Equity Raising Myths

There are a number of issues that entrepreneurial companies need to consider when thinking about raising equity capital. The first question that needs to be addressed is "What do I need the capital for?" It might be to enable you to grow your business (either organically or by acquisition). Alternatively it might be to provide you with a partial exit from the business or to allow you to reduce your company's debts. On the following pages we analyse these issues with a particular focus on:

- Preparing your business for equity raising
- What equity investors look for in a business
- Sources of equity investment
- The cost of equity
- Other considerations.

Preparing your business for equity raising

The raising of additional equity is a significant event in the development of your business. When raising equity capital, first impressions count, so it is important to get things right, first time.

As you approach the equity raising process you should focus on two key objectives:

- Maximising your chances of successfully raising equity; and
- Optimising the value at which new equity buys into your business.

To achieve the above, it is important that you have prepared your business for the equity raising process. We call this process of preparation “grooming”.

Grooming your business enables you to identify and mitigate potential risk areas and present your business in the best light possible to potential providers of equity. From the outset, objectivity is a key issue. You should approach your business as if you were an outside investor. Using an independent advisor can be advantageous, as they bring a degree of objectivity to your review of the business and are often able to identify areas of risk that may not seem obvious to you. It is important to remember that what may not seem like a risk to you, might appear to be a very real risk to an outside investor.

So what does grooming involve? It involves a whole range of risk identification and mitigation actions that apply to all aspects of the business.

What do equity investors look for?

Myth #1 – Equity investors are only interested in high growth, high tech businesses

It is a commonly held misconception that equity investors focus solely on high growth and high tech companies. While these sectors certainly received more than their fair share of attention during the late 1990s, in today’s environment the reality is that equity investors are willing to invest in a far wider range of sectors than many people think.

Key factors equity investors look for in a company are:

- A quality management team with a proven track record.
- An attractive company with maintainable growth prospects / competitive advantage.
- An attractive sector.
- A sound and well researched business plan.
- A strategy for delivering value growth in your company.
- A clean and tidy business.

A quality management team with a proven track record

Equity investors will look for a committed management team possessing all the skills necessary to grow the business to its next level of development and will be reassured if these skills are spread amongst a team of individuals rather than in one key person. Management's commitment is typically evidenced by a shareholding or other performance-related incentive. Management teams of proven calibre with a successful track record will have a clear advantage with investors.

An attractive company with maintainable growth prospects / competitive advantage

Equity investors will examine the critical success factors of the business and seek to identify where the company has sustainable competitive advantage over other companies in that sector. Examples of competitive advantage include high market share (or a defensible niche position), strong brands, intellectual property and / or some form of technological advantage.

An attractive sector

Although equity investors will consider many sectors of the economy for investment, some sectors will be more favoured than others. Clearly sectors that can demonstrate a growing market, limited competition or potential outside of India will be more attractive than those where the market is shrinking, competition is intense (and potentially price driven). Accordingly it is important to consider your company's competitive position within its sector and how attractive this would be to potential investors.

A sound and well researched business plan

Typically you will need to provide equity investors with some form of written document outlining your proposals for their equity investment. This document is normally prepared in the form of a Business Plan and should provide a clear explanation of the background to your business, what your company does, its critical success factors and what the equity capital is required for.

The more detailed and better researched the Business Plan is, the more favourable the impression you will make on potential equity investors. For example, it is important that the Plan considers such issues as the overall size of the market for your company's products/services, how quickly that market is growing and what share of the market you currently have. In addition your Business Plan should consider your company's competitive position vis-à-vis other players in the sector. In all of the above respects, an independent advisor can add significant value to the preparation of your Business Plan.

A strategy for delivering value growth in your company

Equity investors are typically looking for a combination of dividend yield and capital growth from their investments, albeit where growth prospects are good, dividends may not be a priority. Accordingly it is important that they can see a clear strategy for growing the value of your business. In addition, most equity investors are also concerned with how they will exit their investment in your business. The anticipated timeframe to exit will vary according to the particular circumstances of the company and the nature of the investor. However it is not unusual for equity investors to exit their investment after three to five years. Accordingly your Business Plan needs to thoroughly explore potential exit routes for the equity investors.

A clean and tidy business

As discussed in our section on "Preparing your business for equity raising", a business that has its internal housekeeping in order is more likely to create a favourable impression on an equity investor.

Sources of equity

Myth #2 – There is a shortage of equity available for SME's

While we often hear that there is a shortage of equity available for SME's in India, in our experience, there is no shortage of capital available for the right opportunities.

The sources of equity capital are to some extent dependent on the amount of capital you wish to raise and the stage of development your business is at.

Friends and family.

Friends, family or close business colleagues provide the vast majority of equity capital for most small and medium-sized businesses. The advantages of approaching friends and family are that they are already known to you and that they may not impose the same requirements on their investment as a third party. However, relying on friends and family for equity investment can produce additional strains both on the business and on your personal relationships. Friends and family are typically involved in providing seed or start-up capital of up to $1 – 2 million.

