Chapter 6

Demystifying Equity Financing

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The Equity Model

Equity is a representation of ownership in an enterprise allocated to individuals or other entities in the form of ownership units (or shares). Equity can be used as a financing tool by for-profit businesses in exchange for ownership (control) and an expected return to investors. Unlike many debt financing tools, equity typically does not require collateral, but is based on the potential for creation of value through the growth of the enterprise. Equity investors may not require ongoing interest payments, however, the future return expectations are higher than debt, ranging from 8% to more than 25% per year over the life of the investment. The primary considerations for any enterprise considering equity are 1) the level of ownership and thus control the founders are willing to relinquish in their enterprise; and 2) the ability to deliver the level of return expected by the equity investors.

The two primary categories of equity are "common" shares (typically for founders and employees) and "preferred" shares (typically for investors). Preferred shares include special features or "terms" to sweeten and protect the investment. Such features include liquidation preference (right to redeem their allocation of proceeds from a sale of the business before common shareholders), anti-dilution protection (protecting the value of preferred equity units at the expense of common shareholders should the value of the enterprise decline), and redemption rights (the right to sell shares at a given price in a certain timeframe). Equity investors may require a seat on the Board of Directors (either an active voting Board seat or an observer seat) for greater control over the enterprise to protect their investment.

When equity investors make an investment in an enterprise, they are purchasing shares of the enterprise. The price per share is determined by the total enterprise value divided by the total number of shares outstanding. For newly-formed enterprises with little to no value, however, that share price will be very low and typically set at an arbitrary value around a penny, focusing investors on the *percentage* of the enterprise they intend to acquire. The idea is that over time as the enterprise grows and new capital is brought in, value will be created and the price per share will therefore increase. Many equity investors experience gains from their investment by an increase in the value of the enterprise from the time of investment to some future "liquidity event" where returns are actually realized. Such events include a sale to another enterprise ("acquisition"), to the general public via an initial public offering ("IPO") or to the management team of the enterprise ("management buy-out"). Equity investors may also be entitled to distributions of earnings as well prior to any liquidity event.

Words of Caution:

Farmers who seek outside capital through any process should consider carefully structuring the agreement to maintain management control. Farmers should also consider carefully limiting the capacity of investors to withdraw capital before the business can withstand a withdrawal of capital. Farmers in an equity agreement might want to consider including provisions to "buy out" the investor by allowing future repurchase of equity. In cases where the investor has the option to sell their shares to another investor, the farmer should consider restricting transfers of equity to other investors without the farmer's approval.

Investor Types & Expectations

During the early venture design and development phase ("seed" stage), **friends and family** are often the source of equity financing. This group suits enterprises in the seed stage because the individuals are known entities, close to the entrepreneur and want to support his/her mission in the venture. Friends and family with the means to invest are often hands-off in the operations of the business (though there are obviously exceptions). When the senior generation steps in to provide capital for the junior generation, they are typically less demanding on the terms of the investment, what return they expect, how much equity they receive and how their investment is protected. Accepting money from friends and family does have potential challenges as they are meaningful personal relationships that may be impacted by the performance of the enterprise and ability to deliver a return.

Once an enterprise reaches a point where additional capital is required to reach the commercialization phase (when you can start generating revenue), other individual investors may be approached. These individuals, known as **"angel" investors** are accredited (meaning they have the net worth to legally qualify for making investments in high risk enterprises), and may invest independently and/or within investment groups called **"angel groups**." Angel investors are typically more sophisticated and experienced investors that will demand more from their investment than friends and family. These demands are reflected in the terms they attach to their investment, often similar (though less demanding) than those used by institutional venture capital funds.

A new breed of angel investor has emerged over the past 20 years, building a new investment field known as **patient capital**. Although still fragmented, patient capital investors have emerged to capitalize upon lower or slower yielding investment opportunities, yet still require high-quality enterprises with balanced risk/return profiles. To generate returns, patient capital investors may look to creative or less common strategies mimicking debt via dividend requirements plus an eventual re-purchase of shares from the management to manufacture a liquidity event. Many of these investors are driven by social and environmental missions that take a holistic view of the investment beyond just the economic return.

