The 9 “Deadly” Capital Raising Mistakes

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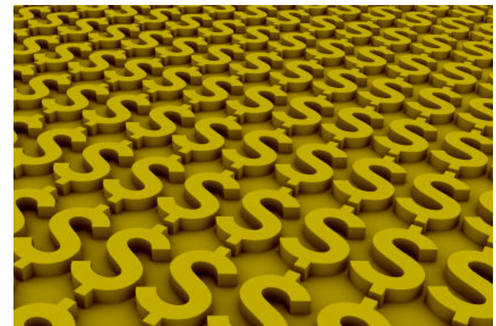
Introduction

Capital is the fuel that allows businesses to grow. Without capital, businesses fail. With capital, early stage companies can begin to grow, and mature companies can achieve even greater scale.

EVERY business requires capital to grow. Some businesses are able to finance their growth through customer revenues. That is, generating revenues and re-investing these revenues in their companies to develop the infrastructure to grow further.



Many other companies rely on debt or equity capital infusions into their companies in order to build infrastructure and grow.

The majority of companies do both. They raise outside capital AND rely on internally generated revenues. And, in terms of outside capital, most companies raise multiple types of capital such as capital from friends and family AND secured lines of credit AND credit card financing.

For early stage companies, particularly those with little or no track record of success, the challenge is to find the capital they need. Because the vast majority of businesses fail, banks, venture capital firms and other lenders and investors are often highly skeptical and not willing to part with their dollars unless significant conditions are met.

For later stage companies, the challenge is to find the right capital at the right terms.

Legendary football coach Vince Lombardi once said, "We didn't lose the game; we just ran out of time." A similar thought holds true for companies -- "we didn't fail, we just ran out of money." Running out of capital is the number one reason companies fail. With capital you have the runway to do whatever is needed, such as alter your products and services and chosen markets, in order to improve your business over time and succeed.

Capital Raising Mistake #1

Targeting the Wrong Types of Capital

One of the biggest mistakes that entrepreneurs and business owners make when raising capital is targeting the wrong types of capital.

Perhaps the biggest blunder within the category of targeting the wrong types of capital are firms who incorrectly believe that venture capital is the solution for them.

Specifically, venture capital firms (VCs) have very strict criteria regarding scale, speed and liquidity potential. They want to fund companies that can grow very quickly (implies a significant relevant market size), achieve significant revenues, and be sold or go public for many times the company's current valuation.

As a result VCs tend to fund technology companies that typically have scale, speed and exit potential. Conversely, many traditional businesses like retail, food & beverage, manufacturing, restaurants and real estate are NOT appropriate for VC financing.

The second key blunder within the category of targeting the wrong types of capital is the fact that most firms seek just ONE type of capital. There are approximately 20 types of capital that can be used to grow your business. For example, in addition to venture capital, Google relied on angel investors, friends and family investors, credit cards, and bank loans in order to build its technology and grow its business.

Capital Raising Mistake #2

Raising the Wrong Amount of Capital

A critical question which entrepreneurs and business owners must answer is how much capital to raise. The amount of capital you are seeking effects the capital sources which might be available to you. It also might have a significant impact on your overall control of your company.

In determining the amount of capital to raise, you need to consider the following factors:

- **Source of funds**. If you are seeking capital from a venture capital firm, the amount of capital sought generally needs to be above $1 million. Even at $1 million, it's too small for most venture capital firms. Why? Because many venture capital firms manage massive funds and rather invest and focus on fewer deals. In addition, it costs money for them to conduct due diligence on new companies, and they rather spread that cost among bigger deals.

- **Control**: In general, the more equity capital you raise, the more control of your company that you are going to give up. Many entrepreneurs and business owners are reluctant to give up too much control.

- **Your ability to comfortably pay back the funds**. If you are seeking debt capital (which, unlike equity capital, needs to be repaid over time), you need to make sure that the amount of capital borrowed, at the interest rate in which you are borrowing it, does not put too much of a financial burden on your firm.

