White Paper

CORPORATE FINANCE INC.

CFI is a steadfast advocate of entrepreneurs and small business enterprise. We believe society's well being is, in large part, the product of entrepreneurship and that every citizen should care about creating an economic and social environment in which emerging ideas can flourish. CFI encourages research and analysis of issues about entrepreneurship and helps disseminate the ensuing White Papers – including many published by senior management of CFI portfolio companies.

Strategies for Equity Capital

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The Margin Between Private and Public Earnings

Investors are attracted to high-growth companies at an early development stage because of the potentially high return on their investment. Entrepreneurs need equity capital and can benefit from strategic alliances with large corporations. Large corporations are interested in the innovation and earnings that come from entrepreneurship through strategic alliances. Merging the interests of each group presents opportunities for all. *Strategies for Equity Capital* is a plan that melds the needs and contributions of these three groups.

The challenge for small businesses and investors is to profit by taking private companies to the point where they can be valued as public companies. Rather than the traditional "all or nothing" approach to an IPO, the process described in *Strategies for Equity Capital* can be viewed as a gradient or series of stepping-stones. Each milestone will add to the company's valuation and allows it to accept capital, while on the way to achieving an exit strategy for investors to cash out.

The dramatic difference in the valuations between private companies and public companies presents an investment opportunity. A privately-held company is typically valued at two to three times earnings, yet investors are willing to pay twenty times earnings or more for public companies that have good growth potential. By having a clear strategy to bridge this gap, a tremendous opportunity exists for investors and entrepreneurs alike.

Investor Interest In Entrepreneurship

It is relatively easy for investors to find companies with innovative products and strong margins, led by dedicated entrepreneurs. Yet while investors recognize the strong up-side potential to investing in small high-growth companies, they are also aware of the risks. These include the danger of dealing with companies that lack capital, a strong management team, or a clear strategic plan for the investor to realize his return. Due diligence determines whether there are sound financials and a cohesive business plan. However, to be an attractive investment, a company must be structured correctly to accept capital and later pay its investors a superior return without a negative impact on the company's growth.

Achieving investor liquidity through an "exchange listing" via an initial public offering has been the ideal, but is often unattainable for a small fast-growing company. The largest barrier to entry is not the $2 million in net worth, the $4 million in assets, or the 350 shareholders that are required for listing. The firm must be a 12G reporting company due to all the government red-tape requirements. The single biggest obstacle is that the entrepreneur cannot allocate the time and expense to personally handle the process. Neither can he afford the management talent to attract the capital, handle the acquisitions, deal with investor relations, and oversee filing the required documents to take the company public. Normally these requirements are met in conjunction with an IPO and are part of the reason for the $500K price tag.

Investing in just one company, no matter how promising, logically carries an element of risk. Always a matter of weighing the costs against the benefits, the chances for loss are substantially decreased by increasing the number of deals in which an investor can participate. However, he does not have unlimited investment dollars nor the time to conduct his own due diligence. Even with virtually unlimited time and resources, there are many unknown factors to an investor that can impact the return on his investment.

The ideal investment strategy for equity capital is to identify a diversified series of high-growth, well-managed, emerging companies and structure the investment so that it offers viable exit strategies for investors. An early-stage bridge fund that receives stock, in addition to interest income, can have a highly diversified return. This self-liquidating fund ends up with an investment in 15-20 high growth companies. If only one of these companies becomes a public company, the fund will realize a high return. It is not unusual for a venture capital fund to yield 45% per year.

Capital For The High Growth Company

Entrepreneurs who succeed today are driven by a compelling vision to create a profitable business in a highly competitive marketplace. Their vision is fueled by determination and represents much more than a job or a way to make money. This relentless commitment creates innovation and wealth in our economy.

Entrepreneurs have been faced with almost insurmountable obstacles to success. In addition to the overwhelming government regulations imposed upon businesses, there are all the normal challenges of producing a product and selling it at a profit. At each step the entrepreneur is also faced with the daunting task of acquiring capital to fund his venture.

