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Q&A: How to raise capital for a new business ?

Regardless how great your idea is, any business requires significant funds to get started. Where can you secure the financing you need to build a successful company? For many entrepreneurs, seed money from investors is the key – but in this economy, attracting investors is particularly challenging. We spoke with Matt Harbaugh, Chief Investment Officer for Innovation Works, Inc., a Pennsylvania company that invests in early-stage companies, to learn how entrepreneurs can find the money they need in a tight market and what steps they can take if they can't secure funding right away.

Question: ***How should business go about finding seed money ?***

Matt Harbaugh: The first place entrepreneurs should look for seed money is the people they know the best: friends, family, and former business partners. It's much more difficult to convince someone who doesn't know the scope of your abilities to bet on your potential than it is to convince someone who already thinks highly of you. You can also check with your attorney or accountant to see if they can introduce you to VCs they know personally.

After you've exhausted personal network, you should take an honest assessment of the growth and return potential of your proposed business. The growth trajectory and likelihood for acquisition will determine whether or not you're appropriate for venture capital (VC) funding.

However, the truth is that only 1 in 1,000 start up businesses is likely to have success obtaining VC funding: venture-backed companies need to provide the potential for a ten-fold return on investors' money in a 5 to 7 year timeframe.

If you're confident that your business can provide the level of returns that will make it attractive to VCs, then you want to start networking to find someone who can introduce you to appropriate institutional investors. Typically, that's done through other entrepreneurs who have received VC backing in the past. If you know people who secured that funding, that's your best way to get introduced.

Question: **What options does an entrepreneur have if they're rejected by a VC ?**

MH: If your business doesn't meet the requirements of a typical VC investment, there's no reason to fret. The idea that a startup must have VC funding has been overhyped in the last 10 years. The vast majority of entrepreneurs would be better off forgoing VC investment entirely and instead seeking angel investors. Angel investors are individuals who may not know you personally, but will make private investments in your new company if they see growth potential.

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The parameters of angel investing can be much broader than VC investing. Angel investors put forth their own money and do so based on personal interests. In addition, SEC regulations require angel investors to meet requirements of being an accredited investor (or high-net worth individual). Gaining a warm introduction to an angel investor is much the same as getting introduced to a VC investor: you want to leverage your personal networks and relationships. Look for sources that have tie-ins with both you and the investor. Also, look for other entrepreneurs who have secured private investments and pick their brains for potential investors.
Be sure to **check with a reputable attorney** before making any overtures to new investors as there are specific regulations you must follow. Some angel investors are perfectly happy to receive a return on investment through capital distributions from ongoing business rather than proceeds whenthe business is eventually sold. This can make angel investing an attractive source of capital for the entrepreneur, particularly if the business has no plans to sell in 5 to 10 years but instead prefers to work on growing a profitable, sustainable business over a longer term.

Certain practices apply no matter where you're getting your capital. You need to have a solid written business plan and comprehensive budget ready to share before you seek funds through a bank, venture capitalist, angel investor, or your Uncle Joe. It's just good business sense. You also need to have the terms of the deal carefully defined – and your attorney should help with that.

Question: How have funding standards changed vs. the dot com era a decade ago ?
MH: Ten years ago, there was a belief that the norm for technology companies was to go from startup phase to buyout or initial public offering (IPO) in a 3 to 5 year timeframe. Obviously, that proved to be false. People are much more realistic these days and understand today that regardless of sector, businesses need to prove themselves in their market over a number of years before they can achieve a successful exit.

Today, investors are much more interested in how an entrepreneur will generate revenue and sustainable profits. In addition, investors are more likely to perform deeper due diligence and have in-depth conversations with current and prospective customers before working with an entrepreneur. Investors also need to have the mindset to live with this investment for a much longer timeframe than a decade ago, and be comfortable with the risk that the investment may never pay off at all.

Angel investors don't stick to the same time guidelines. Their restrictions are much looser and completely dependant on the individual. They just want a good return on their investment, but will often exhibit patience to achieve that ROI.

Question: Does the industry matter as much as the idea? Should new companies seek funding from a venture firm that focuses exclusively on a certain industry?

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MH: The industry definitely matters. You want to seek an industry-focused investor who can provide more than just money. Ideally, your investor should be able to open doors with customers and provide valuable insight into industry trends and experience based on their own operating background. This knowledge-based assistance for the entrepreneur is often worth more than the amount printed on the checks.

Question: Do venture capital firms have a direct say in how initial funds can be used (budgeting, new hires, etc.)?
MH: Depending on the size of the investment, an investor who is providing a large percentage of the round capital being raised will expect to have more or less voice in how the money will be spent.
But it's important to note that those discussions typically take place before the investment is made. I would expect that most investors would decline to make the investment if they didn't have a clear understanding of how their money would be used and how those expenditures would directly lead to increased value for the company and its shareholders.

Question: What is a venture capital firm's role when the new company needs to embark on a second round of funding?
MH: In today's environment, any experienced investor should expect to participate in more than one round of financing for an aspiring company.
The entrepreneur should be in steady contact with investors. If a VC provided the seed money, it's highly likely that the VC will have a seat on the Board of Directors and participate in required monthly meetings. Investors will know a company's financial situation on a monthly basis, and any future fundraising efforts should be planned 6 to 12 months in advance.
Now if it's an angel-backed company, the entrepreneur and angel investor may have less interaction with each other. However, each party should ensure sufficient financial information is regularly shared with the investors. That way, the investors know when to expect that they'll be called in to make a subsequent investment.

Question: What advice do you typically provide aspiring businesses that you turn down ?
MH: Most professional investors will tell you that they try to provide value even when they say "no" to a business idea. That value may come in the form of advice on how to change the company's strategy, or some helpful suggestions of specific industry experts that the entrepreneur should reach out to.

If I think a business has promise, I may provide guidance on specific milestones that the entrepreneur should try to achieve in order to become attractive for investors in the future.

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Question: What tips should businesses looking for seed money keep in mind during a tough economy?

MH: "ABC" – always be creative. This allows you to get a better grip on what it takes to become profitable. If that means you can't build the Taj Mahal on the first day, it's probably the right decision to make.

Good businesses are created every day regardless of economic climate. The true entrepreneurs won't let a difficult funding environment dissuade them from their goal. Instead, they'll work harder, find other ways to get the business off the ground, and perhaps develop different, more logical business models. They'll also look to form partnerships with companies that can provide resources that enable them to reach the market faster and with far less investment.

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