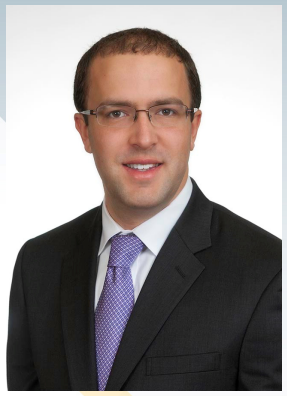
Raising Capital For Your Business? The Advantages and Disadvantages of Equity Financing



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As a business owner, it is often necessary to find resources to raise capital in order to fund growth. Some of the capital raising options available to entrepreneurs include equity financing, debt, and hybrid financing. It is important to be aware of the advantages and disadvantages of each of these funding options in order to select the one that best meets your business needs. In this article, we discuss raising capital through equity financing.

Equity financing can be a very appealing option for funding growth when a company is not yet generating positive cash flow from operations. Unlike debt, equity does not have an amortization schedule that requires the capital to be returned at a specific time. The ability to retain the capital and reinvest it in the company instead of returning it to the lender on a set timeline allows business owners to invest in infrastructure or intellectual property.

When seeking an equity investment, there are several items that a business owner needs to determine: How much capital does the business require to grow and over what period of time is the capital needed? How much ownership and control is the owner willing to relinquish? What type of partner is the owner seeking? What is the ultimate goal for this capital raise? When is the right time to try and raise equity capital? How frequently is the owner willing to invest time in capital raising, and what impact will that focus have on the ability to focus on the business' growth? How many investors will need to be added in order to meet the equity financing requirements of the business, and what are their investment objectives? These questions cannot be answered one at a time by the business owner. Contemplating the questions together causes business owners to step back and examine the situation from a holistic perspective.

To begin the process of raising equity, a business owner needs to determine the amount of equity that their business needs to execute its goals. One exercise that helps an owner determine the amount of capital necessary is to project the anticipated cash burn that the company will experience over a given time period. The time period is typically the time that it is going to take the business to start generating positive cash flow or get to the next round of the capital raise. Knowing this number will help ensure that the business owner is able to execute the growth and development desired by the venture capital investor.

Once the amount of equity needed is determined, the owner has to determine the timing of the raise. The timing of the equity raise is important to maximize value for the business owner and to set the business up for success while minimizing equity dilution. A business owner can seek one large investment, or try and space out the rounds of capital raises. If an owner wishes to execute one large capital raise, they will hopefully only have to go through the process once, but will ultimately likely take a larger dilution in ownership and control assuming the company executes it growth initiatives, and its valuation grows over time. If an owner chooses to instead seek smaller equity investments over a period of time, the owner will take less dilution than in the former situation. This assumes that the

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enterprise value of the company increases as time lapses. Ultimately the same amount of capital can come into the business, but the original owner will retain a larger portion of the value and control of the company. There is a considerable amount of execution risk associated with this strategy. The time spent in future fundraising rounds detracts from the owners' ability to focus on the business' operations. A cost-benefit and risk analysis should be performed to see which timing sequence works best for the given situation.

The particular partner chosen by the business owner is equally as important as the amount and timing of the money, and this decision can be a strategic one. Accessing "smart money" from a strategic partner who knows the industry can yield new opportunities and vision for the company. Bringing in a strategic partner has the ability to add credibility to your business, and this additional credibility is beneficial for future financing needs. It can also be beneficial if/when you, as a business owner, decide to sell your business.

Equity investments do not come without their own set of disadvantages. Typically equity investors require a rate of return on their investment that is greater than that of a debt instrument. With the equity investment, the business owner is selling off a portion of the future profits and value of their business. The greater the equity investment, relative to the enterprise value of the business, the more control the business owner will be selling. When seeking an equity investment, a business owner needs to be conscious of the fact that they will no longer be the sole decision makers.

These investments also can come with complex regulations by the Securities Exchange Commission (SEC). Most offerings will need to comply with Regulation D unless they are issued under Regulation A, a part of the JOBS Act. In addition to SEC regulations, equity offerings also have to comply with State regulations. As a result of the regulations surrounding equity offerings, the professional fees associated with this type of capital sourcing can become expensive.

Knowing this information, a business owner should spend a considerable amount of time researching and understanding the behaviors and expectations of the potential equity investors. It is important that the new equity investor shares the business owner's vision for the company.

As with most business decisions, the facts and circumstances will dictate the path that the owner takes. It is important for the business owner to evaluate the short-term and long-term needs of the business and the costs associated with each of the options. In subsequent blog posts, we will evaluate other capital raising options, including debt.

If your business is experiencing a need for new capital, and you would like to be advised on your different options, please contact your Keiter Professional or Scott Zickefoose at szickefoose@Keitercpa.com.

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