Hanging on to Equity During Pre-Launch (*Entrepreneur Magazine* – December 23, 2002)

Many entrepreneurs continue to ask about the difficult decision of establishing ownership stakes for investors in the earliest rounds of business development. The concern is always that a few friends, family and close associates will provide some seed funds, but in exchange for this needed capital, the entrepreneur often ends up giving away far too large of an ownership percentage in the venture's equity allotment. Then later on, when the pre-launch activities are completed, the entrepreneur finds it difficult to raise additional investment dollars because a disproportionate amount of the company's stock has already been given away to these early-round capital providers. The key issue is to get the venture valued as soon as possible.

The pre-launch stage is typically characterized by activities that have no immediate direct connection to generating revenues. For example, the company's legal form must be organized and put into place (partnership, LLC, corporation, Sub-S corporation and so on). Key members of the proposed management structure must be approached about joining the team. Preliminary work is normally done on the product concept, various levels of R&D might need to be completed, and key suppliers have to be contracted and readied for the launch.

A formal business plan will need to completed, both as a roadmap for the founding team in implementing operations and overall strategy, and as a document used in raising capital from investors. A certain physical site (a building, a strategically positioned plot of land, an access way to a key distribution channel) might have to be secured in order for the venture to move forward in preparation for the launch. Also, an environmental impact report might have to be completed. The entrepreneur may have to complete a comprehensive market test using various focus groups, or an industry analysis and market feasibility study might have to be completed before the venture can open its doors for business.

Every one of these pre-launch activities requires time and money to get them finished and integrated into the venture's operations and strategic planning. Often times, entrepreneurs are perhaps too quick to grant certain ownership stakes to early-stage investors. Entrepreneurs are also often too quick to give away equity in exchange for legal, consulting, accounting and other services when they don't have a lot of cash on hand to pay for these professionals.

Two items come into play here. First, pre-launch investors understand that there really is no business to speak of at the time they bring their funding to the table. This leverages their investment position and allows them to ask for a sizeable equity stake because they perceive the venture is not yet operational and still quite a way from generating revenues. So for this increased risk, they want an increased stake. Second, entrepreneurs in this pre-launch early-round funding are generally desperate for funding, because they know they have to get these funds secured in order for their great idea to move forward. The combination of the investor's perception of risk and the entrepreneur's need for funds strongly favors the investor in requesting a somewhat large equity stake because there's really not yet any solid or tangible value, and the entrepreneur really needs the money.

The key component to balancing the relative positions of the investors and the entrepreneur is to get the venture valued as soon as possible. A reputable valuator with a solid and lengthy track record of successfully completed valuation projects can help the entrepreneur put a baseline value on the enterprise, even when it's still in the pre-launch stage and there are no revenues. The business model can be evaluated relative to conservative estimates about the market, competition, pricing, costs, margins, overhead and traffic, and projected future after-tax cash flows can be generated to support a baseline valuation. With this in hand, the entrepreneur then has a basis upon which to parcel out equity stakes in exchange for seed capital.

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Take the example of the entrepreneur who gave up 20 percent of the company to some friends and close associates for $50,000 at a very early pre-launch stage. That money ran out in just three months, paying for an initial market study, lease negotiations and corporate formation. But there was still a feasibility study to complete and suppliers to secure, as well as personnel to get for the management team and other development costs to complete. So he got another $25,000 together, but had to give up 10 percent in equity (the same proportion as the initial funding). At that point, nearly a third of the venture had been opted out to investors for just $75,000. That placed an *implied* value on the firm of only $250,000 ($75,000 divided by 30 percent). And this severely limited the entrepreneur in the launch round of funding to go after revenues because there was less than 20 percent equity remaining to offer to investors if the entrepreneur wanted to maintain a majority equity stake. And then when the next round needed $500,000 to do the launch, the implied value from the initial $75,000 raised was quite a sticking point because the launch round by itself represented twice the entire implied value for the entire firm from early round. This put the entrepreneur in a very awkward position in trying to negotiate reasonable stakes with new potential equity investors.

Having a solid value established is the most important item to check off the planning list when raising capital, especially during the earliest rounds of funding. It should help the entrepreneur give up smaller stakes for smaller investments in the pre-launch rounds and save sizeable equity stakes for later rounds.