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Sources of capital: Pros, cons, and comparisons

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Sources of Capital: Pros, Cons, and Comparisons

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The second most important objective of a high-tech entrepreneur is to raise capital. Perhaps he needs funds to develop a disk drive idea into a marketable concept. Perhaps he is looking for R&D money to build a prototype medical device. Or, maybe he makes environmental testing equipment and needs to finance a move into overseas markets.

Seed capital. Start-up money. Funds to fuel expansion. Whatever the need or product, all these people share one thing in common: they need capital to underwrite their dreams.

How much money is being raised to finance high-tech businesses? No one really knows the answer. But the total pool of capital raised from just one source—venture capital funds—reached $7.5 billion last year, which is nearly triple the total invested in these funds as of 1977.

According to Stanley E. Pratt, publisher and editor of *Venture Capital Journal*—a magazine that has been tracking the venture capital industry for more than two decades—the pool grew by about $1.6 billion in 1982, well above the $1.3 billion increase in 1981 and miles ahead of the paltry $39 million raised five years before.

And remember, this is but one source. Add in the capital raised through initial offerings of public stock, bank loans, private placements, Small Business Investment Companies, and the like, and the total pool could well add up to tens of billions of dollars.

Venture Capital

Despite the glamour attached to the name, venture capital is probably as old as commerce itself. Earlier in our own century, the great venture capitalists were the families that controlled private fortunes—the Rockefellers, Whitneys, and Astors—people who were able to take big risks on tosses of the economic dice.

In our own day, venture capital is very much a creature of the tax laws. When the capital gains tax was raised from 25 percent to 49 percent in 1969, much venture capital simply evaporated. A decade later, the capital gains tax was rolled back to 28 percent, and interest revived. The annual amount of venture capital invested nearly doubled in a year—from $550 million in 1978 to about $1 billion in 1979. The tax rate reduction in 1981, from 28 percent to 20 percent, further spurred growth.

Another factor in venture capital's growth is the Small Business Investment Act of 1980. This act makes it considerably easier for venture capital firms to raise public financing, since they can sell up to $5 million in securities without having to meet SEC

registration requirements. Managers can also own a piece of the action. It is much like an ordinary mutual fund but without that fund's restrictions.

The business development companies created under this law can raise capital from the sales of shares to the public, and this capital can be invested in companies not yet traded publicly. The net result is to make more money available for less-established businesses—and up to 70 percent of new venture capital is believed to go to high-tech enterprises.

Venture capital investment usually is made at four stages in a company's growth: seed, start-up, high-growth, and established. The expected failure rate ranges from 70 percent in the seed stage to 20 percent in the established stage.

What are the private venture capitalists looking for in terms of ideas? Lately, productivity-enhancing inventions have been very much in style—a reaction, no doubt, to a cost consciousness heightened by recessionary times. There seems to be a move away from biotechnology investments, which may only be temporary, and toward computer software, process control, office automation, CAD/CAM, robotics, and the health care area. One widely recognized source of measuring venture capital activity reports that ideas fostering productivity improvement accounted for 82 percent of all new venture capital invested in 1981.

Most venture capitalists seek aggressively managed companies, those aiming to reach $10 to $15 million in revenues and at least $1 million in net earnings within a five- to eight-year period. In other words, quick-growing companies that can either go public or be sold to a larger company at a substantial profit.

"Out of every ten investments," says Edward A. Goodman, a general partner in Hambro International Venture Capital, a private venture capital fund, "I expect to come up with at least one really great company which will provide a compound annual return of 50 to 65 percent. Two or three others will perform very well, with returns of between 20 and 35 percent. You might get three more that will generate 10 to 15 percent, while on the rest you will cover only part of your investment."

Al Palladino, a general partner in Advanced Technology Ventures, also comments on the return question: "It would be fair to say that each firm has its own return criteria, but a 38 to 40 percent compound annual return over a five-year period would be acceptable to most investors in a professionally managed venture capital firm."

Most venture capital firms are partnerships, with money drawn from large corporations, family trusts, wealthy individuals, and, more and more, from pension funds and foreign investors. With potential returns at 40 percent or more, small wonder that pension funds have eagerly been putting a portion of their portfolios into venture capital. Indeed, during the first six months of 1982, Stanley Pratt reports that 32 percent of the $706 million in new money that came into the venture capital pool came from pension funds, which was the largest single source of investment.

Another source, now more frequently seen, is the venture capital subsidiary of large corporations. This started when some of the larger companies realized that their own size and complexity often dampened the entrepreneurial drive needed to invent tomorrow's technologies.

Partnerships or corporate, professional venture capital firms can invest their money pretty much as they please; their only obligation is to their investors. As a result, they can take bigger risks in the hope for bigger payoffs.

Not so with Small Business Investment Companies (SBICs). Created by special legislation, SBICs qualify for long-term loans at favorable rates from the U.S. Small Business Administration. They are the most conservative of the breed—barely considered venture capital firms by many observers. In the main, they are geared toward small businesses that will grow slowly and moderately, partly because of federal restrictions on the types of investments they can make, partly because they pay interest on the money they invest. Only $300 million was invested by SBICs in 1980.

