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Equity Capital: Show Me the Money – But How Much?

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Once you've decided to finance your new business with equity capital and reconciled yourself to sharing ownership with a partner or partners for several years, it's time to decide how much money you should raise and when to do it.

It's not as simple as predicting how much cash you'll need in the early years and setting off to raise that amount all at once. What you decide at the beginning has a great bearing on how much of your business you'll own a few years down the road when it becomes self-sustaining.

If you decide instead to raise the money in multiple rounds, you give up less equity in the long run. You might even become established enough to forgo further equity financing and instead borrow money through a traditional loan.

Transaction costs and investor needs often frame this funding decision.

Understand transaction costs

Raising money costs money — and time. The biggest time-consumer involves managing the equity-investment transaction: reviewing documents, preparing due-diligence materials and negotiating specifics of the deal.

The amount of time depends partly on the size of the financing; a larger investment might have more terms to negotiate, for example. But 200 hours is the minimum you can expect to spend on a transaction of any size once you've lined up a financing source.

More tangible costs include what you'll owe the attorneys who draft and review transaction documents and the consultants and advisers who contribute their expertise. In addition, many investors — and almost all professional venture capitalists — expect the entrepreneur to pay their legal fees from the proceeds of financing. This means you have two sets of legal fees to pay, and the total can exceed $20,000.

Given these expenses, it's cost-effective to minimize the number of financing rounds by deciding

on a minimum amount to raise in any one transaction. At the Verge Fund, we usually consider $250,000 the absolute minimum, with $500,000 being a more attractive floor.

The costs of raising money for your business are comparable to those a homeowner incurs when refinancing a home. Just as a homeowner should not refinance more often than every few years in order for the home's appreciated value to cover the costs of a refinance, an entrepreneur should not refinance his or her business more than once a year.

Know your investors

The frequency and size of your investment rounds depend on your company's needs and those of your investors. When putting together your plan, target investors whose capabilities and interests match your own.

What you're looking for are investors with "dry powder" or surplus financial capital they keep in reserve to use as needed. Professional venture-capital firms and sophisticated angel investors always reserve some funds from what they first invest in a company to prepare for the possibility that gains will fall short of goals or to use in later rounds of funding.

Not all investors do this, however, so be clear in advance whether your ground-floor investors intend to participate in future rounds. If they can't or won't commit to a second or third contribution to your company, you'll need to find other ways to get the funds you need in the future — or you'll need to raise enough capital at the start to carry you through to a new round of financing with new investors.

If professional venture capitalists are part of your original investor group, they probably plan to join future rounds, but confirm this during due diligence, when your potential investors are evaluating your company's abilities to meet their investment goals.

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