CHAPTER 8

Raising Capital

> Money is always dull, except when you haven't got any, and then it's terrifying.
>
> Sheila Bishop, *The House with Two Faces* (1960)

INTRODUCTION

As Gene Wang, a successful business owner, noted, for the entrepreneur who is in the capital-raising stage, there are four important things to do:

1. Never run out of money.
2. Really understand your business or product.
3. Have a good product.
4. Never run out of money.[1]

These are great words of advice, but for many entrepreneurs, accomplishing points 1 and 4 is easier said than done.

One of the most common complaints about entrepreneurship concerns money. Entrepreneurs repeatedly lament the fact that raising capital is their greatest challenge because there seemingly is never enough and the fund-raising process takes too long. These are not groundless complaints. Thomas Balderston, a venture capitalist, said, "Too few entrepreneurs recognize that raising capital is a continuing process."[2] Also, it is extremely tough, as it should be, to raise capital, be it debt or equity, for start-ups, expansions, or acquisitions. The process typically takes several years and multiple rounds.

The founding and funding of Google is a classic example of this process. Initially, college friends Sergey Brin and Larry Page maxed out their credit cards to buy the terabytes of storage that they needed to start Google. Next, they raised $100,000 from Andy Bechtolsheim, one of the founders of Sun Microsystems, and another $900,000 from their network of family, friends, and acquaintances. Subsequently, Google raised $24 million from two venture capital firms and $1.67 billion from its IPO. The company was $3^1/_2$ years old when it raised venture capital, and $8^1/_2$ when it had its initial public offering (IPO).[3]

Why is it so difficult to raise capital? The most logical reason is that capital providers are taking major risks in financing entrepreneurial ventures. Remember the statistic cited in Chapter 2? Roughly 60 percent of businesses fail within the first 4 years, and almost nine out of ten fail within 10 years. Over a long time window, the success rate is only 10 percent. Given this fact, capital providers are justified in performing lengthy due diligence to determine the creditworthiness of entrepreneurs. It may seem sacrilegious for this author to say, but it must be said: those who become entrepreneurs are not entitled to financing simply because they joined the club.

As stated in Chapter 1, one of my objectives for this book is to supply you with information, insights, and advice that will, I hope, increase your chances of procuring capital. Here are some words on the advice front: since it is so tough to raise capital, the entrepreneur must be *steadfast and undeviating* in this pursuit. Recall from Chapter 2 that this is one of the traits of successful high-growth entrepreneurs. They are not quitters. They are thick-skinned enough that hearing the word *no* does not completely deter or terminate their efforts. A great example of an entrepreneur with such perseverance is Howard Schultz, the CEO of Starbucks. When he was in search of financing for the acquisition of Starbucks, he approached 242 people and was rejected 217 times. He finally procured the financing, acquired the company, and today boasts a public company that has 12,400 locations and more than 145,000 employees.[4]

VALUE-ADDED INVESTORS

Howard Schultz and all other successful high-growth entrepreneurs know not only that it is important to raise the proper amount of capital at the best terms, but that it is even more important to raise it from the right investors. There is an old saying in entrepreneurial finance: whom you raise money from is more important than the amount or the cost. The ideal is to raise capital from "value-added" investors. These are people who provide you with value in addition to their financial investment. For example, value-added investors may give the company legitimacy and credibility because of their upstanding reputation.

Value-added investors also include those who help entrepreneurs acquire new customers, employees, or additional capital. A great example of an entrepreneur who understands the importance of value-added investors is the founder of eBay, who accepted capital from the famous venture capital firm Benchmark. Ironically, eBay did not really need the money. It has always been profitable. It took $5 million from Benchmark for two reasons. The first was that it felt that Benchmark's great reputation would give eBay credibility. The second was that it wanted Benchmark, which had extensive experience in the public markets, to help eBay make an IPO.