The vast majority of entrepreneurial undertakings are initially self-financed through a combination of savings, small personal loans, and credit cards. Often idealistic risk-takers, entrepreneurs generally underestimate the amount of capital needed and are overly optimistic about the time required to produce anticipated results. Once the business is underway and more capital is needed, borrowing money can be difficult as resources have been tapped and assets tied up. While it is common knowledge that under-capitalization is a major reason many small businesses fail, debt capital can cripple a growing company.

Entrepreneurs do not usually have the resources to "go public," which would allow them to profit from the difference in valuation between private and public earnings. The entrepreneur is usually the largest shareholder in a small corporation. When founding the company, the concerns revolve around getting started, not getting out. When he recognizes that his stock, once publicly-held, will command a dramatically higher price per share, it gets his attention. *Strategies for Equity Capital* involves a series of manageable steps that support operational milestones and attracts infusions of capital as the stock becomes liquid.

Equity capital is the vehicle of choice for more established companies, but has not been an alternative available to most smaller, privately-held businesses. According to the Small Business Administration, equity capital from outside sources accounts for less than 5% of the total funding for new small business ventures. There are several reasons for this. First, government regulations make equity capital expensive and time consuming to obtain. An even larger challenge for entrepreneurs is the lack of an appealing exit strategy for investors who could not be assured of ever having liquidity or receiving any return on their investment. Add to this the risk associated with the lack of diversification inherent in investing in one company. Venture capitalists also need controls that can be a disincentive for the entrepreneur. Finally, this funding does not necessarily give him the non-monetary resources he really needs to reach his goals.

Beyond Capital Needs

Entrepreneurs typically perceive capital as the solution to their problems. Certainly it can give them control and more options, but as a solution it is often overrated. In reality, cash without the correct perspective, plan, and control can create new problems. Entrepreneurs do not always need as much cash as they think they do; they need the right amount of capital at the right time. The most important part of having access to capital is for the day-to-day liquidity required for operating the business, with an amount that can be viewed as a "safety net." Beyond this, entrepreneurs should view capital as just one tool required for success.

Understanding *Strategies for Equity Capital*, the entrepreneur will see the potential for capitalization through equity. He will also recognize that liquidity is the key to having an exit strategy for himself and

his investors. To accomplish this goal, the company needs the correct financial structure tied in with a strategic plan to move toward options for liquidity. The strategic plan must be specifically created for a business and tailored to its situation and needs. Implementing the plan requires entrepreneurial understanding and experienced advisors who know how to actively deal with new and evolving situations.

Another important and often missing ingredient for entrepreneurs is moral support. As they wage their battle, entrepreneurs need emotional and psychological support. Feeling in control with a good plan and the resources to put it into action can minimize the stress caused by uncertainty. Developing the right attitude and perspective are also key elements to personal resilience. Entrepreneurs' need for emotional support can strain personal relationships. They would benefit by having a "coach" who listens, understands what they are up against, and advises them as they work their way through the many challenges.

Beyond these issues, the entrepreneur should not have to "reinvent the wheel" or minimize the importance of expertise in management, technical skills, and systemization. Many entrepreneurs have become overly self-reliant and accustomed to "doing everything themselves." With the right resources, they have the ability to hire or acquire team members with knowledge, expertise, and experience gained from making mistakes. Having a good team and being able to work effectively together is essential for achieving success.

Strategic Alliances

Recognizing that an entrepreneur has a number of nonmonetary needs, the question is how to effectively meet those needs. Since capitalism is built on the "win-win" concept, the ideal solution must mutually benefit for both the entrepreneur and the allied party. Many benefits, including access to markets and industry experts, come from alliances with strategic partners. Emerging high-growth companies achieve explosive growth under the "wing" of an established alliance that provides real services and funding while functioning as a strategic corporate partner.

