sites

  A service of Batterson Venture Partners, and is provided for entrepreneurs seeking venture capital and investors seeking investments in entrepreneurial high growth companies.

  *American Venture Magazine*, a quarterly publication for entrepreneurs, angels, and VCs. The site provides an ordering form for a complementary copy.

- [http://www.businessfinance.com/](http://www.businessfinance.com/)
  America's Business Funding Directory. A free site for locating sources of equity and debt capital.

  NVST.com Private Equity Network site. A fee-based membership program that provides exchange for entrepreneurs, advisors, and investors.

- [http://4venturecapital.com/publications.shtml](http://4venturecapital.com/publications.shtml)
  Site provides links to various venture capital groups (e.g., Allied Capital) and management consulting firms.

Section 1: Types of Business Ownership

Exercises
1. Define equity financing and discuss its advantages and disadvantages when compared to debt financing. Describe the most common and assessable sources of equity capital.

2. What is an angel? Describe the various types of angels, how they can assist a start-up small business, and what business criteria they consider when evaluating a company.

3. Describe the operations of a venture capital firm, the types of companies targeted, and the expected return on investment.