Venture capital ("VC") funds are professional intermediary financial institutions that manage risk capital for large institutions (pension funds, endowments, mutual funds, etc.), foundations, family offices and accredited investors. VCs invest capital in start-up enterprises from seed stage through later-stage growth. VC fund entities typically have a life term of ten years and are responsible for realizing gains for their investors within the ten year period. VCs realize returns predominantly through acquisition of portfolio companies by larger market enterprises or private equity firms and less commonly via an initial public offering of portfolio company stock. Because VC funds are typically multi-million dollar pools of capital, the VC managers need to deploy large amounts of capital to put the money to work. VCs seek an annual 25% return over the life of the fund - on a cash basis, this means VC money is targeting 10 times their investment within 3-7 years – a formidable task for entrepreneurs.

The VC model is built to anticipate failures, many flat investments, some modest return investments and one or two high-return investments within a portfolio; however, investments are assessed and made only in enterprises VCs believe have the ability to achieve or exceed their return requirements. Most VC funds are focused on technology-based enterprises with a particular competitive advantage (e.g., intellectual property), within large and growing markets and with an ability to rapidly scale and exit. The typical community farm enterprise model does not qualify for institutional venture capital investment primarily due to the small target markets and thus the inability to rapidly scale with a resulting liquidity event.

Equity Financing Process

Seeking equity investors can be very time consuming and drain significant resources and energy. The first step is to determine if equity financing is appropriate for your enterprise based on control tolerance and return potential. Successful fund raisings stem from finding the right individual investor with a passion for the space, a clear fit within their portfolio of companies and at the right time in their investment cycle (investing capital or liquidating investments?). To increase the odds of success, entrepreneurs must have some key business elements and documentation in place when first approaching prospective investors including:

- Full business plan (including an executive summary and financials)
- Historical and projected financials (5-year projections, monthly for the first year)
- Use of proceeds (how you will deploy the invested capital and over what period)
- Capitalization table (showing equity holders, their % ownership and investment if any)

The time to close on equity financing can take anywhere from a few weeks to more than a year, depending on how prepared the entrepreneur is and the ability of the investor to focus on the investment analysis and structuring. The process generally includes:

1. Identification and qualification of prospective investors
2. Initial outreach (with executive summary)
3. Provide business plan with full financials
4. Initial meeting ("pitch")
5. Investor due diligence (deep dive into the business to validate assumptions, get to know management team and determine return potential)
6. Investment terms (negotiation, usually initiated by a "term sheet" highlighting key terms)
7. Closing (money is moved to the entrepreneur's account)

Building a Framework for Financing Considerations

Any entrepreneur assessing what financing is appropriate for his/her enterprise should begin by assessing the fundamental drivers behind his/her enterprise. These drivers can provide early direction on the kind of appropriate financing strategies. Answers to the following questions can reveal some of these drivers and provide a basic framework for financing considerations:

- Why am I personally starting or growing this enterprise (what you want out of the business)?
- How large do I want this enterprise to be (customers, revenue, earnings, employees, # products, etc.)?
- What are my expectations with this enterprise (ongoing concern, multi-generation, eventual sale)?
- What is my target market and who are the competitors in that market?
- What assets do I have now (partners, staff, equipment, facilities, existing capital)?
- What level of control do I want and can I tolerate giving up (100%, investor partial ownership, employee ownership)?

For the community farm, equity may play a role in the overall capitalization; however, it should be viewed as just one of many layers of financing in the overall capital structure of the enterprise. For community farm enterprises with the potential to meet return expectations and with a tolerance for giving up some ownership and control, some friends, family, and patient capital investors may be well-aligned to provide a layer of equity-based capital to support the business growth.

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