  Oftentimes firms who are faced with a significant monthly debt repayment are forced to make bad decisions to service their debt; that is, make decisions that generate short-term cash but hurt long-term value (e.g., offering deep discounts to customers to generate cash now, but which harm your long-term profitability and/or cause customers to expect more discounts in the future).

- **What milestones have you met and when will you accomplish your next milestones**. There are many hurdles required to raise different rounds of capital. For example, the main hurdle to get from a Series A to a Series B investment is for the entrepreneur or business owner to demonstrate market adoption.

  If you have not met a major milestone such as market adoption, you are probably not ready for a Series B venture capital round (typically $5 million to $10 million), but rather maybe better suited for a Series A venture capital round (typically $2 million to $5 million). Likewise, if your company will reach an important milestone in the near future, it is often smart to raise less capital now (giving up less equity), reach the milestone, and then raise more capital at a higher valuation (the valuation of the company goes up as you achieve milestones).

- **Room for error**: unless your financial projections have been developed in conjunction with a firm who has significant financial model experience for emerging companies, chances are that you have exaggerated your revenues and underestimated your costs. Make sure you request more money than you think you might need in order to cover contingencies and unforeseen circumstances. You do NOT want to run out of money.

To figure out your precise capital requirements, you need to put together a statement of your sources and uses of funds. You also need to build your complete financial model, including your income statement, balance sheet, and cash flow statement. It is the cash flow statement that you really need to focus on.

For those of you who are not too versed in financial modeling, a purchase such as computers goes on your balance sheet and cash flow statement, not your income or P&L statement, which is why you must focus on the cash flow statement when determining funding requirements.

In preparing your financials, be sure to conduct research and create the most realistic assumptions possible. Once you know your precise cash needs, consider the issues above (e.g., source of funds, control, etc.) and modify your business strategy as needed to reflect your financing needs. For example, if you decide it's best to raise less money now, then you need to modify your roll-out and HR strategies (since this will most likely require you to roll-out and hire more slowly).

Capital Raising Mistake #3

Having a Weak Business Plan

Want to turn off investors and lenders? Then tell them you have no competitors and that you compete in the trillion dollar healthcare market.

But seriously, making mistakes like these can **ruin** your chances of raising capital.

For starters, most business plans complicate their message. Believe it or not, after reading the first page of most business plans, investors often do not understand the business in which the company is operating! This is particularly true when a company is involved in a complex, highly technical business. It may seem obvious, but it is critical to remember that investors cannot invest in what they do not understand.

Here is one extremely simple idea that unfortunately most business owners don't leverage: relate your business to a successful existing business. For example, if you plan to offer an online book club membership, say that your company is like Netflix, but for books. Anyone will get that concept right away. Or maybe your company is a Hollywood-themed dry cleaning chain; if so, say your business is the Planet Hollywood of dry cleaners.

Other key mistakes include excluding successful companies and presenting large, generic market sizes.

With regards to excluding successful companies, too many business plans want to show how unique their company is and, as such, list no or few competitors. However, this often has a negative connotation.

If no or few companies are in a market space, it implies that there may not be a large enough customer need to support the company's products and/or services. In fact, according to Joel Balbien, former partner at Smart Technology Ventures, including successful and/or public companies in a competitive space can be a positive sign since it

implies that the market size is big. It also gives investors the assurance that if management executes well, the company has substantial profit and liquidity potential.

With regards to presenting large, generic market sizes, defining the market size for a company too broadly provides little to no value for the investor. For example, mentioning the trillion dollar U.S. healthcare market is generally extraneous since no company could reap $1 trillion in sales in this market.

Rather, a more meaningful metric is the relevant market size, which equals the company's sales if it were to capture 100% of its specific niche of the market.

Specifically defining and communicating a credible relevant market size, and a plan to capture a significant share within this market is far more powerful and believable to investors.

Capital Raising Mistake #4

Failing to Develop and Present a Complete Financial Forecast

The Financial Plan section of your business plan must explain how the execution of the company's vision will reap great financial rewards for the lender or investor. As such, it is the section that lenders/investors often spend the most time scrutinizing.