An excellent way to bring in expertise and support is to form a strategic alliance with a larger company in a related, noncompetitive business. Larger companies have cash, expertise, and a successful business structure. They often find it difficult or impossible to hire employees who have creativity and talent that produce innovation. While they may only be interested in seeing a product developed, simply acquiring a smaller company is likely to make the entrepreneur lose incentive and possibly walk away. Yet, since the entrepreneur brings research and development to the table, the Strategic Alliance Company is often willing to put up a substantial amount of capital -- $2 to $4 million -- to begin building a profitable relationship with the entrepreneurial company. To the Strategic Alliance Company, the investment constitutes an option to buy the smaller company at a later date, when the Entrepreneurial Company has reached additional operational milestones. Best of all it can be done in a way that keeps the entrepreneur's choices open and without being locked into a definite commitment.

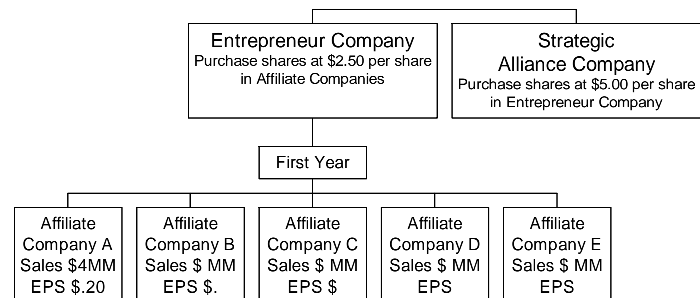
This affiliation gives both groups advantages and options they would not have otherwise. However, for the Strategic Alliance Company to be interested, the Entrepreneurial Company must meet certain conditions. Privately-held companies are often not structured or managed the same as public companies. The Entrepreneurial Company must be structured to make the Strategic Alliance Company comfortable with the arrangement. Criteria that potential Strategic Alliance Companies consider include:

1) An entrepreneur, who is committed, experienced, and resourceful.
2) Audited, clear financial records that show solid revenues and no-nonsense spending.
3) A competent management team able to effectively implement the company's plans.
4) A clear strategic plan that is realistic and flexible.
5) A plan for creating shareholder wealth with contingency plans and possible exit strategies.
6) A strong Board of Directors consisting of knowledgeable and experienced leaders.

7) An Advisory Board of committed supporters bringing insight and expertise to the firm.
8) An organizational structure designed around jobs rather than personalities.
9) A Marketing Plan with effective marketing materials (identity package, brochures, etc.)
10) A Stock Option Plan to give employees an incentive to generate profits.

If any criteria are missing or severely lacking, Strategic Alliance Companies will be reluctant to become involved. Management simply does not have the time to spend "hand-holding" while a small company tries to "get its act together." It is essential that an entrepreneurial company spend three to eighteen months preparing and positioning itself before approaching a potential Strategic Alliance Company. The significance of organization and preparation cannot be overemphasized.

Once the entrepreneurial company is positioned and has reached certain operational milestones, it is the right time to identify potential Strategic Alliance companies. Several potential companies should be approached and conversations started with the understanding that there is a "courting period." Since there is more to this relationship than simply an infusion of capital, it is important that the companies determine whether they can work together harmoniously for mutual benefit. These negotiations are most effectively orchestrated by a third party who understands the industry, can identify the specific benefits for each company, and is familiar with the entrepreneur and his company.



The Strategic Alliance concept can be significant to a company's growth. Further, it can work in conjunction with or apart from the concept of building relationships with "Affiliate Companies."

Affiliate Companies

Another alternative for expansion is a model of developing relationships with companies called "Affiliate Companies." Affiliate Companies are compatible businesses of comparable or smaller size than the original Entrepreneurial Company. Once the Entrepreneurial Company has developed itself and achieved some significant operational milestones, it can work with Affiliate Companies in a mutually beneficial position of leadership.

Assuming that revenues have increased and the profits have grown, the Entrepreneurial Company has been receiving infusions of capital for a couple of years. During this time it has developed its management team, operating systems, and marketing strategy. In addition to raising capital and reaching operational milestones, a company must continue to identify ways to grow and increase net worth. Liquidity is important for cashing out, but it is also important to build up the value of the stock.