Another great example of an entrepreneur who understood the importance of a value-added investor is Jeff Bezos of Amazon.com. When pursuing venture capital financing, Bezos rejected money from two funds that offered a higher valuation and better terms than Kleiner Perkins Caufield & Byers (KPCB), which he accepted. When asked why he took KPCB's lower bid, he responded, "If we'd thought all this was purely about money, we'd have gone with another firm. But KPCB is the gravitational center of a huge piece of the Internet world. Being with them is like being on prime real estate."[5]

In addition to investing $8 million, KPCB also helped persuade Scott Cook, the chairman of Intuit, to join Amazon.com's board. KPCB also immediately helped Bezos recruit two vice presidents and, in May 1997, helped him take Amazon.com public.

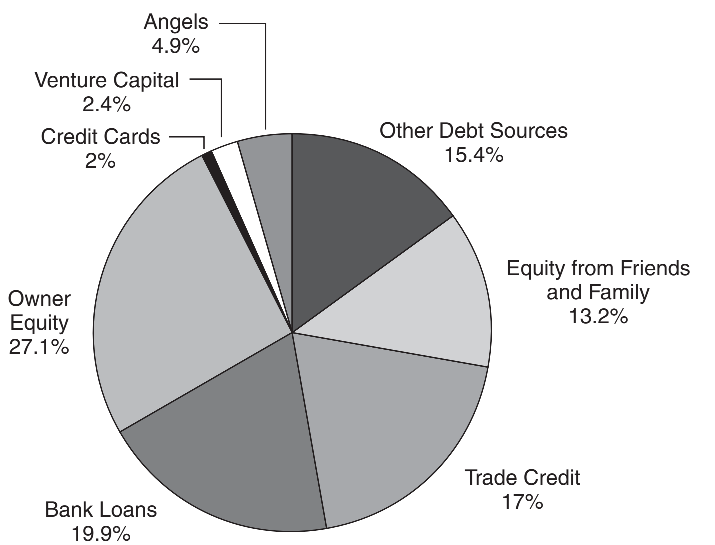
While these two examples highlight only venture capitalists, it must be made perfectly clear that there are several other sources of value-added capital.

SOURCES OF CAPITAL

The source of capital that gets the most media attention is venture capital funds. But in reality, as Figure 8-1 shows, these funds have been a small contributor to the total annual capital provided to entrepreneurs. According to the 2006 Global Entrepreneurship Monitor (GEM) report on financing, eliminating venture capital would not make a perceptible difference in entrepreneurial activity overall because fewer than 1 in 10,000 new ventures has venture capital in hand at the outset, and fewer than 1 in 1,000 businesses ever has venture capital at any time during its existence. According to the GEM, across the world, 62 percent of start-up funds comes from the entrepreneurs themselves, with the remaining 38 percent coming from external sources.[6]

FIGURE 8-1

Sources of Small-Businesses Financing



Source: Offroad Capital/Federal Reserve National Survey of Small Business Finances.

Money from friends, family, and the owners themselves is a bit more difficult to track. Table 8-1 shows data from a study conducted a few years back that examines the more formal sources of financing for entrepreneurs, and it shows that banks, with $179 billion in annual loans to small businesses at that time, were the most active backers of entrepreneurs. The number two providers, with $9.6 billion, were nonbank financial institutions such as GE Capital and Prudential Insurance. Venture capital was less than one-tenth of the amount of capital provided by banks. These relative levels have not changed drastically today.

TABLE 8-1

Sources of Capital for Entrepreneurs

Banks	$179 billion
Nonbanks	96 billion
Angels	30 billion
Venture capitalists	10 billion
Other	20 billion
Total capital	$335 billion

The fact that banks are more important to entrepreneurship than venture capitalists can be further highlighted by the fact that even the most active venture capitalist will finance only 15 to 25 deals a year after receiving as many as 7,000 business plans. The result is that in fiscal year 2000, after receiving approximately 8 million business plans, the entire venture capital industry invested in a record 5,380 companies. This is akin to a pebble in the ocean compared with banks. Arthur Andersen reported that each year, approximately 37 percent of the more than 20 million small-business owners apply for a commercial loan, and bankers reject only 25 percent.

