Finance New Mexico

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Equity Funding: Milestones That Matter in the Life of Your Business

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Creating a road map with meaningful milestones for the development of your business will help you determine how much equity capital to raise and when to raise it in such a way that you maximize ownership of your company over time.

Many entrepreneurs who decide to share ownership in their companies in exchange for capital investment identify goals that substantially increase the value of their business when reached, and they schedule financing rounds to follow these achievements.

If your product requires pre-approval from a federal agency such as the Food and Drug Administration or United States Department of Agriculture, for example, clearing this hurdle represents a success that makes your business more valuable and attractive to investors. If you raise just enough money to accomplish this goal and carry you through another three months — until you can complete your next round of fundraising and deal with unexpected costs — you can increase the amount of equity that you and your earliest investors maintain in the company.

Reaching these milestones also means you've reduced the risk for investors and greatly improves your chances of finding new partners and greater amounts of capital.

Do the math

Suppose your business plan shows that you'll need an infusion of $3 million at the start to achieve profitability in three years. If you raise the total sum at the start of your venture, you might have to surrender a large share of ownership in your company — as much as 75 percent — in exchange, which leaves you only 25 percent interest in your own company.

But if you can split that investment into two rounds, you'll probably end up owning more of the business over time.

For example, if you raise $1 million at the beginning, you might only have to give up 50 percent of the company in return. A year or so later, when you raise the next $2 million, it might cost you only another 33 percent equity in the company. If you multiply 50 percent by 67 percent — your share of equity retained in the first and second financing rounds — your total ownership would be 33 percent of the business instead of the 25 percent you might keep if you raised all the capital at once.

Most investors will let you do this because they're balancing their desire to make money with their desire to not lose money, and the risks associated with the company are much higher at the beginning.

By investing twice in the life of the company, investors risk only $1 million of capital in the embryonic stage and another $2 million when the risk of failure is greatly reduced. They pay a higher price for the second round of investment, but they can expect a higher potential rate of return and a much smaller risk of losing their entire investment.

Business milestones versus product milestones

Many entrepreneurs make the mistake of measuring their company's progress by the development of a central product. It's a common error especially for technology innovators whose perspective as scientists and engineers is often clearer than their perspective as business owners.

Technology entrepreneurs frequently see a milestone when the product is "done" and ready to ship to customers. But product-development markers, while important for adding value to a company, aren't the same as markers that demonstrate the viability or stability of the business itself.

Creating the product is a critical step in the life of a business, but selling it is when the hard work really begins. That's why reaching business-development milestones, such as hiring a work force and developing sales, adds the kind of value that makes a company attractive to serious investors.

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