While the most obvious ways to increase profits involve increasing revenues and decreasing costs, an approach for building net worth often overlooked by many small to medium-size companies is mergers and acquisitions. Although the entrepreneur is perfectly aware of the possibilities in mergers and acquisitions, he often is not clear about how to proceed.

The Entrepreneurial Company wants to continue to grow and may choose to increase its value by acquiring other companies. Yet, at this stage of the game, it could require too much capital or be too great a risk to purchase those companies outright. Negotiations can be a strain on management causing the Entrepreneurial Company to lose its focus. There is also potential danger that the acquired company's existing management may lose incentive.

A successful solution is to identify potential Affiliate Companies, develop ties and build relationships in much the same manner as described above for Strategic Alliance Companies. The selection criteria are similar to that of the Strategic Alliance Company.

The Entrepreneurial Company may choose to purchase a small percentage of stock in the Affiliate Company – perhaps even using funds from the investment made by their Strategic Alliance Company. The Entrepreneurial Company may also receive shares of stock in exchange for contributing services and technical expertise.

The Entrepreneurial Company works closely with these new Affiliates in developing their strategic plan, raising capital, and reaching operational milestones. The companies can join forces in marketing and promotional arenas to increase their market share. The leaders of the Entrepreneurial Company can function as "coaches" for the Affiliate Company and be an active part of their growth. Holding stock in the Affiliate Company gives the Entrepreneurial Company a strong vested interest in their success. Their association causes the value of all the companies stock to increase, and brings them closer to being a publicly-traded company.

At the appropriate time, all three groups may consider a "roll-up." This involves merging the companies together to build a larger, more diversified company that can be readily listed on NASDAQ. The valuations of each company's individual stock increases many times over as it becomes publicly traded. The stock in the new company is far more attractive to current stockholders who now have liquid stock that they can easily sell.

Stages Of Raising Equity Capital

Raising equity capital is an art and a science. Each business situation is uniquely complex, with a myriad of factors to consider. Each entrepreneur has his aspirations and goals. *Strategies for Raising Equity Capital* must be a part of the overall business plan and objectives in order to achieve those goals.

The stages of raising capital should correspond to attaining certain operational milestones. These operational milestones are significant to potential investors since they relate to the value of the stock. The entrepreneur should realize that there is a Scale of Investor Value, with one extreme being a publicly held company with a high P/E ratio and the other extreme being the new privately owned business. Operational milestones are reflected in the Scale of Investor Value.

Criteria For Scale Of Investor Value

1) Quality of management team
2) Quality of earnings (audited)
3) Implementation of business systems
4) Corporate structure
5) Profitability and margins
6) Strategic relationships
7) Proprietary nature of business/uniqueness of products
8) Due diligence
9) Marketing plan quality
10) Market share size
11) Liquidity of shares

The above factors can move a company along the perceived value gradient in the eyes of investors. Ultimately, how close a company is to public earnings is the most significant factor in making a stock attractive for liquidity and earning multiples.

Public Offerings

The term IPO is a general term meaning the initial public offering of shares for sale to the public. An initial public offering (IPO) is usually facilitated by securities firms who have formed an underwriting syndicate, with one of the firms acting as a lead or managing underwriter. There are several types of initial public offerings with different governmental requirements in terms of qualification, disclosure, and filings.

There are two distinctions: offerings and listings. Offering securities to the public creates capital for the company. Listing the equity of the company creates a public market for the securities.

Types of Public Offerings

Two main types of offerings are available.

Listing on an over-the-counter market In 1992, the SEC approved a vehicle called Small Corporate Offering Registration (SCOR) as a form of a public offering. A SCOR is technically a DPO – a direct public offering. It allows the company to advertise, market, solicit and sell its stock to the general public. It does not get a stock listed on an exchange, although it is a step closer, making it easier and less expensive to get listed.

Listing on an exchange Because SCOR offerings are exempt from federal regulation by Rule 504D, they are significantly less complicated, costly and time consuming than traditional IPOs. One advantage of filing a SCOR is that it does not preclude other options for raising capital. An Entrepreneurial Company can still at any point accept venture capital, decide to file a Regulation A, or find an underwriter.

