THE ABRIDGED VERSION OF RAISING MONEY FROM PRIVATE INVESTORS

By Frank Demmler

Requirements For A Successful Closing

There are three requirements for a successful closing on an investment from private investors:

- A deal,
- A closing date, and
- Money committed from private investors.

The Process

It's all about **reducing the perceived risk**.

Consider the **amount of money** you would like to raise:

- The optimal amount, if you could wave a magic wand;
- The practical amount that will allow you to accomplish significant achievements and is likely to be available on reasonable terms;
- The minimum amount that allows you to make some progress; and
- The bootstrap amount that keeps your company alive.

Seek advice and feedback from your business associates and mentors. **Pick a number.**

Compile **lists of potential investors**, probing down the paths of people who know you and people who know the business.

- Your Christmas card list;
- Your Rolodex;
- Those of your close friends and business associates;
- Potential suppliers, their founders, and individuals within them;
- Potential customers, their founders, and individuals within them;
- Potential channel members, their founders, and individuals within them; and
- Who knows who, who knows someone else, who knows the person you really want to talk to?

Refine the list and **categorize the potential investors** by their level of perceived risk.

Identify that subset of potential investors whose participation in your deal would significantly reduce the perceived risk by others and motivate them to invest as well (**anchor investors**).

Get access to that subset of potential anchor investors and generate **investment desires of at least 20% of the entire deal** from one-to-three individuals.

Considering the universe of potential deal structures, and the investment interests of the potential anchor investors, propose and negotiate a deal structure with the anchor investors. **THIS SATISFIES THE FIRST NECESSARY CLOSING CONDITION: YOU HAVE A DEAL!**

In parallel, you will have informed other potential investors of the status of your company, all the great things it has done, and all the opportunities that are in front of it. You will now communicate with those whose investment interest can be converted to commitment by virtue of the anchor investor commitments.

Pursue this second tier of potential investors until you have received cumulative commitments of 40% of the required capital. These are mostly people who were inclined to do the deal, but wanted someone else to step up first.

Pursue the next tier of potential investors until you have received cumulative commitments of 60% of the required capital. At this point you can sell the deal based upon its momentum and the fact that the investor may get shut out. By now, people who weren't on your original lists will have been introduced to the deal.

When you sense positive momentum for the deal, **set a closing date for the transaction in about 45 days.**

WITH A CLOSING DATE, YOU HAVE NOW SATISFIED THE SECOND CONDITION FOR A SUCCESSFUL INVESTMENT.

You are now in a position to get the next tier of potential investors to commit to your deal. Not only are they aware of the business progress you've made, but they are also aware of the momentum building for the deal. You've got quality anchor investors validating the investment opportunity. You've got additional investors who have also committed. There is a deal that they can look at and evaluate. There is a closing date that forces them to make a decision. And there's the implied threat of not being allowed into the deal if it gets fully subscribed before they make a commitment.

If you are truly an entrepreneur, your deal will be oversubscribed and you will have to decide whether to take more money than you had intended. [The answer is "YES!" almost without exception, but that's a topic for another column.]

THE THIRD CONDITION, INVESTMENT COMMITMENTS, IS MET AND YOU'VE CONCLUDED A SUCCESSFUL ROUND OF PRIVATE INVESTMENT! CONGRATULATIONS!

Reminders For Entrepreneurs

- Investors want to say, "No." You need to make them say, "Maybe."
- Make sure that you are "selling" something that that investor is interested in "buying."
- Understanding the arithmetic of deals is very important.

- Deals are negotiated with percentages, but they are structured with shares.
- Post-financing Value = Pre-financing Value + Investment
- Pre-financing Value = Post-financing Value - Investment
- Valuation is only meaningful in the context of the complete deal.
- Deals are complex. Ignorance is not a defense against unpleasant outcomes.
- Preferred stock provides the investor with extra benefits and rights as compared to the common stock shareholders.
- Stock options can disguise a reduction in the pre-financing valuation.
- Ask for a written term sheet so that you can evaluate the entire proposed investment before commenting on any of its individual features.
- Securing a written term sheet from an investor is an **extraordinarily important accomplishment** in the fund raising process.
- The potential investor's **perception of risk** will greatly influence whether he has an interest in investing in your company under any circumstances.
- In all probability, your funding is going to come from private investors, not institutional venture capital.
- There is no single "private investor." Each is an individual with his or her own views and sensitivities. Attracting an investment from such sources is not a "one size fits all" proposition.
- Private investors are less predictable than institutional investors. You need to understand and categorize potential private investors according to their **perceptions of risk**.
    - Do they know anything about the business?
    - Do they know you?
- Identify less than 10 individuals whose investment commitment will have a favorable impact on the investment decisions of others (**anchor investors**).
- Create a proactive fund raising game plan that you can execute to your advantage.
- Deal structures are only limited by the imaginations and expectations of the participating parties.
- You need to understand the complexities of different deal structures and select the ones that are acceptable to you.
- There are ways to raise money without giving up equity, such as a royalty on sales, but only a few private investors will find these alternatives attractive.
- Surround yourself with professionals, mentors, and advisors who can help you level the playing field.