Business angels / habitual investors.

India has a number of private individuals who are willing to invest in small and growing businesses. Very often these individuals are former businessmen who have accumulated significant wealth and can bring not only capital but additional expertise to your business. The key issue with accessing these individuals is finding the right person for your particular business and sector.

Private equity investors.

Private equity investors are fund managers that focus on investing equity in privately owned businesses. Private equity institutions typically raise their money from third party investors or invest the funds of their parent company. There are a number of private equity institutions operating and investing in India, ranging from those focused on start-up and seed capital to the larger funds focused on $5m+ of equity.

The Stock Exchange.

The Stock Exchange is typically best suited to companies with larger market capitalisations (in excess of $50 million). However, in recognition of the difficulties some companies face in raising smaller amounts of equity, SEBI is proposing a new, secondary market, for SME's. The exchange has yet to be formally launched but is intended to provide a public market for companies seeking to raise relatively modest amounts of equity.

Irrespective of the amount of equity you are seeking to raise, there is significant advantage in using an independent professional advisor to direct you towards the most appropriate source of funding for your particular circumstances. All of the above providers of equity will have their own individual preferences as to sector, stage of investment and quantum of investment. A professional advisor can add significant value by eliminating those investors unlikely to be interested in your business and by presenting your opportunity to investors in the most appropriate form.

The cost of equity

Myth #3 – Equity has no fixed return and is therefore cheap

Many business people are under the misconception that equity is a cheaper form of finance than debt. The reality is that nothing could be further from the truth. Equity is typically the most expensive form of finance available to a business.

So what is the cost of equity? Investors typically expect equity returns in the range of 15-35% (depending on the risks involved) for investing in small to medium-sized private businesses. In the case of early stage or start-up companies where the viability of the product is yet to be proven or where the company is not currently cash flow positive, the returns expected by investors can comfortably exceed 50%. These returns are measured as a combination of dividend flows and and capital gains.

To many entrepreneurs, this level of return can seem excessive. So why is equity so expensive?

Equity investment in private companies is one of the riskiest forms of investment open to an investor. If we consider the investment opportunities available to a large investor, be they an individual or a financial institution, we can rank them both in terms of risk and reward. The following table sets out an indication of the levels of risk and reward investors can expect from different asset classes:

Asset Class	**Risk**	**Typical Returns**
Cash	Usually very low	4-5.0% (pre tax)
Government Bonds	Very low	5-7% (pre tax)
Blue Chip Corporate Bonds	Low	6-8% (pre tax)
Property (rental & capital gain)	Medium	6 – 18% (pre tax)
Public Equity Investments (stock market) (dividend & capital gain)	Medium to high	15 - 25% (post tax)
Private Equity Investment (dividend & capital gain)	Very high	25 - 35% (post tax)

Accordingly private equity investment requires higher returns to offset the greater risks that it presents. So what are the risk factors attaching to private equity investment? They include:

- The inherent risk of smaller companies compared to larger companies. Small companies have less scale and are more likely to suffer from issues such as lack of competitive advantage, lack of market power and insufficient management depth.
- The lack of liquidity in private company shares i.e. there is no ready market for the buying and selling of shares in private companies.
- The higher entry and exit costs that attach to making an investment in private company shares as opposed to public quoted shares (e.g. legal and due diligence costs).

In addition to the returns that investors expect, there are also typically costs attached to the raising of equity in terms of arrangement fees, legal and professional fees and ongoing monitoring and compliance costs.

Other considerations

Myth #4 – Equity investors will constantly interfere with the running of my business

Most equity investors will not want to be actively involved in the day-today running of your business. Typically private equity investors are from a financial background rather than an operational one and consequently are more concerned more with the monitoring of their investment, than the detailed operations of the business.

The areas where equity investors will typically want to be involved are in attending monthly Board meetings and participating in major decisions surrounding business strategy, major items of capital expenditure, appointment of key management and the capital structure of the business.

The following list provides an indication of the typical requirements of an equity investor:

- A seat on the company's Board
- Monthly management accounts
- Detailed budgeting process
- An outside review or audit of the company's financial accounts
- Discipline and control in respect of decision making and authority levels.

In addition to the above, the major requirement of most private equity investors will be for a clear and defined strategy to exit from the business. Typically most equity investors will need to be convinced that they are able to realise their investment in your business at some point in the future. Accordingly your funding proposition needs to identify clearly the potential exit routes for their investment. In addition, the major strategic decisions within the business need to be made with the investor's ultimate exit in mind. The most common forms of exit for equity investors in private companies are:

- Trade sale
  The business is sold to a company which has some existing business in, or understanding of, the industry sector.
- Initial Public Offering ("IPO")
  The business is floated on the stock market and the equity investor is able to sell their shares on the public market.
- Refinancing
  The business is refinanced (either through new equity or new debt) at some point in the future and these funds are used to repay the equity investor's investment.