PLDW
CORPORATE & BUSINESS

CLIENT ADVISORY:

EQUITY FINANCING FOR PRIVATELY HELD COMPANIES – SOME DO'S AND DON'TS

It is a rare company indeed that is able to start a business and grow it to a profitable enterprise solely on the basis of cash generated from operations. The vast majority of companies require some form of outside financing. That leaves two alternatives: (i) the company can borrow the required capital (usually from banks, finance companies or asset-based lenders) or (ii) they can sell stock or other securities to raise the necessary funds. This latter approach is generally referred to as equity financing.

Equity financing takes a variety of forms. Early on, equity financing most often involves the issuance of stock to founders in exchange for cash, assets or services (so-called "sweat equity") and raising investment capital from friends and family, who more often invest based on who the founders are, rather than thorough due diligence of the company and its business plan. As the company continues to grow, equity financing is often provided by more professional investors, including angel investors, venture capital and private equity funds and sometimes strategic partners of the company seeking the capital (key customers and suppliers).

If you are starting a new company or already own a privately held company, there are some important things to keep in mind regarding a planned or future equity financing.

Plan Ahead

A company that seeks one round of equity financing will often need to do additional rounds. For that reason, it is important to plan ahead. As a practical matter, that means minimizing the risk one or a small number of owners can block actions that will benefit the company as a whole. One thing to consider is authorizing a sufficient amount of equity to meet the company's needs, assuming several rounds of equity financing. It also means giving careful consideration to the potential benefits of issuing more than one class or series of equity. Companies are often well advised to authorize three classes of equity at the time they are formed: voting common shares, non-voting common shares (often issued to future service providers) and so-called "blank check" preferred shares. Many states permit the creation of a class of preferred shares that can be issued in one or more series, with whatever preferences, dividend rights and other terms as the board of directors may determine, without the need to go back and obtain another stockholder vote. Note, the authorization of blank check preferred does not prohibit election of S corporation status, though the issuance of preferred shares would result in loss of an existing S election. It is also worth noting that this approach can also be mirrored in an LLC operating agreement as well.

Keep It Simple

With early stage equity investors, keeping it simple makes a lot of sense. It is both time consuming and expensive to create a particular class or series of preferred stock (which often features complicated dividend and liquidation preference and sometimes conversion rights) in order to raise a relatively modest amount of capital from friends and family. Perhaps more importantly, even if your early investors insist upon some class of preferred shares, future professional investors will typically require, as a condition to investing, that they receive a new class of preferred equity with rights that are superior to any existing preferred shares.

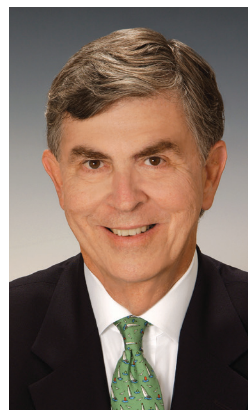
Consider Convertible Debt

One of the most challenging aspects of an equity financing for a private company, particularly if it does not already have an established history of cash flow and profits, is agreeing with the potential investors on the value of the company. That is critically important because it determines how much equity the company will have to give up to attract a given amount of investment capital. The following example over-simplifies the analysis (because preferred stock often has senior rights to dividends, liquidation proceeds and perhaps voting rights, which give it a higher per share value than common) but it is useful in understanding the process.

Assume Newco has a "pre-money" (pre-investment) valuation of $1 million and it wants to raise $200,000 from equity investors. The "post-money" valuation would therefore be $1.2 million (pre-money value plus the new investment capital). This would suggest that the investors get just under 17% of the company's stock ($200,000/$1.2 million) leaving the existing shareholders with roughly 83% of the company. Conversely, if the company could convince the investors the company was worth $1.5 million on a pre-money basis, the investors would receive less than 12% of the equity, leaving the existing stockholders with over 88% of the company. On a future sale of the company, that difference could be substantial in terms of sale proceeds.

One way to postpone the need to agree on the present valuation of the company is to issue convertible notes. The typical convertible note starts out as debt, with a stated maturity date and interest rate. However, the note provides that the company can require that the investors convert their notes into the same class of equity as that issued to investors in a future equity financing. The concept is that you do not need to agree on the current valuation of the company because is issuing debt (promissory notes) rather than equity. Furthermore, the proceeds of the convertible note financing will be used to advance the company's business plan, thereby increasing the pre-money valuation at the time of the future equity financing. When the notes convert to equity, it is typically at a higher company valuation, so the founders suffer less dilution than they would have had the early convertible note investors gotten equity at a much lower valuation.

The foregoing description of a convertible note financing is a simple one, and in practice there are often additional features, including rights of the company to extend the maturity date, warrants or conversion discounts as incentives to compensate the convertible note investors for the higher risk, vis-à-vis the later equity investors, etc. For more information on equity financing or other business matters, please contact PLDW.



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