There are five key elements that you must include in your Financial Plan.

1. Detailed Revenue Streams

The Financial Plan should verbally present the revenue model of the company including each area in which the company derives revenue. These revenue streams could include, among others:

- Sales of products/services
- Referral revenues
- Advertising sales
- Licensing/royalty/commission fees
- Data sales

2. The Pro-Forma Financial Statements

The Financial Plan must numerically detail the revenue model through past (if applicable) and pro-forma (projected) Income Statements, Balance Sheets and Cash Flow Statements. It is critical that the figures used in these statements flow from the analyses in every other section of the business plan. For instance, the relevant market size (Industry Analysis) should be reflected, as should competitors' operating margins (Competitive Analysis), customer acquisition costs (Marketing Plan), employee requirements (Operations Plan), etc.

A summary of the financial projections should be presented in the text portion of the plan, while full projections should appear in the Appendix. For existing companies, the

Financial Plan should note any significant deviations (e.g., increase in margins) between past and projected results.

3. Validating Assumptions and Projections

The Financial Plan must also detail the key assumptions such as penetration rates, operating margins, headcount, etc. It is critical that these assumptions are feasible. For instance, if the company is categorized as a networking infrastructure firm, and the business plan projects 80% operating margins, investors will raise a red flag. This is because investors can readily access the operating margins of publicly-traded networking infrastructure firms and find that none have operating margins this high.

A key point is that while every company is unique, each bears similarities to other companies. Accessing and basing financial projections on those of similar firms will greatly validate the realism and maturity of the financial projections.

4. Sources and Uses of Funds

The Financial Plan should detail the sources and uses of funds. The sources of funds primarily include outside investments (e.g., equity investments, bank loans, etc.) and operating revenues. Uses of funds could include expenses involved with marketing, staffing, technology development, office space, etc.

5. Exit Strategy

Equity investors greatly desire and are motivated by a clear picture of the company's exit strategy, or the timing and method through which they can "cash in" on their investment. This picture best comes into focus when the key valuation and liquidity drivers of the company are clearly delineated. An excellent method to accomplish this is through descriptions of comparable firms that have had successful liquidity events, either through acquisition, merger or public offerings.

The most common exit strategies in business plans are IPOs or acquisitions. While the method of exit is not always crucial, the investor often wants to see the choice of exit laid out in the plan in order to better understand the management team's motivation and commitment to building long-term value.

Capital Raising Mistake #5

Not Using Online & Offline Networking to Your Advantage

A lender or investor is looking at two equally compelling business plans that they are interested in funding. One has a CEO that was introduced by a close friend. The other CEO they just met.

Who will they fund?

Well, all else being equal, the investor will most likely fund the company with the CEO who was introduced by a close friend. The introduction implies trust, which is an important factor in making investment decisions.

And perhaps more importantly than trust is simply coming into contact with the right investors. By networking, both online and offline, you can accomplish just this.

In the a recent Growthink interview of Kwiry.com CEO Ron Feldman, Feldman revealed that a chance encounter with an investor at an alumni networking event resulted in a capital raise from a prominent venture capital firm.

Likewise, even Google's founders raised their initial equity capital via networking. Specifically, Page and Brin told their ideas to others in hopes that they would get great advice and connections.

And sure enough, it worked. Page and Brin discussed their concept with their computer science professor David R. Cheriton. Cheriton then introduced them to his friend Andy Bechtolsheim. Bechtolsheim then wrote Google a check for $100,000.

If you already know some quality people, speak to them and then get them to refer you to other people. If you feel you don't have highly networked people that you know, go out and find them.

Go to industry events and conferences and meet people. Befriend them and follow-up with them. Then get them to open up their networks to you. And/or meet them on professional networking sites like LinkedIn, Spoke or Facebook. (Interesting note: Spoke (http://www.spoke.com/) usually features a member on their home page. The other day the featured member was Tim Connors, a General Partner at US Venture Partners. Yes, investors DO use social networks to meet people.)

