Determining Returns On Investments (*Entrepreneur Magazine* – August 21, 2000)

A large number of recent inquiries have focused on the investment returns that various capital providers expect to earn when funding emerging ventures. First let me say there are no deals out there where the money changes hands and the owner of the small business simply plugs along while the investor waits on the sidelines for company prospects to improve. Investors delineate and rank business and market risks very carefully, and then require that strategies and operating plans be put in place to minimize their overall risk.

But many business owners are reluctant to accept conditions and strategic moves the investors have linked to the funding deal. So it's very important to understand the way return is measured and anticipated by the funding source. This can clear much of the air in the early stages of the negotiation and perhaps set the stage for a more realistic chance of closing a deal.

Three major issues are tied to the investor's "return expectations." The first is the initial form of the funding. This is where the baseline percentage return starts. Debt (a creditor position) requires a lower return than equity (an ownership position). Notes often have assets pledged as collateral. Class "A" common stock gives the investor a vote with company owners in management-policy decisions. Preferred stock removes that voting right but locks the firm into a fixed after-tax dividend payment prior to calculating company earnings.

The required return on secured debt for a new business begins at around 400 to 600 basis points (4 to 6 percent) above the prime rate. In today's market, that's around 13 to 14 percent; compounding is then calculated either monthly or quarterly. Unsecured debt adds more risk and tacks on another 200 basis points or more (now you're at 15 to 16 percent). And unsecured debt only works if the new business has a solid lock on significant revenues from one or more large and reliable buyers who have long-term contracts with the new venture. Preferred stock adds another 500 to 700 basis points beyond unsecured debt (now you're up to 20 to 23 percent). Voting common stock puts another 5 percent to 12 percent on the required return (the 25 to 35 percent range).

The second issue involves management's impact on projected future cash flows. Regardless of the debt or equity position, investors increase their required return when there's less certainty in the senior team's ability to deliver strong and growing sales and manage costs profitably. The "management premium" often adds 500 to 700 basis points to the return. An incredibly strong management team (marketing, operations, financials, strategic positioning, research and development) can actually reduce the required return arrived at in the first stage.

The third issue involves investment timing and the strength of the proposed exit strategy. If capital providers feel confident that within 24 months your business will be an excellent takeover target in the industry, the required return might not be adjusted at all or could be reduced. But if the window for success goes out 40 to 48 months and an IPO is the only idea you have for potential investor returns, then another 500 basis points (or more) will be added to the required return.

In summary, a solid business deal with a secured note, convertible to equity at the investors' option is on the low end (say, 13.5 percent today). A pure voting stock play in a brand new marketplace with no solid partnerships in place, a still-forming management team, and a longer investment horizon is on the high end (think 40 to 45 percent in this current market).

Once you understand where investors are coming from, you can make plans before you sit down to negotiate a deal that incorporates terms (and expectations) you can live with.