THE INVESTMENT IS IN THE ENTREPRENEUR

While there are many sources of capital, there are basically two ways to finance a business: the capital can be invested in the form of debt or in the form of equity. Be it debt or equity, the most important determinant of whether the capital will be provided is the entrepreneur and his management team. As venture capitalist

Richard Kracum of Wind Point Partners said, "During the course of 70 investments we have made in many different kinds of situations over a 16 year period, we have observed that the quality of the CEO is the top factor in the success of the investment. We believe that the CEO represents approximately 80% of the variance of outcome of the transaction."[7]

The importance of the entrepreneur can be further supported by a statement from Leslie Davis, former vice president at South Shore Bank in Chicago, who said, "The most important thing we consider when reviewing a loan application is the entrepreneur. Can we trust him to do what he said he would do in his business plan?" Banks, just like venture capitalists, bet on the jockey. Now, the horse (the business) can't be some run-down creature knocking on the door to the glue factory, but ultimately, financial backers have to trust the management team. What are investors primarily looking for in entrepreneurs? Ideally, investors prefer people who have both entrepreneurial and specific industry experience.

As Table 8-2 shows, investors grade entrepreneurs as either "A," "B," or "C." They believe the best entrepreneurs to invest in are the "A" entrepreneurs, people who have experience as an owner or even an employee in an entrepreneurial firm, and also experience in the industry that the company will compete in.

TABLE 8-2

Investor Ratings of Entrepreneurs

Rating	Experience
A	Entrepreneurship and industry
B	Entrepreneurship or industry
C	No entrepreneurship or industry

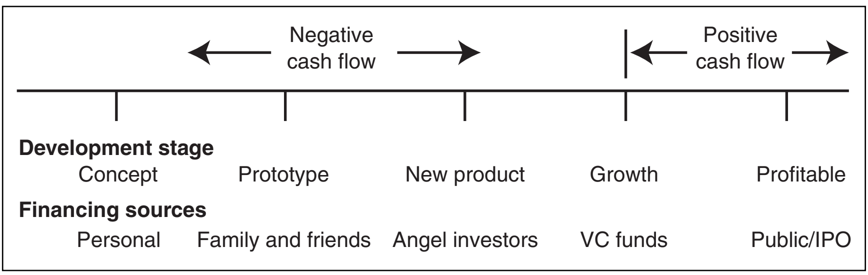
The second most desirable investment candidates are the "B" entrepreneurs, who have experience either in entrepreneurship or in the industry, but not both.

The last category of people is the least attractive to investors. People who fall into this category should try to eliminate at least one of the shortcomings prior to seeking capital. As one investor said, "There is nothing worse than a young person with no experiences. The combination is absolutely deadly." There is nothing a young person can do about her age except wait for time to pass. But experience can be gained by working for an entrepreneur and/or in the desired industry.

The financing spectrum in Figure 8-1 best depicts the financing sources typically used by start-up entrepreneurs. In Chapter 9, "Debt Financing," we will discuss each of these sources in greater detail. And at the end of Chapter 9, we will show how one entrepreneur became successful by using almost all the sources. Using all the sources is quite common among successful high-growth entrepreneurs.

FIGURE 8-2

Financing Spectrum



NOTES

1. *Chicago Sun-Times*, April 4, 1996, p. 44.
2. *Business Philadelphia Magazine*, November 1996.
3. Global Entrepreneurship Monitor, "2006 Financing Report," p. 14.
4. Starbucks, 2006 Annual Report, Starbucks home page, www.starbucks.com.
5. *The New Yorker*, August 11, 1997.
6. Global Entrepreneurship Monitor, "2006 Financing Report," p. 12.
7. *Buyouts*, February 19, 2001, p. 56.