Capital Raising Mistake #6

Not Being Creative

If there's one capital raising mistake that really angers me, it's this one: Not Being Creative.

Why? Because entrepreneurs are, by their very nature, extremely creative people. They come up with great products and services, great marketing concepts, etc. So why don't entrepreneurs use their creativity when it comes to financing?

While there are many other examples of creative financing, consider these accomplishments:

- When he first launched his company, **shoe designer Kenneth Cole** had no money. So, he found a small Italian shoe production facility that had been hit hard by the economy of the 1980s and desperately needed more clients. Cole approached the company and got it to offer him a line of credit (they manufactured the shoes and he didn't have to pay for them until he sold the shoes), and they immediately started manufacturing shoes.

- **Australia's Blowfly Beer** was equally creative in funding its early operations. How? The company sold equity to its customers. Not only did this provide the capital that that company needed, but it provided the company with market research, a customer base, and great word of mouth advertising (people are much more likely to support and promote products in which they invested).

You are an entrepreneur. You are creative. Now get creative in your financing!

Capital Raising Mistake #7

Failing to Get Meetings with Investors

The best investors are inundated with business plans. As such, it's not easy to get their attention and even harder to convince them to invest the time to meet with you.

Like most other things in entrepreneurship, if you take the easy road, you will lose!!! Want an example? Well, most venture capital firms have forms in which you can submit your business plan or a generic email address (e.g., businessplans@ourvcfirm.com) to send your plan.

It is extremely rare that investors fund these plans. In fact, these plans are collected mostly for *research purposes*. For example, if investors are considering investing in a company, they will use the generic business plan submissions to search for stealth-mode competition. They will also look at the market research within some of the generically submitted plans to learn more about markets and competition…not to fund the plans themselves!

Rather, smart entrepreneurs research who the right individuals are at professional investment firms (e.g., private equity firms, venture capital firms, banks, etc.) and use teaser emails to gain their interest.

Capital Raising Mistake #8

Poor Presentation Skills and Collateral

Far too often, investment discussions go astray because of poor oral presentation skills on the part of Company management and weak collateral (i.e., investor slide presentation).

Active investors across the risk spectrum (startup equity to secured debt) are literally inundated with investment opportunities. It is not unusual for a principal at a high profile venture capital firm to review dozens of prospective investments every month.

As such, it is imperative that your investment presentation be extraordinarily brisk, to the point, and delivered with flair and great enthusiasm. If the key presenters on a management team do not have these skills, then invest immediately in professional presentation and public speaking coaching, or replace company principals with more impressive presenters. It is that important.

Likewise, it is always good to try to adhere to venture capitalist Guy Kawasaki's 10/20/30 Rule of PowerPoint as follows: a PowerPoint presentation should have ten slides, last no more than twenty minutes, and contain no font smaller than thirty points.

In investor meetings, be sure to focus on investors' key needs such as discussing "what pain does your solution solve" and "what is your timeline/roll-out plan/milestones."

Capital Raising Mistake #9

Not Being Fully Prepared

Once you've made it past the first meeting or two with a venture capital firm, angel investor, bank, etc., you'll begin to be hit with a barrage of questions and requests. This will progress until, if you're lucky, you'll enter the due diligence phase.

The highly meticulous due diligence screening phase is the main boundary between investors meeting you and hearing about your venture, and their allocating funds to your cause.

Unfortunately, many entrepreneurs do not adequately prepare for this phase, and oftentimes, while having to deal with the day-to-day aspects of running their businesses, entrepreneurs respond too slowly to due diligence requests. This delay can derail a deal and thus cost the entrepreneur their funding.

Growthink's 10-Point Checklist for Preparing for Due Diligence includes the ten key due diligence items that equity investors seek and the ten key items that debt investors seek.

For example, equity investors will want to see your capitalization table and employment agreements, and business loan/debt lenders will want to see your business tax returns for the last 3 years (if applicable) and your accounts receivable and payable aging forms.

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How Growthink Can Help

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