Initial Public Stock Offerings

On the face of it, given the recent roaring of a bull market, a promising company should be successful going public at any stage in its life cycle. An even stronger argument might be made for high-technology companies. According to Norman G. Fosback, publisher of the newsletter *New Issues*, about 45 percent of the 400 companies that underwriters expect to go public in 1983 will be high-tech companies. These companies are not only leading initial public stock offering (IPO) activity, they have the highest valuations of IPOs in history—some over $500 million.

The prospect is surely tempting. Based on last year's new issues, the best investment opportunities were high-tech companies. On average, reported a recent issue of *Venture* magazine, information processing new issues rose 40.7 percent, medical technology new issues rose 112.4 percent, computers and new software issues rose 109.7 percent, and electronics new issues rose 225 percent.

But when one stops and thinks about it, a shrewder strategy—particularly for a high-tech company that can raise capital by other means—might be to delay going public *until the company and its products have proven themselves in the marketplace.* With a tidy balance sheet and an attractive profit and loss statement, the initial offering price at that stage is likely to be substantially higher, meaning more

money raised for less equity given up.

Many of my friends in the investment banking community would not agree with this perspective, and the bull market gives credence to their arguments. But, having gone the entrepreneur route twice myself, I would suggest that owners of a young, growing company have enough to be concerned about—without worrying about the SEC, public shareholders, and all that goes with being a public organization. So long as U.S. tax policy continues to encourage investment by venture capital firms, and so long as the pool of venture capital continues to grow, most high-tech entrepreneurs should probably think about going public only after their first dreams—of development, profitability, and growth—have been realized.

Bank Financing

Some deals practically scream for bank financing. Not long ago the management of a U.S. company that manufactures communications equipment landed a major order with a foreign customer. The company was doing well, management had its own money invested in the business, and the order would assure them a 45 percent margin on the sale. Their first thought was to raise $500,000 of working capital to build inventory by going the venture capital avenue. "Hold it," I said. "Don't give away any equity. You don't need to."

They didn't. First, they had their overseas' sales representative open a letter of credit with a bank in its home country. This guaranteed payment for the product when delivered FOB point-of-shipment. Then, with the letter of credit as collateral, they arranged financing with a short-term line of credit (L/C) tied to an L/C through a bank in the U.S. Everyone made a profit at a reasonable risk, and the company did not forfeit any of its equity position.

Not all bank financing is so easy. As fiduciary institutions—guardians of the deposits entrusted to them—banks are required by law to avoid unnecessarily risky investments. The way they often do this is by gaining access to property worth as much as they lend. This is another way of describing collateral, and collateral is something that entrepreneurs—except the few very wealthy ones—rarely have much of when starting their business.

But banks are changing. The traditional asset-based or debt-financing vehicles are looking more and more like debt with convertible equity features. A number of banks are agreeing to lend money to a fledgling enterprise in return for some type of equity "kicker"—a return that reflects the risk being taken—in addition to the interest on their loan. Many of them have corporate finance departments, and the really aggressive ones will package a debt deal with equity investors that they bring to the party. Organizations like Citibank and Bankers Trust are giving new meaning to the Glass-Steagall Act—and it's good news for the entrepreneur.

Private Placements

Private placements, without the use of a reputable financial services organization, are for the very well connected. The investor usually wants a real return, beyond the tax writeoff, and the promise of future profits. Although the expected return would usually be less than a venture capitalist ought to expect, the corresponding risk that is most often associated with private placement is lower. So far, private placements have been limited as sources for high-tech capital.

How do you persuade an investor to put money in your company? Sources for high-tech capital scrutinize every business plan they receive. They place a great deal of emphasis on their projected compounded annual return and the company's projected growth and profitability possibilities. Investors look to see if you know your weaknesses and your strengths—how good your people are and how strong is your motivation. They examine how realistic your views are and how flexible you will be to make them a success. And then, they frequently turn you away. Statistics indicate that only three out of every 100 hopeful companies achieve agreement with an investor and obtain the capital they need to survive.

One group of Boston entrepreneurs recently went about it the wrong way. They declared a need of $700,000 to get them through the rest of this year, with $4 million next year—not unreasonable requests on the surface. But then the projection showed they needed *$400 million* the following year. Obviously, they had no idea of the impression they were making on the venture capitalists they were talking to. Here was a group that was having some difficulty in meeting its current payroll, and it wanted to corner 25 percent of last year's total private venture capital commitments.

High-tech entrepreneurs have special obligations. On the one hand, they must know enough about their product, its technology, and its potential market to satisfy would-be investors or lenders that the promise of future profits more than compensates for present risks. Then, they must learn which sources of capital are most likely to be attracted by what they offer.

There's good news and bad news to report about these facts. The bad news is that the high-tech company's appetite for capital in its development stage and start-up phases will discourage many investors from all but the most promising projects. The good news is that investors everywhere are looking for a first-rate idea that promises to take off. △