Types of Filings

1) Small Corporation Offering Registration (SCOR)
2) Filing under SEC Regulation A
3) SB2 Filing
4) S1 Filing

Stages of Raising Equity Capital

EARLY STAGE FINANCING can take anywhere from three to six months. Prior to beginning, it is critical that the company is structured correctly from legal, accounting, and organizational standpoints. This generally requires professional advice.

STAGE 1 - INITIAL BRIDGE LOAN by a venture fund. Money is paid back within 90 days from funds generated by subsequent investments. A matching of stock for funds loaned allows for a large potential return to investors in the venture fund. This fund should be able to accumulate stock in ten to fifteen companies who are raising capital in a one-year period.

STAGES 2 - FOUNDERS STOCK INVESTMENTS ARE made by close associates, friends, and family of the entrepreneur. This investment structure makes it possible for them to invest in a legitimate manner, express their support, and own stock that increases in value as the company advances through each stage of growth.

STAGE 3 - PRIVATE PLACEMENT INVESTMENTS are made by qualified investors who now see that the company has reached some of its goals and operational milestones. The appropriate disclosure documents must be given to both investors and prospective investors.

MID-STAGE FINANCING may unfold in a number of ways and these stages may occur in a different order. While Stages 1-3 always happen in that sequence, Stages 4-7 are interrelated and somewhat interchangeable. This depends on the unique situation and needs of the business. Intense planning and strategizing is required throughout these mid-stages of raising capital. Rarely will a company engage in all of these options, as they will be able to generate adequate capital from several of these venues.

STAGE 4 - STRATEGIC ALLIANCE INVESTMENT this is made by a larger company who purchases a minority interest in the Entrepreneurial Company by buying stock. This company may also participate in strategic planning and provide services to the Entrepreneurial Company.

STAGE 5 - VENTURE CAPITAL GROUP INVESTMENT is much easier and far less costly at this stage. Venture Capitalist Groups can see that the Company is structured to go public, is well-managed, and has earnings with potential growth.

STAGE 6 – ANGEL INVESTORS OR MANAGERIAL PARTNERS may come in at this stage as they can see the strong growth potential and higher probability of the company's success. They can be compensated in stock options and can contribute cash and expertise.

STAGE 7 - SCOR OFFERING TO AFFINITY GROUP allows the entrepreneur to solicit investors state by state. SEC Rule 504D allows the Company to sell its stock to the public and raise up to $1,000,000 in a

twelve-month period, as long as the Company meets each state's Blue Sky Laws. A SEC Regulation A offering is similar but allows the Company to raise up to $5 million dollars in twelve months.

STAGE 8 - AFFILIATE COMPANY ASSOCIATIONS can be considered an intermediary step that allows the Company to reach new investor groups and increase its net worth.

END-STAGE FINANCING is when stockholders achieve liquidity for their shares. Stages 9-14 are also interrelated and interchangeable. There are so many options that careful planning is required throughout each level of financing to ensure the best possible strategy. The company should clearly understand its goals since it will only implement one or two of these choices.

STAGE 9 - "ROLL-UP" can be done two ways: Strategic Alliance Company in a stock for stock exchange or a "Roll-up" of Affiliate Companies to a new company.

STAGE 10 – FUND INVESTMENT OF CONVERTIBLE SECURITIES or a Reg. S., this interim financing is available to well-structured companies that are near-term listing.

STAGE 11 – LISTING ON NASDAQ by the Company can be achieved through a reverse merger or Filing Form 10 once other requirements are met.

STAGE 12 – PURCHASE OF THE COMPANY by a nonaffiliated company is always an option.

STAGE 13 – BRIDGE FINANCING for the cost of the roll-up and/or public company offering.

STAGE 14 - PUBLIC OFFERING AIMED FOR LISTING STOCK ON NASDAQ involves locating an underwriter and underwriting syndicate.

