LOCKHART business advisors

Chartered Accountants

... When Advice Matters ...

In the Company of Strangers: Should Your Business Bring in Investors?

Sometimes the difference between a good business and a great business is simply having sufficient capital to execute your business plan. For many businesses, the owners have put everything they have into growing the business but there is still a gap. Investors offer an opportunity to close that gap but at what cost?

How do you know you need investors?

Unfortunately, most businesses seek investment funding at the point it is most critical or for the wrong reasons - seeking funding for a business when it is in financial distress is always going to be hard. Neediness is never a good negotiating position or very attractive. And, few will be prepared to invest to save you.

Funding from investors is used to fund growth where a major investment is required - where the business cannot service its growth or capital requirements and these requirements are greater than what the business can fund on its own.

On most occasions, investment is needed to build out scale and take advantage of the potential of the business. In many cases the owners can only afford to fund a portion of what is required but the scale they need will make the difference between an okay business and a great business.

What will investors expect?

Before seeking investors you need to get your house in order.

Every business operator knows that they should have a business plan in place. Most don't. With a strategic business plan, you can track performance and growth, departures from the plan, etc., and this management information will tell you the point at which you need investment - either debt or another form. A strategic business plan will also inject reality into blue sky entrepreneurialism and flush out many of the issues that investors will inevitably question. It will shore up the business case and demonstrate that the growth path anticipated has been sufficiently thought through - a big issue for many entrepreneurs.

This planning stage is important because there are more ideas chasing capital than there is capital chasing ideas. You have one chance to pitch to investors and often you are competing with a range of unrelated or different opportunities.

Investment types

Investment can be debt or equity investment. A debt investment is paid back in some form. There are many ways to structure debt investment from traditional interest payments to profit sharing.

Equity investment however is what most people think of when they think of investors. Equity investment is where the injection of capital buys equity in the business and often a degree of management participation or control. There are many ways of structuring these arrangements depending on the motivation of the parties involved - everything from a direct injection of cash to the provision of essential infrastructure and knowledge.

Investor types

The most common investor for SMEs is family or friends investing out of loyalty and often a belief in the skill set of the business operators. The key problem with family and friends as investors is that often the details of the investment are loose. Trust is high and everyone has a belief, at the beginning, that the other party will act in their best interest. If family and friends are investing, you must put in place the same level of formality to the arrangement as if strangers were investing. It prevents confusion and upset.

Another reason for a high degree of formality is that on some occasions, the person looking to unwind or exit the arrangement in the future will not be the person who entered into it. It's important to ensure that the exit provisions are clear in case someone dies.

Commercial investors come in many forms – angel investors, venture capitalists, private equity, or investment by associated parties. At the SME end of the market, angel and venture capitalists dominate.

Angel investors tend to operate at investment levels between $100k and $500k. Angels are generally individuals looking to for a great idea from a start-up that they can capitalise on.

Private equity investors are at the other end of the scale and look to invest tens of millions - generally with established businesses reaching for another level and expectations of high growth. Private equity generally look for a compound internal rate of return on capital in excess of 30%. They look for high returns and an identified exit timeline. They want confidence in return on capital and ultimately, return of capital.

In general, commercial investors will seek a regimented approach - shareholders agreement, restrictions around what can be done without their consent, and a clear exit path. This is not an area you should approach without expert advice.

Some things to look out for

•Insufficient formality around the agreement – misunderstandings and boardroom battles over direction take the focus off achieving growth

•The wrong structure at the beginning – a bad deal won't get better

•Exit clauses - look at what the deal looks like at the end of the investment not just at the beginning

•Not being able to fulfil the stated plan - be certain about what you're offering

•What are you giving away? Often business owners are so keen to secure the investment they forget about what they are giving away

•Control and how much the investor can achieve over time and the influence they have - you don't want to be voted out of your own company once it's successful

•The level of management control and influence exerted - infighting and debates about direction will only take the focus off the big picture

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