The Reality of Raising Capital

The reality is raising capital is that it is nearly as much work as running the business. Naturally, the entrepreneur must focus on the company's production and management needs, making it difficult for him to focus on the investor's needs. While an entrepreneur must be intimately involved in the process of raising capital, it is also essential to for him to work closely with experienced professionals who understand the investor's concerns.

The three primary investor concerns are stock appreciation, safety, and exit strategies.

Stock Appreciation.

As the entrepreneur builds his business, the infusion of equity capital at strategic points of growth will increase the company's value. As the stock valuation increases, so will the demand for stock.

Safety.

Even more than wanting to make money, investors want to not lose accumulated money. Investors try to get as much information as possible regarding the product, management, strategies, and plans.

Exit Strategies.

It is impossible for anyone to know the best exit strategy early in the game. So, the ideal approach allows for the maximum number of exit options at each stage of the company's growth. Ultimately, investors can benefit from dividends, the sale of the company, or one of the four methods for a public offering.

Before deciding which vehicle or strategy to use to raise capital, the company should have the following reviewed by an experienced professional or group:

1. The thorough history and future goals of the company.
2. The company's financial status and fiscal history, particularly its present condition.
3. The company's products, services, market, and marketing strategies.
4. A complete valuation of the business

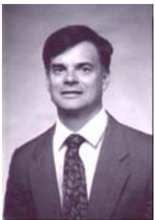
REALIZING THE VISION

Raising capital requires intense, on-going planning that must coincide with the company's goals and vision. When the vision is clearly defined, it becomes most important to focus on reaching and surpassing operational milestones. Each milestone represents higher overall valuation, satisfied investors, and another successful step toward the entrepreneur's ultimate goal. The process of planning, re-evaluating, and planning again is essential for each party to come out a winner.

In truth, time is a more precious commodity than money. The entrepreneur must maintain a clear direction throughout the process of raising capital, while remaining flexible. The alliances and affiliates must effectively contribute to the group while respecting the intrinsic vision of the entrepreneur. Once the objectives and goals are set, reaching them may include being on several tracks at the same time. Opportunities will surface when the entrepreneur continually looks at multiple possibilities.

Entrepreneurs should endeavor to create a sense of partnership with professionals who have a thorough, in-depth understanding of small business and who show an overall commitment to entrepreneurial success. He should explore each avenue of equity possibility with a sense of adventure and a careful eye for a profitable alliance. If both parties demonstrate a willingness to share, this indicates the right attitude. When resources are pooled in mutual participation and profit, a synergy occurs that makes unpredictable results possible.

Good business is all about building relationships. *Strategies for Equity Capital* outlines the creation of a medium of exchange to build those relationships. For this plan to be successful, each group must allow others to contribute and to acknowledge those contributions. It also becomes important to only work with people who truly have a "win-win" attitude. Entrepreneurs, investors and strategic partners all profit from this alliance of energy, ideas and capital as well as trust and understanding. Each benefit allows the entrepreneur



Thomas C. Trexler, MBA, CPA, founded The Corporate Finance Institute, Inc., with the idea of energizing entrepreneurs through teamwork and collaboration. With over twenty years experience in corporate finance, he is currently serving a President of CFI which has supported more than 300 emerging companies through early stage processes. Tom is also the president of Resource Allocation Management, Inc., where he is involved in developing and executing equity financings, mergers, and acquisitions.

Tom is considered a national authority on the subject of direct public offerings. His experience assisting companies in their search for equity capital, combined with his past experience with the SEC Institute and membership on the NASDAQ Committee on Investor Relations, has earned him this role. He is a member of the American Institute of Certified Public Accountants and the Maryland Society of Accountants. Tom received his MBA from the University of Maryland in 1982.

As the former Chief Financial Officer and Director for Insituform East, Inc., a NASDAQ trading company, Tom successfully planned and executed the company's initial public offering and subsequent equity earnings. Prior to joining Insituform East in 1986, Tom was a partner of Oehmann & Company, in Bethesda, Maryland, a certified public accounting firm.

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